

OLD SECOND BANCORP INC  
Form 10-Q  
November 12, 2013  
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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, 2013

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 60506**

(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, 2013, the Registrant had outstanding 13,917,108 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)<br>September 30,<br>2013 | December 31,<br>2012 |
|---|--------------------------------------|----------------------|
| <b>Assets</b>   |                                      |                      |
| Cash and due from banks                               | \$ 47,486                            | \$ 44,221            |
| Interest bearing deposits with financial institutions | 32,586                               | 84,286               |
| Cash and cash equivalents                             | 80,072                               | 128,507              |
| Securities available-for-sale, at fair value          | 373,478                              | 579,886              |
| Securities held-to-maturity, at amortized cost        | 258,101                              | -                    |
| Federal Home Loan Bank and Federal Reserve Bank stock | 10,292                               | 11,202               |
| Loans held-for-sale                                   | 3,129                                | 9,571                |
| Loans   | 1,077,640                            | 1,150,050            |
| Less: allowance for loan losses                       | 29,547                               | 38,597               |
| Net loans   | 1,048,093                            | 1,111,453            |
| Premises and equipment, net                           | 46,392                               | 47,002               |
| Other real estate owned                               | 49,066                               | 72,423               |
| Mortgage servicing rights, net                        | 5,456                                | 4,116                |
| Core deposit, net                                     | 1,702                                | 3,276                |
| Bank-owned life insurance (BOLI)                      | 55,005                               | 54,203               |
| Deferred tax assets, net                              | 78,865                               | 928                  |
| Other assets  | 23,137                               | 23,232               |
| Total assets  | \$ 2,032,788                         | \$ 2,045,799         |
| <b>Liabilities</b>                                    |                                      |                      |
| Deposits:   |                                      |                      |
| Noninterest bearing demand                            | \$ 373,499                           | \$ 379,451           |
| Interest bearing:                                     |                                      |                      |
| Savings, NOW, and money market                        | 809,521                              | 826,976              |
| Time  | 490,103                              | 510,792              |
| Total deposits  | 1,673,123                            | 1,717,219            |
| Securities sold under repurchase agreements           | 20,719                               | 17,875               |
| Other short-term borrowings                           | 55,000                               | 100,000              |
| Junior subordinated debentures                        | 58,378                               | 58,378               |
| Subordinated debt                                     | 45,000                               | 45,000               |
| Notes payable and other borrowings                    | 500                                  | 500                  |
| Other liabilities                                     | 38,029                               | 34,275               |
| Total liabilities                                     | 1,890,749                            | 1,973,247            |
| <b>Stockholders Equity</b>                            |                                      |                      |
| Preferred stock                                       | 72,667                               | 71,869               |
| Common stock  | 18,830                               | 18,729               |
| Additional paid-in capital                            | 66,168                               | 66,189               |
| Retained earnings                                     | 92,612                               | 12,048               |

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|  |    |           |    |           |
|--|----|-----------|----|-----------|
| Accumulated other comprehensive loss       |    | (12,435)  |    | (1,327)   |
| Treasury stock                             |    | (95,803)  |    | (94,956)  |
| Total stockholders' equity                 |    | 142,039   |    | 72,552    |
| Total liabilities and stockholders' equity | \$ | 2,032,788 | \$ | 2,045,799 |

|                    | September 30, 2013 |              | December 31, 2012 |              |
|--------------------|--------------------|--------------|-------------------|--------------|
|                    | 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             | 18,829,734   | 73,000            | 18,729,134   |
| Shares outstanding | 73,000             | 13,917,108   | 73,000            | 14,084,328   |
| Treasury shares    | -                  | 4,912,626    | -                 | 4,644,806    |

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)<br>Three Months Ended<br>September 30, |           | (unaudited)<br>Nine Months Ended<br>September 30, |           |
|---|--|-----------|---|-----------|
|   | 2013   | 2012      | 2013  | 2012      |
| <b>Interest and Dividend Income</b>                                     |  |           |   |           |
| Loans, including fees   | \$ 14,327  | \$ 16,193 | \$ 43,153   | \$ 51,476 |
| Loans held-for-sale   | 38   | 68        | 124   | 201       |
| Securities:   |  |           |   |           |
| Taxable   | 3,113  | 1,868     | 8,109   | 5,222     |
| Tax exempt  | 148  | 98        | 441   | 303       |
| Dividends from Federal Reserve Bank and Federal Home<br>Loan Bank stock | 76   | 77        | 228   | 228       |
| Interest bearing deposits with financial institutions                   | 22   | 29        | 91  | 89        |
| Total interest and dividend income                                      | 17,724   | 18,333    | 52,146  | 57,519    |
| <b>Interest Expense</b>   |  |           |   |           |
| Savings, NOW, and money market deposits                                 | 206  | 253       | 655   | 807       |
| Time deposits   | 1,674  | 1,973     | 5,327   | 6,920     |
| Securities sold under repurchase agreements                             | 1  | 1         | 2   | 2         |
| Other short-term borrowings   | 5  | -         | 24  | 4         |
| Junior subordinated debentures  | 1,336  | 1,243     | 3,937   | 3,660     |
| Subordinated debt   | 209  | 223       | 610   | 684       |
| Notes payable and other borrowings                                      | 4  | 5         | 12  | 13        |
| Total interest expense  | 3,435  | 3,698     | 10,567  | 12,090    |
| Net interest and dividend income  | 14,289   | 14,635    | 41,579  | 45,429    |
| (Release) provision for loan losses                                     | (1,750)  | -         | (6,050)   | 6,284     |
| Net interest and dividend income after provision for loan<br>losses     | 16,039   | 14,635    | 47,629  | 39,145    |
| <b>Noninterest Income</b>   |  |           |   |           |
| Trust income  | 1,494  | 1,489     | 4,666   | 4,603     |
| Service charges on deposits   | 1,904  | 1,982     | 5,379   | 5,706     |
| Secondary mortgage fees   | 183  | 350       | 680   | 957       |
| Mortgage servicing income, net of changes in fair value                 | 235  | (155)     | 1,222   | (365)     |
| Net gain on sales of mortgage loans                                     | 814  | 2,504     | 4,601   | 7,509     |
| Securities (losses) gains, net  | (7)  | 513       | 2,191   | 1,306     |
| Increase in cash surrender value of bank-owned life<br>insurance        | 419  | 425       | 1,198   | 1,246     |
| Death benefit realized on bank-owned life insurance                     | 6  | -         | 381   | -         |
| Debit card interchange income   | 873  | 788       | 2,565   | 2,661     |
| Lease revenue from other real estate owned                              | 309  | 840       | 974   | 2,930     |
| Net gain on sale of other real estate owned                             | 608  | 20        | 1,175   | 398       |
| Other income  | 1,549  | 1,592     | 4,434   | 4,257     |
| Total noninterest income  | 8,387  | 10,348    | 29,466  | 31,208    |
| <b>Noninterest Expense</b>  |  |           |   |           |
| Salaries and employee benefits  | 9,299  | 8,963     | 27,508  | 26,835    |
| Occupancy expense, net  | 1,266  | 1,242     | 3,787   | 3,684     |
| Furniture and equipment expense   | 1,026  | 1,078     | 3,274   | 3,416     |
| FDIC insurance  | 987  | 1,029     | 3,046   | 3,058     |

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|   |           |            |           |            |
|---|-----------|------------|-----------|------------|
| General bank insurance                                    | 489       | 851        | 1,829     | 2,538      |
| Amortization of core deposit and other intangible asset   | 524       | 420        | 1,574     | 865        |
| Advertising expense                                       | 347       | 400        | 841       | 982        |
| Debit card interchange expense                            | 366       | 388        | 1,072     | 1,183      |
| Legal fees  | 615       | 760        | 1,424     | 2,215      |
| Other real estate expense                                 | 3,461     | 6,545      | 11,092    | 17,987     |
| Other expense   | 3,119     | 3,187      | 9,773     | 9,186      |
| Total noninterest expense                                 | 21,499    | 24,863     | 65,220    | 71,949     |
| Income (loss) before income taxes                         | 2,927     | 120        | 11,875    | (1,596)    |
| Income tax benefit  | (69,997)  | -          | (69,997)  | -          |
| <b>Net Income (loss)</b>                                  | \$ 72,924 | \$ 120     | \$ 81,872 | \$ (1,596) |
| Preferred stock dividends and accretion                   | 1,323     | 1,255      | 3,917     | 3,716      |
| <b>Net income (loss) available to common stockholders</b> | \$ 71,601 | \$ (1,135) | \$ 77,955 | \$ (5,312) |
| Basic earnings (loss) per share                           | \$ 5.08   | \$ (0.08)  | \$ 5.52   | \$ (0.37)  |
| Diluted earnings (loss) per share                         | 5.08      | (0.08)     | 5.52      | (0.37)     |

See accompanying notes to consolidated financial statements.

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

|   | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|----------|------------------------------------|------------|
|   | 2013                                | 2012     | 2013                               | 2012       |
| Net Income (loss)   | \$ 72,924                           | \$ 120   | \$ 81,872                          | \$ (1,596) |
| Unrealized holding (losses) gains on available-for-sale securities arising during the period                  | (3,411)                             | 2,908    | (16,780)                           | 3,255      |
| Related tax benefit (expense)   | 1,405                               | (1,194)  | 6,913                              | (1,335)    |
| Holding (losses) income after tax on available-for-sale securities  | (2,006)                             | 1,714    | (9,867)                            | 1,920      |
| Less: Reclassification adjustment for the net gains realized during the period                                |                                     |          |                                    |            |
| Net realized (losses) gains   | (7)                                 | 513      | 2,191                              | 1,306      |
| Income tax benefit (expense) on net realized gains  | 3                                   | (208)    | (899)                              | (532)      |
| Net realized (losses) gains after tax   | (4)                                 | 305      | 1,292                              | 774        |
| Other comprehensive (loss) income on available-for-sale securities  | (2,002)                             | 1,409    | (11,159)                           | 1,146      |
| Accretion of net unrealized holding losses on held-to-maturity transferred from available-for-sale securities | 87                                  | -        | 87                                 | -          |
| Related tax expense   | (36)                                | -        | (36)                               | -          |
| Other comprehensive income on held-to-maturity securities   | 51                                  | -        | 51                                 | -          |
| Total other comprehensive (loss) income   | (1,951)                             | 1,409    | (11,108)                           | 1,146      |
| Total comprehensive income (loss)   | \$ 70,973                           | \$ 1,529 | \$ 70,764                          | \$ (450)   |

See accompanying notes to consolidated financial statements.



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

(In thousands)

|  | (Unaudited)              |             |
|--|--------------------------|-------------|
|  | <b>Nine Months Ended</b> |             |
|  | <b>September 30,</b>     |             |
|  | <b>2013</b>              | <b>2012</b> |
| <b>Cash flows from operating activities</b>  |                          |             |
| Net income (loss)  | \$ 81,872                | \$ (1,596)  |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                          |             |
| Depreciation and amortization of leasehold improvement                                   | 2,147                    | 2,339       |
| Change in market value of mortgage servicing rights                                      | (81)                     | 1,315       |
| (Release) provision for loan losses  | (6,050)                  | 6,284       |
| Gain on recapture of restricted stock  | (612)                    | -           |
| Provision for deferred tax benefit   | (70,161)                 | -           |
| Originations of loans held-for-sale  | (151,601)                | (208,710)   |
| Proceeds from sales of loans held-for-sale   | 160,966                  | 222,590     |
| Net gain on sales of mortgage loans  | (4,601)                  | (7,509)     |
| Change in current income taxes (payable) receivable                                      | (101)                    | 815         |
| Increase in cash surrender value of bank-owned life insurance                            | (1,198)                  | (1,246)     |
| Death claim on bank owned life insurance   | 396                      | -           |
| Change in accrued interest receivable and other assets                                   | (334)                    | (2,437)     |
| Change in accrued interest payable and other liabilities                                 | 4,341                    | 4,689       |
| Net discount (accretion)/premium amortization on securities                              | (131)                    | 664         |
| Securities gains, net  | (2,191)                  | (1,306)     |
| Amortization of core deposit and other intangible assets                                 | 1,574                    | 865         |
| Stock based compensation   | 123                      | 220         |
| Net gain on sale of other real estate owned  | (1,175)                  | (398)       |
| Provision for other real estate owned losses   | 6,537                    | 12,101      |
| Net gain on disposal of fixed assets   | (5)                      | -           |
| Net cash provided by operating activities  | 19,715                   | 28,680      |
| <b>Cash flows from investing activities</b>  |                          |             |
| Proceeds from maturities and calls including pay down of securities available-for-sale   | 38,175                   | 65,940      |
| Proceeds from sales of securities available-for-sale                                     | 484,112                  | 185,861     |
| Purchases of securities available-for-sale   | (564,372)                | (353,992)   |
| Proceeds from maturities and calls including pay down of securities held-to-maturity     | 541                      | -           |
| Purchases of securities held-to-maturity   | (21,382)                 | -           |
| Net sales of Federal Reserve Bank and Federal Home Loan Bank stock                       | 910                      | 2,250       |
| Net change in loans  | 49,885                   | 115,728     |
| Investment in other real estate owned  | (60)                     | (646)       |
| Proceeds from sales of other real estate owned   | 32,103                   | 20,915      |
| Proceeds from disposition of fixed assets  | 6                        | -           |
| Net purchases of premises and equipment  | (1,538)                  | (371)       |
| Net cash provided by investing activities  | 18,380                   | 35,685      |
| <b>Cash flows from financing activities</b>  |                          |             |
| Net change in deposits   | (44,096)                 | (43,847)    |
| Net change in securities sold under repurchase agreements                                | 2,844                    | 837         |
| Net change in other short-term borrowings  | (45,000)                 | -           |
| Purchase of treasury stock   | (278)                    | (63)        |
| Net cash used in financing activities  | (86,530)                 | (43,073)    |

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|  |           |           |
|--|-----------|-----------|
| Net change in cash and cash equivalents          | (48,435)  | 21,292    |
| Cash and cash equivalents at beginning of period | 128,507   | 50,949    |
| Cash and cash equivalents at end of period       | \$ 80,072 | \$ 72,241 |

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

(In thousands)

| <b>Supplemental cash flow information</b>   | (Unaudited)                                |             |
|---|--|-------------|
|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|   | <b>2013</b>                                | <b>2012</b> |
| Income taxes paid (received)  | \$ 266                                     | \$ (815)    |
| Interest paid for deposits  | 6,144                                      | 8,444       |
| Interest paid for borrowings  | 656  | 702         |
| Non-cash transfer of loans to other real estate owned                             | 14,196                                     | 26,944      |
| Non-cash transfer of loans to securities available-for-sale                       | 5,329                                      | -           |
| Non-cash transfer of securities available-for-sale to securities held-to-maturity | 237,154                                    | -           |
| Change in dividends declared not paid   | 510  | 2,968       |
| Accretion on preferred stock warrants   | 798  | 748         |
| Fair value difference on recapture of restricted stock                            | 43   | -           |

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

|  | Common<br>Stock | Preferred<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) | Treasury<br>Stock | Total<br>Stockholders<br>Equity |
|--|-----------------|--------------------|----------------------------------|----------------------|--|-------------------|---------------------------------|
| Balance, December 31, 2011   | \$ 18,628       | \$ 70,863          | \$ 65,999                        | \$ 17,107            | \$ (3,702)   | \$ (94,893)       | \$ 74,002                       |
| 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                       |

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|   |           |           |           |           |             |             |            |
|---|-----------|-----------|-----------|-----------|-------------|-------------|------------|
| Balance, December 31, 2012  | \$ 18,729 | \$ 71,869 | \$ 66,189 | \$ 12,048 | \$ (1,327)  | \$ (94,956) | \$ 72,552  |
| Net income  |           |           |           | 81,872    |             |             | 81,872     |
| Change in net unrealized loss on securities net of \$7,776 tax effect |           |           |           |           | (11,108)    |             | (11,108)   |
| Change in restricted stock  | 101       |           | (101)     |           |             |             | -          |
| Recapture of restricted stock   |           |           | (43)      |           |             | (569)       | (612)      |
| Stock based compensation  |           |           | 123       |           |             |             | 123        |
| Purchase of treasury stock  |           |           |           |           |             | (278)       | (278)      |
| Preferred dividends declared and accrued (5% per preferred share)     |           | 798       |           | (1,308)   |             |             | (510)      |
| Balance, September 30, 2013   | \$ 18,830 | \$ 72,667 | \$ 66,168 | \$ 92,612 | \$ (12,435) | \$ (95,803) | \$ 142,039 |

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, 2013, are not necessarily indicative of the results that may be expected for the year ending December 31, 2013. 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, 2012. 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 United States generally accepted accounting practices (GAAP) and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the consolidated financial statements. Future changes in information may affect these estimates, assumptions, and judgments, which, in turn, may affect amounts reported in the financial statements.

All significant accounting policies are presented in Note 1 to the consolidated financial statements included in the Company's annual report on Form 10-K for the year ended December 31, 2012. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the consolidated financial statements and how those values are determined.

**Recent Accounting Pronouncements**

In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-02 *Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU 2013-02 requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under GAAP to be reclassified to net income in its entirety in the same reporting period. The impact of ASU 2013-02 on the Company's consolidated financial statements is reflected in the consolidated statement of comprehensive income (loss) and has been reflected in the Company's financial statements since January 1, 2013.

**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 Old Second National Bank (the Bank), portions of the portfolio also serve as income producing assets. The size of the portfolio reflects liquidity needs, loan demand and interest income objectives. The Company views the September 30, 2013, securities available-for-sale portfolio (\$386.5 million amortized cost and \$373.5 million fair value) as a substantial source of liquidity that will allow for loan growth without having to raise deposits. Consistent with the comments above, management views the portion of the portfolio not carried in an unrealized loss

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position and the Bank's ability to borrow a substantial amount with securities as collateral providing the Bank a comfortable liquidity position. Portfolio size and composition may be adjusted from time to time.

Investments are comprised of debt securities and non-marketable equity investments. Until the third quarter 2013, all debt securities had been classified as available-for-sale. Past purchases and sales were done under our management and asset/liability 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. As of September 1, 2013, securities with a fair value of \$237.2 million, and a cost basis of \$245.4 million, with an August 31, 2013 unrealized loss of \$8.2 million, were transferred from available-for-sale to held-to-maturity. In addition new held-to-maturity securities purchases were made during September. Specifically, two purchases were made of securities issued by the Government National Mortgage Association. In accordance with GAAP, the Company has the positive intent and ability to hold the securities to maturity. Securities held-to-maturity are carried at amortized cost and the discount or premium created in the transfer is accreted or amortized to the maturity or expected payoff date but not an earlier call. The Company has followed and will follow GAAP accounting on all securities holdings.

Nonmarketable equity investments include Federal Home Loan Bank of Chicago ( FHLBC ) stock and Federal Reserve Bank of Chicago ( FRB ) stock. FHLBC stock was recorded at a value of \$5.5 million at September 30, 2013, and \$6.4 million at December 31, 2012. FRB stock was recorded at \$4.8 million at September 30, 2013, and December 31, 2012. Our FHLBC stock is necessary to maintain access to FHLBC advances.

