

OLD SECOND BANCORP INC

Form 10-Q

November 09, 2009

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2009

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)

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Delaware
(State or other jurisdiction
of incorporation or organization)

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

37 South River Street, Aurora, Illinois
(Address of principal executive offices)

60507
(Zip Code)

(630) 892-0202

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

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

Indicate by check mark whether the 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 Exchange Act. (check one):

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). 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 5, 2009, the Registrant had outstanding 13,823,321 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, 2009	December 31, 2008
Assets		
Cash and due from banks	\$ 37,449	\$ 66,099
Interest bearing deposits with financial institutions	75,456	809
Federal funds sold	1,235	5,497
Short-term securities available-for-sale	4,039	809
Cash and cash equivalents	118,179	73,214
Securities available-for-sale	242,354	405,577
Federal Home Loan Bank and Federal Reserve Bank stock	13,044	13,044
Loans held-for-sale	9,234	23,292
Loans	2,152,691	2,271,114
Less: allowance for loan losses	58,003	41,271
Net loans	2,094,688	2,229,843
Premises and equipment, net	59,571	62,522
Other real estate owned	24,492	15,212
Mortgage servicing rights, net	1,579	1,374
Goodwill, net		59,040
Core deposit and other intangible assets, net	6,946	7,821
Bank-owned life insurance (BOLI)	49,702	48,754
Accrued interest and other assets	79,305	44,912
Total assets	\$ 2,699,094	\$ 2,984,605
Liabilities		
Deposits:		
Non-interest bearing demand	\$ 314,669	\$ 318,092
Interest bearing:		
Savings, NOW, and money market	994,976	928,204
Time	1,026,022	1,140,832
Total deposits	2,335,667	2,387,128
Securities sold under repurchase agreements	21,835	46,345
Federal funds purchased		28,900
Other short-term borrowings	9,739	169,383
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	23,184
Accrued interest and other liabilities	17,160	33,191
Total liabilities	2,488,279	2,791,509

Stockholders Equity

Preferred stock, \$1.00 par value; authorized 300,000 shares at September 30, 2009; series B, 5% cumulative perpetual, 73,000 shares issued and outstanding at September 30, 2009, \$1,000.00 liquidation value	68,827	
Common stock, \$1.00 par value; authorized 20,000,000 shares; issued 18,373,008 at September 30, 2009 and 18,304,331 at December 31, 2008; outstanding 13,823,321 at September 30, 2009 and 13,755,884 at December 31, 2008	18,373	18,304
Additional paid-in capital	64,184	58,683
Retained earnings	152,655	213,031
Accumulated other comprehensive income (loss)	1,580	(2,123)
Treasury stock, at cost, 4,549,379 shares at September 30, 2009 and December 31, 2008	(94,804)	(94,799)
Total stockholders equity	210,815	193,096
Total liabilities and stockholders equity	\$ 2,699,094	\$ 2,984,605

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,	
	2009	2008	2009	2008
Interest and dividend income				
Loans, including fees	\$ 29,060	\$ 33,961	\$ 89,008	\$ 102,523
Loans held-for-sale	165	89	782	497
Securities, taxable	1,278	3,574	7,247	12,500
Securities, tax exempt	1,343	1,484	4,190	4,481
Dividends from Federal Reserve Bank and Federal Home Loan Bank stock	56	17	169	51
Federal funds sold	14	40	17	124
Interest bearing deposits	27	30	31	41
Total interest and dividend income	31,943	39,195	101,444	120,217
Interest Expense				
Savings, NOW, and money market deposits	1,586	3,563	4,978	11,877
Time deposits	7,972	8,987	26,735	32,742
Securities sold under repurchase agreements	13	182	128	720
Federal funds purchased		196	73	1,359
Other short-term borrowings	36	848	257	2,249
Junior subordinated debentures	1,071	1,072	3,215	3,209
Subordinated debt	241	495	1,040	1,287
Notes payable and other borrowings	2	219	116	673
Total interest expense	10,921	15,562	36,542	54,116
Net interest and dividend income	21,022	23,633	64,902	66,101
Provision for loan losses	9,650	6,300	66,575	9,100
Net interest and dividend income (expense) after provision for loan losses	11,372	17,333	(1,673)	57,001
Non-interest Income				
Trust income	2,042	1,952	5,777	6,324
Service charges on deposits	2,285	2,543	6,570	6,911
Secondary mortgage fees	270	157	1,148	672
Mortgage servicing income	128	137	399	432
Net gain on sales of mortgage loans	1,799	938	6,995	4,651
Securities gains (losses), net	454	(20)	1,768	1,363
Increase in cash surrender value of bank-owned life insurance	474	65	948	685
Debit card interchange income	693	623	1,904	1,792
Net interest rate swap gains and fees	712	71	145	219
Net gain (loss) on sales of other real estate owned	169	(13)	462	(13)
Other income	1,186	1,334	3,585	3,714
Total non-interest income	10,212	7,787	29,701	26,750
Non-interest Expense				
Salaries and employee benefits	9,421	10,630	29,982	33,825
Occupancy expense, net	1,427	1,478	4,587	4,475
Furniture and equipment expense	1,673	1,713	5,155	5,084
FDIC insurance	822	380	4,060	992

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Amortization of core deposit and other intangible asset	292	301	875	797
Advertising expense	313	592	987	1,600
Impairment of goodwill			57,579	
Other real estate expense	1,862	5	6,034	10
Other expense	4,428	4,551	13,109	13,119
Total non-interest expense	20,238	19,650	122,368	59,902
Income (loss) before income taxes	1,346	5,470	(94,340)	23,849
(Benefit) provision for income taxes	(126)	1,349	(38,370)	6,842
Net income (loss)	\$ 1,472	\$ 4,121	\$ (55,970)	\$ 17,007
Preferred stock dividends and accretion	1,121		3,157	
Net income (loss) available to common stockholders	\$ 351	\$ 4,121	\$ (59,127)	\$ 17,007
Basic earnings (loss) per share	\$ 0.03	\$ 0.30	\$ (4.26)	\$ 1.26
Diluted earnings (loss) per share	0.03	0.30	(4.26)	1.25
Dividends paid per share	0.01	0.16	0.09	0.47

