

OLD SECOND BANCORP INC

Form 10-Q

May 08, 2018

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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 March 31, 2018

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

(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction)

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

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of incorporation or organization)

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices) (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, smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company Emerging growth company

(Do not check if a smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

Yes No

As of May 4, 2018, the Registrant had 29,747,078 shares of common stock outstanding at \$1.00 par value per share.

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OLD SECOND BANCORP, INC.

Form 10-Q Quarterly Report

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

This report and other publicly available documents of the Company, including the documents incorporated herein by reference, contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act, including, but not limited to, statements regarding management's belief that we are positioned for future growth, expectations regarding future plans, strategies and financial performance, regulatory developments, industry and economic trends, and other matters. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, can be identified by the inclusion of such qualifications as "expects," "intends," "believes," "may," "will," "would," "could," "should," "plan," "estimate," "seeks," "possible," "likely" or other indications that the particular statements are not historical facts and refer to future periods. Because forward-looking statements relate to the future, they are subject to inherent uncertainties, risks and changes in circumstances that are difficult to predict and may be outside of the Company's control. Actual events and results may differ significantly from those described in such forward-looking statements, due to numerous factors, including:

- negative economic conditions that adversely affect the economy, real estate values, the job market and other factors nationally and in our market area, in each case that may affect our liquidity and the performance of our loan portfolio;
- defaults and losses on our loan portfolio;
- the anticipated benefits of the Company's recent merger with Greater Chicago Financial Corp., including estimated cost savings and anticipated strategic gains, may be significantly harder or take longer to achieve than expected or may not be achieved in their entirety as a result of unexpected factors or events;
- the integration of Greater Chicago Financial Corp.'s business and operations into the Company, which will include conversion of Greater Chicago Financial Corp.'s operating systems and procedures, may take longer than anticipated or be more costly than anticipated or have unanticipated adverse results relating to Greater Chicago Financial Corp.'s or the Company's existing businesses;
- the Company's ability to achieve anticipated results from the Greater Chicago Financial Corp. transaction is dependent on the state of the economic and financial markets going forward. Specifically, the Company may incur more credit losses than expected, cost savings may be less than expected and customer attrition may be greater than expected;
- the financial success and viability of the borrowers of our commercial loans;
- market conditions in the commercial and residential real estate markets in our market area;
- changes in U.S. monetary policy, the level and volatility of interest rates, the capital markets and other market conditions that may affect, among other things, our liquidity and the value of our assets and liabilities;
- competitive pressures in the financial services business;
- any negative perception of our reputation or financial strength;
- ability to raise additional capital on acceptable terms when needed;
- ability to use technology to provide products and services that will satisfy customer demands and create efficiencies in operations;
- adverse effects on our information technology systems resulting from failures, human error or cyberattacks;
- adverse effects of failures by our vendors to provide agreed upon services in the manner and at the cost agreed, particularly our information technology vendors;
- the impact of any claims or legal actions, including any effect on our reputation;

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- losses incurred in connection with repurchases and indemnification payments related to mortgages;
- the soundness of other financial institutions;
- changes in accounting standards, rules and interpretations and the impact on our financial statements;
- our ability to receive dividends from our subsidiaries;
- a decrease in our regulatory capital ratios;
  - legislative or regulatory changes, particularly changes in regulation of financial services companies;
- increased costs of compliance, heightened regulatory capital requirements and other risks associated with changes in regulation and the current regulatory environment, including the Dodd-Frank Act;
- the impact of heightened capital requirements; and
- each of the factors and risks under the heading “Risk Factors” in our 2017 Form 10-K and Form 10-Qs filed with the SEC.

Because the Company’s ability to predict results or the actual effect of future plans or strategies is inherently uncertain, there can be no assurances that future actual results will correspond to any forward-looking statements and you should not rely on any forward-looking statements. Additionally, all statements in this Form 10-Q, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements

## Old Second Bancorp, Inc. and Subsidiaries

## Consolidated Balance Sheets

(In thousands, except share data)

|  | (unaudited)<br>March 31,<br>2018 | December 31,<br>2017 |
|--|----------------------------------|----------------------|
| Assets   |                                  |                      |
| Cash and due from banks  | \$ 29,478                        | \$ 37,444            |
| Interest bearing deposits with financial institutions                                    | 18,394                           | 18,389               |
| Cash and cash equivalents  | 47,872                           | 55,833               |
| Securities available-for-sale, at fair value   | 550,942                          | 541,439              |
| Federal Home Loan Bank Chicago ("FHLBC") and Federal Reserve Bank Chicago ("FRBC") stock | 7,468                            | 10,168               |
| Loans held-for-sale  | 2,426                            | 4,067                |
| Loans  | 1,601,812                        | 1,617,622            |
| Less: allowance for loan and lease losses  | 18,188                           | 17,461               |
| Net loans  | 1,583,624                        | 1,600,161            |
| Premises and equipment, net  | 37,209                           | 37,628               |
| Other real estate owned  | 7,063                            | 8,371                |
| Mortgage servicing rights, net   | 7,541                            | 6,944                |
| Goodwill and core deposit intangible   | 8,901                            | 8,922                |
| Bank-owned life insurance ("BOLI")   | 60,808                           | 61,764               |
| Deferred tax assets, net   | 26,581                           | 25,356               |
| Other assets   | 26,050                           | 22,776               |
| Total assets   | \$ 2,366,485                     | \$ 2,383,429         |
| Liabilities  |                                  |                      |
| Deposits:  |                                  |                      |
| Noninterest bearing demand   | \$ 582,766                       | \$ 572,404           |
| Interest bearing:  |                                  |                      |
| Savings, NOW, and money market   | 998,008                          | 967,750              |
| Time   | 381,274                          | 382,771              |
| Total deposits   | 1,962,048                        | 1,922,925            |
| Securities sold under repurchase agreements  | 41,366                           | 29,918               |
| Other short-term borrowings  | 45,000                           | 115,000              |
| Junior subordinated debentures   | 57,650                           | 57,639               |
| Senior notes   | 44,083                           | 44,058               |
| Other liabilities  | 12,337                           | 13,539               |
| Total liabilities  | 2,162,484                        | 2,183,079            |

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|   |              |              |
|---|--------------|--------------|
| Stockholders' Equity                          |              |              |
| Common stock                                  | 34,717       | 34,626       |
| Additional paid-in capital                    | 117,379      | 117,742      |
| Retained earnings                             | 151,833      | 142,959      |
| Accumulated other comprehensive (loss) income | (3,634)      | 1,479        |
| Treasury stock                                | (96,294)     | (96,456)     |
| Total stockholders' equity                    | 204,001      | 200,350      |
| Total liabilities and stockholders' equity    | \$ 2,366,485 | \$ 2,383,429 |

|                    | March 31, 2018 | December 31, 2017 |
|--------------------|----------------|-------------------|
|                    | Common         | Common            |
|                    | Stock          | Stock             |
| Par value          | \$ 1.00        | \$ 1.00           |
| Shares authorized  | 60,000,000     | 60,000,000        |
| Shares issued      | 34,716,589     | 34,625,734        |
| Shares outstanding | 29,747,078     | 29,627,086        |
| Treasury shares    | 4,969,511      | 4,998,648         |

See accompanying notes to consolidated financial statements.



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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Income

(In thousands, except per share data)

|  | (unaudited)<br>Quarters Ended<br>March 31, |           |
|--|--|-----------|
|  | 2018                                       | 2017      |
| Interest and dividend income   |  |           |
| Loans, including fees  | \$ 18,732                                  | \$ 16,609 |
| Loans held-for-sale  | 24   | 24        |
| Securities:  |  |           |
| Taxable  | 2,170                                      | 2,963     |
| Tax exempt   | 2,061                                      | 912       |
| Dividends from FHLBC and FRBC stock  | 106  | 85        |
| Interest bearing deposits with financial institutions                                | 49   | 23        |
| Total interest and dividend income   | 23,142                                     | 20,616    |
| Interest expense   |  |           |
| Savings, NOW, and money market deposits  | 344  | 223       |
| Time deposits  | 1,175                                      | 979       |
| Other short-term borrowings  | 408  | 108       |
| Junior subordinated debentures   | 927  | 1,084     |
| Senior notes   | 672  | 673       |
| Total interest expense   | 3,526                                      | 3,067     |
| Net interest and dividend income   | 19,616                                     | 17,549    |
| Release of loan and lease losses   | (722)                                      | -         |
| Net interest and dividend income after (release) provision for loan and lease losses | 20,338                                     | 17,549    |
| Noninterest income   |  |           |
| Trust income   | 1,495                                      | 1,458     |
| Service charges on deposits  | 1,592                                      | 1,618     |
| Secondary mortgage fees  | 162  | 176       |
| Mortgage servicing rights mark to market loss  | 305  | (133)     |
| Mortgage servicing income  | 452  | 435       |
| Net gain on sales of mortgage loans  | 917  | 1,147     |
| Securities gains (losses), net   | 35   | (136)     |
| Increase in cash surrender value of BOLI   | 248  | 359       |
| Death benefit realized on bank-owned life insurance                                  | 1,026                                      | -         |
| Debit card interchange income  | 1,012                                      | 975       |
| Losses on disposal and transfer of fixed assets, net                                 | -  | (2)       |
| Other income   | 1,261                                      | 1,131     |
| Total noninterest income   | 8,505                                      | 7,028     |
| Noninterest expense  |  |           |
| Salaries and employee benefits   | 10,207                                     | 10,573    |
| Occupancy, furniture and equipment   | 1,558                                      | 1,566     |