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The following table summarizes the amortized cost and fair value of the securities portfolio at September 30, 2013 and December 31, 2012 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive loss (in thousands):

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| <b>September 30, 2013:</b>             |                   |                              |                               |               |
| <b>Securities Available-for-Sale</b>   |                   |                              |                               |               |
| U.S. Treasury                          | \$ 1,554          | \$ -                         | \$ (6)                        | \$ 1,548      |
| U.S. government agencies               | 1,745             | -                            | (52)                          | 1,693         |
| States and political subdivisions      | 19,275            | 731                          | (165)                         | 19,841        |
| Corporate bonds                        | 22,889            | 75                           | (764)                         | 22,200        |
| Collateralized mortgage obligations    | 51,619            | 182                          | (3,676)                       | 48,125        |
| Asset-backed securities                | 272,236           | 1,575                        | (4,827)                       | 268,984       |
| Collateralized debt obligations        | 17,173            | -                            | (6,086)                       | 11,087        |
| Total Securities Available-for-Sale    | \$ 386,491        | \$ 2,563                     | \$ (15,576)                   | \$ 373,478    |
| <b>Securities Held-to-Maturity</b>     |                   |                              |                               |               |
| U.S. government agency mortgage-backed | \$ 35,241         | \$ 547                       | \$ -                          | \$ 35,788     |
| Collateralized mortgage obligations    | 222,860           | 1,773                        | -                             | 224,633       |
| Total Securities Held-to-Maturity      | \$ 258,101        | \$ 2,320                     | \$ -                          | \$ 260,421    |
| <b>December 31, 2012:</b>              |                   |                              |                               |               |
| U.S. Treasury                          | \$ 1,500          | \$ 7                         | \$ -                          | \$ 1,507      |
| U.S. government agencies               | 49,848            | 122                          | (120)                         | 49,850        |
| U.S. government agency mortgage-backed | 127,716           | 1,605                        | (583)                         | 128,738       |
| States and political subdivisions      | 14,639            | 1,216                        | -                             | 15,855        |
| Corporate bonds                        | 36,355            | 586                          | (55)                          | 36,886        |
| Collateralized mortgage obligations    | 168,795           | 1,895                        | (1,090)                       | 169,600       |
| Asset-backed securities                | 165,347           | 2,468                        | (322)                         | 167,493       |
| Collateralized debt obligations        | 17,941            | -                            | (7,984)                       | 9,957         |
| Total Securities Available-for-Sale    | \$ 582,141        | \$ 7,899                     | \$ (10,154)                   | \$ 579,886    |

The fair value, amortized cost and weighted average yield of debt securities at September 30, 2013, by contractual maturity, were as follows in the table below. Securities not due at a single maturity date, primarily mortgage-backed securities ( MBS ), asset-backed securities, and collateralized debt obligations are shown separately (in thousands):



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|  | Amortized<br>Cost | Weighted<br>Average<br>Yield | Fair<br>Value |
|--|-------------------|------------------------------|---------------|
| <b>Securities Available-for-Sale</b>   |                   |                              |               |
| Due in one year or less                | \$ 772            | 3.58%                        | \$ 789        |
| Due after one year through five years  | 4,425             | 2.35%                        | 4,510         |
| Due after five years through ten years | 29,271            | 3.04%                        | 28,885        |
| Due after ten years                    | 10,995            | 4.31%                        | 11,098        |
|  | 45,463            | 3.29%                        | 45,282        |
| Collateralized mortgage obligations    | 51,619            | 2.62%                        | 48,125        |
| Asset-back securities                  | 272,236           | 1.67%                        | 268,984       |
| Collateralized debt obligations        | 17,173            | 1.62%                        | 11,087        |
|  | \$ 386,491        | 1.99%                        | \$ 373,478    |
| <b>Securities Held-to-Maturity</b>     |                   |                              |               |
| Mortgage-backed securities             | \$ 258,101        | 3.07%                        | \$ 260,421    |

Securities with unrealized losses at September 30, 2013, and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands except for number of securities):

| <b>September 30, 2013</b>  | Less than 12 months<br>in an unrealized loss position |                      |               | Greater than 12 months<br>in an unrealized loss position |                      |               | Total                   |                      |               |
|--|---|----------------------|---------------|--|----------------------|---------------|-------------------------|----------------------|---------------|
|  | Number of<br>Securities                               | Unrealized<br>Losses | Fair<br>Value | Number of<br>Securities                                  | Unrealized<br>Losses | Fair<br>Value | Number of<br>Securities | Unrealized<br>Losses | Fair<br>Value |
| <b>Securities Available-for-Sale</b>                             |   |                      |               |  |                      |               |                         |                      |               |
| U.S. Treasury  | 1   | \$ 6                 | \$ 1,548      | -  | \$ -                 | \$ -          | 1                       | \$ 6                 | \$ 1,548      |
| U.S. government agencies<br>States and political<br>subdivisions | 1   | 52                   | 1,693         | -  | -                    | -             | 1                       | 52                   | 1,693         |
| Corporate bonds  | 7   | 165                  | 6,195         | -  | -                    | -             | 7                       | 165                  | 6,195         |
| Collateralized mortgage<br>obligations                           | 5   | 717                  | 13,009        | 2  | 47                   | 2,162         | 7                       | 764                  | 15,171        |
| Asset-backed securities  | 3   | 3,676                | 35,471        | -  | -                    | -             | 3                       | 3,676                | 35,471        |
| Collateralized debt<br>obligations                               | 18  | 4,784                | 162,705       | 1  | 43                   | 3,791         | 19                      | 4,827                | 166,496       |
|  | -   | -                    | -             | 2  | 6,086                | 11,087        | 2                       | 6,086                | 11,087        |
|  | 35  | \$ 9,400             | \$ 220,621    | 5  | \$ 6,176             | \$ 17,040     | 40                      | \$ 15,576            | \$ 237,661    |

| <b>December 31, 2012</b>                  | Less than 12 months<br>in an unrealized loss position |                      |               | Greater than 12 months<br>in an unrealized loss position |                      |               | Total                      |                      |               |
|---|---|----------------------|---------------|--|----------------------|---------------|----------------------------|----------------------|---------------|
|   | Number<br>of<br>Securities                            | Unrealized<br>Losses | Fair<br>Value | Number<br>of<br>Securities                               | Unrealized<br>Losses | Fair<br>Value | Number<br>of<br>Securities | Unrealized<br>Losses | Fair<br>Value |
| <b>Securities Available-for-Sale</b>      |   |                      |               |  |                      |               |                            |                      |               |
| U.S. government agencies                  | 4   | \$ 120               | \$ 17,039     | -  | \$ -                 | \$ -          | 4                          | \$ 120               | \$ 17,039     |
| U.S. government agency<br>mortgage-backed | 12  | 583                  | 53,184        | -  | -                    | -             | 12                         | 583                  | 53,184        |
| Corporate bonds                           | 4   | 55                   | 9,724         | -  | -                    | -             | 4                          | 55                   | 9,724         |
| Collateralized mortgage<br>obligations    | 6   | 1,060                | 37,778        | 1  | 30                   | 2,343         | 7                          | 1,090                | 40,121        |
| Asset-backed securities                   | 6   | 322                  | 37,488        | -  | -                    | -             | 6                          | 322                  | 37,488        |
| Collateralized debt<br>obligations        | -   | -                    | -             | 2  | 7,984                | 9,957         | 2                          | 7,984                | 9,957         |
|   | 32  | \$ 2,140             | \$ 155,213    | 3  | \$ 8,014             | \$ 12,300     | 35                         | \$ 10,154            | \$ 167,513    |

Recognition of other-than-temporary impairment was not necessary in the nine months ended September 30, 2013, or the year ended December 31, 2012. The changes in fair values related primarily to interest rate fluctuations and were not related to credit quality deterioration.

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Further to this point as shown in tables below, the amount of deferrals and defaults in the pooled collateralized debt obligations ( CDOs ) decreased in the period from December 31, 2012, to September 30, 2013.

Uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for certain investments, particularly the CDOs. In the case of the CDOs fair value measurement, management included a risk premium adjustment as of September 30, 2013, 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, 2013. As of September 30, 2013, management did 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.

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Below is additional information as it relates to the CDOs, 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   | Issuance             |              | Issuance             |              |
|---------------------------|-----------|-----------|------------|----------|----------|----------------------|--------------|----------------------|--------------|
|                           | Cost      | Value     | Unrealized | Credit   | of       | Deferrals & Defaults |              | Excess Subordination |              |
|                           |           |           | Loss       | Rating 1 | Banks in | Amount               | Collateral % | Amount               | Collateral % |
|                           |           |           |            |          | Issuance |                      |              |                      |              |
| <b>September 30, 2013</b> |           |           |            |          |          |                      |              |                      |              |
| Class A1                  | \$ 8,157  | \$ 5,619  | \$ (2,538) | BB+      | 63       | \$ 207,000           | 27.6%        | \$ 227,472           | 30.3%        |
| Class A2A                 | 9,016     | 5,468     | (3,548)    | B+       | 63       | 207,000              | 27.6%        | 130,472              | 17.4%        |
|                           | \$ 17,173 | \$ 11,087 | \$ (6,086) |          |          |                      |              |                      |              |
| <b>December 31, 2012</b>  |           |           |            |          |          |                      |              |                      |              |
| Class A1                  | \$ 9,038  | \$ 5,768  | \$ (3,270) | BB+      | 63       | \$ 208,000           | 27.7%        | \$ 190,982           | 25.5%        |
| Class A2A                 | 8,903     | 4,189     | (4,714)    | B+       | 63       | 208,000              | 27.7%        | 93,982               | 12.5%        |
|                           | \$ 17,941 | \$ 9,957  | \$ (7,984) |          |          |                      |              |                      |              |

1 Moody's credit rating for class A1 and A2A were upgraded to Baa1 and Baa3, respectively, as of September 30, 2013, compared to Baa2 and Ba2 at December 31, 2012. The Fitch ratings for class A1 and A2A were also upgraded to A and BBB, respectively, as of September 30, 2013, compared to BBB and B at December 31, 2012.

**Note 3 Loans**

Major classifications of loans were as follows:

|                             | September 30, 2013 | December 31, 2012 |
|-----------------------------|--------------------|-------------------|
| Commercial                  | \$ 86,822          | \$ 86,941         |
| Real estate - commercial    | 554,874            | 579,687           |
| Real estate - construction  | 30,996             | 42,167            |
| Real estate - residential   | 376,859            | 414,543           |
| Consumer                    | 2,570              | 3,101             |
| Overdraft                   | 544                | 994               |
| Lease financing receivables | 11,204             | 6,060             |
| Other                       | 13,236             | 16,451            |
|                             | 1,077,105          | 1,149,944         |
| Net deferred loan fees      | 535                | 106               |
|                             | \$ 1,077,640       | \$ 1,150,050      |

It is the policy of the Company to review each prospective credit in order to determine if an adequate level of security or collateral was obtained prior to making a loan. The type of collateral, when required, will vary from liquid assets to real estate. The Company's access to collateral, in the event of borrower default, is assured through adherence to lending laws, the Company's lending standards and credit monitoring procedures. The Bank generally makes loans solely within its market area. There are no significant concentrations of loans where the customers' ability to honor loan terms is dependent upon a single economic sector although the real estate related categories listed above represent 89.3% and 90.1% of the portfolio at September 30, 2013, and December 31, 2012, respectively. The Company has been and remains committed to overseeing and

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managing its loan portfolio to reduce its real estate credit concentrations. Previously, this was done in accordance with the requirements of the Stipulation and Consent to the Issuance of a Consent Order the Bank entered into with the Office of the Controller of the Currency (the OCC ) on May 16, 2011 (the Consent Order ), which was terminated on October 17, 2013. Regulatory and Capital matters affecting the Company, 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, 2013</b>          |                        |                        |                                   |                   |              |            |              |   |  |
|------------------------------------|------------------------|------------------------|-----------------------------------|-------------------|--------------|------------|--------------|---|--|
|                                    | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>Greater Past<br>Due | Total Past<br>Due | Current      | Nonaccrual | Total Loans  | Recorded<br>Investment<br>90 days or<br>Greater Past<br>Due and<br>Accruing |  |
| Commercial                         | \$ 69                  | \$ 132                 | \$ -                              | \$ 201            | \$ 97,796    | \$ 29      | \$ 98,026    | \$ -  |  |
| Real estate - commercial           |                        |                        |                                   |                   |              |            |              |   |  |
| Owner occupied general purpose     | 165                    | -                      | -                                 | 165               | 109,584      | 3,497      | 113,246      | -   |  |
| Owner occupied special purpose     | 650                    | 227                    | -                                 | 877               | 162,435      | 5,947      | 169,259      | -   |  |
| Non-owner occupied general purpose | -                      | -                      | -                                 | -                 | 128,084      | 7,273      | 135,357      | -   |  |
| Non-owner occupied special purpose | -                      | -                      | -                                 | -                 | 75,595       | 438        | 76,033       | -   |  |
| Retail properties                  | -                      | -                      | -                                 | -                 | 39,829       | 5,056      | 44,885       | -   |  |
| Farm                               | -                      | -                      | -                                 | -                 | 16,094       | -          | 16,094       | -   |  |
| Real estate - construction         |                        |                        |                                   |                   |              |            |              |   |  |
| Homebuilder                        | -                      | -                      | -                                 | -                 | 4,563        | 168        | 4,731        | -   |  |
| Land                               | -                      | -                      | -                                 | -                 | 4,640        | 209        | 4,849        | -   |  |
| Commercial speculative             | -                      | -                      | -                                 | -                 | 8,811        | 3,534      | 12,345       | -   |  |
| All other                          | -                      | -                      | -                                 | -                 | 8,323        | 748        | 9,071        | -   |  |
| Real estate - residential          |                        |                        |                                   |                   |              |            |              |   |  |
| Investor                           | 213                    | -                      | -                                 | 213               | 122,031      | 8,307      | 130,551      | -   |  |
| Owner occupied                     | 625                    | -                      | -                                 | 625               | 112,515      | 5,858      | 118,998      | -   |  |
| Revolving and junior liens         | 522                    | 75                     | 45                                | 642               | 124,170      | 2,498      | 127,310      | 45  |  |
| Consumer                           | -                      | -                      | -                                 | -                 | 2,570        | -          | 2,570        | -   |  |
| All other                          | -                      | -                      | -                                 | -                 | 14,315       | -          | 14,315       | -   |  |
|                                    | \$ 2,244               | \$ 434                 | \$ 45                             | \$ 2,723          | \$ 1,031,355 | \$ 43,562  | \$ 1,077,640 | \$ 45   |  |

| <b>December 31, 2012</b>           |                        |                        |                                   |                   |           |            |             |   |  |
|------------------------------------|------------------------|------------------------|-----------------------------------|-------------------|-----------|------------|-------------|---|--|
|                                    | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>Greater Past<br>Due | Total Past<br>Due | Current   | Nonaccrual | Total Loans | Recorded<br>Investment<br>90 days or<br>Greater Past<br>Due and<br>Accruing |  |
| Commercial                         | \$ 159                 | \$ -                   | \$ -                              | \$ 159            | \$ 92,080 | \$ 762     | \$ 93,001   | \$ -  |  |
| Real estate - commercial           |                        |                        |                                   |                   |           |            |             |   |  |
| Owner occupied general purpose     | 1,580                  | 50                     | -                                 | 1,630             | 119,994   | 5,487      | 127,111     | -   |  |
| Owner occupied special purpose     | 172                    | -                      | -                                 | 172               | 149,439   | 11,433     | 161,044     | -   |  |
| Non-owner occupied general purpose | -                      | 1,046                  | -                                 | 1,046             | 128,817   | 13,436     | 143,299     | -   |  |
| Non-owner occupied special purpose | -                      | 4,304                  | -                                 | 4,304             | 69,299    | 477        | 74,080      | -   |  |
| Retail properties                  | -                      | -                      | -                                 | -                 | 37,732    | 10,532     | 48,264      | -   |  |
| Farm                               | -                      | -                      | -                                 | -                 | 23,372    | 2,517      | 25,889      | -   |  |
| Real estate - construction         |                        |                        |                                   |                   |           |            |             |   |  |
| Homebuilder                        | -                      | -                      | -                                 | -                 | 4,469     | 1,855      | 6,324       | -   |  |
| Land                               | -                      | -                      | -                                 | -                 | 2,747     | 254        | 3,001       | -   |  |
| Commercial speculative             | -                      | -                      | -                                 | -                 | 10,755    | 6,587      | 17,342      | -   |  |
| All other                          | 300                    | 215                    | 68                                | 583               | 14,360    | 557        | 15,500      | 68  |  |
| Real estate - residential          |                        |                        |                                   |                   |           |            |             |   |  |
| Investor                           | 276                    | 164                    | -                                 | 440               | 140,141   | 9,910      | 150,491     | -   |  |

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|                            |          |          |       |           |              |           |              |       |
|----------------------------|----------|----------|-------|-----------|--------------|-----------|--------------|-------|
| Owner occupied             | 3,151    | 375      | 21    | 3,547     | 110,735      | 9,918     | 124,200      | 21    |
| Revolving and junior liens | 888      | 203      | -     | 1,091     | 134,990      | 3,771     | 139,852      | -     |
| Consumer                   | 3        | -        | -     | 3         | 3,075        | 23        | 3,101        | -     |
| All other                  | -        | -        | -     | -         | 17,551       | -         | 17,551       | -     |
|                            | \$ 6,529 | \$ 6,357 | \$ 89 | \$ 12,975 | \$ 1,059,556 | \$ 77,519 | \$ 1,150,050 | \$ 89 |

The Bank had no commitments to any borrower whose loans were classified as impaired at September 30, 2013 and December 31, 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. This analysis includes loans with outstanding balances or commitments greater than \$50,000 and excludes homogeneous loans such as home equity lines of credit and residential mortgages. Loans with a classified risk rating are reviewed quarterly regardless of size or loan type. The Company uses the following definitions for classified risk ratings:

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

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

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

Credits that are not covered by the definitions above are pass credits, which are not considered to be adversely rated. 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, 2013**

|                                    | Pass       | Special<br>Mention | Substandard 1 | Doubtful | Total        |
|------------------------------------|------------|--------------------|---------------|----------|--------------|
| Commercial                         | \$ 89,051  | \$ 8,711           | \$ 264        | \$ -     | \$ 98,026    |
| Real estate - commercial           |            |                    |               |          |              |
| Owner occupied general purpose     | 97,309     | 8,560              | 7,377         | -        | 113,246      |
| Owner occupied special purpose     | 159,678    | 1,480              | 8,101         | -        | 169,259      |
| Non-owner occupied general purpose | 118,741    | 1,574              | 15,042        | -        | 135,357      |
| Non-owner occupied special purpose | 61,874     | 9,893              | 4,266         | -        | 76,033       |
| Retail Properties                  | 35,833     | 3,006              | 6,046         | -        | 44,885       |
| Farm                               | 14,607     | 1,487              | -             | -        | 16,094       |
| Real estate - construction         |            |                    |               |          |              |
| Homebuilder                        | 1,216      | 1,770              | 1,745         | -        | 4,731        |
| Land                               | 4,640      | -                  | 209           | -        | 4,849        |
| Commercial speculative             | 5,232      | 3,579              | 3,534         | -        | 12,345       |
| All other                          | 8,289      | 34                 | 748           | -        | 9,071        |
| Real estate - residential          |            |                    |               |          |              |
| Investor                           | 116,627    | 3,282              | 10,642        | -        | 130,551      |
| Owner occupied                     | 111,323    | 383                | 7,292         | -        | 118,998      |
| Revolving and junior liens         | 123,435    | 200                | 3,675         | -        | 127,310      |
| Consumer                           | 2,569      | -                  | 1             | -        | 2,570        |
| All other                          | 14,315     | -                  | -             | -        | 14,315       |
| Total                              | \$ 964,739 | \$ 43,959          | \$ 68,942     | \$ -     | \$ 1,077,640 |

**December 31, 2012**

|                                    | Pass       | Special<br>Mention | Substandard 1 | Doubtful | Total        |
|------------------------------------|------------|--------------------|---------------|----------|--------------|
| Commercial                         | \$ 88,071  | \$ 3,867           | \$ 1,063      | \$ -     | \$ 93,001    |
| Real estate - commercial           |            |                    |               |          |              |
| Owner occupied general purpose     | 113,118    | 2,995              | 10,998        | -        | 127,111      |
| Owner occupied special purpose     | 134,152    | 9,036              | 17,856        | -        | 161,044      |
| Non-owner occupied general purpose | 105,192    | 14,273             | 23,834        | -        | 143,299      |
| Non-owner occupied special purpose | 68,682     | 3,911              | 1,487         | -        | 74,080       |
| Retail Properties                  | 32,715     | 1,873              | 13,676        | -        | 48,264       |
| Farm                               | 21,262     | 2,110              | 2,517         | -        | 25,889       |
| Real estate - construction         |            |                    |               |          |              |
| Homebuilder                        | 1,318      | 2,196              | 2,810         | -        | 6,324        |
| Land                               | 2,747      | -                  | 254           | -        | 3,001        |
| Commercial speculative             | 7,122      | -                  | 10,220        | -        | 17,342       |
| All other                          | 14,607     | 37                 | 856           | -        | 15,500       |
| Real estate - residential          |            |                    |               |          |              |
| Investor                           | 123,876    | 14,608             | 12,007        | -        | 150,491      |
| Owner occupied                     | 110,858    | 396                | 12,946        | -        | 124,200      |
| Revolving and junior liens         | 133,992    | 166                | 5,694         | -        | 139,852      |
| Consumer                           | 3,075      | -                  | 26            | -        | 3,101        |
| All other                          | 17,331     | 220                | -             | -        | 17,551       |
| Total                              | \$ 978,118 | \$ 55,688          | \$ 116,244    | \$ -     | \$ 1,150,050 |