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In thousands)

	(Unaudited) Nine Months Ended September 30,	
	2009	2008
Cash flows from operating activities		
Net (loss) income	\$ (55,970)	\$ 17,007
Adjustments to reconcile net (loss) income to net cash provided by operating activities:		
Depreciation	3,731	3,419
Amortization of leasehold improvement	168	150
Amortization and recovery of mortgage servicing rights, net	290	477
Provision for loan losses	66,575	9,100
Provision for deferred tax expense	32,110	
Originations of loans held-for-sale	(354,916)	(244,411)
Proceeds from sales of loans held-for-sale	375,483	254,051
Net gain on sales of mortgage loans	(6,994)	(4,651)
Change in current income taxes payable	(42,169)	(2,373)
Increase in cash surrender value of bank-owned life insurance	(948)	(685)
Change in accrued interest receivable and other assets	(24,497)	5,720
Change in accrued interest payable and other liabilities	(14,900)	(6,153)
Net premium amortization on securities	416	504
Securities gains, net	(1,768)	(1,363)
Impairment of goodwill	57,579	
Amortization of core deposit and other intangible assets	875	797
Stock based compensation	754	760
(Gain) loss on sale of other real estate owned	(462)	13
Write-down of other real estate owned	4,794	
Net cash provided by operating activities	40,151	32,362
Cash flows from investing activities		
Proceeds from maturities and pre-refunds including pay down of securities available-for-sale	110,173	188,000
Proceeds from sales of securities available-for-sale	213,790	61,819
Purchases of securities available-for-sale	(153,435)	(81,781)
Purchases of Federal Reserve Bank and Federal Home Loan Bank stock		(1,917)
Net change in loans	51,073	(80,056)
Investment in other real estate owned	(2,354)	
Proceeds from sales of other real estate owned	6,088	595
Purchase of bank-owned life insurance		(202)
Cash paid for acquisition, net of cash and cash equivalents retained		(38,852)
Net purchases of premises and equipment	(948)	(5,520)
Net cash provided by investing activities	224,387	42,086
Cash flows from financing activities		
Net change in deposits	(51,461)	(78,782)
Net change in securities sold under repurchase agreements	(24,510)	(14,457)
Net change in federal funds purchased	(28,900)	(164,300)
Net change in other short-term borrowings	(164,778)	135,802
Proceeds from the issuance of preferred stock	68,245	
Proceeds from the issuance of common stock warrants	4,755	

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Proceeds from the issuance of subordinated debt		45,000	
Proceeds from junior subordinated debentures		979	
Proceeds from notes payable and other borrowings	2,240		4,503
Repayment of note payable	(19,790)		(5,825)
Proceeds from exercise of stock options	55		161
Tax benefit from stock options exercised			64
Tax benefit from dividend equivalent payment	6		12
Dividends paid	(5,430)		(6,053)
Purchase of treasury stock	(5)		
Net cash used in financing activities	(219,573)		(82,896)
Net change in cash and cash equivalents	44,965		(8,448)
Cash and cash equivalents at beginning of period		73,214	64,739
Cash and cash equivalents at end of period	\$	118,179	\$ 56,291

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

(In thousands)

	(Unaudited) Nine Months Ended September 30,	
	2009	2008
Supplemental cash flow information		
Income taxes paid	\$ 2,330	\$ 11,467
Interest paid for deposits	32,550	45,991
Interest paid for borrowings	4,886	9,464
Non-cash transfer of loans to other real estate	17,346	1,533
Non-cash transfer of notes payable to other short-term borrowings	5,134	
Change in dividends declared not paid	(1,606)	374
Non-cash transfer related to deferred taxes on goodwill	1,461	
2008 Acquisition of HeritageBanc, Inc.		
Non-cash assets acquired:		
Securities available-for-sale		\$ 43,971
Federal Home Loan Bank and Federal Reserve Bank stock		1,470
Loans, net		283,552
Premises and equipment		11,567
Goodwill		56,923
Core deposit and other intangible asset		8,917
Other assets		1,482
Total non-cash assets acquired		\$ 407,882
Liabilities assumed:		
Deposits		294,356
Federal funds purchased		17,100
Advances from the Federal Home Loan Bank		9,331
Other liabilities		5,243
Total liabilities assumed		326,030
Net non-cash assets acquired		\$ 81,852
Cash and cash equivalents acquired		\$ 5,718
Stock issuance in lieu of cash paid in acquisition		\$ 43,000

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Changes in

Stockholders Equity

(In thousands, except share data)

	Common Stock	Preferred Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock
Balance, December 31, 2007	\$ 16,695	\$	\$ 16,114	\$ 209,867	\$ 1,971	\$ (94,758)
Comprehensive income:						
Net income				17,007		
Change in net unrealized loss on securities available-for-sale net of \$4,152 tax effect					(6,298)	
Total comprehensive income						
Dividends declared, \$.47 per share				(6,427)		
Purchase of Heritage	1,564		41,436			
Change in restricted stock	27		(27)			
Stock options exercised	16		145			
Tax effect of stock options exercised			64			
Tax effect of dividend equivalent payments			12			
Stock based compensation			760			
Balance, September 30, 2008	\$ 18,302	\$	\$ 58,504	\$ 220,447	\$ (4,327)	\$ (94,758)
Balance, December 31, 2008	\$ 18,304	\$	\$ 58,683	\$ 213,031	\$ (2,123)	\$ (94,799)
Comprehensive loss:						
Net loss				(55,970)		
Change in net unrealized gain on securities available-for-sale net of \$2,345 tax effect					3,608	
Change in unrealized gain on cash flow hedge net of \$63 tax effect					95	
Total comprehensive loss						
Dividends Declared, \$.09 per share				(1,249)		
Change in restricted stock	63		(63)			
Stock options exercised	6		49			
Tax effect of stock options exercised						
Tax effect of dividend equivalent payments			6			
Stock based compensation			754			
Purchase of treasury stock						(5)
Preferred dividends declared (5% per preferred share)		582		(3,157)		
Issuance of preferred stock		68,245				
Issuance of stock warrants			4,755			
Balance, September 30, 2009	\$ 18,373	\$ 68,827	\$ 64,184	\$ 152,655	\$ 1,580	\$ (94,804)

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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, 2009 are not necessarily indicative of the results that may be expected for the year ending December 31, 2009. 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, 2008. 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 A to the consolidated financial statements included in the Company's annual report on Form 10-K for the year ended December 31, 2008. 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.

