

OLD SECOND BANCORP INC
Form 10-Q
August 14, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For transition period from _____ to _____

Commission File Number 0 -10537

OLD SECOND BANCORP, INC.

(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation or organization)

36-3143493
(I.R.S. Employer Identification Number)

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices) (Zip Code)

(630) 892-0202

(Registrant's telephone number, including area code)

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

Yes No

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

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

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

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

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: As of August 10, 2012, the Registrant had outstanding 14,084,328 shares of common stock, \$1.00 par value per share.

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OLD SECOND BANCORP, INC.

Form 10-Q Quarterly Report

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Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****Old Second Bancorp, Inc. and Subsidiaries****Consolidated Balance Sheets***(In thousands, except share data)*

| | (Unaudited) June 30, 2012 | December 31, 2011 |
|---|---------------------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 45,015 | \$ 2,692 |
| Interest bearing deposits with financial institutions | 85,014 | 48,257 |
| Cash and cash equivalents | 130,029 | 50,949 |
| Securities available-for-sale | 398,895 | 307,564 |
| Federal Home Loan Bank and Federal Reserve Bank stock | 12,177 | 14,050 |
| Loans held-for-sale | 6,445 | 12,806 |
| Loans | 1,238,134 | 1,368,985 |
| Less: allowance for loan losses | 40,286 | 51,997 |
| Net loans | 1,197,848 | 1,316,988 |
| Premises and equipment, net | 49,196 | 50,477 |
| Other real estate owned | 89,671 | 93,290 |
| Mortgage servicing rights, net | 3,531 | 3,487 |
| Core deposit and other intangible assets, net | 4,233 | 4,678 |
| Bank-owned life insurance (BOLI) | 53,416 | 52,595 |
| Other assets | 40,217 | 34,534 |
| Total assets | \$ 1,985,658 | \$ 1,941,418 |
| Liabilities | | |
| Deposits: | | |
| Noninterest bearing demand | \$ 412,635 | \$ 361,963 |
| Interest bearing: | | |
| Savings, NOW, and money market | 800,200 | 761,335 |
| Time | 557,189 | 617,483 |
| Total deposits | 1,770,024 | 1,740,781 |
| Securities sold under repurchase agreements | 13,802 | 901 |
| Junior subordinated debentures | 58,378 | 58,378 |
| Subordinated debt | 45,000 | 45,000 |
| Notes payable and other borrowings | 500 | 500 |
| Other liabilities | 27,807 | 21,856 |
| Total liabilities | 1,915,511 | 1,867,416 |
| Stockholders Equity | | |
| Preferred stock | 71,358 | 70,863 |
| Common stock | 18,729 | 18,628 |
| Additional paid-in capital | 66,051 | 65,999 |
| Retained earnings | 12,930 | 17,107 |
| Accumulated other comprehensive loss | (3,965) | (3,702) |
| Treasury stock | (94,956) | (94,893) |
| Total stockholders equity | 70,147 | 74,002 |
| Total liabilities and stockholders equity | \$ 1,985,658 | \$ 1,941,418 |