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|   |          |          |
|---|----------|----------|
| Computer and data processing                | 1,344    | 1,090    |
| FDIC insurance                              | 156      | 148      |
| General bank insurance                      | 251      | 270      |
| Amortization of core deposit intangible     | 21       | 25       |
| Advertising expense                         | 341      | 386      |
| Debit card interchange expense              | 281      | 349      |
| Legal fees                                  | 159      | 104      |
| Other real estate expense, net              | 173      | 709      |
| Other expense                               | 2,863    | 2,834    |
| Total noninterest expense                   | 17,354   | 18,054   |
| Income before income taxes                  | 11,489   | 6,523    |
| Provision for income taxes                  | 2,000    | 2,096    |
| Net income available to common stockholders | \$ 9,489 | \$ 4,427 |
| Basic earnings per share                    | \$ 0.32  | \$ 0.15  |
| Diluted earnings per share                  | 0.31     | 0.15     |

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(In thousands)

|  | (unaudited)    |          |
|--|----------------|----------|
|  | Quarters Ended |          |
|  | March 31,      |          |
|  | 2018           | 2017     |
| Net Income   | \$ 9,489       | \$ 4,427 |
| Unrealized holding (losses) gains on available-for-sale securities arising during the period | (8,808)        | 4,231    |
| Related tax benefit (expense)  | 2,484          | (1,675)  |
| Holding (losses) gains after tax on available-for-sale securities                            | (6,324)        | 2,556    |
| Less: Reclassification adjustment for the net gains (losses) realized during the period      |                |          |
| Net realized gains (losses)  | 35             | (136)    |
| Income tax (expense) benefit on net realized gains (losses)                                  | (10)           | 54       |
| Net realized gains (losses) after tax  | 25             | (82)     |
| Other comprehensive (loss) income on available-for-sale securities                           | (6,349)        | 2,638    |
| Changes in fair value of derivatives used for cash flow hedges                               | 1,279          | 149      |
| Related tax expense  | (362)          | (61)     |
| Other comprehensive income on cash flow hedges   | 917            | 88       |
| Total other comprehensive (loss) income  | (5,432)        | 2,726    |
| Total comprehensive income   | \$ 4,057       | \$ 7,153 |

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)     |           |
|---|-----------------|-----------|
|   | Three Months    |           |
|   | Ended March 31, |           |
|   | 2018            | 2017      |
| Cash flows from operating activities  |                 |           |
| Net income  | \$ 9,489        | \$ 4,427  |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: |                 |           |
| Depreciation of fixed assets and amortization of leasehold improvements                     | 537             | 593       |
| Change in fair value of mortgage servicing rights   | (305)           | 133       |
| Release for loan and lease losses   | (722)           | -         |
| Provision for deferred tax expense  | 907             | 2,036     |
| Originations of loans held-for-sale   | (31,096)        | (30,401)  |
| Proceeds from sales of loans held-for-sale  | 33,305          | 32,313    |
| Net gains on sales of mortgage loans  | (917)           | (1,147)   |
| Net premium amortization/discount (accretion) of purchase accounting adjustment on loans    | 51              | (345)     |
| Change in current income taxes receivable   | 1,093           | 60        |
| Increase in cash surrender value of BOLI  | (248)           | (359)     |
| Change in accrued interest receivable and other assets                                      | (4,081)         | (2,407)   |
| Change in accrued interest payable and other liabilities                                    | (152)           | 718       |
| Net premium amortization/discount (accretion) on securities                                 | 706             | 275       |
| Securities (gains) losses, net  | (35)            | 136       |
| Amortization of core deposit  | 21              | 25        |
| Amortization of junior subordinated debentures issuance costs                               | 11              | 12        |
| Amortization of senior notes issuance costs   | 25              | 26        |
| Stock based compensation  | 395             | 321       |
| Net gains on sale of other real estate owned  | (80)            | (74)      |
| Provision for other real estate owned valuation losses                                      | 112             | 318       |
| Net losses on disposal and transfer of fixed assets   | -               | 2         |
| Net cash provided by operating activities   | 9,016           | 6,662     |
| Cash flows from investing activities  |                 |           |
| Proceeds from maturities and calls including pay down of securities available-for-sale      | 2,391           | 15,005    |
| Proceeds from sales of securities available-for-sale  | 2,522           | 64,388    |
| Purchases of securities available-for-sale  | (23,930)        | (154,653) |
| Net disbursements/proceeds from sales (purchases) of FHLBC stock                            | 2,700           | (675)     |
| Net change in loans   | 17,208          | (12,700)  |
| Proceeds from claims on BOLI, net of premiums paid  | 1,204           | -         |
| Improvements in other real estate owned   | (59)            | -         |

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|   |           |           |
|---|-----------|-----------|
| Proceeds from sales of other real estate owned, net of participation purchase | 1,335     | 1,607     |
| Net purchases of premises and equipment                                       | (118)     | (212)     |
| Net cash provided by (used in) investing activities                           | 3,253     | (87,240)  |
| Cash flows from financing activities  |           |           |
| Net change in deposits  | 39,123    | 70,369    |
| Net change in securities sold under repurchase agreements                     | 11,448    | 9,016     |
| Net change in other short-term borrowings                                     | (70,000)  | 15,000    |
| Payment of senior note issuance costs   | -         | (42)      |
| Dividends paid on common stock  | (296)     | (296)     |
| Purchase of treasury stock  | (505)     | (124)     |
| Net cash (used in) provided by financing activities                           | (20,230)  | 93,923    |
| Net change in cash and cash equivalents                                       | (7,961)   | 13,345    |
| Cash and cash equivalents at beginning of period                              | 55,833    | 47,334    |
| Cash and cash equivalents at end of period                                    | \$ 47,872 | \$ 60,679 |

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

| Supplemental cash flow information                    | Three Months<br>Ended March 31, |          |
|---|---------------------------------|----------|
|   | 2018                            | 2017     |
| Interest paid for deposits                            | \$ 1,518                        | \$ 1,247 |
| Interest paid for borrowings                          | 1,321                           | 1,164    |
| Non-cash transfer of loans to other real estate owned | -                               | 3,416    |

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)

|   | Common<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Treasury<br>Stock | Total<br>Stockholders'<br>Equity |
|---|-----------------|----------------------------------|----------------------|---|-------------------|----------------------------------|
| Balance,<br>December 31, 2016               | \$ 34,534       | \$ 116,653                       | \$ 129,005           | \$ (8,762)  | \$ (96,220)       | \$ 175,210                       |
| Net income                                  |                 |                                  | 4,427                |   |                   | 4,427                            |
| Other comprehensive<br>income, net of tax   |                 |                                  |                      | 2,726   |                   | 2,726                            |
| Dividends declared and<br>paid              |                 |                                  | (296)                |   |                   | (296)                            |
| Vesting of restricted<br>stock              | 36              | (36)                             |                      |   |                   | -                                |
| Stock based<br>compensation                 |                 | 321                              |                      |   |                   | 321                              |
| Purchase of treasury<br>stock               |                 |                                  |                      |   | (124)             | (124)                            |
| Balance, March 31, 2017                     | \$ 34,570       | \$ 116,938                       | \$ 133,136           | \$ (6,036)  | \$ (96,344)       | \$ 182,264                       |
| Balance,<br>December 31, 2017               | \$ 34,626       | \$ 117,742                       | \$ 142,959           | \$ 1,479  | \$ (96,456)       | \$ 200,350                       |
| Net income                                  |                 |                                  | 9,489                |   |                   | 9,489                            |
| Other comprehensive<br>loss, net of tax     |                 |                                  |                      | (5,432)   |                   | (5,432)                          |
| Dividends declared and<br>paid              |                 |                                  | (296)                |   |                   | (296)                            |
| Vesting of restricted<br>stock              | 91              | (758)                            |                      |   | 667               | -                                |
| Reclassification of<br>stranded tax effects |                 |                                  | (319)                | 319   |                   | -                                |
| Stock based<br>compensation                 |                 | 395                              |                      |   |                   | 395                              |
| Purchase of treasury<br>stock               |                 |                                  |                      |   | (505)             | (505)                            |
| Balance, March 31, 2018                     | \$ 34,717       | \$ 117,379                       | \$ 151,833           | \$ (3,634)  | \$ (96,294)       | \$ 204,001                       |

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

(Dollar 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 consolidated financial statements are consistent with those used in the preparation of the annual financial information. The interim consolidated financial statements reflect all normal and recurring adjustments that are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended March 31, 2018, are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. These interim consolidated financial statements are unaudited and 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, 2017. Unless otherwise indicated, amounts in the tables contained in the notes to the consolidated financial statements 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 principles ("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 consolidated 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, 2017. 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 May 2014, the FASB issued ASU No. 2014-09 "Revenue from Contracts with Customers (Topic 606)." The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. In August 2015, the FASB issued ASU 2015-14 "Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date." This accounting standard update deferred the effective date of ASU 2014-09 for an additional year. ASU 2015-14 was effective for annual reporting periods beginning after December 15, 2017. The amendments could be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. Early application was not permitted. In March 2016, the FASB issued ASU 2016-08 "Revenue from Contracts with Customers (TOPIC 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)" and in April 2016, the FASB issued ASU 2016-10 "Revenue from Contracts with Customers (TOPIC 606): Identifying Performance Obligations and Licensing." ASU 2016-08 requires the entity to determine if it is acting as a principal with control over the goods or services it is contractually obligated to provide, or an agent with no control over specified goods or services provided by another party to a customer. ASU 2016-10 was issued to further clarify ASU 2014-09 implementation regarding identifying performance obligation materiality, identification of key contract components, and scope.