ASC 805 (formerly Statement No. 141R, *Business Combinations*), broadens the guidance, extending its applicability to all transactions and other events in which one entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed, and interests transferred as a result of business combinations. ASC 805 expands on required disclosures to improve the statement users' abilities to evaluate the nature and financial effects of business combinations. The provisions of ASC 805 will only impact the Company if we are party to a business combination closing on or after January 1, 2009.

ASC 810 (formerly FAS 160, *Noncontrolling Interest in Consolidated Financial Statements*), which requires that a noncontrolling interest in a subsidiary be reported separately within equity and the amount of consolidated net income specifically attributable to the noncontrolling interest be identified in the consolidated financial statements. It also calls for consistency in the manner of reporting changes in the parent's ownership interest and requires fair value measurement of any noncontrolling equity investment retained in a deconsolidation.

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ASC 815 (formerly FAS 161, *Disclosures about Derivative Instruments and Hedging Activities*) amends and expands the disclosure requirements for derivative instruments and hedging activities. ASC 815 requires qualitative disclosure about objectives and strategies for using derivative and hedging instruments, quantitative disclosures about fair value amounts of the instruments and gains and losses on such instruments, as well as disclosures about credit-risk features in derivative agreements. Information related to provisions of ASC 815 including the impact on our financial statements is outlined in Note 16.

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ASC 260 (formerly FASB Staff Position (FSP) EITF 03-6-1, *Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities*), provides that unvested share-based payment awards that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities and shall be included in the computation of earnings per share pursuant to the two-class method. All previously reported earnings per share data have been retrospectively adjusted to conform with the provisions of ASC 260.

ASC 825 (formerly FSP 107-1 and Accounting Principles Board (APB) 28-1, *Interim Disclosures about Fair Value of Financial Instruments*), requires a public entity to provide disclosures about fair value of financial instruments in interim financial information.

ASC 320 (formerly FSP FAS 115-2, FAS124-2 and Emerging Issues Task Force (EITF) 99-20-2, *Recognition and Presentation of Other-Than-Temporary-Impairment*), (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC 320, declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income.

ASC 820 (formerly FSP FAS 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*), affirms the objective of fair value when a market is not active, clarifies and includes additional factors for determining whether there has been a significant decrease in market activity, eliminates the presumption that all transactions are distressed unless proven otherwise, and requires an entity to disclose a change in valuation technique.

ASC 855 (formerly FAS 165, *Subsequent Events*), establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. Information related to the provisions of ASC 855 is reflected in Note 19 - Subsequent Events.

In June 2009, the FASB issued Statement No. 166, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (FAS 166). FAS 166 amends the derecognition accounting and disclosure guidance relating to FAS 140. FAS 166 eliminates the exemption from consolidation for qualifying special-purpose entities (QSPE s), it also requires a transferor to evaluate all existing QSPEs to determine whether it must be consolidated in accordance with FAS 167. FAS 166 is effective as of the beginning of the first annual reporting period that begins after November 15, 2009. Management is currently assessing the impact of FAS 166 on our financial condition, results of operations, and disclosures.

In June 2009, the FASB issued Statement No. 167, *Amendments to FASB Interpretation No. 46(R)* (FAS 167). FAS 167 amends the consolidation guidance applicable to variable interest entities. The amendments to the consolidation guidance affect all entities currently within the scope of FAS 167, as well as QSPE s that are currently excluded from the scope of FAS 167. FAS 167 is effective as of the beginning of the first annual reporting period that begins after November 15, 2009. Management is currently assessing the impact of FAS 167 on our financial condition, results of operations, and disclosures.

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Accounting Standards Update (ASU) No. 2009-01 (formerly Statement No. 168) *Topic 105 - Generally Accepted Accounting Principles-FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles* (the Codification), is the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP). The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents will be superseded and all other accounting literature not included in the Codification will be considered nonauthoritative. The Codification is effective for interim or annual reporting periods ending after September 15, 2009. Management has made the appropriate changes to GAAP references in our financial statements.

ASU No. 2009-05, *Fair Value Measurements and Disclosures (Topic 820) Measuring Liabilities at Fair Value* . This ASU provides amendments for fair value measurements of liabilities. It provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more techniques. ASU 2009-05 also clarifies that when estimating a fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance or fourth quarter 2009. Management is currently assessing the impact of ASU 2009-05 on our financial condition, results of operations, and disclosures.

Note 2 Business Combination

Old Second Acquisition, Inc., was formed as part of the November 5, 2007 Agreement and Plan of Merger between the Company, Old Second Acquisition, Inc., a wholly-owned subsidiary of the Company, and HeritageBanc, Inc. (Heritage), located in Chicago Heights. The parties consummated the merger on February 8, 2008, at which time Old Second Acquisition, Inc. was merged with and into Heritage with Heritage as the surviving corporation as a wholly-owned subsidiary of the Company. Additionally, the parties merged Heritage Bank, a wholly-owned subsidiary of Heritage, with and into Old Second National Bank, with Old Second National Bank as the surviving bank (the Bank). After the completion of the merger transaction, Heritage was dissolved and is no longer an existing subsidiary. The purchase price was paid through a combination of cash and approximately 1.6 million shares of the Company s common stock totaling \$86.0 million, excluding transaction costs. The final accounting for the transaction generated \$55.4 million in goodwill and \$8.9 million in intangible assets subject to amortization.

