

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) September 30, 2013	December 31, 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) Three Months Ended September 30,		(unaudited) Nine Months Ended 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 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 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 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 September 30,		Nine Months Ended 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 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 Stock	Preferred Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders 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 Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair 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 Cost	Weighted Average Yield	Fair 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 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
<b>Securities Available-for-Sale</b>									
U.S. Treasury	1	\$ 6	\$ 1,548	-	\$ -	\$ -	1	\$ 6	\$ 1,548
U.S. government agencies States and political subdivisions	1	52	1,693	-	-	-	1	52	1,693
Corporate bonds	7	165	6,195	-	-	-	7	165	6,195
Collateralized mortgage 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 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 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
<b>Securities Available-for-Sale</b>									
U.S. government agencies	4	\$ 120	\$ 17,039	-	\$ -	\$ -	4	\$ 120	\$ 17,039
U.S. government agency mortgage-backed	12	583	53,184	-	-	-	12	583	53,184
Corporate bonds	4	55	9,724	-	-	-	4	55	9,724
Collateralized mortgage 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 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 Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Nonaccrual	Total Loans	Recorded Investment 90 days or Greater Past Due and Accruing	
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 Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Nonaccrual	Total Loans	Recorded Investment 90 days or Greater Past Due and Accruing	
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 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 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 September 30, 2013	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income 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 September 30, 2012	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income 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				