The Company performed an analysis of the impact of adoption of this ASU, reviewing revenue recorded from service charges on deposit accounts, asset management fees, gains (losses) on other real estate owned, and debit card interchange fees. Certain revenue received, such as service charges on deposit accounts and interchange fees, is recorded immediately or as the service is performed. Asset management fees recorded by the Company take the form of wealth management income and brokerage income, and both types of fees are recorded after services are rendered, with no contractual requirement of refund to a customer based on non-achievement of fund performance objectives. Finally, the methodology used to record revenue from gains (losses) due to the sale of other real estate owned is not anticipated to change, as the Company currently records income or expense only upon consummation of the sale, and any revenue recorded stemming from seller financed transactions is reviewed for deferral, as appropriate. The Company adopted ASU 2014-09 and related issuances on January 1, 2018, with no cumulative effect adjustment to opening retained earnings required upon implementation of this standard.

In January 2016, the FASB issued ASU No. 2016-01 "Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The objective of the issuance is to provide users of financial statements with more decision-useful information, by making targeted improvements to GAAP. These targeted improvements included revisions to the methodology of accounting for equity investments, eliminating certain disclosures on fair value assumptions for financial instruments measured at amortized cost, and requiring public business entities to use the exit price notion, as defined in ASC 820, for

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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

the measurement of the fair value of financial instruments. This standard was effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this standard as of January 1, 2018. Adoption of this standard resulted in the Company's use of an exit price rather than an entrance price to determine the fair value of loans and deposits not already measured at fair value on a non-recurring basis in the consolidated balance sheet disclosures; see Note 14—Fair Value of Financial Instruments for further information regarding the valuation processes.

In February 2016, the FASB issued ASU No. 2016-02 "Leases (Topic 842)." This ASU was issued to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and disclosing key information about leasing arrangements. One key revision from prior guidance was to include operating leases within assets and liabilities recorded; another revision was included which created a new model to follow for sale-leaseback transactions. The impact of this pronouncement will affect lessees primarily, as virtually all of their assets will be recognized on the balance sheet, by recording a right of use asset and lease liability. This pronouncement is effective for fiscal years beginning after December 15, 2018. The Company is assessing the impact of ASU 2016-02 on its accounting and disclosures.

In June 2016, the FASB issued ASU No. 2016-13 "Measurement of Credit Losses on Financial Instruments (Topic 326)." ASU 2016-13 was issued to provide financial statement users with more useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date to enhance the decision making process. The new methodology to be used should reflect expected credit losses based on relevant vintage historical information, supported by reasonable forecasts of projected loss given defaults, which will affect the collectability of the reported amounts. This new methodology will also require available-for-sale debt securities to have a credit loss recorded through an allowance rather than write-downs. ASU 2016-13 is effective for financial statements issued for fiscal years beginning after December 15, 2019. The Company is assessing the impact of ASU 2016-13 on its accounting and disclosures, and is in the process of accumulating data and evaluating model options to support future risk assessments.

In March 2017, the FASB issued ASU No. 2017-08 "Receivables-Nonrefundable Fees and Other Costs – Premium Amortization on Purchased Callable Debt Securities (Subtopic 310-20)." This ASU was issued to shorten the amortization period for the premium to the earliest call date on debt securities. This premium is required to be recorded as a reduction to net interest margin during the shorter yield to call period, as compared to prior practice of amortizing the premium as a reduction to net interest margin over the contractual life of the instrument. This ASU does not change the current method of amortizing any discount over the contractual life of the debt security, and this pronouncement is effective for fiscal years beginning after December 15, 2018, with earlier adoption permitted. The Company adopted ASU 2017-08 as a change in accounting principle in the third quarter of 2017 on a modified retrospective basis, which required the Company to reflect its adoption effective January 1, 2017. The effect of amortizing the premium over a shorter period will continue to decrease future quarterly net interest income over the

call period until the premium is fully amortized. As a result of management's analysis, the impact of the change in accounting principle as a result of ASU 2017-08 to adjust beginning of year retained earnings was considered insignificant and, accordingly, the impact was adjusted through 2017 earnings.

In August 2017, the FASB issued ASU No. 2017-12, "Derivatives and Hedging: Targeted Improvements to Accounting for Hedging Activities". The purpose of this updated guidance is to better align a company's financial reporting for hedging activities with the economic objectives of those activities. ASU 2017-12 is effective for public business entities for fiscal years beginning after December 15, 2018, with early adoption, including adoption in an interim period, permitted. The Company adopted ASU 2017-12 on January 1, 2018, on a modified retrospective basis. FASB ASC 815, Derivatives and Hedging ("ASC 815"), provides the disclosure requirements for derivatives and hedging activities with the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how the entity accounts for derivative instruments and related hedged items, and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. Further, qualitative disclosures are required that explain the Company's objectives and strategies for using derivatives, as well as quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

As required by ASC 815, the Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Derivatives may also be designated as hedges of the foreign currency exposure of a net investment in a foreign operation. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into

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derivative contracts that are intended to economically hedge certain of its risk, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

In accordance with the FASB's fair value measurement guidance in ASU 2011-04, the Company made an accounting policy election to measure the credit risk of its derivative financial instruments that are subject to master netting agreements on a net basis by counterparty portfolio. As the Company does not currently have any derivative financial instruments subject to master netting agreements, there was no impact to the balance sheet.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement-Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." This ASU was issued in response to the enactment of tax bill H.R.1 "Tax Cuts and Jobs Act", which resulted in "stranding" the tax effects of items within accumulated other comprehensive income related to the adjustment of deferred taxes due to the reduction of the federal corporate income tax rate. The amendments proposed allow the reclassification of these stranded tax effects to retained earnings, and were effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, and should be applied either in the period of adoption or retrospectively to each period in which the effect of the change in the U.S. federal corporate tax rate is recognized. The Company adopted ASU 2018-02 as of January 1, 2018, and a reclassification of \$319,000, net, was recorded, which increased accumulated other comprehensive income and reduced retained earnings with the change in accounting principle.

Subsequent Events

On April 17, 2018, the Company's Board of Directors declared a cash dividend of \$0.01 per share payable on May 7, 2018, to stockholders of record as of April 27, 2018; dividends of \$297,000 were paid to stockholders on May 7, 2018.

On April 20, 2018, the Company acquired Greater Chicago Financial Corp. ("GCFC"), and its wholly owned subsidiary, ABC Bank. See the information disclosed in Note 2, "Acquisitions", for further details.

Note 2 – Acquisitions

On April 20, 2018, the Company acquired GCFC, and its wholly owned subsidiary, ABC Bank, which operates four branches in the Chicago metro area. GCFC reported total assets of \$333.7 million as of March 31, 2018, which includes \$233.1 million of net loans, and total liabilities of \$300.0 million, comprised primarily of deposits totaling \$250.5 million. In addition to the acquisition price of \$41.1 million, the Company also retired the convertible and nonconvertible debentures held by GCFC upon acquisition, which totaled \$6.6 million. The purchase and the debentures' retirement were funded with the Company's cash on hand, and all GCFC common stock was retired and cancelled simultaneous with the close of the transaction. Acquisition related costs incurred by the Company during the first quarter of 2018 totaled \$246,000. In the second quarter of 2018, the Company will perform the appropriate purchase accounting valuation analysis, and record the commensurate fair market value adjustments as needed.

### Note 3 – Securities

#### Investment Portfolio Management

Our investment portfolio serves the liquidity needs and income objectives of the Company. While the portfolio serves as an important component of the overall liquidity management at the Bank, portions of the portfolio also serve as income producing assets. The size and composition of the portfolio reflects liquidity needs, loan demand and interest income objectives. Portfolio size and composition will be adjusted from time to time. While a significant portion of the portfolio consists of readily marketable securities to address liquidity, other parts of the portfolio may reflect funds invested pending future loan demand or to maximize interest income without undue interest rate risk.

Investments are comprised of debt securities and non-marketable equity investments. Securities available-for-sale are carried at fair value. Unrealized gains and losses, net of tax, 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.

FHLBC and FRBC stock are considered nonmarketable equity investments. FHLBC stock was recorded at \$2.7 million at March 31, 2018, and \$5.4 million at December 31, 2017. FRBC stock was recorded at \$4.8 million at March 31, 2018, and December 31, 2017.