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

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

| | (unaudited) Three Months Ended June 30, | | (unaudited) Six Months Ended June 30, | |
|--|---|-----------|---|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Interest and Dividend Income | | | | |
| Loans, including fees | \$ 17,617 | \$ 20,749 | \$ 35,283 | \$ 41,965 |
| Loans held-for-sale | 49 | 75 | 133 | 126 |
| Securities: | | | | |
| Taxable | 1,856 | 885 | 3,354 | 1,763 |
| Tax exempt | 102 | 127 | 205 | 269 |
| Dividends from Federal Reserve Bank and Federal Home Loan Bank stock | 77 | 74 | 151 | 143 |
| Federal funds sold | - | 1 | - | 1 |
| Interest bearing deposits with financial institutions | 35 | 69 | 60 | 139 |
| Total interest and dividend income | 19,736 | 21,980 | 39,186 | 44,406 |
| Interest Expense | | | | |
| Savings, NOW, and money market deposits | 254 | 372 | 554 | 948 |
| Time deposits | 2,342 | 3,791 | 4,947 | 7,784 |
| Securities sold under repurchase agreements | 1 | - | 1 | - |
| Other short-term borrowings | 1 | - | 4 | - |
| Junior subordinated debentures | 1,220 | 1,133 | 2,417 | 2,246 |
| Subordinated debt | 224 | 206 | 461 | 409 |
| Notes payable and other borrowings | 4 | 4 | 8 | 8 |
| Total interest expense | 4,046 | 5,506 | 8,392 | 11,395 |
| Net interest and dividend income | 15,690 | 16,474 | 30,794 | 33,011 |
| Provision for loan losses | 200 | 500 | 6,284 | 4,500 |
| Net interest and dividend income after provision for loan losses | 15,490 | 15,974 | 24,510 | 28,511 |
| Noninterest Income | | | | |
| Trust income | 1,463 | 1,715 | 3,114 | 3,499 |
| Service charges on deposits | 1,893 | 2,047 | 3,724 | 3,864 |
| Secondary mortgage fees | 311 | 236 | 607 | 463 |
| Mortgage servicing (loss) income, net of changes in fair value | (397) | (263) | (210) | 107 |
| Net gain on sales of mortgage loans | 2,358 | 1,117 | 5,005 | 2,353 |
| Securities gains, net | 692 | 512 | 793 | 651 |
| Increase in cash surrender value of bank-owned life insurance | 326 | 434 | 821 | 897 |
| Debit card interchange income | 1,113 | 784 | 1,873 | 1,484 |
| Lease revenue from other real estate owned | 911 | 957 | 2,090 | 1,477 |
| Net gain on sale of other real estate owned | 355 | 402 | 378 | 636 |
| Litigation related income | 3 | - | 119 | - |
| Other income | 1,368 | 1,456 | 2,546 | 2,907 |
| Total noninterest income | 10,396 | 9,397 | 20,860 | 18,338 |
| Noninterest Expense | | | | |
| Salaries and employee benefits | 8,823 | 8,580 | 17,872 | 17,509 |
| Occupancy expense, net | 1,207 | 1,310 | 2,442 | 2,655 |
| Furniture and equipment expense | 1,183 | 1,475 | 2,338 | 2,935 |
| FDIC insurance | 1,029 | 1,113 | 2,029 | 2,852 |
| General bank insurance | 841 | 826 | 1,687 | 1,651 |
| Amortization of core deposit and other intangible asset | 250 | 206 | 445 | 435 |
| Advertising expense | 264 | 187 | 582 | 420 |
| Debit card interchange expense | 453 | 324 | 795 | 697 |
| Legal fees | 770 | 1,040 | 1,455 | 1,983 |
| Other real estate expense | 6,788 | 5,951 | 11,442 | 11,265 |
| Other expense | 3,026 | 3,346 | 5,999 | 6,554 |

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| | | | | |
|---|---------|-----------|------------|------------|
| Total noninterest expense | 24,634 | 24,358 | 47,086 | 48,956 |
| Income (Loss) before income taxes | 1,252 | 1,013 | (1,716) | (2,107) |
| Income taxes | - | - | - | - |
| Net income (loss) | 1,252 | 1,013 | (1,716) | (2,107) |
| Preferred stock dividends and accretion | 1,238 | 1,175 | 2,461 | 2,334 |
| Net income (loss) available to common stockholders | \$ 14 | \$ (162) | \$ (4,177) | \$ (4,441) |
| Basic earnings (loss) per share | \$ 0.00 | \$ (0.01) | \$ (0.29) | \$ (0.31) |
| Diluted earnings (loss) per share | 0.00 | (0.01) | (0.29) | (0.31) |
| Dividends declared per share | - | - | - | - |

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------|------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Net income (loss) | \$ 1,252 | \$ 1,013 | \$ (1,716) | \$ (2,107) |
| Total unrealized holding (loss) gains on available-for-sale securities arising during the period | (657) | 1,300 | 347 | 1,462 |
| Related tax benefit (expense) | 272 | (534) | (141) | (526) |
| Holding (loss) income after tax | (385) | 766 | 206 | 936 |
| Less: Reclassification adjustment for the net gains and losses realized during the period | | | | |
| Net realized gains | 692 | 512 | 793 | 651 |
| Income tax expense on net realized gains | (283) | (209) | (324) | (266) |
| Net realized gains after tax | 409 | 303 | 469 | 385 |
| Total other comprehensive (loss) income | (794) | 463 | (263) | 551 |
| Comprehensive income (loss) | \$ 458 | \$ 1,476 | \$ (1,979) | \$ (1,556) |

See accompanying notes to consolidated financial statements.