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, 2013 were as follows:

|   | As of September 30, 2013 |                                |                      | Nine Months Ended<br>September 30, 2013 |                                  |
|---|--------------------------|--------------------------------|----------------------|---|----------------------------------|
|   | Recorded<br>Investment   | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>       |                          |                                |                      |   |                                  |
| Commercial                                      | \$ 29                    | \$ 35                          | \$ -                 | \$ 113                                  | \$ -                             |
| Commercial real estate                          |                          |                                |                      |   |                                  |
| Owner occupied general purpose                  | 2,657                    | 3,016                          | -                    | 3,565                                   | 3                                |
| Owner occupied special purpose                  | 4,647                    | 5,529                          | -                    | 5,913                                   | -                                |
| Non-owner occupied general purpose              | 9,633                    | 12,131                         | -                    | 11,995                                  | 113                              |
| Non-owner occupied special purpose              | 438                      | 623                            | -                    | 457                                     | -                                |
| Retail properties                               | 5,056                    | 6,293                          | -                    | 6,918                                   | -                                |
| Farm  | -                        | -                              | -                    | 1,259                                   | -                                |
| Construction                                    |                          |                                |                      |   |                                  |
| Homebuilder                                     | 3,039                    | 3,039                          | -                    | 3,597                                   | 120                              |
| Land  | 209                      | 308                            | -                    | 231                                     | -                                |
| Commercial speculative                          | 1,913                    | 2,550                          | -                    | 2,089                                   | -                                |
| All other                                       | 297                      | 333                            | -                    | 188                                     | -                                |
| Residential                                     |                          |                                |                      |   |                                  |
| Investor  | 6,523                    | 8,580                          | -                    | 5,845                                   | -                                |
| Owner occupied                                  | 9,823                    | 11,629                         | -                    | 9,606                                   | 151                              |
| Revolving and junior liens                      | 1,968                    | 2,886                          | -                    | 1,668                                   | 5                                |
| Consumer  | -                        | -                              | -                    | 12                                      | -                                |
| Total impaired loans with no recorded allowance | 46,232                   | 56,952                         | -                    | 53,456                                  | 392                              |
| <b>With an allowance recorded</b>               |                          |                                |                      |   |                                  |
| Commercial                                      | -                        | -                              | -                    | 283                                     | -                                |
| Commercial real estate                          |                          |                                |                      |   |                                  |
| Owner occupied general purpose                  | 935                      | 955                            | 322                  | 974                                     | -                                |
| Owner occupied special purpose                  | 1,300                    | 1,493                          | 371                  | 2,777                                   | -                                |
| Non-owner occupied general purpose              | 183                      | 183                            | 57                   | 1,481                                   | -                                |
| Non-owner occupied special purpose              | -                        | -                              | -                    | -                                       | -                                |
| Retail properties                               | -                        | -                              | -                    | 876                                     | -                                |
| Farm  | -                        | -                              | -                    | -                                       | -                                |
| Construction                                    |                          |                                |                      |   |                                  |
| Homebuilder                                     | 168                      | 604                            | 71                   | 97                                      | -                                |
| Land  | -                        | -                              | -                    | -                                       | -                                |
| Commercial speculative                          | 1,621                    | 4,225                          | 100                  | 2,971                                   | -                                |
| All other                                       | 451                      | 477                            | 241                  | 465                                     | -                                |
| Residential                                     |                          |                                |                      |   |                                  |
| Investor  | 1,784                    | 2,151                          | 584                  | 3,263                                   | -                                |
| Owner occupied                                  | 986                      | 1,082                          | 161                  | 3,448                                   | 12                               |
| Revolving and junior liens                      | 591                      | 623                            | 243                  | 1,527                                   | -                                |
| Consumer  | -                        | -                              | -                    | -                                       | -                                |
| Total impaired loans with a recorded allowance  | 8,019                    | 11,793                         | 2,150                | 18,162                                  | 12                               |
| Total impaired loans                            | \$ 54,251                | \$ 68,745                      | \$ 2,150             | \$ 71,618                               | \$ 404                           |



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Impaired loans by class of loans as of December 31, 2012 were as follows:

|   | As of December 31, 2012 |                                |                      | Nine Months Ended<br>September 30, 2012 |                                  |
|---|-------------------------|--------------------------------|----------------------|---|----------------------------------|
|   | Recorded<br>Investment  | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>       |                         |                                |                      |   |                                  |
| Commercial                                      | \$ 196                  | \$ 229                         | \$ -                 | \$ 516                                  | \$ -                             |
| Commercial real estate                          |                         |                                |                      |   |                                  |
| Owner occupied general purpose                  | 4,473                   | 5,021                          | -                    | 4,149                                   | -                                |
| Owner occupied special purpose                  | 7,180                   | 8,486                          | -                    | 10,222                                  | -                                |
| Non-owner occupied general purpose              | 14,356                  | 17,381                         | -                    | 10,996                                  | 210                              |
| Non-owner occupied special purpose              | 477                     | 634                            | -                    | 933                                     | -                                |
| Retail properties                               | 8,780                   | 15,323                         | -                    | 5,851                                   | -                                |
| Farm  | 2,517                   | 2,517                          | -                    | 1,335                                   | -                                |
| Construction                                    |                         |                                |                      |   |                                  |
| Homebuilder                                     | 4,155                   | 4,729                          | -                    | 7,952                                   | 83                               |
| Land  | 254                     | 308                            | -                    | 1,021                                   | -                                |
| Commercial speculative                          | 2,265                   | 3,451                          | -                    | 6,297                                   | -                                |
| All other                                       | 78                      | 168                            | -                    | 2,204                                   | -                                |
| Residential                                     |                         |                                |                      |   |                                  |
| Investor  | 5,168                   | 6,979                          | -                    | 4,500                                   | -                                |
| Owner occupied                                  | 9,389                   | 11,002                         | -                    | 10,788                                  | 187                              |
| Revolving and junior liens                      | 1,368                   | 1,689                          | -                    | 1,466                                   | 2                                |
| Consumer  | 23                      | 23                             | -                    | -                                       | -                                |
| Total impaired loans with no recorded allowance | 60,679                  | 77,940                         | -                    | 68,230                                  | 482                              |
| <b>With an allowance recorded</b>               |                         |                                |                      |   |                                  |
| Commercial                                      | 566                     | 619                            | 458                  | 646                                     | -                                |
| Commercial real estate                          |                         |                                |                      |   |                                  |
| Owner occupied general purpose                  | 1,014                   | 1,057                          | 230                  | 5,173                                   | -                                |
| Owner occupied special purpose                  | 4,253                   | 6,200                          | 712                  | 4,505                                   | -                                |
| Non-owner occupied general purpose              | 2,779                   | 3,906                          | 204                  | 9,047                                   | -                                |
| Non-owner occupied special purpose              | -                       | -                              | -                    | 217                                     | -                                |
| Retail properties                               | 1,752                   | 1,812                          | 1,102                | 7,958                                   | -                                |
| Farm  | -                       | -                              | -                    | 347                                     | -                                |
| Construction                                    |                         |                                |                      |   |                                  |
| Homebuilder                                     | 26                      | 75                             | 3                    | 2,411                                   | -                                |
| Land  | -                       | -                              | -                    | -                                       | -                                |
| Commercial speculative                          | 4,322                   | 6,613                          | 757                  | 4,554                                   | -                                |
| All other                                       | 479                     | 649                            | 353                  | 459                                     | -                                |
| Residential                                     |                         |                                |                      |   |                                  |
| Investor  | 4,742                   | 5,954                          | 477                  | 9,552                                   | -                                |
| Owner occupied                                  | 5,909                   | 6,923                          | 1,089                | 6,726                                   | 34                               |
| Revolving and junior liens                      | 2,464                   | 2,625                          | 874                  | 1,608                                   | -                                |
| Consumer  | -                       | -                              | -                    | -                                       | -                                |
| Total impaired loans with a recorded allowance  | 28,306                  | 36,433                         | 6,259                | 53,203                                  | 34                               |
| Total impaired loans                            | \$ 88,985               | \$ 114,373                     | \$ 6,259             | \$ 121,433                              | \$ 516                           |

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

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the loan collection process with modifications generally initiated at the request of the borrower. These modifications may include reduction in interest rates, extension of term, deferrals of principal, and other modifications. The Bank participates in the U.S. Department of the Treasury's (the Treasury) Home Affordable Modification Program (HAMP) which gives qualifying homeowners an opportunity to refinance into more affordable monthly payments.

The specific allocation of the allowance for loan losses on a TDR is determined by either discounting the modified cash flows at the original effective rate of the loan before modification or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the

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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 on loans that are not individually evaluated for specific impairment. All loans charged-off, including TDRs charged-off, are factored into this calculation by portfolio segment.

TDRs that were modified during the periods three and nine months ended September 30, 2013, were as follows:

|                                     | TDR Modifications<br>Three months ended September 30, 2013 |                                      |                                       | TDR Modifications<br>Nine months ended September 30, 2013 |                                      |                                       |
|-------------------------------------|--|--------------------------------------|---------------------------------------|---|--------------------------------------|---------------------------------------|
|                                     | # of contracts   | Pre-modification recorded investment | Post-modification recorded investment | # of contracts  | Pre-modification recorded investment | Post-modification recorded investment |
| <b>Troubled debt restructurings</b> |  |                                      |                                       |   |                                      |                                       |
| Real estate - commercial            |  |                                      |                                       |   |                                      |                                       |
| Deferral <sup>3</sup>               | -  | \$ -                                 | \$ -                                  | 1   | \$ 610                               | \$ 472                                |
| Real estate - residential           |  |                                      |                                       |   |                                      |                                       |
| Owner occupied                      |  |                                      |                                       |   |                                      |                                       |
| Deferral <sup>3</sup>               | -  | -                                    | -                                     | 1   | 137                                  | 137                                   |
| Other <sup>5</sup>                  | -  | -                                    | -                                     | 1   | 30                                   | 29                                    |
|                                     | -  | \$ -                                 | \$ -                                  | 3   | \$ 777                               | \$ 638                                |

|                                     | TDR Modifications<br>Three months ended September 30, 2012 |                                      |                                       | TDR Modifications<br>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>Troubled debt restructurings</b> |  |                                      |                                       |   |                                      |                                       |
| Real estate - commercial            |  |                                      |                                       |   |                                      |                                       |
| Deferral <sup>1</sup>               | 1  | \$ 689                               | \$ 433                                | 2   | \$ 898                               | \$ 640                                |
| Interest <sup>2</sup>               | -  | -                                    | -                                     | 2   | 3,381                                | 3,148                                 |
| Real estate - residential           |  |                                      |                                       |   |                                      |                                       |
| Investor                            |  |                                      |                                       |   |                                      |                                       |
| Deferral <sup>1</sup>               | 1  | 405                                  | 167                                   | 2   | 405                                  | 167                                   |
| Bifurcate <sup>3</sup>              | -  | -                                    | -                                     | 1   | 337                                  | 88                                    |
| Owner occupied                      |  |                                      |                                       |   |                                      |                                       |
| Deferral <sup>3</sup>               | -  | -                                    | -                                     | 1   | 108                                  | 108                                   |
| Revolving and junior liens          |  |                                      |                                       |   |                                      |                                       |
| Hamp <sup>4</sup>                   | -  | -                                    | -                                     | 1   | 117                                  | 61                                    |
|                                     | 2  | \$ 1,094                             | \$ 600                                | 9   | \$ 5,246                             | \$ 4,212                              |

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

2 Interest: Interest rate concession below normal market

3 Deferral: Refers to the deferral of principal payments

4 HAMP: Home Affordable Modification Program

5 Other

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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 the modified terms. The following table presents TDRs that defaulted during the periods shown and were restructured within the 12 month period prior to default:

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

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



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, 2013, were as follows:

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

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

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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 (release)                          | (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 (release)                          | (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.

**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:

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|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
| <u>Other real estate owned</u>          | 2013                                | 2012      | 2013                               | 2012      |
| Balance at beginning of period          | \$ 59,465                           | \$ 89,671 | \$ 72,423                          | \$ 93,290 |
| Property additions                      | 3,015                               | 7,594     | 14,196                             | 26,944    |
| Development improvements                | 10                                  | 131       | 60                                 | 646       |
| Less:                                   |                                     |           |                                    |           |
| Property disposals, net of gains/losses | 11,463                              | 4,829     | 30,928                             | 20,517    |
| Period valuation adjustments            | 1,961                               | 4,474     | 6,685                              | 12,270    |
| Balance at end of period                | \$ 49,066                           | \$ 88,093 | \$ 49,066                          | \$ 88,093 |

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Activity in the valuation allowance was as follows:

|            | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|------------|-------------------------------------|------|------------------------------------|------|
|            | 2013                                | 2012 | 2013                               | 2012 |
| [REDACTED] |                                     |      |                                    |      |

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

|                                 | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |           |
|---------------------------------|-------------------------------------|----------|------------------------------------|-----------|
|                                 | 2013                                | 2012     | 2013                               | 2012      |
| Gain on sales, net              | \$ (608)                            | \$ (20)  | \$ (1,175)                         | \$ (398)  |
| Provision for unrealized losses | 1,961                               | 4,474    | 6,537                              | 12,101    |
| Operating expenses              | 1,500                               | 2,071    | 4,555                              | 5,886     |
| Less:                           |                                     |          |                                    |           |
| Lease revenue                   | 309                                 | 840      | 974                                | 2,930     |
|                                 | \$ 2,544                            | \$ 5,685 | \$ 8,943                           | \$ 14,659 |

**Note 6 Deposits**

Major classifications of deposits were as follows:

|  | September 30, 2013 |           | December 31, 2012 |           |
|--|--------------------|-----------|-------------------|-----------|
| Noninterest bearing demand                     | \$                 | 373,499   | \$                | 379,451   |
| Savings  |                    | 227,823   |                   | 216,305   |
| NOW accounts                                   |                    | 272,632   |                   | 286,860   |
| Money market accounts                          |                    | 309,066   |                   | 323,811   |
| Certificates of deposit of less than \$100,000 |                    | 299,632   |                   | 318,844   |
| Certificates of deposit of \$100,000 or more   |                    | 190,471   |                   | 191,948   |
|  | \$                 | 1,673,123 | \$                | 1,717,219 |

**Note 7 Borrowings**

The following table is a summary of borrowings as of September 30, 2013, and December 31, 2012. Junior subordinated debentures are discussed in detail in Note 8:

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|   | September 30, 2013 |         | December 31, 2012 |         |
|---|--------------------|---------|-------------------|---------|
| Securities sold under repurchase agreements | \$                 | 20,719  | \$                | 17,875  |
| FHLB advances                               |                    | 55,000  |                   | 100,000 |
| Junior subordinated debentures              |                    | 58,378  |                   | 58,378  |
| Subordinated debt                           |                    | 45,000  |                   | 45,000  |
| Notes payable and other borrowings          |                    | 500     |                   | 500     |
|   | \$                 | 179,597 | \$                | 221,753 |

The Company enters into deposit sweep transactions where the transaction amounts are secured by pledged securities. These transactions consistently mature within 1 to 90 days from the transaction date and

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are governed by sweep repurchase agreements. All sweep repurchase agreements are treated as financings secured by U.S. government agencies and collateralized MBS and had a carrying amount of \$32.1 million at September 30, 2013, and \$26.0 million at December 31, 2012. At September 30, 2013, there was no customer with secured balances exceeding 10% of stockholders' equity.

The Company's borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC and total borrowings are generally limited to the lower of 35% of total assets or 60% of the book value of certain mortgage loans. As of September 30, 2013, the Bank took an advance of \$55.0 million at 0.13% interest on the FHLBC stock valued at \$5.5 million and collateralized by \$99.9 million of loans of which \$44.9 million is available for additional borrowings. This advance matured on October 1, 2013 and was replaced with short term FHLBC advances that matured in October 2013. Previous borrowing capacity at the FRB that was not used at either September 30, 2013, or December 31, 2012 was dropped by the Company in October 2013 as management determined that it was not needed given current and prospective liquidity projections.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with a correspondent bank. That credit began in January 2008 and was originally composed of a \$30.5 million senior debt facility, which included \$500,000 in term debt, and \$45.0 million of subordinated debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly and at the Company's option, is based on, either the lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the subordinated debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The Company had no principal outstanding balance on the senior line of credit when it matured and the senior line of credit has been terminated. The Company had \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in subordinated debt at the end of both December 31, 2012, and September 30, 2013. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts outstanding on a timely basis. Pursuant to the Written Agreement dated July 22, 2011 between the Company and the FRB (the "Written Agreement"), the Company must receive the FRB's approval prior to making any interest payments on the subordinated debt.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the senior debt agreement. The senior debt agreement also contains certain customary representations and warranties and financial and negative covenants. At September 30, 2013, the Company was out of compliance with one of the financial covenants contained within the credit agreement. Previously, the Company had been out of compliance with two of the financial covenants. The agreement provides that noncompliance is an event of default and as the result of the Company's failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line of the term debt by 200 basis points, (iii) declare the senior debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal 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 senior debt agreement does not provide the lender with any rights of acceleration or other remedies with regard to the subordinated debt upon an event of default caused by the Company's failure to comply with a financial covenant.

## **Note 8 Junior Subordinated Debentures**

The Company completed the sale of \$27.5 million of cumulative trust preferred securities by its unconsolidated subsidiary, Old Second Capital Trust I in June 2003. An additional \$4.1 million of cumulative trust preferred securities were sold in July 2003. The 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



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by the Company. The stated call period commenced on June 30, 2008 and a call 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 Old Second Capital Trust I in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

The Company issued an additional \$25.0 million of cumulative trust preferred securities through a private placement completed by an additional, unconsolidated subsidiary, Old Second Capital Trust II, in April 2007. 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 Old Second Capital Trust II in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

Under the terms of the subordinated debentures issued to each of Old Second Capital Trust I and II, the Company is allowed to defer payments of interest for 20 quarterly periods without default or penalty, but such amounts 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. On August 31, 2010, the Company announced that it 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 related 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, totals \$15.7 million at September 30, 2013.

## **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 Incentive Plan were 45,368 at September 30, 2013. Stock based awards may be granted to selected directors and officers or employees under the Incentive Plan at the discretion of the board of directors. There were no stock options granted in the first nine months of 2013 or 2012. 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 the Incentive Plan was \$57,000 in the third quarter of 2013 and \$123,000 in the first nine months of 2013. 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.



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There were no stock options exercised during the third quarter of 2013 or 2012. There is no unrecognized compensation cost related to nonvested stock options as all stock options of the Company's common stock have vested.

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A summary of stock option activity in the Incentive Plan for the nine months ending September 30, 2013, is as follows:

|                              | Shares  |    | Weighted<br>Average<br>Exercise<br>Price |      | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (years) |  | Aggregate<br>Intrinsic Value |
|------------------------------|---------|----|--|------|---|--|------------------------------|
| Beginning outstanding        | 409,500 | \$ | 28.75                                    |      |   |  |                              |
| Canceled                     | (2,000) |    | 32.59                                    |      |   |  |                              |
| Ending outstanding           | 407,500 | \$ | 28.74                                    | 2.28 | \$  |  | -                            |
| Exercisable at end of period | 407,500 | \$ | 28.74                                    | 2.28 | \$  |  | -                            |

Under the Incentive Plan, restricted stock was granted beginning in 2005 and the grant of restricted stock 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. Further, in first quarter 2013 after completion on Treasury's auction of the Old Second Bancorp Series B Preferred Stock at a discount, 45,000 unvested restricted stock shares previously awarded were recaptured in addition to 133,943 restricted stock shares that were fully vested. These recaptures provided an income statement benefit of \$612,000 included in other noninterest income during the second quarter of 2013. There were no restricted awards issued during the third quarter of 2013 and 155,500 restricted awards issued for the nine months ending September 30, 2013. 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. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award at issue date.

A summary of changes in the Company's nonvested restricted awards for the nine months ending September 30, 2013, is as follows:

|                                   | September 30, 2013                      |    |   |
|-----------------------------------|---|----|---|
|                                   | Restricted<br>Stock Shares<br>and Units | \$ | Weighted<br>Average<br>Grant Date<br>Fair Value |
| Nonvested at January 1            | 327,920                                 | \$ | 2.21  |
| Granted                           | 155,500                                 |    | 3.28  |
| Vested                            | (241,920)                               |    | 2.50  |
| Forfeited                         | (11,000)                                |    | 2.47  |
| Recaptured after Series B auction | (45,000)                                |    | 1.25  |
| Nonvested at September 30         | 185,500                                 | \$ | 2.95  |

Total unrecognized compensation cost of restricted awards was \$411,000 as of September 30, 2013, which is expected to be recognized over a weighted-average period of 2.46 years. Total unrecognized compensation cost of restricted awards was \$161,000 as of September 30, 2012, which was expected to be recognized over a weighted-average period of 0.93 years.