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The business combination was accounted for under the purchase method of accounting. Accordingly, the results of operations of Heritage have been included in the Company's results of

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operations since the date of acquisition. Under this method of accounting, the purchase price was allocated to the respective assets acquired and liabilities assumed based on their estimated fair values, net of applicable income tax effects. The excess cost over fair value of net assets acquired was recorded as goodwill. The following table summarizes the allocation of the purchase price.

Purchase Price of Heritage (in thousands):		
Market value (market value per share of \$27.50) of the Company's common stock issued	\$	43,000
Cash paid		43,000
Transaction costs		1,557
Total purchase price	\$	87,557
Allocation of the purchase price		
Historical net assets of Heritage as of February 8, 2008	\$	24,390
Fair market value adjustments as of February 8, 2008		
Real estate		529
Equipment		(134)
Artwork		(30)
Loans		(122)
Goodwill		55,449
Core deposit intangible and other intangible assets		8,917
Time deposits		(1,111)
FHLB advances		(331)
Total purchase price	\$	87,557

The Company decreased the goodwill attributable to the Heritage transaction by \$1.4 million in the first quarter of 2009 along with an offsetting decrease to deferred tax liabilities. In addition, the Company recorded a goodwill impairment charge of \$57.6 million in the second quarter of 2009, which primarily resulted from the goodwill that was attributable to Heritage. See Note 6 in these Notes to Consolidated Financial Statements and Item 2 of this quarterly report for additional information on the goodwill impairment charge.

The following is the unaudited pro forma consolidated results of operations of the Company as though Heritage had been acquired as of the beginning of the periods indicated.

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	Three Months Ended September 2008		Nine Months Ended September 2008	
Net interest income after provision	\$	17,262	\$	58,057
Noninterest income		7,800		26,981
Noninterest expense		19,636		65,485
Income before income taxes		5,426		19,553
Income taxes		1,544		5,794
Net income	\$	3,882	\$	13,759
Per common share information				
Earnings	\$	0.28	\$	1.00
Diluted earnings	\$	0.28	\$	0.99
Average common shares issued and outstanding		13,747,723		13,743,510
Average diluted common shares outstanding		13,832,869		13,858,729

Included in the pro forma results of operations for the nine months ended September 30, 2008 was one-time pretax merger costs of \$3.9 million.

Note 3 Securities

Securities available-for-sale are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2009:				
U.S. Treasury	\$ 1,498	\$ 37	\$	\$ 1,535
U.S. government agencies	19,623	410		20,033
U.S. government agency mortgage-backed States and political subdivisions	45,828	1,820	(40)	47,608
Collateralized mortgage obligations	134,591	6,288	(114)	140,765
Collateralized debt obligations	24,376	954	(11)	25,319
Equity securities	17,817		(6,778)	11,039
	99	1	(6)	94
	\$ 243,832	\$ 9,510	\$ (6,949)	\$ 246,393
December 31, 2008:				
U.S. Treasury	\$ 1,496	\$ 72	\$	\$ 1,568
U.S. government agencies	95,290	1,178	(113)	96,355
U.S. government agency mortgage-backed States and political subdivisions	86,062	1,396	(208)	87,250
Collateralized mortgage obligations	150,313	2,939	(1,659)	151,593
Collateralized debt obligations	58,684	711	(125)	59,270
Equity securities	17,834		(7,567)	10,267
	99		(16)	83
	\$ 409,778	\$ 6,296	\$ (9,688)	\$ 406,386

Recognition of other-than-temporary impairment was not necessary in the quarter ended September 30, 2009 or the year ended December 31, 2008. The changes in fair values related to interest rate fluctuations and other market factors and were generally not related to credit quality

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deterioration although the amount of deferrals and defaults in the pooled collateralized debt obligation increased from December 31, 2008. An increase in rates will generally cause a decrease in the fair value of individual securities while a decrease in rates typically results in an increase in fair value. In addition to the impact of rate changes upon pricing, uncertainty in the financial markets in the periods presented has resulted in

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reduced liquidity for certain investments, particularly the collateralized debt obligations (CDO), which also impacted market pricing for the periods presented. In the case of the CDO fair value measurement, management included a risk premium adjustment as of September 30, 2009, to reflect an estimated amount that a market participant would demand because of uncertainty in cash flows. Management made that adjustment because the level of market activity for the CDO security has continued to decrease and information on orderly transaction sales was not generally available. Accordingly, management designated this security as a level 3 security at June 30, 2009 as described in Note 15 of this quarterly report and continues with that designation as of September 30, 2009. Management does not have the intent to sell the above securities and it is more likely than not the Company will not have to 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. This collateralized debt obligation was rated AAA at the time of purchase by the Company.

	Amortized	Fair	Gross	S&P	Number	Issuance	Issuance	Issuance	Issuance
	Cost	Value	Unrealized	Credit	of	Deferrals & Defaults	Collateral	Excess Subordination	Collateral
			Loss	Rating	Banks in	Amount	%	Amount	%
				(1)	Issuance				
September 30, 2009									
Class A1	\$ 9,353	\$ 5,587	\$ (3,766)	BB+	63	\$ 123,500	16.5%	\$ 260,928	34.8%
Class A2A	8,464	5,452	(3,012)	BB-	63	123,500	16.5%	163,928	21.9%
	\$ 17,817	\$ 11,039	\$ (6,778)						
December 31, 2008									
Class A1	\$ 9,478	\$ 4,657	\$ (4,821)	AAA	63	\$ 37,500	5.0%	\$ 340,917	45.5%
Class A2A	8,356	5,610	(2,746)	AAA	63	37,500	5.0%	243,917	32.5%
	\$ 17,834	\$ 10,267	\$ (7,567)						

(1) Moody's credit rating for class A1 and A2A were A1 and Baa2, respectively, as of September 30, 2009. The Moody's credit ratings at December 31, 2008 for class A1 and A2A were both Aaa. The Fitch ratings for class A1 and A2A were AA and A, respectively, as of September 30, 2009. The Fitch ratings at December 31, 2008 for class A1 and A2A were both AAA.