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The following table summarizes the amortized cost and fair value of the securities portfolio at March 31, 2018, and December 31, 2017, and the corresponding amounts of gross unrealized gains and losses:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| March 31, 2018  |                   |                              |                               |               |
| Securities available-for-sale   |                   |                              |                               |               |
| U.S. Treasuries   | \$ 4,003          | \$ -                         | \$ (108)                      | \$ 3,895      |
| U.S. government agencies  | 12,788            | -                            | (58)                          | 12,730        |
| U.S. government agencies mortgage-backed<br>States and political subdivisions | 14,331            | -                            | (487)                         | 13,844        |
| Corporate bonds   | 287,825           | 2,046                        | (4,331)                       | 285,540       |
| Collateralized mortgage obligations   | 685               | 23                           | (5)                           | 703           |
| Asset-backed securities   | 65,561            | 71                           | (1,888)                       | 63,744        |
| Collateralized loan obligations   | 111,493           | 1,264                        | (1,887)                       | 110,870       |
| Total securities available-for-sale   | \$ 555,991        | \$ 3,738                     | \$ (8,787)                    | \$ 550,942    |

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| December 31, 2017   |                   |                              |                               |               |
| Securities available-for-sale   |                   |                              |                               |               |
| U.S. Treasury   | \$ 4,002          | \$ -                         | \$ (55)                       | \$ 3,947      |
| U.S. government agencies  | 13,062            | 8                            | (9)                           | 13,061        |
| U.S. government agencies mortgage-backed<br>States and political subdivisions | 12,372            | 7                            | (165)                         | 12,214        |
| Corporate bonds   | 272,240           | 7,116                        | (1,264)                       | 278,092       |
| Collateralized mortgage obligations   | 823               | 21                           | (11)                          | 833           |
| Asset-backed securities   | 66,892            | 202                          | (1,155)                       | 65,939        |
| Collateralized loan obligations   | 113,983           | 862                          | (1,913)                       | 112,932       |
| Total securities available-for-sale   | \$ 537,645        | \$ 8,467                     | \$ (4,673)                    | \$ 541,439    |

The fair value, amortized cost and weighted average yield of debt securities at March 31, 2018, by contractual maturity, were as follows in the table below. Securities not due at a single maturity date are shown separately.

|   | Amortized<br>Cost | Weighted<br>Average<br>Yield |   | Fair<br>Value |
|---|-------------------|------------------------------|---|---------------|
| Securities available-for-sale                           |                   |                              |   |               |
| Due in one year or less                                 | \$ 18,800         | 1.90                         | % | \$ 18,645     |
| Due after one year through five years                   | 4,207             | 1.96                         |   | 4,095         |
| Due after five years through ten years                  | 5,919             | 3.34                         |   | 6,017         |
| Due after ten years                                     | 276,375           | 2.96                         |   | 274,111       |
|   | 305,301           | 2.89                         |   | 302,868       |
| Mortgage-backed and collateralized mortgage obligations | 79,892            | 2.98                         |   | 77,588        |
| Asset-backed securities                                 | 111,493           | 2.93                         |   | 110,870       |
| Collateralized loan obligations                         | 59,305            | 4.64                         |   | 59,616        |
| Total securities available-for-sale                     | \$ 555,991        | 3.10                         | % | \$ 550,942    |

At March 31, 2018, the Company's investments include \$93.9 million of asset-backed securities that are backed by student loans originated under the Federal Family Education Loan program ("FFEL"). Under the FFEL, private lenders made federally guaranteed student loans to parents and students. While the program was modified several times before elimination in 2010, FFEL securities are generally guaranteed by the U.S Department of Education ("DOE") at not less than 97% of the outstanding principal amount of the loans. The guarantee will reduce to 85% if the DOE receives reimbursement requests in excess of 5% of insured loans; reimbursement will drop to 75% if reimbursement requests exceed 9% of insured loans. In addition to the U.S. Department of Education guarantee, total added credit enhancement in the form of overcollateralization and/or subordination amounted to \$11.5 million, or 11.80%, of outstanding principal.



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The Company has invested in securities issued from three originators that individually amount to over 10% of the Company's stockholders equity. Information regarding these three issuers and the value of the securities issued follows:

| Issuer                             | March 31, 2018 |            |
|------------------------------------|----------------|------------|
|                                    | Amortized Cost | Fair Value |
| GCO Education Loan Funding Corp    | \$ 27,651      | \$ 26,687  |
| Towd Point Mortgage Trust          | 29,174         | 28,659     |
| Student Loan Marketing Association | 25,737         | 26,213     |

Securities with unrealized losses at March 31, 2018, and December 31, 2017, 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):

| March 31, 2018                              | Less than 12 months<br>in an unrealized loss position |                      |               | 12 months or more<br>in an unrealized loss position |                      |               | Total                   |                      |               |
|---|---|----------------------|---------------|---|----------------------|---------------|-------------------------|----------------------|---------------|
|   | Number of<br>Securities                               | Unrealized<br>Losses | Fair<br>Value | Number of<br>Securities                             | Unrealized<br>Losses | Fair<br>Value | Number of<br>Securities | Unrealized<br>Losses | Fair<br>Value |
| Securities                                  |   |                      |               |   |                      |               |                         |                      |               |
| Available-for-sale                          |   |                      |               |   |                      |               |                         |                      |               |
| U.S. Treasuries                             | 1   | \$ 108               | \$ 3,895      | -   | \$ -                 | \$ -          | 1                       | \$ 108               | \$ 3,895      |
| U.S. government<br>bonds                    | 4   | 58                   | 12,730        | -   | -                    | -             | 4                       | 58                   | 12,730        |
| U.S. government<br>bonds                    |   |                      |               |   |                      |               |                         |                      |               |
| Mortgage-backed<br>securities and<br>REMICs | 7   | 254                  | 9,130         | 5   | 233                  | 4,714         | 12                      | 487                  | 13,844        |
| Asset<br>backed<br>securities               | 42  | 3,068                | 140,012       | 2   | 1,263                | 3,742         | 44                      | 4,331                | 143,754       |
| Corporate bonds                             | -   | -                    | -             | 1   | 5                    | 200           | 1                       | 5                    | 200           |
| Collateralized<br>debt<br>obligations       | 4   | 110                  | 21,191        | 8   | 1,778                | 38,589        | 12                      | 1,888                | 59,780        |
|   | 1   | 46                   | 1,603         | 6   | 1,841                | 56,385        | 7                       | 1,887                | 57,984        |

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|                                 |    |          |            |    |          |            |    |          |            |
|---------------------------------|----|----------|------------|----|----------|------------|----|----------|------------|
| Asset-backed securities         |    |          |            |    |          |            |    |          |            |
| Collateralized debt obligations | 2  | 23       | 12,991     | -  | -        | -          | 2  | 23       | 12,991     |
| Other securities                |    |          |            |    |          |            |    |          |            |
| Available-for-sale              | 61 | \$ 3,667 | \$ 201,552 | 22 | \$ 5,120 | \$ 103,630 | 83 | \$ 8,787 | \$ 305,117 |

| As of March 31, 2017                               | Less than 12 months in an unrealized loss position |                   |            | 12 months or more in an unrealized loss position |                   |            | Total | Unrealized | Fair Value |
|--|--|-------------------|------------|--|-------------------|------------|-------|------------|------------|
|  | Number of Securities                               | Unrealized Losses | Fair Value | Number of Securities                             | Unrealized Losses | Fair Value |       |            |            |
| Available-for-sale                                 |  |                   |            |  |                   |            |       |            |            |
| Treasuries   | 1  | \$ 55             | \$ 3,947   | -  | \$ -              | \$ -       | 1     | \$ 55      | \$ 3,947   |
| Government securities                              | 2  | 9                 | 6,550      | -  | -                 | -          | 2     | 9          | 6,550      |
| Government securities                              |  |                   |            |  |                   |            |       |            |            |
| Mortgage-backed securities and political divisions | 4  | 24                | 5,501      | 5  | 141               | 4,843      | 9     | 165        | 10,344     |
| Corporate bonds                                    | 13   | 1,237             | 45,985     | 1  | 27                | 1,512      | 14    | 1,264      | 47,502     |
| Collateralized mortgage obligations                | -  | -                 | -          | 1  | 11                | 332        | 1     | 11         | 332        |
| Asset-backed securities                            |  |                   |            |  |                   |            |       |            |            |
| Collateralized loan obligations                    | 3  | 31                | 11,534     | 8  | 1,124             | 40,219     | 11    | 1,155      | 51,753     |
| Asset-backed securities                            |  |                   |            |  |                   |            |       |            |            |
| Collateralized loan obligations                    | -  | -                 | -          | 7  | 1,913             | 61,745     | 7     | 1,913      | 61,745     |
| Other securities                                   |  |                   |            |  |                   |            |       |            |            |
| Available-for-sale                                 | 3  | 101               | 29,313     | -  | -                 | -          | 3     | 101        | 29,313     |
| Other securities                                   |  |                   |            |  |                   |            |       |            |            |
| Available-for-sale                                 | 26   | \$ 1,457          | \$ 102,830 | 22   | \$ 3,216          | \$ 108,651 | 48    | \$ 4,673   | \$ 211,481 |

Recognition of other-than-temporary impairment was not necessary as of March 31, 2018. The changes in fair value related primarily to interest rate fluctuations. Our review of other-than-temporary impairment determined that there was no credit quality deterioration.

The following table presents net realized gains (losses) on securities available-for-sale for the quarters ended March 31, 2018 and 2017.

|                                     | March 31, |           |
|-------------------------------------|-----------|-----------|
|                                     | 2018      | 2017      |
| Securities available-for-sale       |           |           |
| Proceeds from sales of securities   | \$ 2,522  | \$ 64,388 |
| Gross realized gains on securities  | 35        | 366       |
| Gross realized losses on securities | -         | (502)     |

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|   |       |          |
|---|-------|----------|
| Securities realized gains (losses), net                     | \$ 35 | \$ (136) |
| Income tax expense (benefit) on net realized gains (losses) | 10    | (54)     |

The majority of the net realized losses in the prior year were incurred as the portfolio was repositioned during 2017 to invest in higher yielding tax exempt municipal securities.

Securities valued at \$286.3 million as of March 31, 2018, a decrease from \$301.0 million at year-end 2017, were pledged to secure deposits and borrowings, and for other purposes.

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Note 4 – Loans

Major classifications of loans were as follows:

|                            | March 31, 2018 | December 31, 2017 |
|----------------------------|----------------|-------------------|
| Commercial                 | \$ 281,134     | \$ 272,851        |
| Leases                     | 66,344         | 68,325            |
| Real estate - commercial   | 713,422        | 750,991           |
| Real estate - construction | 91,479         | 85,162            |
| Real estate - residential  | 438,610        | 426,230           |
| Consumer                   | 2,120          | 2,774             |
| Other <sup>1</sup>         | 7,725          | 10,609            |
|                            | 1,600,834      | 1,616,942         |
| Net deferred loan costs    | 978            | 680               |
| Total loans                | \$ 1,601,812   | \$ 1,617,622      |

<sup>1</sup> The “Other” class includes overdrafts.