Table of Contents**Note 10 Earnings (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<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2013                                | 2012       | 2013                               | 2012       |
| Basic earnings (loss) per share:  |                                     |            |                                    |            |
| Weighted-average common shares outstanding  | 13,885,884                          | 14,084,328 | 13,947,606                         | 14,070,783 |
| Weighted-average common shares less stock based awards                                  | 13,870,884                          | 13,883,008 | 13,895,136                         | 13,873,819 |
| Weighted-average common shares stock based awards                                       | 231,152                             | 327,920    | 217,107                            | 332,198    |
| Net income (loss)   | \$ 72,924                           | \$ 120     | \$ 81,872                          | \$ (1,596) |
| Dividends and accretion of discount on preferred shares                                 | 1,323                               | 1,255      | 3,917                              | 3,716      |
| Net income (loss) available to common shareholders                                      | 71,601                              | (1,135)    | 77,955                             | (5,312)    |
| Undistributed earnings (loss)   | 71,601                              | (1,135)    | 77,955                             | (5,312)    |
| Basic earnings (loss) per share common undistributed earnings (loss)                    | 5.08                                | (0.08)     | 5.52                               | (0.37)     |
| Basic earnings (loss) per share   | \$ 5.08                             | \$ (0.08)  | \$ 5.52                            | \$ (0.37)  |
| Diluted earnings (loss) per share:  |                                     |            |                                    |            |
| Weighted-average common shares outstanding  | 13,885,884                          | 14,084,328 | 13,947,606                         | 14,070,783 |
| Dilutive effect of restricted shares <sup>1</sup>                                       | 216,152                             | 126,600    | 164,637                            | 135,234    |
| Diluted average common shares outstanding   | 14,102,036                          | 14,210,928 | 14,112,243                         | 14,206,017 |
| Net earnings (loss) available to common stockholders                                    | \$ 71,601                           | \$ (1,135) | \$ 77,955                          | \$ (5,312) |
| Diluted earnings (loss) per share   | \$ 5.08                             | \$ (0.08)  | \$ 5.52                            | \$ (0.37)  |
| Number of antidilutive options excluded from the diluted earnings per share calculation | 1,224,839                           | 1,286,839  | 1,224,839                          | 1,286,839  |

<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 a Consent Order with the Office of the Comptroller of the Currency (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. On October 17, 2013, the OCC terminated the Consent Order.

The Bank has exceeded both capital ratio objectives in the now terminated Consent Order since June 30, 2011. At September 30, 2013, the Bank's Tier 1 capital leverage ratio was 11.08%, up 141 basis points from December 31, 2012, and 233 basis points above the 8.75% objective the Bank had agreed to maintain in the Consent Order. The Bank's total capital ratio was 17.08%, up 222 basis points from December 31, 2012,

and 583 basis points above the objective of 11.25%.

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

On July 22, 2011, the Company entered into a Written Agreement with the FRB. 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. Although the Consent Order was terminated, the Written Agreement is still in effect until terminated, modified or rescinded by the FRB.

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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 complied with the now terminated Consent Order it entered into with the OCC on May 16, 2011; (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 FRB 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, 2013, and December 31, 2012. These ratios are calculated on a consistent basis with the ratios disclosed in the most recent filings with the regulatory agencies.

In July 2013, the U.S. federal banking authorities approved the implementation of the Basel III regulatory capital reforms and issued rules effecting certain changes required by the Dodd-Frank Act (the Basel III Rules). The Basel III Rules are applicable to all U.S. banks that are subject to minimum capital requirements as well as to bank and savings and loan holding companies. The Basel III Rules not only increase selected minimum regulatory capital ratios, but also introduce a new Common Equity Tier 1 capital ratio and the concept of a capital conservation buffer. The Basel III rules also revise the criteria that certain instruments must meet to qualify as Tier 1 or Tier 2 capital. A number of instruments that now qualify as Tier 1 capital will not qualify under the Basel III rules. The Basel III Rules also permit smaller banking organizations to retain, through a one-time election, the existing treatment of accumulated other comprehensive income. The Basel III Rules have maintained the general structure of the current prompt corrective action framework while incorporating the increased requirements. The Basel III Rules also revise prompt corrective action guidelines to add the Common Equity Tier 1 capital ratio. Generally, the new Basel III Rules become effective on January 1, 2015, although parts of the Basel III Rules will be phased in through 2019. Management is reviewing the new rules to assess their impact on the Company.

At September 30, 2013, 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.

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Capital levels and industry defined regulatory minimum required levels:

|  | Actual     |        | Minimum Required<br>for Capital |       | Minimum Required<br>to be Well |       |
|--|------------|--------|---------------------------------|-------|--------------------------------|-------|
|  | Amount     | Ratio  | Adequacy Purposes<br>Amount     | Ratio | Capitalized 1<br>Amount        | Ratio |
| <b>September 30, 2013</b>              |            |        |                                 |       |                                |       |
| Total capital to risk weighted assets  |            |        |                                 |       |                                |       |
| Consolidated                           | \$ 198,822 | 15.15% | \$ 104,989                      | 8.00% | N/A                            | N/A   |
| Old Second Bank                        | 224,171    | 17.08  | 104,998                         | 8.00  | 131,248                        | 10.00 |
| Tier 1 capital to risk weighted assets |            |        |                                 |       |                                |       |
| Consolidated                           | 132,129    | 10.07  | 52,484                          | 4.00  | N/A                            | N/A   |
| Old Second Bank                        | 207,607    | 15.82  | 52,492                          | 4.00  | 78,738                         | 6.00  |
| Tier 1 capital to average assets       |            |        |                                 |       |                                |       |
| Consolidated                           | 132,129    | 7.11   | 74,334                          | 4.00  | N/A                            | N/A   |
| Old Second Bank                        | 207,607    | 11.08  | 74,948                          | 4.00  | 93,685                         | 5.00  |
| <b>December 31, 2012</b>               |            |        |                                 |       |                                |       |
| Total capital to risk weighted assets  |            |        |                                 |       |                                |       |
| Consolidated                           | \$ 189,466 | 13.62% | \$ 111,287                      | 8.00% | N/A                            | N/A   |
| Old Second Bank                        | 206,496    | 14.86  | 111,169                         | 8.00  | 138,961                        | 10.00 |
| Tier 1 capital to risk weighted assets |            |        |                                 |       |                                |       |
| Consolidated                           | 94,817     | 6.81   | 55,693                          | 4.00  | N/A                            | N/A   |
| Old Second Bank                        | 188,873    | 13.59  | 55,592                          | 4.00  | 83,388                         | 6.00  |
| Tier 1 capital to average assets       |            |        |                                 |       |                                |       |
| Consolidated                           | 94,817     | 4.85   | 78,200                          | 4.00  | N/A                            | N/A   |
| Old Second Bank                        | 188,873    | 9.67   | 78,127                          | 4.00  | 97,659                         | 5.00  |

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

The Company's credit facility with a correspondent bank 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, 2013, trust preferred security proceeds of \$51.5 million qualified as Tier 1 regulatory capital and \$5.1 million qualified as Tier 2 regulatory capital. As of December 31, 2012, trust preferred proceeds of \$24.6 million qualified as Tier 1 regulatory capital and \$32.0 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, 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. Other dividend payment restrictions on the Bank and the Company as included in the Written Agreement preclude dividend payment without prior regulatory approval.

As discussed in Note 8, as of September 30, 2013, the Company had \$58.4 million of junior subordinated debentures held by two statutory business trusts that it controls. The Company has the right to defer interest payments on the debentures for a period of up to 20 consecutive quarters, and elected to begin such a deferral in August 2010. However, all deferred interest must be paid before the Company may pay dividends on its common stock. 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, 2013, was \$15.7 million.



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Furthermore, as with the debentures discussed above, the Company is prohibited from paying dividends on its common stock unless it has fully paid all deferred dividends on the Series B Preferred Stock, which the Company announced that it would begin deferring on August 31, 2010. Therefore, in addition to paying all the accrued and unpaid distributions on the debentures set forth above, the Company must also fully pay all deferred and unpaid dividends on the Series B 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, 2013, was \$12.3 million. In addition, the Written Agreement contains 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 by the Company also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Three levels of inputs that may be used to measure fair value are:

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

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

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

Transfers between levels are deemed to have occurred at the end of the reporting period. For the quarters ended September 30, 2013, and 2012 there were no significant transfers between levels.

Securities (available-for-sale and held-to-maturity) are valued by a third party pricing agent and both the market and income valuation approaches are implemented. The Company uses the following methods and significant assumptions to estimate fair value:

- Government-sponsored agency debt securities are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.

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- Other government-sponsored agency securities, MBS and some of the actively traded real estate mortgage investment conduits and collateralized mortgage obligations are priced using available market information including benchmark yields, prepayment speeds, spreads, volatility of similar securities and trade date.
- Other inactive government-sponsored agency securities and auction rate asset backed securities are priced using consensus pricing and dealer quotes.
- State and political subdivisions are largely grouped by characteristics (e.g., geographical data and source of revenue in trade dissemination systems). Because some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities and could be valued with Level 3 measurements.
- CDOs are collateralized by trust preferred security issuances of other financial institutions. CDOs are valued utilizing a discounted cash flow analysis. To reflect an appropriate fair value measurement, management included a risk premium adjustment to provide an estimate of the amount

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that a market participant would demand because of uncertainty in cash flows in the discounted cash flow analysis. Changes in unobservable inputs such as future cash flows, prepayment speeds and market rates which may result in a significantly higher or lower fair value measurement. Due to the significant amount of unobservable inputs for the security and limited market activity, these securities are considered Level 3 valuations.

- Asset-backed securities (see above) are also priced using a single expected cash flow stream model using trades, covers, bids, offers and price for similar bonds as well as prepayment and default projections based on historical statistics of the underlying collateral and current market data. As some of asset-backed securities are auction rate securities, there is additional liquidity risk estimated by the Company. Therefore, the valuation of some asset-backed securities are considered Level 3 valuations
- Residential mortgage loans eligible for sale in the secondary market are carried at fair market value. The fair value of loans held for sale is determined using quoted secondary market prices.
- Lending related commitments to fund certain residential mortgage loans, e.g. residential mortgage loans with locked in interest rates to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors as well as forward commitments for future delivery of MBS are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including prices for MBS from the date of the commitment and do not typically involve significant judgments by management.
- The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.
- Interest rate swap positions, both assets and liabilities, are based on valuation pricing models using an income approach reflecting readily observable market parameters such as interest rate yield curves.
- Both the credit valuation reserve on current interest rate swap positions and on receivables related to unwound customer interest rate swap positions were determined based upon management's estimate of the amount of credit risk exposure, including by available collateral protection and/or by utilizing an estimate related to a probability of default as indicated in the Bank credit policy. Such adjustments would result in a Level 3 classification.
- The fair value of impaired loans with specific allocations of the allowance for loan losses is essentially based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are made in the appraisal process by the appraisers to reflect differences between the available comparable sales and income data. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.
- Nonrecurring adjustments to certain commercial and residential real estate properties classified as OREO are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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

The tables below present the balance of assets and liabilities at September 30, 2013, and December 31, 2012, respectively, measured by the Company at fair value on a recurring basis:

|   | September 30, 2013 |                   |                   | Total             |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Level 1            | Level 2           | Level 3           |                   |
| <b>Assets:</b>  |                    |                   |                   |                   |
| Securities available-for-sale   |                    |                   |                   |                   |
| U.S. Treasury   | \$ 1,548           | \$ -              | \$ -              | \$ 1,548          |
| U.S. government agencies  | -                  | 1,693             | -                 | 1,693             |
| States and political subdivisions   | -                  | 19,709            | 132               | 19,841            |
| Corporate Bonds   | -                  | 22,200            | -                 | 22,200            |
| Collateralized mortgage obligations                                       | -                  | 48,125            | -                 | 48,125            |
| Asset-backed securities   | -                  | 121,772           | 147,212           | 268,984           |
| Collateralized debt obligations   | -                  | -                 | 11,087            | 11,087            |
| Loans held-for-sale   | -                  | 3,129             | -                 | 3,129             |
| Mortgage servicing rights   | -                  | -                 | 5,456             | 5,456             |
| Other assets (Interest rate swap agreements net of swap credit valuation) | -                  | 584               | (13)              | 571               |
| Other assets (Forward MBS)  | -                  | 69                | -                 | 69                |
| <b>Total</b>  | <b>\$ 1,548</b>    | <b>\$ 217,281</b> | <b>\$ 163,874</b> | <b>\$ 382,703</b> |
| <b>Liabilities:</b>   |                    |                   |                   |                   |
| Other liabilities (Interest rate swap agreements)                         | \$ -               | \$ 584            | \$ -              | \$ 584            |
| Other liabilities (Interest rate lock commitments to borrowers)           | -                  | 1                 | -                 | 1                 |
| <b>Total</b>  | <b>\$ -</b>        | <b>\$ 585</b>     | <b>\$ -</b>       | <b>\$ 585</b>     |

|   | December 31, 2012 |                   |                  | Total             |
|---|-------------------|-------------------|------------------|-------------------|
|   | Level 1           | Level 2           | Level 3          |                   |
| <b>Assets:</b>  |                   |                   |                  |                   |
| Securities available-for-sale   |                   |                   |                  |                   |
| U.S. Treasury   | \$ 1,507          | \$ -              | \$ -             | \$ 1,507          |
| U.S. government agencies  | -                 | 49,850            | -                | 49,850            |
| U.S. government agency mortgage-backed                                    | -                 | 128,738           | -                | 128,738           |
| States and political subdivisions   | -                 | 15,723            | 132              | 15,855            |
| Corporate Bonds   | -                 | 36,886            | -                | 36,886            |
| Collateralized mortgage obligations                                       | -                 | 169,600           | -                | 169,600           |
| Asset-backed securities   | -                 | 167,493           | -                | 167,493           |
| Collateralized debt obligations   | -                 | -                 | 9,957            | 9,957             |
| Loans held-for-sale   | -                 | 9,571             | -                | 9,571             |
| Mortgage servicing rights   | -                 | -                 | 4,116            | 4,116             |
| Other assets (Interest rate swap agreements net of swap credit valuation) | -                 | 1,349             | (47)             | 1,302             |
| Other assets (Forward MBS)  | -                 | 567               | -                | 567               |
| <b>Total</b>  | <b>\$ 1,507</b>   | <b>\$ 579,777</b> | <b>\$ 14,158</b> | <b>\$ 595,442</b> |
| <b>Liabilities:</b>   |                   |                   |                  |                   |
| Other liabilities (Interest rate swap agreements)                         | \$ -              | \$ 1,349          | \$ -             | \$ 1,349          |

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Other liabilities (Interest rate lock commitments to  
borrowers)

|       |    |   |    |       |    |   |    |       |
|-------|----|---|----|-------|----|---|----|-------|
|       |    | - |    | 5     |    | - |    | 5     |
| Total | \$ | - | \$ | 1,354 | \$ | - | \$ | 1,354 |

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

Nine months ended September 30, 2013

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

Nine months ended September 30, 2012

|   | Investment securities           |                                   |                           |                              |
|---|---------------------------------|-----------------------------------|---------------------------|------------------------------|
|   | 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)                      |

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The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of September 30, 2013:

| <b>Measured at fair value on a recurring basis:</b> | Fair Value | Valuation Methodology                       | Unobservable Inputs    | Range of Input        | Weighted Average of Inputs |
|---|------------|---|------------------------|-----------------------|----------------------------|
| Collateralized Debt Obligations                     | \$ 11,087  | Discounted Cash Flow                        | Discount Rate          | Libor +<br>5.25-6.25% | 5.7%                       |
|   |            |   | Prepayment %           | 0%-76.0%              | 13.5%                      |
|   |            |   | Default range          | 3.0%-100.0%           | 15.7%                      |
| Mortgage Servicing rights                           | 5,456      | Discounted Cash Flow                        | Discount Rate          | 10.0%                 | 10.0%                      |
|   |            |   | Prepayment Speed       | 10.8%                 | 10.8%                      |
| Interest Rate Swap Valuation                        | (13)       | Management estimate of credit risk exposure | Probability of Default | 5%-20%                | 13.4%                      |
| Asset-backed securities                             | 147,212    | Discounted Cash Flow                        | Credit Risk Premium    | 1.00%-1.5%            | 1.3%                       |
|   |            |   | Liquidity Risk Premium | 1.0%                  | 1.0%                       |

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The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of December 31, 2012:

| <b>Measured at fair value on a recurring basis:</b> | Fair Value | Valuation Methodology                       | Unobservable Inputs                            | Range of Input                       | Weighted Average of Inputs |
|---|------------|---|--|--------------------------------------|----------------------------|
| Collateralized Debt Obligations                     | \$ 9,957   | Discounted Cash Flow                        | Discount Rate<br>Prepayment %<br>Default range | Libor + 6%-7%<br>0%-76%<br>3.1%-100% | 6.4%<br>16.4%<br>19.1%     |
| Mortgage Servicing rights                           | 4,116      | Discounted Cash Flow                        | Discount Rate<br>Prepayment Speed              | 10.5%<br>15.8%                       | 10.5%<br>15.8%             |
| Interest Rate Swap Valuation                        | (47)       | Management estimate of credit risk exposure | Probability of Default                         | 2%-31%                               | 17.9%                      |

The \$132,000 on the state and political subdivisions line at September 30, 2013, under Level 3 represents a security from a small, local municipality. Given the small dollar amount and size of the municipality involved, this is categorized as Level 3 based on the payment stream received by the Company from the municipality. That payment stream is otherwise an unobservable input. The \$147.2 million on the asset backed securities line at September 30, 2013, under Level 3 represents auction rate securities held at that date. These are categorized as Level 3 based on the Company's approach of valuing the securities based on pricing from a limited number of brokers and that the pricing is otherwise an unobservable input.

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

The Company may be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with GAAP. These assets consist of impaired loans and OREO. For assets measured at fair value on a nonrecurring basis at September 30, 2013, and December 31, 2012, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

|   | September 30, 2013 |   |         |   |           |           |
|---|--------------------|---|---------|---|-----------|-----------|
|   | Level 1            |   | Level 2 |   | Level 3   | Total     |
| Impaired loans <sup>1</sup>               | \$                 | - | \$      | - | \$ 5,653  | \$ 5,653  |
| Other real estate owned, net <sup>2</sup> |                    | - |         | - | 49,066    | 49,066    |
| <b>Total</b>                              | \$                 | - | \$      | - | \$ 54,719 | \$ 54,719 |

<sup>1</sup> Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans, had a carrying amount of \$7.8 million, with a valuation allowance of \$2.1 million, resulting in a decrease of specific allocations within the allowance for loan losses of \$4.1 million for the nine months ending September 30, 2013.



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2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of \$49.1 million, which is made up of the outstanding balance of \$75.8 million, net of a valuation allowance of \$24.6 million and participations of \$2.1 million, at September 30, 2013.

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|  |  |  |  |  | December 31, 2012 |         |         |       |
|--|--|--|--|--|-------------------|---------|---------|-------|
|  |  |  |  |  | Level 1           | Level 2 | Level 3 | Total |
|  |  |  |  |  |                   |         |         |       |

1 Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans, had a carrying amount of \$27.8 million, with a valuation allowance of \$6.3 million, resulting in a decrease of specific allocations within the provision for loan losses of \$6.8 million for the year ending December 31, 2012.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of \$72.4 million, which is made up of the outstanding balance of \$109.7 million, net of a valuation allowance of \$31.4 million and participations of \$5.9 million, at December 31, 2012, resulting in a charge to expense of \$16.4 million for the year ended December 31, 2012.

**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 an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. Due to financial covenant violations relating to nonperforming loans, the Bank had \$3.2 million in investment securities pledged to support interest rate swap activity with three correspondent financial institutions at September 30, 2013. The Bank had \$7.4 million in investment securities pledged to support interest rate swap activity with two correspondent financial institutions at December 31, 2012. In connection with each transaction, the Bank agreed to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Bank agreed to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to effectively convert a variable rate loan to a fixed rate loan and is part of the Company's interest rate risk management strategy. Because the Bank acts as an intermediary for the client, changes in the fair value of the underlying derivative contracts offset each other and do not generally affect the results of operations. Fair value measurements include an assessment of credit risk related to the client's ability to perform on their contract position, however, and valuation estimates related to that

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exposure are discussed in Note 12 above. At September 30, 2013, the notional amount of non-hedging interest rate swaps was \$80.3 million with a weighted average maturity of 1.3 years. At December 31, 2012, the notional amount of non-hedging interest rate swaps was \$82.1 million with a weighted average maturity of 1.3 years. The Bank offsets derivative assets and liabilities that are subject to a master netting arrangement.