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

(In thousands)

| | (Unaudited) Six Months Ended June 30, | |
|--|---|------------|
| | 2012 | 2011 |
| Cash flows from operating activities | | |
| Net loss | \$ (1,716) | \$ (2,107) |
| Adjustments to reconcile net loss to net cash provided by operating activities: | | |
| Depreciation and amortization of leasehold improvement | 1,580 | 2,144 |
| Change in market value of mortgage servicing rights | 835 | 500 |
| Provision for loan losses | 6,284 | 4,500 |
| Originations of loans held-for-sale | (129,803) | (98,257) |
| Proceeds from sales of loans held-for-sale | 140,323 | 103,549 |
| Net gain on sales of mortgage loans | (5,005) | (2,353) |
| Change in current income taxes receivable | 815 | - |
| Increase in cash surrender value of bank-owned life insurance | (821) | (897) |
| Change in accrued interest receivable and other assets | (5,567) | (1,126) |
| Change in accrued interest payable and other liabilities | 3,204 | (866) |
| Net premium amortization on securities | 553 | 98 |
| Securities gains, net | (793) | (651) |
| Amortization of core deposit and other intangible assets | 445 | 435 |
| Stock based compensation | 153 | 491 |
| Net gain on sale of other real estate owned | (378) | (636) |
| Write-down of other real estate owned | 7,796 | 6,502 |
| Net cash provided by operating activities | 17,905 | 11,326 |
| Cash flows from investing activities | | |
| Proceeds from maturities and pre-refunds including pay down of securities available-for-sale | 126,358 | 17,299 |
| Proceeds from sales of securities available-for-sale | 8,359 | 15,277 |
| Purchases of securities available-for-sale | (226,254) | (28,178) |
| Net sales (purchases) of Federal Reserve Bank and Federal Home Loan Bank stock | 1,873 | (359) |
| Net change in loans | 93,506 | 114,420 |
| Investment in other real estate owned | (515) | (2,167) |
| Proceeds from sales of other real estate owned | 16,066 | 19,816 |
| Net purchases of premises and equipment | (299) | (196) |
| Net cash provided by investing activities | 19,094 | 135,912 |
| Cash flows from financing activities | | |
| Net change in deposits | 29,243 | (139,468) |
| Net change in securities sold under repurchase agreements | 12,901 | (687) |
| Net change in other short-term borrowings | - | (8) |
| Purchase of treasury stock | (63) | (49) |
| Net cash provided by (used in) financing activities | 42,081 | (140,212) |
| Net change in cash and cash equivalents | 79,080 | 7,026 |
| Cash and cash equivalents at beginning of period | 50,949 | 98,758 |
| Cash and cash equivalents at end of period | \$ 130,029 | \$ 105,784 |

Supplemental cash flow information

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| | | | | |
|---|----|--------|----|--------|
| Income taxes received | \$ | (815) | \$ | - |
| Interest paid for deposits | | 6,029 | | 9,177 |
| Interest paid for borrowings | | 473 | | 417 |
| Non-cash transfer of loans to other real estate owned | | 19,350 | | 30,513 |
| Change in dividends declared not paid | | 1,966 | | 1,870 |
| Accretion on preferred stock warrants | | 495 | | 464 |