It is the policy of the Company to review each prospective credit prior to making a loan in order to determine if an adequate level of security or collateral has been obtained. 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. With selected exceptions, the Bank 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 77.6% and 78.0% of the portfolio at March 31, 2018, and December 31, 2017, respectively.

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

Recorded  
Investment

|  | 90 Days or<br>Greater Past |                    |                     |                   | Current      | Nonaccrual | Total Loans  | 90<br>days<br>or<br>Greater Past<br>Due and |
|--|----------------------------|--------------------|---------------------|-------------------|--------------|------------|--------------|---|
|  | 30-59 Days<br>Past         | 60-89 Days<br>Past | Greater Past<br>Due | Total Past<br>Due |              |            |              | Accruing                                    |
| March 31, 2018                           |                            |                    |                     |                   |              |            |              |   |
| Commercial                               | \$ 332                     | \$ -               | \$ -                | \$ 332            | \$ 280,802   | \$ -       | \$ 281,134   | \$ -  |
| Leases                                   | 152                        | -                  | -                   | 152               | 66,192       | -          | 66,344       | -   |
| Real estate -<br>commercial              |                            |                    |                     |                   |              |            |              |   |
| Owner occupied<br>general purpose        | 63                         | -                  | -                   | 63                | 141,540      | 683        | 142,286      | -   |
| Owner occupied<br>special purpose        | 744                        | -                  | -                   | 744               | 165,104      | 440        | 166,288      | -   |
| Non-owner<br>occupied                    |                            |                    |                     |                   |              |            |              |   |
| general purpose                          | 330                        | 111                | -                   | 441               | 253,748      | 42         | 254,231      | -   |
| Non-owner<br>occupied special<br>purpose | -                          | -                  | -                   | -                 | 88,642       | 3,575      | 92,217       | -   |
| Retail properties                        | -                          | -                  | -                   | -                 | 42,577       | -          | 42,577       | -   |
| Farm                                     | -                          | -                  | -                   | -                 | 15,823       | -          | 15,823       | -   |
| Real estate -<br>construction            |                            |                    |                     |                   |              |            |              |   |
| Homebuilder                              | -                          | -                  | -                   | -                 | 2,503        | -          | 2,503        | -   |
| Land                                     | -                          | -                  | -                   | -                 | 2,479        | -          | 2,479        | -   |
| Commercial<br>speculative                | -                          | -                  | -                   | -                 | 35,432       | -          | 35,432       | -   |
| All other                                | 190                        | -                  | -                   | 190               | 50,678       | 197        | 51,065       | -   |
| Real estate -<br>residential             |                            |                    |                     |                   |              |            |              |   |
| Investor                                 | 92                         | -                  | -                   | 92                | 56,163       | 361        | 56,616       | -   |
| Multifamily                              | 338                        | -                  | -                   | 338               | 125,086      | -          | 125,424      | -   |
| Owner occupied                           | 258                        | 69                 | -                   | 327               | 123,779      | 4,625      | 128,731      | -   |
| Revolving and<br>junior liens            | 321                        | -                  | 401                 | 722               | 125,998      | 1,119      | 127,839      | 409   |
| Consumer                                 | 1                          | -                  | -                   | 1                 | 2,102        | 17         | 2,120        | -   |
| Other1                                   | -                          | -                  | -                   | -                 | 8,703        | -          | 8,703        | -   |
| Total                                    | \$ 2,821                   | \$ 180             | \$ 401              | \$ 3,402          | \$ 1,587,351 | \$ 11,059  | \$ 1,601,812 | \$ 409                                      |

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|                                    | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>Greater Past<br>Due | Total Past<br>Due | Current    | Nonaccrual | Total Loans | Recorded<br>Investment<br>90<br>days<br>or<br>Greater Past<br>Due and<br>Accruing |
|------------------------------------|------------------------|------------------------|-----------------------------------|-------------------|------------|------------|-------------|---|
| December 31, 2017                  |                        |                        |                                   |                   |            |            |             |   |
| Commercial Leases                  | \$ 995                 | \$ 275                 | \$ -                              | \$ 1,270          | \$ 271,581 | \$ -       | \$ 272,851  | \$ -  |
| Real estate - commercial           |                        |                        |                                   |                   |            |            |             |   |
| Owner occupied general purpose     | 1,136                  | -                      | -                                 | 1,136             | 144,267    | 455        | 145,858     | -   |
| Owner occupied special purpose     | 226                    | -                      | -                                 | 226               | 170,546    | 342        | 171,114     | -   |
| Non-owner occupied general purpose | -                      | 593                    | -                                 | 593               | 273,203    | 1,163      | 274,959     | -   |
| Non-owner occupied special purpose | -                      | -                      | 248                               | 248               | 92,923     | -          | 93,171      | 254   |
| Retail properties                  | -                      | -                      | -                                 | -                 | 49,538     | 1,081      | 50,619      | -   |
| Farm                               | -                      | -                      | -                                 | -                 | 15,270     | -          | 15,270      | -   |
| Real estate - construction         |                        |                        |                                   |                   |            |            |             |   |
| Homebuilder                        | 129                    | -                      | -                                 | 129               | 2,221      | -          | 2,350       | -   |
| Land                               | 1,124                  | -                      | -                                 | 1,124             | 1,319      | -          | 2,443       | -   |
| Commercial speculative             | -                      | -                      | -                                 | -                 | 32,028     | -          | 32,028      | -   |
| All other                          | -                      | -                      | -                                 | -                 | 48,140     | 201        | 48,341      | -   |
| Real estate - residential          |                        |                        |                                   |                   |            |            |             |   |
| Investor                           | -                      | -                      | -                                 | -                 | 55,248     | 372        | 55,620      | -   |
| Multifamily                        | -                      | -                      | -                                 | -                 | 125,049    | 4,723      | 129,772     | -   |
| Owner occupied                     | 74                     | -                      | -                                 | 74                | 123,838    | 4,674      | 128,586     | -   |
| Revolving and junior liens         | 491                    | 278                    | -                                 | 769               | 110,291    | 1,192      | 112,252     | -   |
| Consumer                           | -                      | -                      | -                                 | -                 | 2,767      | 7          | 2,774       | -   |
| Other                              | 37                     | -                      | -                                 | 37                | 11,252     | -          | 11,289      | -   |

|       |          |          |        |          |              |           |              |        |
|-------|----------|----------|--------|----------|--------------|-----------|--------------|--------|
| Total | \$ 4,212 | \$ 1,146 | \$ 248 | \$ 5,606 | \$ 1,597,628 | \$ 14,388 | \$ 1,617,622 | \$ 254 |
|-------|----------|----------|--------|----------|--------------|-----------|--------------|--------|

1 The "Other" class includes overdrafts and net deferred costs.

#### 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.

**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.

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

Credit Quality Indicators by class of loans were as follows:

| March 31, 2018                     | Pass         | Special<br>Mention | Substandard 1 | Doubtful | Total        |
|------------------------------------|--------------|--------------------|---------------|----------|--------------|
| Commercial                         | \$ 278,276   | \$ 2,858           | \$ -          | \$ -     | \$ 281,134   |
| Leases                             | 65,734       | -                  | 610           | -        | 66,344       |
| Real estate - commercial           |              |                    |               |          |              |
| Owner occupied general purpose     | 138,424      | 1,821              | 2,041         | -        | 142,286      |
| Owner occupied special purpose     | 164,707      | 1,141              | 440           | -        | 166,288      |
| Non-owner occupied general purpose | 253,551      | 638                | 42            | -        | 254,231      |
| Non-owner occupied special purpose | 88,642       | -                  | 3,575         | -        | 92,217       |
| Retail Properties                  | 41,373       | 1,204              | -             | -        | 42,577       |
| Farm                               | 12,134       | 1,250              | 2,439         | -        | 15,823       |
| Real estate - construction         |              |                    |               |          |              |
| Homebuilder                        | 2,503        | -                  | -             | -        | 2,503        |
| Land                               | 2,479        | -                  | -             | -        | 2,479        |
| Commercial speculative             | 35,432       | -                  | -             | -        | 35,432       |
| All other                          | 49,018       | 1,676              | 371           | -        | 51,065       |
| Real estate - residential          |              |                    |               |          |              |
| Investor                           | 56,180       | -                  | 436           | -        | 56,616       |
| Multifamily                        | 125,424      | -                  | -             | -        | 125,424      |
| Owner occupied                     | 122,696      | 559                | 5,476         | -        | 128,731      |
| Revolving and junior liens         | 125,801      | -                  | 2,038         | -        | 127,839      |
| Consumer                           | 2,102        | -                  | 18            | -        | 2,120        |
| Other                              | 8,703        | -                  | -             | -        | 8,703        |
| Total                              | \$ 1,573,179 | \$ 11,147          | \$ 17,486     | \$ -     | \$ 1,601,812 |

| December 31, 2017                  | Pass       | Special<br>Mention | Substandard 1 | Doubtful | Total      |
|------------------------------------|------------|--------------------|---------------|----------|------------|
| Commercial                         | \$ 270,889 | \$ 1,962           | \$ -          | \$ -     | \$ 272,851 |
| Leases                             | 67,500     | -                  | 825           | -        | 68,325     |
| Real estate - commercial           |            |                    |               |          |            |
| Owner occupied general purpose     | 142,843    | 1,927              | 1,088         | -        | 145,858    |
| Owner occupied special purpose     | 169,621    | 1,152              | 341           | -        | 171,114    |
| Non-owner occupied general purpose | 271,731    | 2,065              | 1,163         | -        | 274,959    |
| Non-owner occupied special purpose | 89,582     | -                  | 3,589         | -        | 93,171     |
| Retail Properties                  | 48,321     | 1,217              | 1,081         | -        | 50,619     |