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

The following table presents derivatives not designated as hedging instruments as of September 30, 2013, and periodic changes in the values of the interest rate swaps are reported in other noninterest income. Periodic changes in the value of the forward contracts related to mortgage loan origination are reported in the net gain on sales of mortgage loans.

|            | Notional or Contractual Amount | Asset Derivatives      |            | Liability Derivatives  |            |
|------------|--------------------------------|------------------------|------------|------------------------|------------|
|            |                                | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| [REDACTED] |                                |                        |            |                        |            |

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

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

The following table presents derivatives not designated as hedging instruments as of December 31, 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 | \$ 82,097                      | Other Assets           | \$ 1,302   | Other Liabilities      | \$ 1,349   |
| Commitments <sup>1</sup>                             | 226,135                        | Other Assets           | 567        | N/A                    | -          |
| Forward contracts <sup>2</sup>                       | 28,000                         | N/A                    | -          | Other Liabilities      | 5          |
| Total  |                                |                        | \$ 1,869   |                        | \$ 1,354   |

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

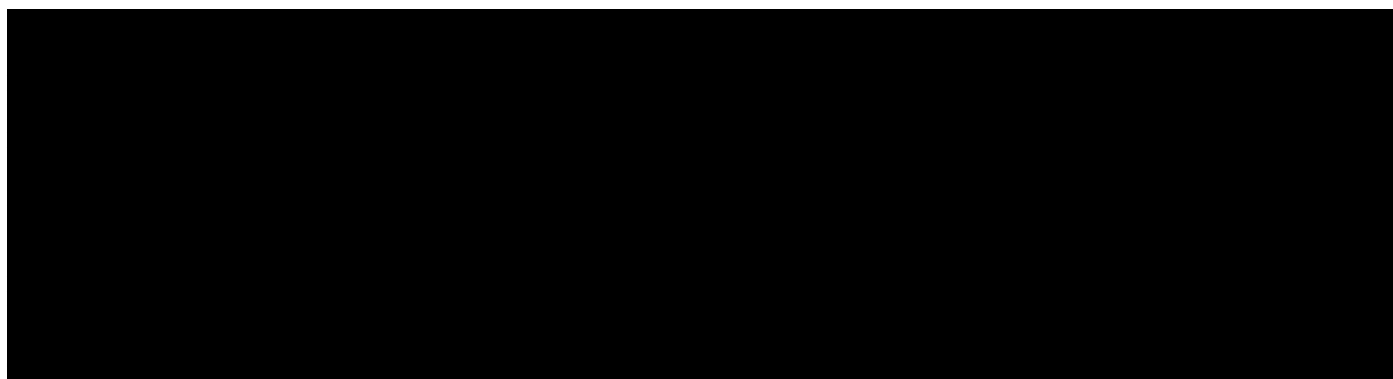
2Includes forward mortgage backed securities contracts.

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

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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, 2013, and December 31, 2012.

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



**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 CDOs 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. As the only market for FHLBC stock is through stock redemption with FHLBC at par, it is not practical to determine any other fair value for the FHLBC investment. 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:

|   | September 30, 2013 |               |            |           |           |
|---|--------------------|---------------|------------|-----------|-----------|
|   | Carrying<br>Amount | Fair<br>Value | Level 1    | Level 2   | Level 3   |
| <b>Financial assets:</b>                              |                    |               |            |           |           |
| Cash, due from banks and federal funds sold           | \$ 47,486          | \$ 47,486     | \$ 47,486  | \$ -      | \$ -      |
| Interest bearing deposits with financial institutions | 32,586             | 32,586        | 32,586     | -         | -         |
| Securities available-for-sale                         | 373,478            | 373,478       | 1,548      | 213,499   | 158,431   |
| Securities held-to-maturity                           | 258,101            | 260,421       | -          | 260,421   | -         |
| FHLBC and FRB Stock                                   | 10,292             | 10,292        | -          | 10,292    | -         |
| Bank-owned life insurance                             | 55,005             | 55,005        | -          | 55,005    | -         |
| Loans held for sale                                   | 3,129              | 3,129         | -          | 3,129     | -         |
| Loans, net  | 1,048,093          | 1,047,557     | -          | -         | 1,047,557 |
| Accrued interest receivable                           | 4,473              | 4,473         | -          | 4,473     | -         |
| <b>Financial liabilities:</b>                         |                    |               |            |           |           |
| Noninterest bearing deposits                          | \$ 373,499         | \$ 373,499    | \$ 373,499 | \$ -      | \$ -      |
| Interest bearing deposits                             | 1,299,624          | 1,302,082     | -          | 1,302,082 | -         |
| Securities sold under repurchase agreements           | 20,719             | 20,719        | -          | 20,719    | -         |
| Other short-term borrowings                           | 55,000             | 55,000        | -          | 55,000    | -         |
| Junior subordinated debentures                        | 58,378             | 63,480        | 37,657     | 25,823    | -         |
| Subordinated debenture                                | 45,000             | 39,193        | -          | 39,193    | -         |
| Note payable and other borrowings                     | 500                | 415           | -          | 415       | -         |
| Borrowing interest payable                            | 15,676             | 15,676        | 9,305      | 6,371     | -         |
| Deposit interest payable                              | 837                | 837           | -          | 837       | -         |
| <b>December 31, 2012</b>                              |                    |               |            |           |           |
|   | Carrying<br>Amount | Fair<br>Value | Level 1    | Level 2   | Level 3   |
| <b>Financial assets:</b>                              |                    |               |            |           |           |
| Cash, due from banks and federal funds sold           | \$ 44,221          | \$ 44,221     | \$ 44,221  | \$ -      | \$ -      |
| Interest bearing deposits with financial institutions | 84,286             | 84,286        | 84,286     | -         | -         |
| Securities available-for-sale                         | 579,886            | 579,886       | 1,507      | 568,290   | 10,089    |
| FHLBC and FRB Stock                                   | 11,202             | 11,202        | -          | 11,202    | -         |
| Bank-owned life insurance                             | 54,203             | 54,203        | -          | 54,203    | -         |
| Loans held-for-sale                                   | 9,571              | 9,571         | -          | 9,571     | -         |
| Loans, net  | 1,111,453          | 1,118,711     | -          | -         | 1,118,711 |
| Accrued interest receivable                           | 5,252              | 5,252         | -          | 5,252     | -         |
| <b>Financial liabilities:</b>                         |                    |               |            |           |           |
| Noninterest bearing deposits                          | \$ 379,451         | \$ 379,451    | \$ 379,451 | \$ -      | \$ -      |
| Interest bearing deposits                             | 1,337,768          | 1,347,603     | -          | 1,347,603 | -         |
| Securities sold under repurchase agreements           | 17,875             | 17,875        | -          | 17,875    | -         |
| Other short-term borrowings                           | 100,000            | 100,000       | -          | 100,000   | -         |
| Junior subordinated debentures                        | 58,378             | 38,308        | 22,725     | 15,583    | -         |
| Subordinated debenture                                | 45,000             | 28,206        | -          | 28,206    | -         |

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|                                   |        |        |       |       |   |
|-----------------------------------|--------|--------|-------|-------|---|
| Note payable and other borrowings | 500    | 302    | -     | 302   | - |
| Borrowing interest payable        | 11,740 | 11,740 | 6,946 | 4,794 | - |
| Deposit interest payable          | 1,006  | 1,006  | -     | 1,006 | - |



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**Note 15 Preferred Stock**

The Series B Preferred Stock was issued as part of the Treasury's Troubled Asset Relief Program and Capital Purchase Program (the CPP), 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.

The Company allocated the \$73 million in proceeds received from the Treasury in the first quarter of 2009 between the Series B Preferred Stock and the 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, on August 31, 2010, the Company announced that it would begin deferring quarterly cash dividends on its outstanding Series B Preferred Stock. Further, as discussed in Note 8 and Note 11, the Company has elected to defer interest payments on certain of its subordinated debentures. In quarters prior to first quarter 2013, during the period in which preferred stock dividends were deferred such dividends continued to be declared and accrued. However, if the Company fails to pay dividends for an aggregate of six quarters on the Series B Preferred Stock, whether or not consecutive, the holders have the right to appoint representatives to the Company's board of directors. As the Company elected to defer dividends for more than six quarters, a new director was appointed by the Treasury to join the board during the fourth quarter of 2012. The terms of the Series B 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 unpaid and deferred Series B Preferred Stock dividends as of September 30, 2013, was \$12.3 million.

All of the Series B Preferred Stock held by Treasury was sold to third parties, including certain of our directors, in auctions that were completed in the first quarter of 2013. The warrants were also sold at a subsequent auction. At December 31, 2012, the Company carried \$71.9 million of Series B Preferred Stock in total stockholders equity. At September 30, 2013, the Company carried \$72.7 million of Series B Preferred Stock in total stockholders equity.

As a result of the completed auctions, the Company's Board elected to stop accruing the dividend on the Series B Preferred Stock in first quarter 2013. Previously, the Company had accrued the dividend on the Series B Preferred Stock quarterly throughout the deferral period. Given the discount reflected in the results of the auction, the board believes that the Company will likely be able to repurchase the Series B Preferred Stock in the future at a price less than the face amount of the Series B Preferred Stock plus accrued and unpaid dividends. Therefore, under GAAP, the Company did not fully accrue the dividend on the Series B Preferred Stock in the first quarter and did not accrue for it in subsequent quarters. The Company will continue to evaluate whether accruing dividends on the Series B Preferred Stock is appropriate in future periods. Pursuant to the terms of the Series B Preferred Stock, the dividends paid on the Series B Preferred Stock will increase from 5% to 9% in 2014.

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Income tax expense (benefit) for year to date September 30, 2013 and September 30, 2012 was as follows:

|                               | 9/30/2013   | 9/30/2012 |
|-------------------------------|-------------|-----------|
| Current federal               | \$ 129      | \$ -      |
| Current state                 | 35          | -         |
| Deferred federal              | 2,935       | (643)     |
| Deferred state                | 1,049       | (552)     |
| Change in valuation allowance | (74,145)    | 1,195     |
|                               | \$ (69,997) | \$ -      |

The following were the components of the deferred tax assets and liabilities as of September 30, 2013 and December 31, 2012:

|  | 9/30/2013 | 12/31/2012 |
|--|-----------|------------|
| Allowance for loan losses                          | \$ 13,700 | \$ 18,236  |
| Deferred compensation                              | 719       | 679        |
| Amortization of core deposit intangible assets     | 1,484     | 965        |
| Goodwill amortization/impairment                   | 15,645    | 16,796     |
| Stock option expense                               | 608       | 785        |
| OREO write downs                                   | 11,072    | 16,632     |
| Federal net operating loss ( NOL ) carryforward    | 26,370    | 20,736     |
| State net operating loss ( NOL ) carryforward      | 11,434    | 10,186     |
| Deferred tax credit                                | 1,444     | 1,444      |
| Other assets                                       | 598       | 585        |
| Total deferred tax assets                          | 83,074    | 87,044     |
| Accumulated depreciation on premises and equipment | (946)     | (1,063)    |
| Accretion on securities                            | (13)      | (122)      |
| Mortgage servicing rights                          | (2,415)   | (1,819)    |
| State tax benefits                                 | (6,982)   | (7,315)    |
| Other liabilities                                  | (194)     | (217)      |
| Total deferred tax liabilities                     | (10,550)  | (10,536)   |
| Net deferred tax asset before valuation allowance  | 72,524    | 76,508     |
| Tax effect on net unrealized losses on securities  | 8,704     | 928        |
| Valuation allowance                                | (2,363)   | (76,508)   |
| Net deferred tax asset                             | \$ 78,865 | \$ 928     |

At September 30, 2013, the Company had \$75.3 million federal net operating loss carryforward of which, \$25.3 million expires in 2030, \$31.4 million expires in 2031, \$8.6 million expires in 2032, and \$10.0 million expires in 2033. The Company had \$120.3 million state net operating loss carryforward of which, \$90.9 million expires in 2025, and \$29.4 million expires in 2021. In addition, the Company had \$1.4 million alternative minimum tax credit that can be carried forward indefinitely.



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

|  | 9/30/2013   | 9/30/2012 |
|--|-------------|-----------|
| Provision for loan losses                      | \$ 4,536    | \$ 5,731  |
| Deferred Compensation                          | (40)        | 24        |
| Amortization of core deposit intangible assets | (519)       | (204)     |
| Stock option expense                           | 177         | 358       |
| OREO write downs                               | 5,560       | (4,358)   |
| Federal net operating loss carryforward        | (5,634)     | (2,384)   |
| State net operating loss carryforward          | (1,248)     | (852)     |
| Depreciation                                   | (117)       | (210)     |
| Net premiums and discounts on securities       | (109)       | 85        |
| Mortgage servicing rights                      | 596         | 55        |
| Goodwill amortization/impairment               | 1,151       | 1,134     |
| State tax benefits                             | (333)       | 154       |
| Change in valuation allowance                  | (74,145)    | 1,195     |
| Other, net                                     | (36)        | (728)     |
| Total deferred tax benefit                     | \$ (70,161) | \$ -      |

At December 31, 2012, the Company had a \$76.5 million valuation allowance on deferred tax assets. The valuation allowance was established in 2010 due to significant negative evidence that indicated it was not more likely than not that the Company would utilize the deferred tax asset. During the quarter ended September 30, 2013, the Company evaluated all positive and negative evidence. The positive evidence considered included the following: (1) the current quarter results reflect the Company's sixth consecutive quarter of pre-tax earnings (2) reduced nonperforming assets for the eleventh consecutive quarter, (3) the removal of the Consent Order by the OCC effective October 17, 2013. Negative evidence considered included the decrease in the Company's net interest margin and reduced noninterest income, primarily from decreased mortgage banking income. Additionally as a tax planning strategy, the Company could elect to sell its bank-owned life insurance policies, generating approximately \$11.4 million of taxable income. While the Company does not anticipate completing this sale, this strategy would be considered if necessary to avoid expiration of deferred tax assets. After consideration of all evidence, management concluded it was more likely than not that the Company would utilize a significant portion of its deferred tax asset and, therefore, removed a large portion of the valuation allowance. The remaining valuation allowance remains for assets that are possible to be utilized, but not more likely than not. The Company will continue to evaluate whether that valuation allowance needs to be adjusted in future periods based on all available evidence.

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

|  | 9/30/2013   | 9/30/2012 |
|--|-------------|-----------|
| Tax at statutory federal income tax rate                         | \$ 4,156    | \$ (558)  |
| Nontaxable interest income, net of disallowed interest deduction | (183)       | (143)     |
| BOLI income  | (553)       | (436)     |
| State income taxes, net of federal benefit                       | 780         | (128)     |
| Change in valuation allowance                                    | (74,145)    | 1,195     |
| Deficiency from restricted stock                                 | 10          | 299       |
| Other, net   | (62)        | (229)     |
| Tax at effective tax rate  | \$ (69,997) | \$ -      |



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

**Overview**

The Company is a financial services company with its main headquarters located in Aurora, Illinois. The Company is the holding company of the Bank, a national banking organization headquartered in Aurora, Illinois and the Bank 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 reviews our financial condition as of September 30, 2013, compared to December 31, 2012, and the results of operations for the three-month and nine-month periods ended September 30, 2013 and 2012. 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 2012 Form 10-K.

The economies in our chosen markets continued to gather strength slowly in the third quarter of 2013 as did the national financial infrastructure. Troubled real estate markets in the Company's market areas continue to detract from borrowers' ability to repay their loans. This has resulted in still elevated, but improving level of nonperforming loans. The Company has seen signs of stabilization in all real estate markets. Management remains vigilant in analyzing loan portfolio quality and making decisions to charge-off loans. To that end, the Company recorded a \$6.1 million loan loss reserve release and net income of \$81.9 million prior to preferred stock dividends (and including the reversal of a significant portion of the valuation allowance against the deferred tax assets) in the first nine months of 2013. This compared to a \$6.3 million provision for loan losses and a net loss of \$1.6 million prior to preferred stock dividends for the same period in 2012.

The Company recorded a \$1.8 million loan loss reserve release after \$3.7 million in net charge-offs in the third quarter of 2013. Net income of \$72.9 million (prior to preferred stock dividends and including the reversal of a significant amount of the valuation allowance against the deferred tax assets) was recorded in the third quarter of 2013 up from \$3.5 million for the second quarter of 2013. Third quarter 2012 results did not include a provision for loan losses but reflected \$120,000 net income prior to preferred stock dividends.

**Results of Operations**

The net income for the third quarter of 2013 was \$72.9 million, or \$5.08 earnings per diluted share after preferred stock dividend and accretion discount, as compared with \$120,000 net income, or \$0.08 loss per diluted share after preferred stock dividend and accretion discount, in the third quarter of 2012. The net income for the first nine months of 2013 was \$81.9 million or \$5.52 earnings per diluted share after preferred stock dividend and accretion, as compared to \$1.6 million in net loss, or \$0.37 loss per diluted share after preferred stock dividend and accretion in the first nine months of 2012. The Company recorded a \$6.1 million release from the loan loss reserve in the first nine months of 2013, which included a release of \$1.8 million in the third quarter. Net loan charge-offs totaled \$3.0 million the first nine months of 2013, which included \$3.7 million of net charge-offs in the third quarter. The net income available to common stockholders was \$71.6 million for the third quarter of 2013 and \$78.0 million for the first nine months of 2013, as compared to a net loss to common shareholders of \$1.1 million and a net loss to common shareholders of \$5.3 million for the third quarter and first nine months of 2012, respectively. Net income for the third quarter of 2013 and the first nine months of 2013 included a \$70.0 million tax benefit which includes the reversal of a valuation allowance of \$74.1 million.

***Net Interest Income***

Net interest and dividend income decreased \$3.9 million, from \$45.4 million in the first nine months of 2012, to \$41.6 million in the first nine months of 2013. Average earning assets increased \$36.1 million, or 2.1%, to \$1.77 billion from the first nine months of 2012 to the first nine months of 2013. Management

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continued to emphasize asset quality with higher portfolio securities (nine month average up 56.8%) while new loan originations continued to be limited. The \$176.6 million decrease in year to date average loans and loans held-for-sale was primarily due to the lack of expansion by local businesses leading to lower utilization of available credit lines. Simultaneously, difficult competitive pricing, paydowns and maturities contributed to the year over year decrease. Finally, the Bank declined to compromise on loan structures to secure new business. To utilize available liquid funds, management continued to increase total securities during the first nine months of 2013 to 31.1% of total assets up from 28.3% at the end of 2012. At the same time, the Company's historically stable deposit base was impacted by the loss of some retail deposits as customers took advantage of other investment opportunities. As a result, average interest bearing deposits decreased \$27.7 million year over year for the nine month periods ended September 30, 2013 and 2012. At this time, management sees no need to grow deposits to fund loan or investment opportunities and management expects that securities sales and maturities will provide cost effective liquidity as those opportunities arise.

The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, decreased from 3.52% in the first nine months of 2012 to 3.17% in the first nine months of 2013. The average tax-equivalent yield on earning assets decreased from 4.39% in the first nine months of 2012 (yield would have been 4.27% except for collection of previously reversed or unrecognized interest on loans that returned to performing status) to 3.92% (yield would have been 3.84% except for adjustments noted above) in the first nine months of 2013. At the same time, however, the cost of funds on interest bearing liabilities decreased from 1.09% to 0.95% helping to offset the decrease in earning asset yield. The growth of lower yielding securities (compared to reductions in higher yielding loans) was the main cause of decreased net interest income. Reductions in higher yielding loans were caused by the factors discussed in the paragraph above. Additionally, management continued to see pressure to reduce interest rates on loans retained at renewal and found it necessary to accept rate concessions to keep the business.

Net interest income decreased \$346,000 from \$14.6 million in the third quarter of 2012 to \$14.3 million in the third quarter of 2013. Higher yielding average loans were down \$141.2 million year over year in the three month period ended September 30 while lower yielding average securities were up \$205.1 million in the same period. Quarterly average interest bearing deposits were down \$19.0 million year over year (down to \$1.31 billion from \$1.33 billion) while securities sold under repurchase agreements increased \$14.5 million and other borrowings comprised of FHLBC advances increased \$15.1 million. The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets decreased from 3.44% in the third quarter of 2012 to 3.25% in the third quarter of 2013. The average tax-equivalent yield on earning assets decreased from 4.24% in the third quarter of 2012 to 3.99% in the third quarter of 2013. The cost of interest-bearing liabilities also decreased from 1.02% to 0.94% in the same period. Consistent with the year to date margin trend, the changed overall average earning assets resulting from reduced levels of higher yielding loans 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 found in interest expense decreases.