In addition to other equity securities, which are recorded at estimated market value, the Bank owns the stock of the Federal Reserve Bank of Chicago (FRB) and the Federal Home Loan Bank of Chicago (FHLBC). Both of these entities require the Bank to invest in their non-marketable stock as a condition of membership. The value of the stock in each of those entities was recorded at cost in the amounts of \$3.8 million and \$9.3 million, respectively, at September 30, 2009, and at December 31, 2008. The FHLBC is a governmental sponsored entity that has been under a regulatory order for a prolonged period that generally requires approval prior to redeeming or paying dividends on their common stock. The Bank continues to utilize the various products and services of the FHLBC and management considers this stock to be a long-term investment. FHLBC members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLBC stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value.

Table of Contents**Note 4 Loans**

Major classifications of loans were as follows:

	September 30, 2009	December 31, 2008
Commercial and industrial	\$ 215,189	\$ 244,019
Real estate - commercial	941,307	929,576
Real estate - construction	303,765	373,704
Real estate - residential	677,198	701,221
Installment	11,682	19,116
Overdraft	808	761
Lease financing receivables	4,194	4,396
	2,154,143	2,272,793
Net deferred loan fees and costs	(1,452)	(1,679)
	\$ 2,152,691	\$ 2,271,114

Note 5 Allowance for Loan Losses

Changes in the allowance for loan losses as of September 30 are summarized as follows:

	2009	2008
Balance at beginning of period	\$ 41,271	\$ 16,835
Addition resulting from acquisition		3,039
Provision for loan losses	66,575	9,100
Loans charged-off	(50,254)	(5,079)
Recoveries	411	280
Balance at end of period	\$ 58,003	\$ 24,175

Note 6 Goodwill and Intangibles

Goodwill and other intangible assets are reviewed for potential impairment on an annual basis as of September 30 and February 28, respectively, or more often if events or circumstances indicate that they may be impaired. As disclosed in the prior quarterly report, goodwill was tested for impairment at the reporting unit level as of June 30, 2009 and a total impairment loss was recorded as a result of management's determination that the carrying amount of goodwill exceeded its implied fair value. The Company's market price per share had continued to be less than its stockholders' common equity as the Company's stock continued to trade at a price below its book value. At the same time, earnings decreased as nonperforming assets, particularly loans and related charge-offs increased. Consistent with prior quarters, the Company considered these and other factors, including the items outlined in the process described below. The Company employed general industry practices in evaluating the impairment of its goodwill using a two-step process that begins with an estimation of the fair value of the reporting unit. The first step included a screen for potential impairment and the second step measured the amount of impairment. Significant management judgment was applied to the process including the development of cash flow projections, selection of appropriate discount rates, identification of relevant market comparables, the incorporation of general economic and market conditions as well as the selection of an appropriate control premium.

The first step of the June 30, 2009 analysis was to determine if there was a potential impairment. The Company used both an income and market approach as part of that analysis. The income approach was based on discounted cash flows, which were derived from internal forecasts and economic expectations for the Bank reporting unit. The key assumptions used to determine fair value under the income approach included the cash flow period, terminal values based on a terminal growth rate and the discount rate. The discount rates used in the income approach evaluated at June 30, 2009 ranged from

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17.5% to 22.5% to attempt to incorporate discount rates a market participant might employ in its valuation of Old Second National Bank. The market approach calculated the change of control price a market participant could have been reasonably expected to pay for the Bank by adding a change of control premium. The results of the first step of the analysis indicated that the Bank's carrying value exceeded its fair value, which indicated that an impairment existed and required that the Company perform the second step of the analysis to determine the amount of the impairment. The second step of the analysis involved a valuation of all of the assets of the Bank as if it had just been acquired and comparing the resultant goodwill with the actual carrying amount of goodwill. The results of the second step of the analysis determined that goodwill was fully impaired, which resulted in the pre-tax impairment charge of \$57.6 million. This was a total impairment and no goodwill remained as a result of that impairment charge. See the management discussion in Item 2 for additional information related to this noncash noninterest expense. The portion of the goodwill intangible asset charge that was attributable to Heritage was tax deductible and had an associated \$22.0 million deferred tax asset, and although not anticipated, there can be no guarantee that a valuation allowance against this deferred tax asset will not be necessary in future periods.

Management also performed an annual review of the core deposit and other intangible assets. Based upon these reviews, management determined there was no impairment of the core deposit and other intangible assets as of September 30, 2009. No assurance can be given that future impairment tests will not result in a charge to earnings. The core deposit and other intangible assets related to Heritage were \$8.9 million at acquisition.

The following table presents the changes in the carrying amount of goodwill and other intangibles during the first nine months ended September 30, 2009, and the year ended December 31, 2008 (in thousands):

	Six Months Ended September 30, 2009		Year Ended December 31, 2008	
	Goodwill	Core Deposit and Other Intangibles	Goodwill	Core Deposit and Other Intangibles
Balance at beginning of period	\$ 59,040	\$ 7,821	\$ 2,130	\$ 8,917
Addition resulting from acquisition			56,910	8,917
Amortization / adjustments (1)	(1,461)	(875)		(1,096)
Impairment	(57,579)			
Balance at end of period	\$	\$ 6,946	\$ 59,040	\$ 7,821

(1) The \$1.46 million adjustment to goodwill was recorded in the first quarter of 2009.