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|                            |              |           |           |      |              |
|----------------------------|--------------|-----------|-----------|------|--------------|
| Farm                       | 11,755       | 1,029     | 2,486     | -    | 15,270       |
| Real estate - construction |              |           |           |      |              |
| Homebuilder                | 2,350        | -         | -         | -    | 2,350        |
| Land                       | 2,443        | -         | -         | -    | 2,443        |
| Commercial speculative     | 32,028       | -         | -         | -    | 32,028       |
| All other                  | 46,913       | 1,052     | 376       | -    | 48,341       |
| Real estate - residential  |              |           |           |      |              |
| Investor                   | 55,172       | -         | 448       | -    | 55,620       |
| Multifamily                | 125,049      | -         | 4,723     | -    | 129,772      |
| Owner occupied             | 122,759      | 561       | 5,266     | -    | 128,586      |
| Revolving and junior liens | 110,353      | -         | 1,899     | -    | 112,252      |
| Consumer                   | 2,754        | -         | 20        | -    | 2,774        |
| Other                      | 11,289       | -         | -         | -    | 11,289       |
| Total                      | \$ 1,583,352 | \$ 10,965 | \$ 23,305 | \$ - | \$ 1,617,622 |

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

The Company had \$1.8 million and \$1.3 million in residential real estate loans in the process of foreclosure as of March 31, 2018, and December 31, 2017, respectively. The Company also had \$257,000 and \$900,000 in residential real estate included in OREO as of March 31, 2018, and December 31, 2017, respectively.

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

Impaired loans, which include nonaccrual loans and accruing troubled debt restructurings, by class of loans for the March 31, 2018 periods listed were as follows:

|   | As of March 31, 2018   |                                |                      | Three Months Ended<br>March 31, 2018 |                                  |
|---|------------------------|--------------------------------|----------------------|--------------------------------------|----------------------------------|
|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment    | Interest<br>Income<br>Recognized |
| With no related allowance recorded              |                        |                                |                      |                                      |                                  |
| Commercial                                      | \$ -                   | \$ -                           | \$ -                 | \$ -                                 | \$ -                             |
| Leases  | -                      | -                              | -                    | 89                                   | -                                |
| Commercial real estate                          |                        |                                |                      |                                      |                                  |
| Owner occupied general purpose                  | 378                    | 421                            | -                    | 417                                  | -                                |
| Owner occupied special purpose                  | 440                    | 552                            | -                    | 391                                  | -                                |
| Non-owner occupied general purpose              | 42                     | 56                             | -                    | 602                                  | -                                |
| Non-owner occupied special purpose              | -                      | -                              | -                    | -                                    | -                                |
| Retail properties                               | -                      | -                              | -                    | 541                                  | -                                |
| Farm  | -                      | -                              | -                    | -                                    | -                                |
| Construction                                    |                        |                                |                      |                                      |                                  |
| Homebuilder                                     | -                      | -                              | -                    | -                                    | -                                |
| Land  | -                      | -                              | -                    | -                                    | -                                |
| Commercial speculative                          | -                      | -                              | -                    | -                                    | -                                |
| All other                                       | 197                    | 227                            | -                    | 199                                  | -                                |
| Residential                                     |                        |                                |                      |                                      |                                  |
| Investor  | 361                    | 531                            | -                    | 366                                  | -                                |
| Multifamily                                     | -                      | -                              | -                    | 2,362                                | -                                |
| Owner occupied                                  | 5,148                  | 6,650                          | -                    | 5,178                                | 9                                |
| Revolving and junior liens                      | 1,125                  | 1,329                          | -                    | 1,125                                | -                                |
| Consumer  | 17                     | 18                             | -                    | 12                                   | -                                |
| Total impaired loans with no recorded allowance | 7,708                  | 9,784                          | -                    | 11,282                               | 9                                |
| With an allowance recorded                      |                        |                                |                      |                                      |                                  |
| Commercial                                      | -                      | -                              | -                    | -                                    | -                                |
| Leases  | -                      | -                              | -                    | -                                    | -                                |
| Commercial real estate                          |                        |                                |                      |                                      |                                  |
| Owner occupied general purpose                  | 305                    | 305                            | 26                   | 152                                  | -                                |
| Owner occupied special purpose                  | -                      | -                              | -                    | -                                    | -                                |

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|  |           |           |        |           |       |
|--|-----------|-----------|--------|-----------|-------|
| Non-owner occupied general purpose             | -         | -         | -      | -         | -     |
| Non-owner occupied special purpose             | 3,575     | 3,575     | 477    | 1,788     | -     |
| Retail properties                              | -         | -         | -      | -         | -     |
| Farm   | -         | -         | -      | -         | -     |
| Construction                                   |           |           |        |           |       |
| Homebuilder                                    | -         | -         | -      | -         | -     |
| Land   | -         | -         | -      | -         | -     |
| Commercial speculative                         | -         | -         | -      | -         | -     |
| All other                                      | -         | -         | -      | -         | -     |
| Residential                                    |           |           |        |           |       |
| Investor                                       | 823       | 823       | 10     | 826       | 11    |
| Multifamily                                    | -         | -         | -      | -         | -     |
| Owner occupied                                 | 3,676     | 3,676     | 46     | 3,559     | 37    |
| Revolving and junior liens                     | 1,143     | 1,143     | 29     | 1,064     | 11    |
| Consumer                                       | -         | -         | -      | -         | -     |
| Total impaired loans with a recorded allowance | 9,522     | 9,522     | 588    | 7,389     | 59    |
| Total impaired loans                           | \$ 17,230 | \$ 19,306 | \$ 588 | \$ 18,671 | \$ 68 |

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Old Second Bancorp, Inc. and Subsidiaries

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

Impaired loans by class of loans as of December 31, 2017, and for the three months ended March 31, 2017, were as follows:

|   | As of December 31, 2017 |                                |                      | Three Months Ended<br>March 31, 2017 |                                  |
|---|-------------------------|--------------------------------|----------------------|--------------------------------------|----------------------------------|
|   | Recorded<br>Investment  | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment    | Interest<br>Income<br>Recognized |
| With no related allowance recorded              |                         |                                |                      |                                      |                                  |
| Commercial                                      | \$ -                    | \$ -                           | \$ -                 | \$ 132                               | \$ -                             |
| Leases  | 178                     | 213                            | -                    | 425                                  | -                                |
| Commercial real estate                          |                         |                                |                      |                                      |                                  |
| Owner occupied general purpose                  | 455                     | 495                            | -                    | 1,270                                | -                                |
| Owner occupied special purpose                  | 342                     | 498                            | -                    | 380                                  | -                                |
| Non-owner occupied general purpose              | 1,163                   | 1,538                          | -                    | 1,445                                | 1                                |
| Non-owner occupied special purpose              | -                       | -                              | -                    | 506                                  | -                                |
| Retail properties                               | 1,081                   | 1,177                          | -                    | 1,170                                | -                                |
| Farm  | -                       | -                              | -                    | -                                    | -                                |
| Construction                                    |                         |                                |                      |                                      |                                  |
| Homebuilder                                     | -                       | -                              | -                    | -                                    | -                                |
| Land  | -                       | -                              | -                    | -                                    | -                                |
| Commercial speculative                          | -                       | -                              | -                    | 72                                   | -                                |
| All other                                       | 201                     | 229                            | -                    | 206                                  | -                                |
| Residential                                     |                         |                                |                      |                                      |                                  |
| Investor  | 372                     | 676                            | -                    | 1,744                                | 12                               |
| Multifamily                                     | 4,723                   | 4,965                          | -                    | -                                    | -                                |
| Owner occupied                                  | 5,208                   | 6,680                          | -                    | 9,202                                | 39                               |
| Revolving and junior liens                      | 1,125                   | 1,313                          | -                    | 2,447                                | 9                                |
| Consumer  | 7                       | 8                              | -                    | 106                                  | -                                |
| Total impaired loans with no recorded allowance | 14,855                  | 17,792                         | -                    | 19,105                               | 61                               |
| With an allowance recorded                      |                         |                                |                      |                                      |                                  |
| Commercial                                      | -                       | -                              | -                    | -                                    | -                                |
| Leases  | -                       | -                              | -                    | -                                    | -                                |
| Commercial real estate                          |                         |                                |                      |                                      |                                  |
| Owner occupied general purpose                  | -                       | -                              | -                    | -                                    | -                                |
| Owner occupied special purpose                  | -                       | -                              | -                    | -                                    | -                                |
| Non-owner occupied general purpose              | -                       | -                              | -                    | 123                                  | -                                |
| Non-owner occupied special purpose              | -                       | -                              | -                    | -                                    | -                                |