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, 2013 and 2012.

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





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( TE ) basis using a marginal rate of 35% to more appropriately compare returns on tax-exempt loans and securities to other earning assets.

ANALYSIS OF AVERAGE BALANCES,

TAX EQUIVALENT INTEREST AND RATES

Three Months ended September 30, 2013, and 2012

(Dollar amounts in thousands - unaudited)

|  | 2013               |           |       | 2012               |           |       |
|--|--------------------|-----------|-------|--------------------|-----------|-------|
|  | Average<br>Balance | Interest  | Rate  | Average<br>Balance | Interest  | Rate  |
| <b>Assets</b>  |                    |           |       |                    |           |       |
| Interest bearing deposits                                    | \$ 36,456          | \$ 22     | 0.24% | \$ 46,138          | \$ 29     | 0.25% |
| Securities:  |                    |           |       |                    |           |       |
| Taxable  | 605,546            | 3,113     | 2.06  | 404,855            | 1,868     | 1.85  |
| Non-taxable (tax equivalent)                                 | 13,937             | 228       | 6.54  | 9,518              | 151       | 6.35  |
| Total securities   | 619,483            | 3,341     | 2.16  | 414,373            | 2,019     | 1.95  |
| FRB and FHLB stock and dividends                             | 10,292             | 76        | 2.95  | 11,984             | 77        | 2.57  |
| Loans and loans held-for-sale 1                              | 1,088,936          | 14,382    | 5.17  | 1,230,180          | 16,279    | 5.18  |
| Total interest earning assets                                | 1,755,167          | 17,821    | 3.99  | 1,702,675          | 18,404    | 4.24  |
| Cash and due from banks                                      | 19,584             | -         | -     | 31,850             | -         | -     |
| Allowance for loan losses                                    | (34,197)           | -         | -     | (40,823)           | -         | -     |
| Other noninterest bearing assets                             | 190,836            | -         | -     | 228,859            | -         | -     |
| Total assets   | \$ 1,931,390       |           |       | \$ 1,922,561       |           |       |
| <b>Liabilities and Stockholders Equity</b>                   |                    |           |       |                    |           |       |
| NOW accounts   | \$ 283,192         | \$ 63     | 0.09% | \$ 270,908         | \$ 65     | 0.10% |
| Money market accounts  | 311,213            | 104       | 0.13  | 321,762            | 137       | 0.17  |
| Savings accounts   | 225,825            | 39        | 0.07  | 213,927            | 51        | 0.09  |
| Time deposits  | 493,722            | 1,674     | 1.35  | 526,314            | 1,973     | 1.49  |
| Interest bearing deposits                                    | 1,313,952          | 1,880     | 0.57  | 1,332,911          | 2,226     | 0.66  |
| Securities sold under repurchase agreements                  | 21,646             | 1         | 0.02  | 7,164              | 1         | 0.06  |
| Other short-term borrowings                                  | 15,707             | 5         | 0.12  | 652                | -         | -     |
| Junior subordinated debentures                               | 58,378             | 1,336     | 9.15  | 58,378             | 1,243     | 8.52  |
| Subordinated debt  | 45,000             | 209       | 1.82  | 45,000             | 223       | 1.94  |
| Notes payable and other borrowings                           | 500                | 4         | 3.13  | 500                | 5         | 3.91  |
| Total interest bearing liabilities                           | 1,455,183          | 3,435     | 0.94  | 1,444,605          | 3,698     | 1.02  |
| Noninterest bearing deposits                                 | 366,889            | -         | -     | 380,226            | -         | -     |
| Other liabilities  | 37,466             | -         | -     | 28,130             | -         | -     |
| Stockholders equity  | 71,852             | -         | -     | 69,600             | -         | -     |
| Total liabilities and stockholders equity                    | \$ 1,931,390       |           |       | \$ 1,922,561       |           |       |
| Net interest income (tax equivalent)                         |                    | \$ 14,386 |       |                    | \$ 14,706 |       |
| Net interest income (tax equivalent) to total earning assets |                    |           | 3.25% |                    |           | 3.44% |
| Interest bearing liabilities to earning assets               | 82.91%             |           |       | 84.84%             |           |       |

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1 Interest income from loans is shown on a tax equivalent basis as discussed in the table on page 45 and includes fees of \$793,000 and \$498,000 for the third quarter of 2013 and 2012, 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 30, 2013, and 2012

(Dollar amounts in thousands - unaudited)

|  | 2013            |           |       | 2012            |           |       |
|--|-----------------|-----------|-------|-----------------|-----------|-------|
|  | Average Balance | Interest  | Rate  | Average Balance | Interest  | Rate  |
| <b>Assets</b>  |                 |           |       |                 |           |       |
| Interest bearing deposits                                    | \$ 49,676       | \$ 91     | 0.24% | \$ 48,871       | \$ 89     | 0.24% |
| Securities:  |                 |           |       |                 |           |       |
| Taxable  | 574,761         | 8,109     | 1.88  | 365,549         | 5,222     | 1.90  |
| Non-taxable (tax equivalent)                                 | 14,912          | 679       | 6.07  | 10,417          | 467       | 5.98  |
| Total securities   | 589,673         | 8,788     | 1.99  | 375,966         | 5,689     | 2.02  |
| FRB and FHLB stock and dividends                             | 10,742          | 228       | 2.83  | 12,562          | 228       | 2.42  |
| Loans and loans held-for-sale 1                              | 1,116,964       | 43,327    | 5.12  | 1,293,533       | 51,741    | 5.26  |
| Total interest earning assets                                | 1,767,055       | 52,434    | 3.92  | 1,730,932       | 57,747    | 4.39  |
| Cash and due from banks                                      | 24,110          | -         | -     | 27,528          | -         | -     |
| Allowance for loan losses                                    | (37,122)        | -         | -     | (46,824)        | -         | -     |
| Other noninterest bearing assets                             | 196,298         | -         | -     | 236,281         | -         | -     |
| Total assets   | \$ 1,950,341    |           |       | \$ 1,947,917    |           |       |
| <b>Liabilities and Stockholders Equity</b>                   |                 |           |       |                 |           |       |
| NOW accounts   | \$ 290,691      | \$ 192    | 0.09% | \$ 275,712      | \$ 204    | 0.10% |
| Money market accounts  | 319,876         | 342       | 0.14  | 311,046         | 438       | 0.19  |
| Savings accounts   | 226,193         | 121       | 0.07  | 211,331         | 165       | 0.10  |
| Time deposits  | 498,846         | 5,327     | 1.43  | 565,183         | 6,920     | 1.64  |
| Interest bearing deposits                                    | 1,335,606       | 5,982     | 0.60  | 1,363,272       | 7,727     | 0.76  |
| Securities sold under repurchase agreements                  | 22,206          | 2         | 0.01  | 4,502           | 2         | 0.06  |
| Other short-term borrowings                                  | 20,000          | 24        | 0.16  | 4,635           | 4         | 0.11  |
| Junior subordinated debentures                               | 58,378          | 3,937     | 8.99  | 58,378          | 3,660     | 8.36  |
| Subordinated debt  | 45,000          | 610       | 1.79  | 45,000          | 684       | 2.00  |
| Notes payable and other borrowings                           | 500             | 12        | 3.16  | 500             | 13        | 3.42  |
| Total interest bearing liabilities                           | 1,481,690       | 10,567    | 0.95  | 1,476,287       | 12,090    | 1.09  |
| Noninterest bearing deposits                                 | 359,438         | -         | -     | 373,975         | -         | -     |
| Other liabilities  | 35,432          | -         | -     | 25,629          | -         | -     |
| Stockholders equity  | 73,781          | -         | -     | 72,026          | -         | -     |
| Total liabilities and stockholders equity                    | \$ 1,950,341    |           |       | \$ 1,947,917    |           |       |
| Net interest income (tax equivalent)                         |                 | \$ 41,867 |       |                 | \$ 45,657 |       |
| Net interest income (tax equivalent) to total earning assets |                 |           | 3.17% |                 |           | 3.52% |
| Interest bearing liabilities to earning assets               | 83.85%          |           |       | 85.29%          |           |       |

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1 Interest income from loans is shown on a tax equivalent basis as discussed in the table on page 45 and includes fees of \$2.0 million and \$1.4 million for the first nine months of 2013 and 2012, respectively. Nonaccrual loans are included in the above stated average balances.

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

|  | Effect of Tax Equivalent Adjustment<br>Three Months Ended<br>September 30, |              | Effect of Tax Equivalent Adjustment<br>Nine Months Ended<br>September 30, |              |
|--|--|--------------|---|--------------|
|  | 2013   | 2012         | 2013  | 2012         |
|  | Interest income (GAAP)   | \$ 17,724    | \$ 18,333   | \$ 52,146    |
| Taxable equivalent adjustment -<br>loans                       | 17   | 18           | 50  | 64           |
| Taxable equivalent adjustment -<br>securities                  | 80   | 53           | 238   | 164          |
| Interest income (TE)   | 17,821   | 18,404       | 52,434  | 57,747       |
| Less: interest expense (GAAP)                                  | 3,435  | 3,698        | 10,567  | 12,090       |
| Net interest income (TE)                                       | \$ 14,386  | \$ 14,706    | \$ 41,867   | \$ 45,657    |
| Net interest and income (GAAP)                                 | \$ 14,289  | \$ 14,635    | \$ 41,579   | \$ 45,429    |
| Average interest earning assets                                | \$ 1,755,167   | \$ 1,702,675 | \$ 1,767,055  | \$ 1,730,932 |
| Net interest income to total interest<br>earning assets (GAAP) | 3.23%  | 3.42%        | 3.15%   | 3.51%        |
| Net interest income to total interest<br>earning assets (TE)   | 3.25%  | 3.44%        | 3.17%   | 3.52%        |

**Provision for Loan Losses**

In the first nine months of 2013, the Company recorded a \$6.1 million release of reserve for loan losses, which included a release of \$1.8 million in the third quarter. The Company experienced continuing improvement in asset quality, notably from reductions in nonperforming loans and continued moderate charge-off experience. In the first nine months of 2012, the provision for loan losses was \$6.3 million, which did not include a provision in the third quarter. Provisions for loan losses are made to provide for probable and estimable losses inherent in the loan portfolio. Nonperforming loans decreased to \$47.8 million at September 30, 2013 from \$82.6 million at December 31, 2012, and \$105.8 million at September 30, 2012. Charge-offs, net of recoveries, totaled \$3.0 million and \$18.0 million in the first nine months of 2013 and 2012, respectively. Net charge-offs totaled \$3.7 million in the third quarter of 2013 and \$29,000 in the third quarter of 2012. These data along with the distribution of the Company's nonperforming loans and charge-offs net of recoveries for the periods are included in the following tables.

| (in thousands)                     | Nonperforming Loans as of |                  |                       | September 30, 2013<br>Dollar change From |                       |
|------------------------------------|---------------------------|------------------|-----------------------|--|-----------------------|
|                                    | September 30,<br>2013     | June 30,<br>2013 | September 30,<br>2012 | June 30,<br>2013                         | September 30,<br>2012 |
| Real estate-construction           | \$ 5,928                  | \$ 6,303         | \$ 16,035             | \$ (375)                                 | \$ (10,107)           |
| Real estate-residential:           |                           |                  |                       |  |                       |
| Investor                           | 8,307                     | 13,662           | 13,007                | (5,355)                                  | (4,700)               |
| Owner occupied                     | 6,212                     | 7,927            | 14,875                | (1,715)                                  | (8,663)               |
| Revolving and junior liens         | 2,543                     | 3,431            | 3,306                 | (888)                                    | (763)                 |
| Real estate-commercial,<br>nonfarm | 24,754                    | 31,190           | 55,642                | (6,436)                                  | (30,888)              |
| Real estate-commercial, farm       | -                         | 53               | 1,790                 | (53)                                     | (1,790)               |
| Commercial                         | 29                        | 104              | 1,157                 | (75)                                     | (1,128)               |

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\$ 47,773      \$ 62,670      \$ 105,812      \$ (14,897)      \$ (58,039)

Nonperforming loans consist of nonaccrual loans, nonperforming restructured accruing loans and loans 90 days or greater past due still accruing. The largest decrease in the nonperforming loans since September 30, 2012, was in the real estate commercial, nonfarm segment as this segment's upgrades and migration to OREO were greater than the migration of loans to nonperforming status.

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| Loan Charge-offs, net of (recoveries)<br>(in thousands) | Three Months Ended<br>September 30, |          | Year to Date<br>September 30, |           |
|---|-------------------------------------|----------|-------------------------------|-----------|
|   | 2013                                | 2012     | 2013                          | 2012      |
| Real estate-construction                                |                                     |          |                               |           |
| Homebuilder   | \$ (5)                              | \$ (151) | \$ (307)                      | \$ 768    |
| Land  | 44                                  | (57)     | 42                            | (723)     |
| Commercial speculative                                  | -                                   | (1,130)  | (49)                          | 668       |
| All other   | (1)                                 | 45       | -                             | 165       |
| Total real estate-construction                          | 38                                  | (1,293)  | (314)                         | 878       |
| Real estate-residential                                 |                                     |          |                               |           |
| Investor  | 2,218                               | 187      | 2,133                         | 3,234     |
| Owner occupied  | 350                                 | 343      | 401                           | 1,440     |
| Revolving and junior liens                              | 817                                 | 481      | 1,867                         | 1,290     |
| Total real estate-residential                           | 3,385                               | 1,011    | 4,401                         | 5,964     |
| Real estate-commercial, nonfarm                         |                                     |          |                               |           |
| Owner general purpose                                   | (5)                                 | (39)     | (43)                          | 1,100     |
| Owner special purpose                                   | (5)                                 | 62       | (148)                         | 1,288     |
| Non-owner general purpose                               | -                                   | 119      | (156)                         | 4,492     |
| Non-owner special purpose                               | 73                                  | -        | (751)                         | 78        |
| Retail properties                                       | 265                                 | 137      | (277)                         | 4,038     |
| Total real estate-commercial, nonfarm                   | 328                                 | 279      | (1,375)                       | 10,996    |
| Real estate-commercial, farm                            | -                                   | -        | -                             | -         |
| Commercial  | (31)                                | (20)     | 204                           | 78        |
| Other   | 25                                  | 52       | 84                            | 108       |
|   | \$ 3,745                            | \$ 29    | \$ 3,000                      | \$ 18,024 |

Charge-offs for the third quarter 2013 were primarily from previously established specific reserves on nonaccrual loans deemed uncollectible. Charge-off activity continued to improve for the year to date period in 2013 compared to the same year to date period in 2012, reflecting an improved economy in our target markets and our efforts to improve loan quality.

| (in thousands)                  | Classified loans as of |                  |                       | September 30, 2013<br>Dollar Change From |                       |
|---------------------------------|------------------------|------------------|-----------------------|--|-----------------------|
|                                 | September 30,<br>2013  | June 30,<br>2013 | September 30,<br>2012 | June 30,<br>2013                         | September 30,<br>2012 |
| Real estate-construction        | \$ 6,236               | \$ 7,005         | \$ 22,387             | \$ (769)                                 | \$ (16,151)           |
| Real estate-residential:        |                        |                  |                       |  |                       |
| Investor                        | 10,642                 | 13,968           | 16,406                | (3,326)                                  | (5,764)               |
| Owner occupied                  | 7,292                  | 11,008           | 17,684                | (3,716)                                  | (10,392)              |
| Revolving and junior liens      | 3,675                  | 5,086            | 5,053                 | (1,411)                                  | (1,378)               |
| Real estate-commercial, nonfarm | 40,832                 | 43,827           | 73,720                | (2,995)                                  | (32,888)              |
| Real estate-commercial, farm    | -                      | 53               | 1,790                 | (53)                                     | (1,790)               |
| Commercial                      | 264                    | 705              | 1,748                 | (441)                                    | (1,484)               |
| Other                           | 1                      | 1                | 5                     | -  | (4)                   |
|                                 | \$ 68,942              | \$ 81,653        | \$ 138,793            | \$ (12,711)                              | \$ (69,851)           |

Classified loans include nonaccrual, performing troubled debt restructurings and all other loans considered substandard. All three components are down since September 30, 2012. Classified assets include both classified loans and OREO. Management monitors a ratio of classified assets to the sum of Bank Tier 1





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capital and the allowance for loan and lease loss reserve. This ratio reflects another measure of overall improvement in loan related asset quality. The decline in both classified loans and OREO as well as improved Tier 1 capital in the third quarter improved this ratio for the eleventh straight quarter.

**Allowance for Loan and Lease Losses**

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

|  | 9/30/2013    | <b>Three Months Ending</b> | 9/30/2012    |
|--|--------------|----------------------------|--------------|
|  |              | <b>6/30/2013</b>           |              |
| Allowance at beginning of quarter                      | \$ 35,042    | \$ 38,634                  | \$ 40,286    |
| Charge-offs:   |              |                            |              |
| Commercial   | 29           | 25                         | 2            |
| Real estate - commercial                               | 851          | 1,018                      | 355          |
| Real estate - construction                             | 53           | 894                        | 909          |
| Real estate - residential                              | 3,594        | 1,014                      | 1,230        |
| Consumer and other loans                               | 168          | 134                        | 186          |
| Total charge-offs                                      | 4,695        | 3,085                      | 2,682        |
| Recoveries:  |              |                            |              |
| Commercial   | 60           | 25                         | 22           |
| Real estate - commercial                               | 523          | 505                        | 76           |
| Real estate - construction                             | 15           | 480                        | 2,202        |
| Real estate - residential                              | 209          | 179                        | 219          |
| Consumer and other loans                               | 143          | 104                        | 134          |
| Total recoveries                                       | 950          | 1,293                      | 2,653        |
| Net charge-offs  | 3,745        | 1,792                      | 29           |
| (Release) provision for loan losses                    | (1,750)      | (1,800)                    | -            |
| Allowance at end of quarter                            | \$ 29,547    | \$ 35,042                  | \$ 40,257    |
| Average total loans (exclusive of loans held-for-sale) | \$ 1,085,487 | \$ 1,113,315               | \$ 1,222,829 |
| Net charge-offs to average loans                       | 0.35%        | 0.16%                      | 0.00%        |
| Allowance at quarter end to average loans              | 2.72%        | 3.15%                      | 3.29%        |
| Ending balance: Individually evaluated for impairment  | \$ 2,150     | \$ 5,036                   | \$ 7,585     |
| Ending balance: Collectively evaluated for impairment  | \$ 27,397    | \$ 30,006                  | \$ 32,672    |

The coverage ratio of the allowance for loan losses to nonperforming loans was 61.9% as of September 30, 2013, which reflects an increase from 55.9% as of June 30, 2013. A decrease of \$14.9 million in nonperforming loans in the three months drove the overall coverage ratio change. Management updated the estimated specific allocations in the third quarter after receiving more recent appraisals for detailed collateral valuations or information on cash flow trends related to the impaired credits. Management determined the estimated amount to provide in the

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allowance for loan losses based upon a number of considerations, including loan growth or contraction, the quality and composition of the loan portfolio and loan loss experience. Loan loss experience was also weighted more heavily based upon recent loss experience. The construction and development ( C & D ) portfolio, which has accounted for significant losses in previous periods, has had diminished adverse migration and the remaining credits are exhibiting more stable credit characteristics. Management believes that adequate reserves have been established for the inherent risk of loss in the C & D portfolio.

Management regularly reviews the performance of the higher risk pool within commercial real estate loans and adjusts the population and the related loss factors taking into account adverse market trends, including collateral valuation, as well as assessments of the credits in that pool. Those assessments capture management's estimate of the potential for adverse migration to an impaired status as well as its estimation of what the potential valuation impact from that migration would be if it were to occur. The amount of assets subject to this pool factor decreased by 36.5% at September 30, 2013, as compared to December 31, 2012. Management has also observed that many stresses in those credits were generally attributable to cyclical economic events that were showing some signs of stabilization. Those signs included a reduction in

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loan migration to watch status, as well as a decrease in 30 to 89 day past due loans and some stabilization in values of certain properties.

The above changes in estimates were made by management to be consistent with observable trends within loan portfolio segments and in conjunction with market conditions and credit review administration activities. Several environmental factors are also evaluated on an ongoing basis and are included in the assessment of the adequacy of the allowance for loan losses. Management determined that an overall improvement in loan asset quality justified a \$1.8 million loan loss reserve release in the third quarter. When measured as a percentage of loans outstanding, the total allowance for loan losses decreased from 3.33% of total loans as of September 30, 2012, to 2.74% of total loans at September 30, 2013. In management's judgment, an adequate allowance for estimated losses has been established for inherent losses at September 30, 2013; however, there can be no assurance that actual losses will not exceed the estimated amounts in the future.