The following table presents the estimated future amortization expense for core deposit and other intangibles as of September 30, 2009 (in thousands):

	Amount
For the rest of 2009	\$ 291
2010	1,130
2011	847
2012	780
2013	732
Thereafter	3,166
Total	\$ 6,946

The following table presents the estimated future amortization expense for core deposit and other intangibles as of

The following table presents the estimated future amortization expense for core deposit and other intangibles as of

Table of Contents**Note 7 Mortgage Servicing Rights**

Changes in capitalized mortgage servicing rights as of September 30, summarized as follows:

	2009	2008
Balance at beginning of period	\$ 1,973	\$ 2,569
Additions	495	99
Amortization	(658)	(562)
Balance at end of period	1,810	2,106

Changes in the valuation allowance for servicing assets were as follows:

Balance at beginning of period	(599)	(87)
Provisions for impairment	(443)	(475)
Recovery credited to expense	811	560
Balance at end of period	(231)	(2)
Net balance	\$ 1,579	\$ 2,104

Note 8 Deposits

Major classifications of deposits as of September 30, 2009, and December 31, 2008, were as follows:

	2009	2008
Noninterest bearing	\$ 314,669	\$ 318,092
Savings	168,333	109,991
NOW accounts	431,726	274,888
Money market accounts	394,917	543,325
Certificates of deposit of less than \$100,000	620,571	696,240
Certificates of deposit of \$100,000 or more	405,451	444,592
	\$ 2,335,667	\$ 2,387,128

Note 9 Borrowings

The following table is a summary of borrowings as of September 30, 2009, and December 31, 2008:

	2009	2008
Securities sold under repurchase agreements	\$ 21,835	\$ 46,345
Federal funds purchased		28,900
FHLB advances	5,048	167,018

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Treasury tax and loan	4,691	2,365
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	23,184
	\$ 135,452	\$ 371,190

The Company enters into sales of securities under agreements to repurchase (repurchase agreements) which generally mature within 1 to 90 days from the transaction date. These repurchase agreements are treated as financings and they were secured by securities with a carrying amount of \$27.5

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and \$48.5 million at September 30, 2009 and December 31, 2008, respectively. The securities sold under agreements to repurchase consisted of U.S. government agencies and mortgage-backed securities during the two-year reporting period.

The Company's borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC and are generally limited to the lesser of 35% of total assets or 60% of the book value of certain mortgage loans. In addition, these borrowings were collateralized by FHLBC stock of \$9.3 million and loans totaling \$437.0 million at September 30, 2009. FHLBC stock of \$9.3 million and loans totaling \$318.4 million were pledged as of December 31, 2008.

The Bank is a Treasury Tax & Loan (TT&L) depository for the FRB and, as such, accepts TT&L deposits. The Company is allowed to hold these deposits for the FRB until they are called. The interest rate is the federal funds rate less 25 basis points. Securities with a face value greater than or equal to the amount borrowed are pledged as a condition of borrowing TT&L deposits. As of September 30, 2009 and December 31, 2008, TT&L deposits were \$4.7 million and \$2.4 million, respectively.

On January 31, 2008, the Company entered into a \$75.5 million credit facility with Bank of America, N.A. (the Lender), which was comprised of a \$30.5 million senior debt facility and \$45.0 million of subordinated debt. The senior debt facility included a \$500,000 term loan with a maturity of March 31, 2018, and a revolving loan with a maturity of March 31, 2010. The loans replaced a \$30.0 million revolving line of credit facility previously held with Marshall & Ilsley Bank. At September 30, 2009, no balance was outstanding on that revolving line. The subordinated debt matures 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 senior debt is secured with all of the issued and outstanding shares of Old Second National Bank. The proceeds of the \$45.0 million of subordinated debt were used primarily to finance the acquisition of Heritage including transaction costs. The \$30.5 million senior debt facility is for general corporate purposes and was primarily used in the past to repurchase common stock.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the agreement, as described therein. The agreement also contains certain customary representations and warranties and financial and negative covenants. At September 30, 2009, the Company did not comply with two of the financial covenants contained within that credit agreement and additional details related to that noncompliance including the Lender notice details in response to that noncompliance are discussed in Item 2 of this quarterly report under the heading, *Deposits and Borrowings*. The agreement provides that upon an event of default as the result of the Company's failure to comply with a financial covenant, the Lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the Senior 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. As illustrated in the above table, the total outstanding principal amount of the Senior Debt is \$500,000. Because the Subordinated Debt is treated as Tier 2 capital for regulatory capital purposes, the Agreement does not provide the Lender with any rights of acceleration or other remedies with regard to the Subordinated Debt upon an event of default caused by the Company's breach of a financial covenant.

In its prior notice to the Company, the Lender indicated that the Lender would not extend any additional credit or make additional disbursements to or for the benefit of the Company. The Lender also indicated in that notice that it was not presently exercising any of its other rights or remedies under the Agreement and that it reserves all of its rights and remedies available to the Lender. The Company and the Lender periodically discuss potential resolution of the issues, including a change in the covenants, but there has been no definitive resolution as of the date of this Form 10-Q. The lender notified the Company on November 2, 2009 that, effective July 27, 2009, the interest rate applicable to the outstanding balance on the Senior Debt (\$500,000), and to the extent permitted by applicable law, any interest payments with respect thereto not paid within 10 days after the same becomes due, shall be equal to the Default Rate. The Company estimated that the additional interest expense

related to that notice was less than two thousand dollars for third quarter 2009.

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Note 10 Junior Subordinated Debentures

The Company completed the sale of \$27.5 million of cumulative trust preferred securities by its unconsolidated subsidiary, Old Second Capital Trust I in June 2003. An additional \$4.1 million of cumulative trust preferred securities was sold in July 2003. The costs associated with the issuance of the cumulative trust preferred securities are being amortized over 30 years. The trust-preferred securities can remain outstanding for a 30-year term but, subject to regulatory approval, can be called in whole or in part by the Company. The stated call period commenced on June 30, 2008 and can be exercised by the Company from time to time hereafter. Cash distributions on the securities are payable quarterly at an annual rate of 7.80%. The Company issued a new \$32.6 million subordinated debenture to the trust in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

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

Both of the debentures issued by Old Second Bancorp, Inc. 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.

Note 11 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 (Incentive Stock Options), nonqualified stock options, restricted stock, and stock appreciation rights. Total shares issuable under the plan were 424,776 at September 30, 2009 and 664,277 at December 31, 2008. Stock based awards may be granted to selected directors and officers or employees at the discretion of the board of directors. All stock options were granted for a term of ten years. Restricted stock vests three years from the grant date. Awards under the Incentive Plan become fully vested upon a merger or change in control of the Company. Compensation expense is recognized over the vesting period of the options based on the fair value of the options at the grant date.