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|  |           |           |        |           |       |
|--|-----------|-----------|--------|-----------|-------|
| Retail properties                              | -         | -         | -      | -         | -     |
| Farm   | -         | -         | -      | -         | -     |
| Construction                                   |           |           |        |           |       |
| Homebuilder                                    | -         | -         | -      | -         | -     |
| Land   | -         | -         | -      | -         | -     |
| Commercial speculative                         | -         | -         | -      | -         | -     |
| All other                                      | -         | -         | -      | -         | -     |
| Residential                                    |           |           |        |           |       |
| Investor                                       | 829       | 829       | 10     | -         | -     |
| Multifamily                                    | -         | -         | -      | -         | -     |
| Owner occupied                                 | 3,443     | 3,443     | 43     | 803       | -     |
| Revolving and junior liens                     | 985       | 985       | 91     | -         | -     |
| Consumer                                       | -         | -         | -      | -         | -     |
| Total impaired loans with a recorded allowance | 5,257     | 5,257     | 144    | 926       | -     |
| Total impaired loans                           | \$ 20,112 | \$ 23,049 | \$ 144 | \$ 20,031 | \$ 61 |

Troubled debt restructurings (“TDRs”) are loans for which the contractual terms have been modified and both of these conditions exist: (1) there is a concession to the borrower and (2) the borrower is experiencing financial difficulties. Loans are restructured on a case-by-case basis during the loan collection process with modifications generally initiated at the request of the borrower. These modifications may include reduction in interest rates, extension of term, deferrals of principal, and other modifications. The Bank

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

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

The specific allocation of the allowance for loan and lease losses for TDRs is determined by calculating the present value of the TDR cash flows by discounting the original payment less an assumption for probability of default at the original note's issue rate, and adding this amount to the present value of collateral less selling costs. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance (i.e., specific reserve) as a component of the allowance for loan and lease losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. The allowance for loan and lease losses also includes an allowance based on a loss migration analysis for each loan category on loans and leases that are not individually evaluated for specific impairment. All loans charged-off, including TDRs charged-off, are factored into this calculation by portfolio segment.

TDRs that were modified during the period are as follows:

|                              | TDR Modifications<br>Three Months Ended March 31, 2018 |   |  |
|------------------------------|--|---|--|
|                              | # of<br>contracts                                      | Pre-modification<br>recorded investment | Post-modification<br>recorded investment |
| Troubled debt restructurings |  |   |  |
| Real estate - residential    |  |   |  |
| Investor                     |  |   |  |
| Deferral <sup>1</sup>        | 1  | \$ 165                                  | \$ 74                                    |
| Revolving and junior liens   |  |   |  |
| Rate <sup>2</sup>            | 1  | 24                                      | 24                                       |
| Other <sup>3</sup>           | 4  | 218                                     | 217                                      |
| Total                        | 6  | \$ 407                                  | \$ 315                                   |

TDR Modifications  
Three Months Ended March 31, 2017

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|                              | # of contracts | Pre-modification recorded investment | Post-modification recorded investment |
|------------------------------|----------------|--------------------------------------|---------------------------------------|
| Troubled debt restructurings |                |                                      |                                       |
| Revolving and junior liens   |                |                                      |                                       |
| HAMP <sup>4</sup>            | 1              | \$ 56                                | \$ 56                                 |
| Other <sup>3</sup>           | 3              | 188                                  | 187                                   |
| Total                        | 4              | \$ 244                               | \$ 243                                |

1 Deferral: Refers to the deferral of principal.

2 Rate: Refers to interest rate reduction.

3 Other: Change of terms from bankruptcy court.

4 HAMP: Home Affordable Modification Program.

TDRs are classified as being in default on a case-by-case basis when they fail to be in compliance with the modified terms. There was no TDR default activity for the March 31, 2018 and March 31, 2017, for loans that were restructured within the 12 month period prior to default.

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Note 5 – Allowance for Loan and Lease Losses

Changes in the allowance for loan and lease losses by segment of loans based on method of impairment for three months ended March 31, 2018, were as follows:

|  |            |           | Real<br>Estate | Real<br>Estate | Real Estate |          |          |              |
|--|------------|-----------|----------------|----------------|-------------|----------|----------|--------------|
| Allowance for<br>loan and lease<br>losses:                     | Commercial | Leases    | Commercial     | Construction   | Residential | Consumer | Other    | Total        |
| Three months<br>ended<br>March 31, 2018                        |            |           |                |                |             |          |          |              |
| Beginning<br>balance   | \$ 2,453   | \$ 692    | \$ 9,522       | \$ 923         | \$ 3,207    | \$ 122   | \$ 542   | \$ 17,461    |
| Charge-offs  | 16         | 5         | (96)           | (16)           | (33)        | 91       | 8        | (25)         |
| Recoveries   | 17         | -         | 367            | 3              | 958         | 74       | 5        | 1,424        |
| Provision<br>(Release)   | 150        | (70)      | (420)          | 201            | (850)       | (39)     | 306      | (722)        |
| Ending balance   | \$ 2,604   | \$ 617    | \$ 9,565       | \$ 1,143       | \$ 3,348    | \$ 66    | \$ 845   | \$ 18,188    |
| Ending balance:<br>Individually<br>evaluated for<br>impairment | \$ -       | \$ -      | \$ 503         | \$ -           | \$ 85       | \$ -     | \$ -     | \$ 588       |
| Ending balance:<br>Collectively<br>evaluated for<br>impairment | \$ 2,604   | \$ 617    | \$ 9,062       | \$ 1,143       | \$ 3,263    | \$ 66    | \$ 845   | \$ 17,600    |
| Loans:   |            |           |                |                |             |          |          |              |
| Ending balance   | \$ 281,134 | \$ 66,344 | \$ 713,422     | \$ 91,479      | \$ 438,610  | \$ 2,120 | \$ 8,703 | \$ 1,601,812 |
| Ending balance:<br>Individually<br>evaluated for<br>impairment | \$ -       | \$ -      | \$ 4,740       | \$ 197         | \$ 12,276   | \$ 17    | \$ -     | \$ 17,230    |
| Ending balance:<br>Collectively                                | \$ 281,134 | \$ 66,344 | \$ 708,682     | \$ 91,282      | \$ 426,334  | \$ 2,103 | \$ 8,703 | \$ 1,584,582 |



evaluated for  
impairment

Changes in the allowance for loan and lease losses by segment of loans based on method of impairment for three months ended March 31, 2017, were as follows:

|  |            |           | Real<br>Estate | Real Estate  | Real Estate |          |           |              |
|--|------------|-----------|----------------|--------------|-------------|----------|-----------|--------------|
| Allowance for<br>loan and lease<br>losses:                     | Commercial | Leases    | Commercial     | Construction | Residential | Consumer | Other     | Total        |
| Three months<br>ended<br>March 31, 2017                        |            |           |                |              |             |          |           |              |
| Beginning<br>balance   | \$ 1,629   | \$ 633    | \$ 9,547       | \$ 389       | \$ 2,692    | \$ 833   | \$ 435    | \$ 16,158    |
| Charge-offs  | 1          | 117       | 274            | 4            | 195         | 100      | -         | 691          |
| Recoveries   | 2          | -         | 35             | 18           | 142         | 75       | 2         | 274          |
| Provision<br>(Release)   | 42         | 87        | (1,477)        | 575          | 417         | (44)     | 400       | -            |
| Ending balance   | \$ 1,672   | \$ 603    | \$ 7,831       | \$ 978       | \$ 3,056    | \$ 764   | \$ 837    | \$ 15,741    |
| Ending balance:<br>Individually<br>evaluated for<br>impairment | \$ -       | \$ -      | \$ -           | \$ -         | \$ 803      | \$ -     | \$ -      | \$ 803       |
| Ending balance:<br>Collectively<br>evaluated for<br>impairment | \$ 1,672   | \$ 603    | \$ 7,831       | \$ 978       | \$ 2,253    | \$ 764   | \$ 837    | \$ 14,938    |
| Loans:   |            |           |                |              |             |          |           |              |
| Ending balance   | \$ 233,922 | \$ 64,607 | \$ 713,358     | \$ 87,049    | \$ 373,477  | \$ 2,913 | \$ 12,695 | \$ 1,488,021 |
| Ending balance:<br>Individually<br>evaluated for<br>impairment | \$ 24      | \$ 484    | \$ 3,341       | \$ 274       | \$ 13,441   | \$ 210   | \$ -      | \$ 17,774    |
| Ending balance:<br>Collectively<br>evaluated for<br>impairment | \$ 233,898 | \$ 64,123 | \$ 710,017     | \$ 86,775    | \$ 360,036  | \$ 2,703 | \$ 12,695 | \$ 1,470,247 |

## Note 6 – Other Real Estate Owned

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

|   | Three Months Ended |           |
|---|--------------------|-----------|
|   | March 31,          |           |
|   | 2018               | 2017      |
| Other real estate owned   |                    |           |
| Balance at beginning of period  | \$ 8,371           | \$ 11,916 |
| Property additions  | -                  | 3,416     |
| Property improvements   | 59                 | -         |
| Less:   |                    |           |
| Proceeds from property disposals, net of participation purchase and of gains/losses | 1,255              | 1,533     |
| Period valuation adjustments  | 112                | 318       |
| Balance at end of period  | \$ 7,063           | \$ 13,481 |

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Activity in the valuation allowance was as follows:

|                                 | Three Months Ended<br>March 31, |          |
|---------------------------------|---------------------------------|----------|
|                                 | 2018                            | 2017     |
| Balance at beginning of period  | \$ 8,208                        | \$ 9,982 |
| Provision for unrealized losses | 112                             | 318      |
| Reductions taken on sales       | (221)                           | (641)    |
| Other adjustments               | -                               | -        |
| Balance at end of period        | \$ 8,099                        | \$ 9,659 |