**Other Real Estate Owned**

OREO decreased \$10.4 million, from \$59.5 million at June 30, 2013, to \$49.1 million at September 30, 2013. Disposition activity and valuation writedowns in the third quarter more than offset numerous but smaller dollar additions to OREO, leading to this overall decrease. In the third quarter of 2013, management successfully managed OREO transactions as shown below. As a result, OREO holdings in all categories (vacant land suitable for farming, single family residences, lots suitable for development, multi-family and commercial property) were down in the quarter. Overall, a net gain on sale of \$608,000 was realized in the third quarter.

| (in thousands)               | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                              | 2013                                | 2012      | 2013                               | 2012      |
| Beginning balance            | \$ 59,465                           | \$ 89,671 | \$ 72,423                          | \$ 93,290 |
| Property additions           | 3,015                               | 7,594     | 14,196                             | 26,944    |
| Development improvements     | 10                                  | 131       | 60                                 | 646       |
| Less:                        |                                     |           |                                    |           |
| Property disposals           | 11,463                              | 4,829     | 30,928                             | 20,517    |
| Period valuation adjustments | 1,961                               | 4,474     | 6,685                              | 12,270    |
| Other real estate owned      | \$ 49,066                           | \$ 88,093 | \$ 49,066                          | \$ 88,093 |

The OREO valuation reserve decreased to \$24.6 million, which was 33.4% of gross OREO at September 30, 2013. The valuation reserve represented 24.9% and 30.3% of gross OREO at September 30, 2012 and December 31, 2012, respectively. In management's judgment, an adequate property valuation allowance has been established to present OREO at current estimates of fair value less costs to sell; however, there can be no assurance that additional losses will not be incurred on disposition or updates to valuation in the future.

Table of Contents**OREO Properties by Type**

| (in thousands)                      | September 30, 2013 |            | June 30, 2013 |            | September 30, 2012 |            |
|-------------------------------------|--------------------|------------|---------------|------------|--------------------|------------|
|                                     | Amount             | % of Total | Amount        | % of Total | Amount             | % of Total |
| Single family residence             | \$ 6,585           | 13%        | \$ 8,161      | 14%        | \$ 10,642          | 12%        |
| Lots (single family and commercial) | 18,993             | 39%        | 23,781        | 40%        | 29,638             | 34%        |
| Vacant land                         | 3,135              | 6%         | 3,266         | 5%         | 7,325              | 8%         |
| Multi-family                        | 2,194              | 5%         | 2,210         | 4%         | 9,447              | 11%        |
| Commercial property                 | 18,159             | 37%        | 22,047        | 37%        | 31,041             | 35%        |
| Total OREO properties               | \$ 49,066          | 100%       | \$ 59,465     | 100%       | \$ 88,093          | 100%       |

**Net OREO Aging**

| (in thousands)     | September 30, 2013 |            | June 30, 2013 |            | September 30, 2012 |            |
|--------------------|--------------------|------------|---------------|------------|--------------------|------------|
|                    | Amount             | % of Total | Amount        | % of Total | Amount             | % of Total |
| 0-90 Days          | \$ 3,012           | 6%         | \$ 4,025      | 7%         | \$ 7,249           | 8%         |
| 91-180 Days        | 3,033              | 6%         | 3,086         | 5%         | 2,654              | 3%         |
| 181 Days - 1 Year  | 4,968              | 10%        | 6,380         | 11%        | 18,036             | 21%        |
| 1 Year to 2 Years  | 10,569             | 22%        | 20,356        | 34%        | 44,836             | 51%        |
| 2 Years to 3 Years | 20,738             | 42%        | 17,404        | 29%        | 10,507             | 12%        |
| 3 Years to 4 Years | 5,189              | 11%        | 4,529         | 8%         | 4,663              | 5%         |
| 4 Years +          | 1,557              | 3%         | 3,685         | 6%         | 148                | 0%         |
| Total              | \$ 49,066          | 100%       | \$ 59,465     | 100%       | \$ 88,093          | 100%       |

As part of the Company's OREO management process, we age or track the time that OREO is held for sale. The table above shows that, in total, where 32% of our OREO at September 30, 2012, had been held for less than one year, that percentage dropped to 22% at September 30, 2013. When properties are tracked as being held for one to three years, the percentage of total OREO in those categories was 64% at September 30, 2013, essentially unchanged from 63% at September 30, 2012. While the dollar totals held for more than three years were smaller than other aging categories, a similar trend was found in properties held in OREO for more than three years (14% as of September 30, 2013, an increase from 5% at September 30, 2012) with approximately \$1.6 million held for over four years at September 30, 2013.

While newer additions to the Company's OREO have slowed, some items held in OREO have been slow to sell leading to the above aging trend. Properties held for longer periods can be a source of incremental cost as they age on the market.

Table of Contents**Noninterest Income**

| (in thousands)  | Three Months Ended    |                  |                       | September 30, 2013<br>Dollar Change From |                       |
|---|-----------------------|------------------|-----------------------|--|-----------------------|
|   | September 30,<br>2013 | June 30,<br>2013 | September 30,<br>2012 | June 30,<br>2013                         | September 30,<br>2012 |
| <b>Noninterest income</b>                                     |                       |                  |                       |  |                       |
| Trust income  | \$ 1,494              | \$ 1,681         | \$ 1,489              | \$ (187)                                 | \$ 5                  |
| Service charges on deposits                                   | 1,904                 | 1,799            | 1,982                 | 105                                      | (78)                  |
| Residential mortgage revenue                                  | 1,232                 | 2,821            | 2,699                 | (1,589)                                  | (1,467)               |
| Securities gains, net   | (7)                   | 745              | 513                   | (752)                                    | (520)                 |
| Increase in cash surrender value of bank-owned life insurance | 419                   | 372              | 425                   | 47                                       | (6)                   |
| Death benefit realized on bank-owned life insurance           | 6                     | 375              | -                     | (369)                                    | 6                     |
| Debit card interchange income                                 | 873                   | 900              | 788                   | (27)                                     | 85                    |
| Lease revenue from other real estate owned                    | 309                   | 257              | 840                   | 52                                       | (531)                 |
| Net gain on sales of other real estate owned                  | 608                   | 386              | 20                    | 222                                      | 588                   |
| Other income  | 1,549                 | 1,147            | 1,592                 | 402                                      | (43)                  |
| <b>Total noninterest income</b>                               | <b>\$ 8,387</b>       | <b>\$ 10,483</b> | <b>\$ 10,348</b>      | <b>\$ (2,096)</b>                        | <b>\$ (1,961)</b>     |

Noninterest income is down in the third quarter from the second quarter as a result of sharply lower residential mortgage revenue (dollar volume of loans sold to investors was down approximately one-third in the third quarter from the second quarter) and gains on securities sales. Other income increased in the third quarter from the second quarter on recognition in income of a forfeited purchase deposit from a loan sale where the purchaser did not complete the sale as contractually required. Similar results are found in the year over year comparison except that other income was essentially flat.

**Noninterest Expense**

| (in thousands)                  | Three Months Ended    |                  |                       | September 30, 2013<br>Dollar Change From |                       |
|---------------------------------|-----------------------|------------------|-----------------------|--|-----------------------|
|                                 | September 30,<br>2013 | June 30,<br>2013 | September 30,<br>2012 | June 30,<br>2013                         | September 30,<br>2012 |
| <b>Noninterest expense</b>      |                       |                  |                       |  |                       |
| Salaries and employee benefits  | \$ 9,299              | \$ 9,177         | \$ 8,963              | \$ 122                                   | \$ 336                |
| Occupancy expense, net          | 1,266                 | 1,242            | 1,242                 | 24                                       | 24                    |
| Furniture and equipment expense | 1,026                 | 1,104            | 1,078                 | (78)                                     | (52)                  |
| FDIC insurance                  | 987                   | 1,024            | 1,029                 | (37)                                     | (42)                  |

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|   |           |           |           |          |            |
|---|-----------|-----------|-----------|----------|------------|
| General bank insurance                        | 489       | 491       | 851       | (2)      | (362)      |
| Amortization of core deposit intangible asset | 524       | 525       | 420       | (1)      | 104        |
| Advertising expense                           | 347       | 328       | 400       | 19       | (53)       |
| Debit card interchange expense                | 366       | 362       | 388       | 4        | (22)       |
| Legal fees                                    | 615       | 486       | 760       | 129      | (145)      |
| OREO valuation expense                        | 1,961     | 2,589     | 4,474     | (628)    | (2,513)    |
| Other OREO expense                            | 1,500     | 1,356     | 2,071     | 144      | (571)      |
| Other expense                                 | 3,119     | 3,510     | 3,187     | (391)    | (68)       |
| <b>Total noninterest expense</b>              | \$ 21,499 | \$ 22,194 | \$ 24,863 | \$ (695) | \$ (3,364) |

Salaries and benefits were up from the second quarter 2013 and year over year on accrual of management bonus amounts under board of directors approved incentive plans. Legal fees increased quarter over quarter on complex loan workouts in the third quarter. However, legal fees were down year over year on continued management control of legal expense. OREO valuation expense decreased from the second quarter of 2013 and the third quarter 2012 as property valuation declines, while still sizable, were more moderate than in the past.

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***Income Taxes***

The Company recorded a deferred income tax expense of \$4.0 million and reversal of \$74.1 million deferred tax valuation allowance benefit for the first nine months of 2013, on \$11.9 million pre-tax income during that period. The valuation allowance against the Company's deferred tax assets was first established as of December 31, 2010. Under GAAP, income tax benefits and the related tax assets are only allowed to be recognized if they will more likely than not be fully realized. The Company's effective tax rates for the first nine months ending September 30, 2013, and 2012 were 33.0% and 0%, respectively.

The determination of being able to realize the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, available tax planning strategies, and assessments of the current and future economic and business conditions. Management considered both positive and negative evidence regarding the Company's ability to ultimately realize the deferred tax assets, which is largely dependent upon the ability to derive benefits based upon future taxable income. As of September 30, 2013, management determined that the realization of most of the deferred tax asset was more likely than not as required by accounting principles and reversed a significant portion of an established valuation allowance to reflect this judgment. The remaining valuation allowance remains for a portion of the state net operating loss carryforward the Company could possibly use, but does not meet the threshold of more likely than not at September 30, 2013. The Company considered the federal and state net operating loss carryforwards separately when determining if a valuation allowance was required. After considering tax-planning strategies, the Company reserved a portion of the state net operating loss carryforward management did not anticipate using by December 31, 2016 based on forecasts made at September 30, 2013. While the state net operating loss carryforward does not begin to expire until 2021, management acknowledges that forecasts are inherently subjective and only periods in the foreseeable future should be considered when determining if net deferred tax assets will be utilized. In each future accounting period, the Company's management will reevaluate whether the current conditions in conjunction with positive and negative evidence support a change in the valuation allowance against the Company's deferred tax assets. Any such subsequent reduction in the estimated valuation allowance would lower the amount of income tax expense recognized in the Company's consolidated statements of operations in future periods.

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

A deferred tax asset related to accumulated other comprehensive loss resulting from the net unrealized loss on available-for-sale securities increased to \$5.4 million and held-to-maturity securities were \$3.3 million at September 30, 2013, compared to total accumulated other comprehensive loss of \$928,000 on total securities holdings at December 31, 2012. An increase in rates will generally cause a decrease in the fair value of individual securities and results in changes in unrealized loss on available-for-sale securities. In addition to the impact of rate changes upon pricing, uncertainty in the financial markets can cause reduced liquidity for certain investments and those changes are discussed in detail in Note 2 to the consolidated financial statements. In the third quarter 2013, management also designated a large volume of securities previously classified as available-for-sale into the held-to-maturity classification.

**Financial Condition**



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Total assets decreased \$13.0 million, or 0.6%, from December 31, 2012, to close at \$2.03 billion as of September 30, 2013. Loans decreased by \$72.4 million, or 6.3% as management continued to emphasize capital management and credit quality along with relationship lending under an intensely competitive market environment and with a customer base that has generally been cautious about expanding business in a

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difficult economy. At the same time, loan charge-off activity reduced balances and collateral that previously secured loans moved to OREO. OREO, net of valuation reserve and reflecting new properties as well as dispositions and improvements to existing properties, decreased \$23.4 million from December 31, 2012, or 32.3% at September 30, 2013. Available-for-sale securities decreased by \$206.4 million for the nine months ended September 30, 2013. The decrease in available-for-sale securities holdings in the nine month period was offset by amounts now carried as held-to-maturity securities. Management is comfortable with the positions held in available-for-sale securities. The portfolio provides benefit to net interest income as loan demand develops. Between the portion of the portfolio that carries no current unrealized loss and the ability to borrow a substantial amount using securities as collateral, management is comfortable with the liquidity provided by available-for-sale securities. In addition, management is confident that deposits could be raised if needed.

The core deposit intangible asset related to the Heritage Bank acquisition in February 2008 was \$8.9 million at acquisition as compared to \$1.7 million as of September 30, 2013. Management performed an annual review of the core deposit intangible asset as of November 30, 2012. Based upon that review and ongoing quarterly monitoring, management determined there was no impairment of other intangible assets as of September 30, 2013. No assurance can be given that future impairment tests will not result in a charge to earnings.

**Loans**

Total loans were \$1.08 billion as of September 30, 2013, a decrease of \$72.4 million from \$1.15 billion as of December 31, 2012.

| (in thousands)              | Major Classification of Loans as of |                  |                       | September 30, 2013<br>Dollar Change From |                       |
|-----------------------------|-------------------------------------|------------------|-----------------------|--|-----------------------|
|                             | September 30,<br>2013               | June 30,<br>2013 | September 30,<br>2012 | June 30,<br>2013                         | September 30,<br>2012 |
| Commercial                  | \$ 86,822                           | \$ 86,173        | \$ 81,438             | \$ 649                                   | \$ 5,384              |
| Real estate - commercial    | 554,874                             | 563,061          | 621,715               | (8,187)                                  | (66,841)              |
| Real estate - construction  | 30,996                              | 34,964           | 48,606                | (3,968)                                  | (17,610)              |
| Real estate - residential   | 376,859                             | 386,504          | 436,837               | (9,645)                                  | (59,978)              |
| Consumer                    | 2,570                               | 2,793            | 3,167                 | (223)                                    | (597)                 |
| Overdraft                   | 544                                 | 505              | 613                   | 39                                       | (69)                  |
| Lease financing receivables | 11,204                              | 11,863           | 3,229                 | (659)                                    | 7,975                 |
| Other                       | 13,236                              | 16,371           | 12,677                | (3,135)                                  | 559                   |
|                             | 1,077,105                           | 1,102,234        | 1,208,282             | (25,129)                                 | (131,177)             |
| Net deferred loan costs     | 535                                 | 469              | 7                     | 66                                       | 528                   |
|                             | \$ 1,077,640                        | \$ 1,102,703     | \$ 1,208,289          | \$ (25,063)                              | \$ (130,649)          |

Although the total dollar value of loans has decreased, the quality of the Bank's loan portfolio has continued to improve over the last 11 consecutive quarters. For example, new items into non-accrual slowed in third quarter. In the third quarter 2013, payoffs or paydowns on loans previously on nonaccrual were received at a pace two and one half times greater than new nonaccrual was added. This improvement is attributable to a number of factors including successful execution of management's plan to reduce troubled and lower-quality assets, the still sluggish but gradually improving business conditions in our operating footprint, and the improvement in most sectors of the northern Illinois real estate market positively affecting real estate based borrowers in our portfolio. Because the Company is located in a growth corridor with significant open space and undeveloped real estate, real estate lending (including commercial and residential) has been and continues to be a sizeable portion of the portfolio. Notwithstanding this, our concentrations of real estate loans are below regulatory advised maximum limits. These categories comprised 89.3% of the portfolio as of September 30, 2013, compared to 90.1% of the portfolio as of December 31, 2012.



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The Company continues to oversee and manage its loan portfolio in accordance with interagency guidance on risk management. Management had previously reorganized the lending function placing increased emphasis upon commercial and industrial lending. While the Bank is beginning to offer new commercial and industrial loan transactions to manufacturing industries, the Bank has also entered into new income producing commercial real estate loans, such as loans to nationally branded hotel franchises and to owners of multi-family apartments. These efforts are beginning to reverse normal loan attrition and movement to OREO. We expect that our continued focus on this strategy in the remainder of 2013 should mitigate future loan runoff.

In the third quarter of 2013, the portfolio showed some stabilization. Total loans declined \$25.1 million in the quarter compared to higher declines in previous recent quarters. For example, we had a decline of \$36.7 million decline between December 31, 2012, and March 31, 2013. While overall loan growth has been difficult to achieve, business development efforts, including work by several new experienced lenders since year end 2012, have produced sizable buildup in loan pipelines and moderate levels of new closed business in the first nine months of 2013.

**Securities**

| (in thousands)  | As of                 |                  | September 30, 2013<br>Dollar Change From |                  |                       |
|---|-----------------------|------------------|--|------------------|-----------------------|
| Securities available-for-sale, at fair value          | September 30,<br>2013 | June 30,<br>2013 | September 30,<br>2012                    | June 30,<br>2013 | September 30,<br>2012 |
| U.S. Treasury   | \$ 1,548              | \$ 1,547         | \$ 1,511                                 | \$ 1             | \$ 37                 |
| U.S. government agencies                              | 1,693                 | 6,726            | 49,455                                   | (5,033)          | (47,762)              |
| U.S. government agency mortgage-backed                | -                     | 52,414           | 73,291                                   | (52,414)         | (73,291)              |
| States and political subdivisions                     | 19,841                | 20,119           | 12,805                                   | (278)            | 7,036                 |
| Corporate Bonds                                       | 22,200                | 34,429           | 34,217                                   | (12,229)         | (12,017)              |
| Collateralized mortgage obligations                   | 48,125                | 168,505          | 96,438                                   | (120,380)        | (48,313)              |
| Asset-backed securities                               | 268,984               | 290,853          | 135,086                                  | (21,869)         | 133,898               |
| Collateralized debt obligations                       | 11,087                | 10,344           | 9,543                                    | 743              | 1,544                 |
| Total securities available-for-sale                   | \$ 373,478            | \$ 584,937       | \$ 412,346                               | \$ (211,459)     | \$ (38,868)           |
| <b>Securities held-to-maturity, at amortized cost</b> |                       |                  |  |                  |                       |
| U.S. government agency mortgage-backed                | \$ 35,241             | \$ -             | \$ -                                     | \$ 35,241        | \$ 35,241             |
| Collateralized mortgage obligations                   | 222,860               | -                | -  | 222,860          | 222,860               |
| Total securities held-to-maturity                     | \$ 258,101            | \$ -             | \$ -                                     | \$ 258,101       | \$ 258,101            |
| Total securities                                      | \$ 631,579            | \$ 584,937       | \$ 412,346                               | \$ 46,642        | \$ 219,233            |

Total holdings show a net increase of \$46.6 million since June 30, 2013 with most categories declining except total collateralized mortgage obligations, which were up \$102.5 million in the period. The held-to-maturity classification was established in the third quarter in order to reflect management's intent with regard to these securities. The Company has the ability, and management has the intent, to hold these securities to maturity. Generally, the held-to-maturity classification consists of fixed-rate securities of longer duration than the available-for-sale classification.

The net unrealized losses, net of deferred tax benefit, in the portfolio increased by \$11.1 million from \$1.3 million as of December 31, 2012, to \$12.4 million as of September 30, 2013. Management believes that the increase in total securities carried with unrealized losses is in no way problematic. Additional information related to the securities portfolio is found in Note 2.