Total compensation cost that has been charged against income for those plans was \$228,000 in the third quarter of 2009 and \$754,000 in the first nine months of 2009. The total income tax benefit was \$80,000 in the third quarter of 2009 and \$264,000 in the first nine months of 2009. Total compensation cost that has been charged against income for those plans was \$255,000 in the third quarter of 2008 and \$760,000 in the first nine months of 2008. The total income tax benefit was \$89,000 in the third quarter of 2008 and \$266,000 in the first nine months of 2008.

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There were no stock options exercised or granted during the third quarter of 2009. There were 10,500 stock options exercised during the third quarter of 2008. There were no stock options granted during the third quarter of 2008. Total unrecognized compensation cost related to nonvested stock options granted under the Incentive Plan was \$282,000 as of September 30, 2009, and is expected to be recognized over a weighted-average period of 1.00 years. Total unrecognized compensation cost related

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to nonvested stock options granted under the Incentive Plan was \$618,000 as of September 30, 2008, and was expected to be recognized over a weighted-average period of 1.98 years.

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

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Beginning outstanding at January 1, 2009	722,132	\$ 24.03		
Granted	16,500	7.49		
Exercised	(5,334)	10.13		
Canceled	(13,000)	29.12		
Expired				
Ending outstanding	720,298	\$ 23.66	4.80	\$
Exercisable at end of quarter	617,136	\$ 23.46	4.24	\$
Beginning outstanding at January 1, 2008	740,798	\$ 23.67		
Granted				
Exercised	(16,000)	10.02		
Expired				
Ending outstanding	724,798	\$ 23.98	5.63	\$ 1,192,719
Exercisable at end of quarter	582,466	\$ 22.93	4.84	\$ 1,192,719

A summary of changes in the Company's nonvested options in the Incentive Plan is as follows:

	Shares	September 30, 2009 Weighted Average Grant Date Fair Value
Nonvested at January 1, 2009	86,662	\$ 6.45
Granted	16,500	2.01
Vested		
Nonvested at September 30, 2009	103,162	\$ 5.74

A summary of stock option activity as of September 30 is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Intrinsic value of options exercised	\$	\$ 97,258	\$ 673	\$ 160,818

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Cash received from option exercises	106,064	54,033	160,259
Tax benefit realized from option exercises	38,655	268	63,917
Weighted average fair value of options granted		2.01	

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Restricted stock was granted beginning in 2005 under the Incentive Plan. Restricted stock units were granted beginning in 2009 under the Incentive Plan. No shares were issued during either the third quarter of 2009 or the third quarter of 2008. These share rights are subject to forfeiture until certain restrictions have lapsed, including employment for a specific period. These share rights vest after a three-year period. Compensation expense is recognized over the vesting period of the shares based on the market value of the shares at issue date. Awards under the Incentive Plan become fully vested upon a merger or change in control of the Company.

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

	September 30, 2009		September 30, 2008	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1	53,311	\$ 28.49	46,065	\$ 30.09
Granted	133,724	7.49	27,254	27.75
Vested	(3,165)	27.57	(702)	31.34
Forfeited	(3,006)	29.28		
Nonvested at September 30	180,864	\$ 12.97	72,617	\$ 29.20

Total unrecognized compensation cost of restricted shares is \$1.1 million as of September 30, 2009, which is expected to be recognized over a weighted-average period of 2.70 years. Total unrecognized compensation cost of restricted shares was \$857,000 as of September 30, 2008, which was expected to be recognized over a weighted-average period of 1.92 years. There were no restricted share rights vested at September 30, 2009 or September 30, 2008.

Note 12 Earnings Per Share

The earnings (loss) per share is included below as of September 30 (share data not in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Basic (loss) earnings per share:				
Weighted-average common shares outstanding	13,823,622	13,747,723	13,813,441	13,520,949
Weighted-average common shares less stock based awards	13,707,907	13,674,404	13,707,692	13,453,337
Weighted-average common shares stock based awards	181,165	72,999	161,027	73,112
Net (loss) income	\$ 1,472	\$ 4,121	\$ (55,970)	\$ 17,007
Dividends and accretion of discount on preferred shares	1,121		3,157	
Net (loss) income available to common shareholders	351	4,121	(59,127)	17,007
Common stock dividends	(137)	(2,189)	(1,234)	(6,395)
Unvested share-based payment awards	(2)	(11)	(15)	(32)

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Undistributed (Loss) Earnings	212	1,921	(60,376)	10,580
Basic (loss) earnings per share common undistributed earnings	0.02	0.14	(4.35)	0.78
Basic (loss) earnings per share common distributed earnings	0.01	0.16	0.09	0.48
Basic (loss) earnings per share	\$ 0.03	\$ 0.30	\$ (4.26)	\$ 1.26
Diluted (loss) earnings per share:				
Weighted-average common shares outstanding	13,823,622	13,747,723	13,813,441	13,520,949
Dilutive effect of restricted shares(1)	112,836	36,103	87,308	31,217
Dilutive effect of stock options		49,049		84,000
Diluted average common shares outstanding	13,936,458	13,832,875	13,900,749	13,636,166
Net (loss) income available to common stockholders	\$ 351	\$ 4,121	\$ (59,127)	\$ 17,007
Diluted (loss) earnings per share	0.03	0.30	(4.26)	1.25
Number of antidilutive options excluded from the diluted earnings per share calculation	1,576,637	550,000	1,576,637	475,000