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

| | Common Stock | Preferred Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Treasury Stock | Total Stockholders Equity |
|---|-----------------|--------------------|----------------------------------|----------------------|--|-------------------|---------------------------------|
| Balance, December 31, 2010 | \$ 18,467 | \$ 69,921 | \$ 65,209 | \$ 28,335 | \$ (3,130) | \$ (94,844) | \$ 83,958 |
| Comprehensive loss: | | | | | | | |
| Net loss | | | | (2,107) | | | (2,107) |
| Change in net unrealized gain on securities available-for-sale net of \$260 tax effect | | | | | 551 | | 551 |
| Change in restricted stock | 161 | | (161) | | | | - |
| Stock based compensation | | | 491 | | | | 491 |
| Purchase of treasury stock | | | | | | (49) | (49) |
| Preferred dividends declared and accrued (5% per preferred share) | | 464 | | (2,334) | | | (1,870) |
| Balance, June 30, 2011 | \$ 18,628 | \$ 70,385 | \$ 65,539 | \$ 23,894 | \$ (2,579) | \$ (94,893) | \$ 80,974 |
| Balance, December 31, 2011 | \$ 18,628 | \$ 70,863 | \$ 65,999 | \$ 17,107 | \$ (3,702) | \$ (94,893) | \$ 74,002 |
| Comprehensive loss: | | | | | | | |
| Net loss | | | | (1,716) | | | (1,716) |
| Change in net unrealized loss on securities available-for-sale net of \$183 tax effect | | | | | (263) | | (263) |
| Change in restricted stock | 101 | | (101) | | | | - |
| Stock based compensation | | | 153 | | | | 153 |
| Purchase of treasury stock | | | | | | (63) | (63) |
| Preferred dividends declared and accrued (5% per preferred share) | | 495 | | (2,461) | | | (1,966) |
| Balance, June 30, 2012 | \$ 18,729 | \$ 71,358 | \$ 66,051 | \$ 12,930 | \$ (3,965) | \$ (94,956) | \$ 70,147 |

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 June 30, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. These interim financial statements should be read in conjunction with the audited financial statements and notes included in Old Second Bancorp, Inc.'s (the Company) annual report on Form 10-K for the year ended December 31, 2011. Unless otherwise indicated, amounts in the tables contained in the notes are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

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

All significant accounting policies are presented in Note 1 to the consolidated financial statements included in the Company's annual report on Form 10-K for the year ended December 31, 2011. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined.

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

In June 2011, the FASB issued ASU No. 2011-05 Comprehensive Income (Topic 220) - Presentation of Comprehensive Income. ASU 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Retrospective application of the standard is required. In December 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-12: Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05, to defer the effective date for the part of

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ASU No. 2011-05 that would require adjustments of items out of accumulated other income to be presented on the components of both net income and other comprehensive income in financial statements. The Company has included the consolidated statements of comprehensive income. There was no impact on the consolidated statements of operations or balance sheets based on the adoption of this standard.

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Note 2 Securities

Investment Portfolio Management

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

Portfolio size and composition may be adjusted from time to time. While a significant portion of the portfolio consists of readily marketable securities to address liquidity, other parts of the portfolio may reflect funds invested pending future loan demand or to maximize interest income without undue interest rate risk.

Investments are comprised of debt securities and non-marketable equity investments. All debt securities are classified as available-for-sale and may be sold under our management and asset/liability management strategies. Securities available-for-sale are carried at fair value. Unrealized gains and losses on securities available-for-sale are reported as a separate component of equity. This balance sheet component changes as interest rates and market conditions change. Unrealized gains and losses are not included in the calculation of regulatory capital.

Non-marketable equity investments include Federal Home Loan Bank of Chicago (FHLBC) stock and Federal Reserve Bank of Chicago (FRB) stock. FHLBC stock was recorded at a value of \$7.4 million at June 30, 2012, a decrease of \$1.9 million from December 31, 2011. FRB stock was recorded at \$4.8 million at June 30, 2012, which was unchanged from December 31, 2011. Our FHLBC stock is necessary to maintain our continued access to FHLBC advances. In late 2011, management at the Bank evaluated the October 17, 2011, FHLBC Capital Plan and determined the best overall course for the Bank was to accept the stock conversion as of January 1, 2012. Subsequently, during the first half of 2012 management redeemed excess FHLBC stock held by the Bank reducing the value of FHLBC stock held by the Bank to \$7.4 million.