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| (in thousands)            | As Of                 |                  | September 30, 2013<br>Dollar Change From |                  |                       |
|---------------------------|-----------------------|------------------|--|------------------|-----------------------|
|                           | September 30,<br>2013 | June 30,<br>2013 | September 30,<br>2012                    | June 30,<br>2013 | September 30,<br>2012 |
| Noninterest bearing       | \$ 373,499            | \$ 366,406       | \$ 381,111                               | \$ 7,093         | \$ (7,612)            |
| Savings                   | 227,823               | 227,687          | 211,452                                  | 136              | 16,371                |
| NOW accounts              | 272,632               | 287,492          | 265,215                                  | (14,860)         | 7,417                 |
| Money market accounts     | 309,066               | 312,773          | 321,614                                  | (3,707)          | (12,548)              |
| Certificates of deposits: |                       |                  |  |                  |                       |
| of less than \$100,000    | 299,632               | 306,302          | 323,464                                  | (6,670)          | (23,832)              |
| of \$100,000 or more      | 190,471               | 189,963          | 194,078                                  | 508              | (3,607)               |
|                           | \$ 1,673,123          | \$ 1,690,623     | \$ 1,696,934                             | \$ (17,500)      | \$ (23,811)           |

The Company saw some decline in total deposits in the third quarter and year over year, but overall total deposits were essentially flat during the quarter and year over year reflecting sluggish loan activity and other liquidity sources utilized by management.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with our correspondent lender. That credit facility was originally comprised of a \$30.5 million senior debt facility, which included \$500,000 in term debt, and \$45.0 million of subordinated debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly and is based on, at the Company's option, either the lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the subordinated debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The Company had no principal outstanding balance on the senior debt line of credit when it matured and the line has been terminated. The Company still had \$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, 2012, and September 30, 2013. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis. Pursuant to the Written Agreement with the FRB, the Company must receive and has received the FRB's approval prior to making any interest payments on the subordinated debt.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the senior debt agreement. The senior debt agreement also contains certain customary representations and warranties and financial and negative covenants. At September 30, 2013, the Company was out of compliance with one of the financial covenants contained within the credit agreement. Previously, the Company had been out of compliance with two of the financial covenants. The agreement provides, that upon an event of default as the result of the Company's failure to comply with a financial covenant, relating to the senior debt, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line of the term debt by 200 basis points, (iii) declare the senior debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal amount of the senior debt is the \$500,000 in term debt. Because the subordinated debt is treated as Tier 2 capital for regulatory capital purposes, the senior debt agreement does not provide the lender with any rights of acceleration or other remedies with regard to the subordinated debt upon an event of default caused by the Company's failure to comply with a financial covenant.

The Company increased its securities sold under repurchase agreements by \$2.8 million, or 15.9%, from December 31, 2012. The Company's other short-term borrowings decreased \$45.0 million from December 31, 2012, as a Federal Home Loan Bank of Chicago (FHLBC) advance matured and was replaced with short term FHLBC advances that matured in October 2013.



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*Capital*

As of September 30, 2013, total stockholders' equity was \$142.0 million, which was an increase of \$69.5 million, or 95.8%, from \$72.6 million as of December 31, 2012. This increase was largely created by the income tax benefit generated by the reversal of the valuation allowance on a significant portion of net deferred tax assets. Unrealized loss on securities available-for-sale net of deferred taxes was \$1.3 million at December 31, 2012 and \$12.4 million at September 30, 2013, causing a reduction in stockholders' equity of \$11.1 million. Additionally, as discussed further below total stockholders' equity benefited by the Company not declaring and accruing a dividend for the third quarter of 2013 and other periods in 2013 on its Series B Preferred Stock.

As of September 30, 2013, the Company's regulatory capital ratios of total capital to risk weighted assets, Tier 1 capital to risk weighted assets and Tier 1 capital to average assets increased to 15.15%, 10.07% and 7.11%, respectively, compared to 13.62%, 6.81% and 4.85%, respectively, at December 31, 2012. The Company, on a consolidated basis, exceeded the minimum capital ratios to be deemed "well capitalized" at September 30, 2013. The same capital ratios at the Bank were 17.08%, 15.82% and 11.08%, respectively, at September 30, 2013, compared to 14.86%, 13.59%, and 9.67%, at December 31, 2012. The Bank's ratios exceeded the heightened capital ratios agreed to in the 2011 Consent Order the Bank entered with the OCC. As indicated previously, the Consent Order was terminated as of October 17, 2013.

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

In July 2013, the U.S. federal banking authorities approved the implementation of the Basel III regulatory capital reforms and issued rules effecting certain changes required by the Dodd-Frank Act (the "Basel III Rules"). The Basel III Rules are applicable to all U.S. banks that are subject to minimum capital requirements as well as to most holding companies of banks and savings and loans. The Basel III Rules not only increase selected minimum regulatory capital ratios, but also introduce a new Common Equity Tier 1 capital ratio and the concept of a capital conservation buffer. The Basel III Rules also revise the criteria that certain instruments must meet to qualify as Tier 1 or Tier 2 capital. A number of instruments that now qualify as Tier 1 capital will not qualify under the Basel III Rules. The Basel III Rules also permit smaller banking organizations to retain, through a one-time election, the existing treatment of accumulated other comprehensive income. The Basel III Rules have maintained the general structure of the current prompt corrective action framework while incorporating the increased requirements. The Basel III Rules also revise prompt corrective action guidelines to add the Common Equity Tier 1 capital ratio. Generally, the new Basel III Rules become effective on January 1, 2015. Management is reviewing the new rules to assess their impact on the Company.

In July 2011, the Company entered into a Written Agreement with the FRB designed to maintain the financial soundness of the Company. Key provisions of the Written Agreement include restrictions on the Company's payment of dividends on its capital stock, restrictions on its taking of dividends or other payments from the Bank that reduce the Bank's capital, restrictions on subordinated debenture and trust preferred security distributions, restrictions on incurring additional debt or repurchasing stock, capital planning provisions, requirements to submit cash flow projections to the FRB, requirements to comply with certain notice provisions pertaining to changes in directors or senior management, requirements to comply with regulatory restrictions on indemnification and severance payments, and requirements to submit certain reports to the FRB. The Written Agreement also calls for the Company to serve as a source of strength for the Bank. Although the Consent Order was terminated, the Written Agreement is still in effect and will remain in effect until terminated, rescinded or modified by the FRB.





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As previously announced in the third quarter of 2010, the Company elected to defer regularly scheduled interest payments on \$58.4 million of junior subordinated debentures related to the trust preferred securities issued by its two statutory trust subsidiaries, Old Second Capital Trust I and Old Second Capital Trust II. Because of the deferral on the subordinated debentures, the trusts will defer regularly scheduled dividends on their trust preferred securities. The total accumulated interest on the trust preferred securities including compounded interest from July 1, 2010 on the deferred payments totaled \$15.7 million at September 30, 2013.

During the fourth quarter of 2012, the Treasury announced the continuation of individual auctions of the preferred stock issued through the CPP. At that time, the Company was informed that the Series B Preferred Stock would be auctioned by Treasury. All of the Series B Preferred Stock held by Treasury was sold to third parties, including certain of our directors, through the auctions that were completed in the first quarter of 2013. The warrant to purchase 815,339 shares of the Company's common stock was also sold to a third-party investor in a separate, subsequent auction. The Company carried \$71.9 million and \$72.7 million of Series B Preferred Stock in Total Stockholders' Equity at December 31, 2012, and at September 30, 2013, respectively.

As a result of the completed auctions, the Company's Board elected to stop accruing the dividend on the Series B Preferred Stock in the first quarter of 2013. Previously, the Company had accrued this dividend quarterly throughout the deferral period. Given the discount reflected in the results of the auction, the Board believes that the Company will likely be able to repurchase the Series B Preferred Stock in the future at a price less than the face amount of the Series B Preferred Stock plus accrued dividends. Therefore, under GAAP, the Company did not fully accrue the dividend on the Series B Preferred Stock in the first quarter and did not accrue for it in the subsequent quarters. The Company will continue to evaluate whether accruing dividends on the Series B Preferred Stock is appropriate in future periods. Pursuant to the terms of the Series B Preferred Stock, the dividends paid on the Series B Preferred Stock will increase from 5% to 9% in 2014.

In addition to the above regulatory ratios, the Company's non-GAAP tangible common equity to tangible assets increased to 3.33% at September 30, 2013, largely attributable to increased capital resulting from the reversal of the valuation allowance on a significant portion of net deferred tax assets, made possible by recent profits. Specifically unrealized loss on securities available-for-sale rose sharply in the third quarter of 2013. The Tier 1 common equity to risk weighted assets increased to 0.61% at September 30, 2013. These 2013 results compare to tangible common equity to tangible assets of (0.13)% and tier 1 common equity to risk weighted assets of (0.12)%, at December 31, 2012.

As evidenced by the improvement in asset quality and earnings, which led to the reversal of a significant portion of the valuation allowance against the deferred tax assets, and the termination of the regulatory Consent Order management is working diligently to position the Company so that it can take further actions to become current on deferred amounts related to the trust preferred securities and the Series B Preferred Stock formerly held by Treasury.

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Management also discloses these non-GAAP ratios to be consistent with industry practice and the table below provides an enumeration of the components of each those non-GAAP equity ratios disclosed above to the most comparable GAAP equivalent.

| (dollars in thousands)  | (unaudited)<br>As of September 30, |              | (unaudited)<br>December 31, |
|---|------------------------------------|--------------|-----------------------------|
|   | 2013                               | 2012         | 2012                        |
| <b>Tier 1 capital</b>   |                                    |              |                             |
| Total stockholders' equity  | \$ 142,039                         | \$ 70,741    | \$ 72,552                   |
| Tier 1 adjustments:   |                                    |              |                             |
| Trust preferred securities  | 51,491                             | 24,432       | 24,626                      |
| Cumulative other comprehensive loss                                 | 12,435                             | 2,556        | 1,327                       |
| Disallowed intangible assets  | (1,702)                            | (3,813)      | (3,276)                     |
| Disallowed deferred tax assets                                      | (71,588)                           | -            | -                           |
| Other   | (546)                              | (360)        | (412)                       |
| Tier 1 capital  | \$ 132,129                         | \$ 93,556    | \$ 94,817                   |
| <b>Total capital</b>  |                                    |              |                             |
| Tier 1 capital  | \$ 132,129                         | \$ 93,556    | \$ 94,817                   |
| Tier 2 additions:   |                                    |              |                             |
| Allowable portion of allowance for loan losses                      | 16,565                             | 18,399       | 17,656                      |
| Additional trust preferred securities disallowed for tier 1 capital | 5,134                              | 32,193       | 31,999                      |
| Subordinated debt   | 45,000                             | 45,000       | 45,000                      |
| Tier 2 additions subtotal   | 66,699                             | 95,592       | 94,655                      |
| Allowable Tier 2  | 66,699                             | 93,556       | 94,655                      |
| Other Tier 2 capital components                                     | (6)                                | (6)          | (6)                         |
| Total capital   | \$ 198,822                         | \$ 187,106   | \$ 189,466                  |
| <b>Tangible common equity</b>                                       |                                    |              |                             |
| Total stockholders' equity  | \$ 142,039                         | \$ 70,741    | \$ 72,552                   |
| Less: Preferred equity  | 72,667                             | 71,611       | 71,869                      |
| Intangible assets   | 1,702                              | 3,813        | 3,276                       |
| Tangible common equity  | \$ 67,670                          | \$ (4,683)   | \$ (2,593)                  |
| <b>Tier 1 common equity</b>   |                                    |              |                             |
| Tangible common equity  | \$ 67,670                          | \$ (4,683)   | \$ (2,593)                  |
| Tier 1 adjustments:   |                                    |              |                             |
| Cumulative other comprehensive loss                                 | 12,435                             | 2,556        | 1,327                       |
| Other   | (72,134)                           | (360)        | (412)                       |
| Tier 1 common equity  | \$ 7,971                           | \$ (2,487)   | \$ (1,678)                  |
| <b>Tangible assets</b>  |                                    |              |                             |
| Total assets  | \$ 2,032,788                       | \$ 1,903,400 | \$ 2,045,799                |
| Less: Intangible assets   | 1,702                              | 3,813        | 3,276                       |
| Tangible assets   | \$ 2,031,086                       | \$ 1,899,587 | \$ 2,042,523                |
| <b>Total risk-weighted assets</b>                                   |                                    |              |                             |
| On balance sheet  | \$ 1,274,628                       | \$ 1,409,071 | \$ 1,356,762                |
| Off balance sheet   | 37,555                             | 40,958       | 34,804                      |
| Total risk-weighted assets  | \$ 1,312,183                       | \$ 1,450,029 | \$ 1,391,566                |
| <b>Average assets</b>   |                                    |              |                             |
| Total average assets for leverage                                   | \$ 1,857,554                       | \$ 1,918,388 | \$ 1,955,000                |



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In addition, management believes the presentation of other financial measures such as core earnings, which excludes taxes, provisions for loan losses, income and expenses associated with OREO, and other nonrecurring items as detailed immediately below, provides useful supplemental information that is helpful in understanding our financial results. Management considers this information useful since certain items such as provisions for loan losses and OREO activities in the current credit cycle are well above historic levels. These disclosures should not be viewed as substitutes for the results determined to be in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies (in thousands).

|   | (unaudited)<br>As of and for the<br>Three Months Ended<br>September 30, |            | (unaudited)<br>As of and for the<br>Nine Months Ended<br>September 30, |            |
|---|---|------------|--|------------|
|   | 2013  | 2012       | 2013   | 2012       |
| <b>Core earnings</b>                      |   |            |  |            |
| Pretax earnings (loss)                    | \$ 2,927  | \$ 120     | \$ 11,875  | \$ (1,596) |
| Excluding impact of:                      |   |            |  |            |
| Other real estate owned, net of income    | 2,544   | 5,685      | 8,943  | 14,659     |
| Provision for loan losses                 | (1,750)   | -          | (6,050)  | 6,284      |
| Death benefit realized on bank owned life | (6)   | -          | (381)  | -          |
| Litigation related income                 | (4)   | (6)        | (19)   | (125)      |
| <i>Core Earnings</i>                      | \$ 3,711  | \$ 5,799   | \$ 14,368  | \$ 19,222  |
| <b>Earnings per core diluted share</b>    |   |            |  |            |
| Average diluted number of shares          | 14,102,036  | 14,210,928 | 14,112,243   | 14,206,017 |
| <i>Core diluted earnings per share</i>    | \$ 0.26   | \$ 0.41    | \$ 1.02  | \$ 1.35    |

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

*Liquidity and Market Risk*

Liquidity is the Company's ability to fund operations, to meet depositor withdrawals, to provide for customer's credit needs, and to meet maturing obligations and existing commitments. The liquidity of the Company principally depends on cash flows from net operating activities, including pledging requirements, investment in and maturity of assets, changes in balances of deposits and borrowings, and its ability to borrow funds. The Company monitors borrowing capacity at correspondent banks as well as the FHLBC and FRB as part of its liquidity management process.

Net cash inflows from operating activities were \$19.7 million during the first nine months of 2013, compared with net cash inflows of \$28.7 million in the same period in 2012. Proceeds from sales of loans held-for-sale, net of funds used to originate loans held-for-sale, continued to be a source of inflow for both of the first nine months of 2013 and 2012. Interest received, net of interest paid, combined with changes in other assets and liabilities were a source of inflow for both the first nine months of 2013 and 2012. The Company's management of investing and financing activities, as well as market conditions, determines the level and the stability of net interest cash flows. Management's policy is to mitigate the impact of changes in market interest rates to the extent possible, as part of the balance sheet management process.

Net cash inflows from investing activities were \$18.4 million in the first nine months of 2013, compared to \$35.7 million in the same period in 2012. In 2013, securities transactions accounted for a net outflow of \$62.9 million, and net principal received on loans accounted for net inflows of \$49.9 million. Proceeds from sales of OREO accounted for \$32.1 million and \$20.9 million in investing cash inflows for the first nine months of 2013 and 2012, respectively. Investing cash outflows for investment in OREO were \$60,000 in the first nine months of 2013 as compared to \$646,000 in the same period in 2012.

Net cash outflows from financing activities in the first nine months of 2013 were \$86.5 million compared with net cash outflows of \$43.1 million in the first nine months of 2012. Net deposit outflows in the first nine months of 2013 were \$44.1 million compared to net deposit outflows of \$43.8 million in the first nine months of 2012. Changes in securities sold under repurchase agreements accounted for \$2.8 million and \$837,000 in net inflows, respectively, in the first nine months of 2013 and 2012.

Under the terms of the Consent Order, (discussed in Note 11 of the Notes to Consolidated Financial Statements) which was terminated October 17, 2013, the Bank had agreed to reaffirm its liquidity risk management program. Management has a well-defined liquidity management program reflecting sound liquidity risk supervision through the Asset and Liability Committee process and Board review. Important elements of the program cover base operating liquidity, a liquid asset cushion, contingency funding strategies to address liquidity shortfalls in emergency situations and periodic stress testing. This program also covers liquidity management for the Company.

*Interest Rate Risk*

As part of its normal operations, the Company is subject to interest-rate risk on the assets it invests in (primarily loans and securities) and the liabilities it funds with (primarily customer deposits and borrowed funds), as well as its ability to manage such risk. Fluctuations in interest rates

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may result in changes in the fair market values of the Company's financial instruments, cash flows, and net interest income. Like most financial institutions, the Company has an exposure to changes in both short-term and long-term interest rates.

The Company manages various market risks in its normal course of operations, including credit, liquidity, and interest-rate risk. Other types of market risk, such as foreign currency exchange risk and commodity price risk, do not arise in the normal course of the Company's business activities and operations. In addition, since the Company does not hold a trading portfolio, it is not exposed to significant market risk

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from trading activities. The Company's interest rate risk exposures from September 30, 2013, and December 31, 2012, are outlined in the table below.

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

The Company utilizes simulation analysis to quantify the impact of various rate scenarios on net interest income. Specific cash flows, repricing characteristics, and embedded options of the assets and liabilities held by the Company are incorporated into the simulation model. Earnings at risk is calculated by comparing the net interest income of a stable interest rate environment to the net interest income of a different interest rate environment in order to determine the percentage change. Due to the significant declines in interest rates that occurred during the first half of 2012 and remain today, management found it was not meaningful to calculate valid interest rate scenarios that represent declines of 0.5% or more. Compared to December 31, 2012, the Company had less earnings gains (in both dollars and percentage) if interest rates should rise. This decrease in rising-rate benefit reflects the Company's acquisition of some longer term loans and securities that offered higher yields to support the margin. Federal Funds rates and the Bank's prime rate were stable throughout the first nine months of 2013 at 0.25% and 3.25%, respectively.

The following table summarizes the effect on annual income before income taxes based upon an immediate increase or decrease in interest rates of 0.5%, 1%, and 2% assuming no change in the slope of the yield curve. The -2%, -1%, and -5% sections of the table do not show model changes for those magnitudes of decrease due to the low interest rate environment over the relevant time periods.

**Analysis of Net Interest Income Sensitivity**

|                           | -2.0% | -1.0% | Immediate Changes in Rates |        |          |          |
|---------------------------|-------|-------|----------------------------|--------|----------|----------|
|                           |       |       | -0.5%                      | 0.5%   | 1.0%     | 2.0%     |
| <b>September 30, 2013</b> |       |       |                            |        |          |          |
| Dollar change             | N/A   | N/A   | N/A                        | \$ 352 | \$ 811   | \$ 2,272 |
| Percent change            | N/A   | N/A   | N/A                        | +0.6%  | +1.4%    | +4.0%    |
| <b>December 31, 2012</b>  |       |       |                            |        |          |          |
| Dollar change             | N/A   | N/A   | N/A                        | \$ 538 | \$ 1,164 | \$ 2,511 |
| Percent change            | N/A   | N/A   | N/A                        | +1.1%  | +2.3%    | +4.9%    |

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

**Item 4. Controls and Procedures**



**Evaluation of Disclosure Controls and Procedures**

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended, as of September 30, 2013. Based

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on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 2013, the Company's disclosure controls and procedures were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities and Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified.

There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 2013, that have materially affected, or are reasonably likely to affect, the Company's internal control over financial reporting.

**Forward-looking Statements**

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company.

Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as believe, expect, anticipate, plan, intend, estimate, will, would, could, should or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

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

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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

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

**Item 1.A. Risk Factors**

There have been no material changes from the risk factors set forth in Part I, Item 1.A. Risk Factors, of the Company's Form 10-K for the year ended December 31, 2012. Please refer to that section of the Company's Form 10-K for disclosures regarding the risks and uncertainties related to the Company's business.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

N/A

**Item 5. Other Information**

None

**Item 6. Exhibits**

**Exhibits:**

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

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

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

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

101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets at September 30, 2013, and December 31, 2012; (ii) Consolidated Statements of Operations for the three and nine months ended September 30, 2013, and September 30, 2012; (iii) Consolidated Statements of Stockholders' Equity for the nine months ended September 30, 2013, and September 30, 2012; (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2013, and September 30, 2012; and (v) Notes to Consolidated Financial Statements, tagged as blocks of text and in detail.

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SIGNATURES

Pursuant to the requirements of the Securities and Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

OLD SECOND BANCORP, INC.

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

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

DATE: November 12, 2013