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

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The following table summarizes the related income tax effect for the components of Other Comprehensive Income (Loss) as of September 30:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Unrealized holding gains (losses) on available-for-sale securities arising during the period				
U.S. Treasury	\$ (10)	\$ 137	\$ (35)	\$ 267
U.S. government agencies	(85)	(983)	(340)	(1,002)
U.S. government agency mortgage-backed States and political subdivisions	255	(122)	1,175	(343)
Collateralized mortgage obligations	4,951	(362)	5,319	(1,751)
Collateralized debt obligations	220	32	802	(396)
Equity securities	(80)	(5,861)	789	(5,869)
	6		11	7
	5,257	(7,159)	7,721	(9,087)
Related tax (expense) benefit	(2,072)	2,846	(3,045)	3,612
Holding gains (losses) after tax	\$ 3,185	\$ (4,313)	\$ 4,676	\$ (5,475)
Less: Reclassification adjustment for the net gains and losses realized during the period				
Realized gains (losses) by security type:				
U.S. Treasury	\$	\$	\$	\$ 95
U.S. government agencies		15	315	349
U.S. government agency mortgage-backed States and political subdivisions	454	(35)	425	(53)
Collateralized mortgage obligations			445	201
Collateralized debt obligations				199
Equity securities				
Net realized gains (losses)	454	(20)	1,768	1,363
Income tax (expense) benefit on net realized gains (loss)	(179)	8	(700)	(540)
Net realized gains (loss) after tax	275	(12)	1,068	823
Other comprehensive income (loss) on available-for-sale	2,910	(4,301)	3,608	(6,298)
Changes in fair value of derivatives used for cashflow hedges arising during the period			158	
Related tax expense			(63)	
Other comprehensive income on cashflow hedges			95	
Total other comprehensive income (loss)	\$ 2,910	\$ (4,301)	\$ 3,703	\$ (6,298)

Note 14 Retirement Plans

The Company maintains tax-qualified contributory and non-contributory profit sharing plans covering substantially all full-time and regular part-time employees. The expense of these plans was \$1.0 million and \$1.8 million in the first nine months of 2009 and 2008, respectively, as the Company eliminated the profit sharing contribution and lowered the amount of the 401K match in 2009. Management had increased the discretionary plan expense in 2008, in part to accommodate the additional permanent employees from Heritage.

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Note 15 Fair Value Option and Fair Value Measurements

In September 2006, Fair Value Measurements was issued. This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about Fair Value Measurements. The guidance establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. This guidance became effective for fiscal years beginning after November 15, 2007. Fair Value Measurements does not change existing guidance as to whether or not an asset or liability is carried at fair value, but it defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Fair Value Option for Financial Assets and Financial Liabilities requirement generally permits the measurement of selected eligible financial instruments at fair value at specified election dates, subject to the conditions set for the in the standard. As disclosed in the Company's 2008 Annual Report, the impact of adoption was not material.

The Company elected to adopt the Fair Value Option for Financial Assets and Financial Liabilities as required on January 1, 2008. That standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. As of April 1, 2009, the Company elected the fair value option for the loans held-for-sale. The Company did not elect the fair value option for any other financial assets or financial liabilities.

Fair Value Measurement

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The fair value hierarchy established, also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Three levels of inputs that may be used to measure fair value:

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

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

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

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

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- Investment securities available-for-sale are valued primarily by a third party pricing agent and both the market and income valuation approaches are implemented using the following types of inputs:
- U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.
- 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.
- Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMOs are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.

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- Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.
- State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Because some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities.
- Collateralized debt obligations are collateralized by trust preferred security issuances of other financial institutions. Uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for these investment securities, which continued to affect market pricing in the period presented. To reflect an appropriate fair value measurement, management included a risk premium adjustment to provide an estimate of the amount that a market participant would demand because of uncertainty in cash flows. Management made that adjustment at June 30, 2009 because the level of market activity for the CDO security has continued to decrease and information on orderly sale transactions was not generally available.
- Marketable equity securities are priced using available market information.
- Residential mortgage loans eligible for sale in the secondary market are carried at fair market value. The fair value of loans held for sale is determined using quoted secondary market prices.
- Lending related commitments to fund certain residential mortgage loans (interest rate locks) to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors as well as forward commitments for future delivery of mortgage-backed securities are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices from the date of the commitment and do not typically involve significant judgments by management.
- The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.
- Interest rate swap positions, both assets and liabilities, are valued by means of Bloomberg pricing models using an income approach based upon readily observable market parameters such as interest rate yield curves.
- The credit valuation reserve on customer interest rate swap positions was determined based upon management's estimate of the amount of credit risk exposure, including available collateral protection and/or by utilizing an estimate related to a probability of default as indicated in the Bank credit policy.

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

The tables below present the balance of assets and liabilities at September 30, 2009 and December 31, 2008, respectively, measured at fair value on a recurring basis:

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	September 30, 2009			
	Level 1	Level 2	Level 3	Total
Assets:				
Investment securities available-for-sale	\$ 1,576	\$ 233,725	\$ 11,092	\$ 246,393
Loans held-for-sale		9,234		9,234
Other assets (Interest rate swap agreements net of credit valuation)		4,352	(981)	3,371
Other assets (Forward loan commitments to investors)		51		51
Total	\$ 1,576	\$ 247,362	\$ 10,111	\$ 259,049
Liabilities:				
Other liabilities (Interest rate swap agreements)	\$	\$ 4,352	\$	\$ 4,352
Other liabilities (Interest rate lock commitments to borrowers)		93		93
Other liabilities (Risk Participation Agreement)			30	30
Total	\$	\$ 4,445	\$ 30	\$ 4,475

	December 31, 2008			
	Level 1	Level 2	Level 3	Total
Assets:				
Investment securities available for sale	\$ 22,779	\$ 383,555	\$ 52	\$ 406,386
Other assets (Interest rate swap agreements)		4,860		4,860
Other assets (Forward loan commitments to investors)		(148)		(148)
Total	\$ 22,779	\$ 388,267	\$ 52	\$ 411,098
Liabilities:				
Other liabilities (Interest rate swap agreements)	\$	\$ 5,018	\$	\$ 5,018
Other liabilities (Interest rate lock commitments to borrowers)		(148)		(148)
Other liabilities (Risk Participation Agreement)			26	26
Total	\$	\$ 4,870	\$ 26	\$ 4,896

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

	September 30, 2009		
	Investment securities available-for-sale	Interest Rate Swap Credit Valuation	Risk Participation Agreement
Beginning balance January 1, 2009	\$ 52	\$	\$ (26)
Total gains or losses (realized/unrealized)			
Included in earnings			(4)
Included in other comprehensive income	(71)		
Purchases and issuances			