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

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| June 30, 2012: | | | | |
| U.S. Treasury | \$ 1,501 | \$ 14 | \$ - | \$ 1,515 |
| U.S. government agencies | 44,482 | 173 | (32) | 44,623 |
| U.S. government agency mortgage-backed States and political subdivisions | 93,458 | 1,766 | (16) | 95,208 |
| | 12,926 | 1,137 | (5) | 14,058 |
| Corporate Bonds | 35,127 | 240 | (100) | 35,267 |
| Collateralized mortgage obligations | 62,890 | 367 | (870) | 62,387 |
| Asset-backed securities | 137,341 | 476 | (1,143) | 136,674 |
| Collateralized debt obligations | 17,910 | - | (8,747) | 9,163 |
| | \$ 405,635 | \$ 4,173 | \$ (10,913) | \$ 398,895 |
| December 31, 2011: | | | | |
| U.S. Treasury | \$ 1,501 | \$ 23 | \$ - | \$ 1,524 |
| U.S. government agencies | 43,112 | 286 | - | 43,398 |
| U.S. government agency mortgage-backed States and political subdivisions | 152,473 | 1,553 | (19) | 154,007 |
| | 12,152 | 1,657 | - | 13,809 |
| Corporate Bonds | 32,357 | 14 | (982) | 31,389 |
| Collateralized mortgage obligations | 25,616 | 242 | (736) | 25,122 |
| Asset-backed securities | 28,755 | - | (414) | 28,341 |
| Collateralized debt obligations | 17,892 | - | (7,918) | 9,974 |
| | \$ 313,858 | \$ 3,775 | \$ (10,069) | \$ 307,564 |

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

| | Amortized Cost | Weighted Average Yield | Fair Value |
|--|-------------------|------------------------------|---------------|
| Due in one year or less | \$ 8,256 | 1.81% | \$ 8,291 |
| Due after one year through five years | 48,540 | 2.01% | 48,981 |
| Due after five years through ten years | 17,283 | 3.18% | 18,043 |
| Due after ten years | 19,957 | 4.04% | 20,148 |
| | 94,036 | 2.64% | 95,463 |
| Mortgage-backed securities | 156,348 | 2.17% | 157,595 |
| Asset-back securities | 137,341 | 1.63% | 137,674 |
| Collateralized debt obligations | 17,910 | 1.89% | 9,163 |
| | \$ 405,635 | 2.08% | \$ 399,895 |

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

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| June 30, 2012 | Less than 12 months in an unrealized loss position | | | Greater than 12 months in an unrealized loss position | | | Total | | |
|---|---|----------------------|---------------|--|----------------------|---------------|----------------------------|----------------------|---------------|
| | Number of Securities | Unrealized Losses | Fair Value | Number of Securities | Unrealized Losses | Fair Value | Number of Securities | Unrealized Losses | Fair Value |
| U.S. government agencies | 4 | \$ 32 | \$ 14,156 | - | \$ - | \$ - | 4 | \$ 32 | \$ 14,156 |
| U.S. government agency mortgage-backed | 2 | 16 | 2,555 | - | - | - | 2 | 16 | 2,555 |
| States and political subdivisions | 1 | 5 | 1,295 | - | - | - | 1 | 5 | 1,295 |
| Corporate bonds | 6 | 100 | 12,184 | - | - | - | 6 | 100 | 12,184 |
| Collateralized mortgage obligations | 12 | 870 | 36,439 | - | - | - | 12 | 870 | 36,439 |
| Asset-backed securities | 12 | 1,143 | 93,066 | - | - | - | 12 | 1,143 | 93,066 |
| Collateralized debt obligations | - | - | - | 2 | 8,747 | 9,163 | 2 | 8,747 | 9,163 |
| | 37 | \$ 2,166 | \$ 159,695 | 2 | \$ 8,747 | \$ 9,163 | 39 | \$ 10,913 | \$ 168,858 |

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

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

Uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for certain investments, particularly the CDO. In the case of the CDO fair value measurement, management included a risk premium adjustment as of June 30, 2012, to reflect an estimated yield that a market participant would demand because of uncertainty in cash flows, based on incomplete and sporadic levels of market activity. Accordingly, management continues to designate these securities as level 3 securities as described in Note 12 of this quarterly report as of June 30, 2012. 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.

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

| Amortized Cost | Fair Value | Gross Unrealized Loss | S&P Credit Rating 1 | Number of Banks in Issuance | Issuance Deferrals & Defaults | | Issuance Excess Subordination | | |
|----------------------|---------------|-----------------------------|---------------------------|--------------------------------------|----------------------------------|--------------|----------------------------------|--------------|--|
| | | | | | Amount | Collateral % | Amount | Collateral % | |
| June 30, 2012 | | | | | | | | | |

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| | | | | | | | | | | | | | | |
|--------------------------|----|--------|----|-------|----|---------|------|----|----|---------|-------|----|---------|-------|
| Class A1 | \$ | 9,084 | \$ | 5,156 | \$ | (3,928) | BB+ | 63 | \$ | 198,000 | 26.4% | \$ | 198,690 | 26.5% |
| Class A2A | | 8,826 | | 4,007 | | (4,819) | B+ | 63 | | 198,000 | 26.4% | | 101,690 | 13.6% |
| | \$ | 17,910 | \$ | 9,163 | \$ | (8,747) | | | | | | | | |
| December 31, 2011 | | | | | | | | | | | | | | |
| Class A1 | \$ | 9,136 | \$ | 5,584 | \$ | (3,552) | CCC+ | 63 | \$ | 212,750 | 28.4% | \$ | 181,630 | 24.2% |
| Class A2A | | 8,756 | | 4,390 | | (4,366) | CCC- | 63 | | 212,750 | 28.4% | | 84,630 | 11.3% |
| | \$ | 17,892 | \$ | 9,974 | \$ | (7,918) | | | | | | | | |

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

Table of Contents**Note 3 Loans**

Major classifications of loans were as follows:

| | June 30, 2012 | December 31, 2011 |
|----------------------------------|---------------|-------------------|
| Commercial | \$ 90,051 | \$ 98,099 |
| Real estate - commercial | 625,056 | 704,492 |
| Real estate - construction | 57,064 | 71,436 |
| Real estate - residential | 447,151 | 477,200 |
| Consumer | 3,321 | 3,789 |
| Overdraft | 520 | 457 |
| Lease financing receivables | 2,644 | 2,087 |
| Other | 12,235 | 11,498 |
| | 1,238,042 | 1,369,058 |
| Net deferred loan fees and costs | 92 | (73) |
| | \$ 1,238,134 | \$ 1,368,985 |

It is the policy of the Company to review each prospective credit in order to determine whether an adequate level of security or collateral was obtained prior to making a loan. The type of collateral, when required, varies from liquid assets to real estate. The Company's access to collateral, in the event of borrower default, is assured through adherence to state lending laws, the Company's lending standards and credit monitoring procedures. The Bank generally makes loans solely within its market area. There are no significant concentrations of loans where the customers' ability to honor loan terms is dependent upon a single economic sector, although the real estate related categories listed above represent 91.2% and 91.5% of the portfolio at June 30, 2012, and December 31, 2011, respectively. The Company remains committed to overseeing and managing its loan portfolio to reduce its real estate credit concentrations in accordance with the requirements of the Consent Order with the Bank and the Office of the Comptroller of the Currency (OCC). Regulatory and capital matters including the Consent Order are discussed in more detail in Note 11 of the consolidated financial statements included in this report.

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

| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due | Total Past Due | Current | Nonaccrual | Total Financing Receivables | Recorded Investment 90 days or Greater Past Due and Accruing |
|------------------------------------|------------------------|------------------------|--------------------------------------|-------------------|--------------|------------|-----------------------------------|--|
| June 30, 2012 | | | | | | | | |
| Commercial | \$ 232 | \$ 87 | \$ - | \$ 319 | \$ 91,285 | \$ 1,091 | \$ 92,695 | \$ - |
| Real estate - commercial | | | | | | | | |
| Owner occupied general purpose | 684 | 9 | - | 693 | 126,477 | 6,091 | 133,261 | - |
| Owner occupied special purpose | 519 | - | - | 519 | 156,580 | 12,234 | 169,333 | - |
| Non-owner occupied general purpose | - | - | - | - | 124,526 | 21,765 | 146,291 | - |
| Non-owner occupied special purpose | - | 247 | - | 247 | 93,391 | 497 | 94,135 | - |
| Retail properties | - | - | - | - | 40,864 | 12,782 | 53,646 | - |
| Farm | - | - | - | - | 26,112 | 2,278 | 28,390 | - |
| Real estate - construction | | | | | | | | |
| Homebuilder | - | - | - | - | 7,686 | 6,087 | 13,773 | - |
| Land | - | - | - | - | 8,197 | 721 | 8,918 | - |
| Commercial speculative | - | - | - | - | 4,603 | 10,626 | 15,229 | - |
| All other | - | 243 | - | 243 | 18,805 | 96 | 19,144 | - |
| Real estate - residential | | | | | | | | |
| Investor | 1,499 | - | - | 1,499 | 153,997 | 13,631 | 169,127 | - |
| Owner occupied | 374 | 672 | - | 1,046 | 117,930 | 9,532 | 128,508 | - |
| Revolving and junior liens | 1,277 | 580 | - | 1,857 | 144,582 | 3,077 | 149,516 | - |
| Consumer | 6 | - | - | 6 | 3,315 | - | 3,321 | - |
| All other | - | - | - | - | 12,847 | - | 12,847 | - |
| | \$ 4,591 | \$ 1,838 | \$ - | \$ 6,429 | \$ 1,131,197 | \$ 100,508 | \$ 1,238,134 | \$ - |

December 31, 2011

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

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| | | | | | | | | |
|-----------|----------|----------|--------|-----------|--------------|------------|--------------|--------|
| Consumer | 8 | - | - | 8 | 3,781 | - | 3,789 | - |
| All other | - | - | - | - | 11,882 | - | 11,882 | - |
| | \$ 7,026 | \$ 5,103 | \$ 318 | \$ 12,447 | \$ 1,229,752 | \$ 126,786 | \$ 1,368,985 | \$ 318 |

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

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

Credit Quality Indicators:

The Company categorizes loans into credit risk categories based on current financial information, overall debt service coverage, comparison against industry averages, historical payment experience, and current economic trends. Each loan and loan relationship is examined. This analysis includes loans with outstanding loans or commitments greater than \$50,000 and excludes homogeneous loans such as home equity lines of credit and residential mortgages. Loans with a classified risk rating are reviewed quarterly regardless of size or loan type. The Company uses the following definitions for classified risk ratings:

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

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

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

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

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Credit Quality Indicators by class of loans as were as follows:

June 30, 2012

| | Pass | Special Mention | Substandard 1 | Doubtful | Total |
|------------------------------------|-----------|--------------------|---------------|----------|-----------|
| Commercial | \$ 86,830 | \$ 4,456 | \$ 1,409 | \$ - | \$ 92,695 |
| Real estate - commercial | | | | | |
| Owner occupied general purpose | 116,221 | 4,893 | 12,147 | - | 133,261 |
| Owner occupied special purpose | 139,707 | 5,880 | 23,746 | - | 169,333 |
| Non-owner occupied general purpose | 95,441 | 20,607 | 30,243 | - | 146,291 |
| Non-owner occupied special purpose | 86,120 | 6,495 | 1,520 | - | 94,135 |
| Retail Properties | 31,643 | 4,524 | 17,479 | - | 53,646 |
| Farm | 22,964 | 3,148 | 2,278 | - | 28,390 |
| Real estate - construction | | | | | |
| Homebuilder | 3,764 | 2,741 | 7,268 | - | 13,773 |
| Land | 5,772 | - | 3,146 | - | 8,918 |
| Commercial speculative | 2,587 | - | 12,642 | - | 15,229 |
| All other | 16,130 | 2,885 | 129 | - | 19,144 |
| Real estate - residential | | | | | |
| Investor | 131,224 | 18,705 | 19,198 | - | 169,127 |
| Owner occupied | 114,603 | 493 | 13,412 | - | 128,508 |
| Revolving and junior loans | 144,782 | 410 | 4,324 | - | 149,516 |
| Consumer | 3,314 | - | 7 | - | 3,321 |
| All other | 12,627 | 220 | - | - | 12,847 |
| Total | \$ | | | | |