Expenses related to OREO, net of lease revenue includes:

|                                 | Three Months<br>Ended<br>March 31, |         |
|---------------------------------|------------------------------------|---------|
|                                 | 2018                               | 2017    |
| Gain on sales, net              | \$ (80)                            | \$ (74) |
| Provision for unrealized losses | 112                                | 318     |
| Operating expenses              | 156                                | 523     |
| Less:                           |                                    |         |
| Lease revenue                   | 15                                 | 58      |
| Net OREO expense                | \$ 173                             | \$ 709  |

## Note 7 – Deposits

Major classifications of deposits were as follows:

|  | March 31, 2018 | December 31, 2017 |
|--|----------------|-------------------|
| Noninterest bearing demand                             | \$ 582,766     | \$ 572,404        |
| Savings  | 274,029        | 262,220           |
| NOW accounts   | 442,119        | 429,448           |
| Money market accounts                                  | 281,860        | 276,082           |
| Certificates of deposit of less than \$100,000         | 216,843        | 216,493           |
| Certificates of deposit of \$100,000 through \$250,000 | 123,132        | 122,489           |
| Certificates of deposit of more than \$250,000         | 41,299         | 43,789            |
| Total deposits   | \$ 1,962,048   | \$ 1,922,925      |

#### Note 8 – Borrowings

The following table is a summary of borrowings as of March 31, 2018, and December 31, 2017. Junior subordinated debentures are discussed in detail in Note 9:

|   | March 31, 2018 | December 31, 2017 |
|---|----------------|-------------------|
| Securities sold under repurchase agreements | \$ 41,366      | \$ 29,918         |
| FHLBC advances <sup>1</sup>                 | 45,000         | 115,000           |
| Junior subordinated debentures              | 57,650         | 57,639            |
| Senior notes                                | 44,083         | 44,058            |
| Total borrowings                            | \$ 188,099     | \$ 246,615        |

<sup>1</sup> Included in other short-term borrowings on the balance sheet.

The Company enters into deposit sweep transactions where the transaction amounts are secured by pledged securities. These transactions consistently mature overnight from the transaction date and are governed by sweep repurchase agreements. All sweep repurchase agreements are treated as financings secured by U.S. government agencies and collateralized mortgage-backed securities and had a carrying amount of \$41.4 million at March 31, 2018, and \$29.9 million at December 31, 2017. The fair value of the pledged



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collateral was \$49.3 million at March 31, 2018 and \$40.0 million at December 31, 2017. At March 31, 2018, there were no customers with secured balances exceeding 10% of stockholders' equity.

The Company's borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC. Total borrowings are generally limited to the lower of 35% of total assets or 60% of the book value of certain mortgage loans. As of March 31, 2018, the Bank had \$45.0 million in advances outstanding under the FHLBC as compared to \$115.0 million outstanding as of December 31, 2017. As of March 31, 2018, FHLBC stock held was valued at \$2.7 million, and any potential FHLBC advances were collateralized by securities with a fair value of \$80.1 million and loans with a principal balance of \$290.4 million, which carried a FHLBC calculated combined collateral value of \$292.5 million. The Company had excess collateral of \$208.3 million available to secure borrowings at March 31, 2018.

The Company also has \$44.1 million of senior notes outstanding, net of deferred issuance costs, as of March 31, 2018 and December 31, 2017. The senior notes mature in ten years, and terms include interest payable semiannually at 5.75% for five years. Beginning December 2021, the senior debt will pay interest at a floating rate, with interest payable quarterly at three month LIBOR plus 385 basis points. The notes are redeemable, in whole or in part, at the option of the Company, beginning with the interest payment date on December 31, 2021, and on any floating rate interest payment date thereafter, at a redemption price equal to 100% of the principal amount of the notes plus accrued and unpaid interest. As of March 31, 2018 and December 31, 2017, unamortized debt issuance costs related to the senior notes were \$917,000 and \$942,000, respectively, and are included as a reduction of the balance of the senior notes on the Consolidated Balance Sheet. These deferred issuance costs will be amortized to interest expense over the ten year term of the notes and are included in the Consolidated Statements of Income.

Note 9 – Junior Subordinated Debentures

The Company completed the sale of \$27.5 million of cumulative trust preferred securities by its unconsolidated subsidiary, Old Second Capital Trust I, in June 2003. An additional \$4.1 million of cumulative trust preferred securities were sold in July 2003. The trust preferred securities may remain outstanding for a 30-year term but, subject to regulatory approval, can be called in whole or in part by the Company after June 30, 2008. When not in deferral, distributions on the securities are payable quarterly at an annual rate of 7.80%. The Company issued a new \$32.6 million subordinated debenture to Old Second Capital Trust I in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

The Company issued an additional \$25.0 million of cumulative trust preferred securities through a private placement completed by an additional, unconsolidated subsidiary, Old Second Capital Trust II, in April 2007. 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 were fixed at 6.77% through June 15, 2017, and float at 150 basis points over three-month LIBOR thereafter. The Trust II issuance converted from fixed to floating rate at three month LIBOR plus 150 basis points on June 15, 2017. Upon conversion to a floating rate, a cash flow hedge was initiated which resulted in the total interest rate paid on the debt of 4.41% as of March 31, 2018, compared to the rate paid prior to June 15, 2017 of 6.77%. The Company issued a new \$25.8 million subordinated debenture to Old Second Capital Trust II in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities. Both of the debentures issued by the Company are disclosed on the Consolidated Balance Sheet as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Income. As of March 31, 2018, and December 31, 2017, unamortized debt issuance costs related to the junior subordinated debentures were \$727,000 and \$739,000 respectively, and are included as a reduction to the balance of the junior subordinated debentures on the Consolidated Balance Sheet.

#### Note 10 – Equity Compensation Plans

Stock-based awards are outstanding under the Company's 2008 Equity Incentive Plan (the "2008 Plan") and the Company's 2014 Equity Incentive Plan (the "2014 Plan," and together with the 2008 Plan, the "Plans"). The 2014 Plan was approved at the 2014 annual meeting of stockholders; a maximum of 375,000 shares were authorized to be issued under this plan. Following approval of the 2014 Plan, no further awards will be granted under the 2008 Plan or any other Company equity compensation plan. At the May 2016 annual stockholders meeting, an amendment to the 2014 Plan authorized an additional 600,000 shares to be issued, which resulted in a total of 975,000 shares authorized for issuance under this plan. The 2014 Plan authorizes the granting of qualified stock options, non-qualified stock options, restricted stock, restricted stock units, and stock appreciation rights. Awards may be granted to selected directors and officers or employees under the 2014 Plan at the discretion of the Compensation Committee of the Company's Board of Directors. As of March 31, 2018, 309,791 shares remained available for issuance under the 2014 Plan.

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There were no stock options granted or exercised in the first quarter of 2018 and 2017. All stock options are granted for a term of ten years. There is no unrecognized compensation cost related to unvested stock options as all stock options of the Company's common stock have fully vested.

A summary of stock option activity in the Plans for the three months ended March 31, 2018, is as follows:

|                              | Shares | Weighted<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (years) | Aggregate<br>Intrinsic Value |
|------------------------------|--------|--|--|------------------------------|
| Beginning outstanding        | 9,000  | \$ 7.49                                  | -  | -                            |
| Canceled                     | -      | -  | -  | -                            |
| Expired                      | -      | -  | -  | -                            |
| Ending outstanding           | 9,000  | \$ 7.49                                  | 0.9  | \$ 58                        |
| Exercisable at end of period | 9,000  | \$ 7.49                                  | 0.9  | \$ 58                        |

Generally, restricted stock and restricted stock units granted under the Plans vest three years from the grant date, but the Compensation Committee of the Company's Board of Directors has discretionary authority to change some terms including the amount of time until the vest date.

Awards under the 2008 Plan will become fully vested upon a merger or change in control of the Company. Under the 2014 Plan, upon a change in control of the Company, if (i) the 2014 Plan is not an obligation of the successor entity following the change in control, or (ii) the 2014 Plan is an obligation of the successor entity following the change in control and the participant incurs an involuntary termination, then the stock options, stock appreciation rights, stock awards and cash incentive awards under the 2014 Plan will become fully exercisable and vested. Performance-based awards generally will vest based upon the level of achievement of the applicable performance measures through the change in control.



The Company granted restricted stock under its equity compensation plans beginning in 2005 and it began granting restricted stock units in February 2009. Restricted stock awards under the Plans generally entitle holders to voting and dividend rights upon grant and are subject to forfeiture until certain restrictions have lapsed including employment for a specific period. Restricted stock units under the Plans are also subject to forfeiture until certain restrictions have lapsed including employment for a specific period, but do not entitle holders to voting rights until the restricted period ends and shares are transferred in connection with the units.

There were 114,281 restricted awards issued under the 2014 Plan during the three months ended March 31, 2018. There were 170,000 restricted awards issued during the three months ended March 31, 2017. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award on the issue date. Total compensation cost that has been recorded for the 2014 Plan was \$401,000 and \$485,000 in the first three months of 2018 and 2017, respectively.

A summary of changes in the Company's unvested restricted awards for the three months ended March 31, 2018, is as follows:

|                       | March 31, 2018                          |   |
|-----------------------|---|---|
|                       | Restricted<br>Stock Shares<br>and Units | Weighted<br>Average<br>Grant Date<br>Fair Value |
| Unvested at January 1 | 465,000                                 | \$ 7.79   |
| Granted               | 114,281                                 | 13.77   |
| Vested                | (155,500)                               | 5.14  |
| Forfeited             | -                                       | -   |
| Unvested at March 31  | 423,781                                 | \$ 10.38  |

Total unrecognized compensation cost of restricted awards was \$2.8 million as of March 31, 2018, which is expected to be recognized over a weighted-average period of 2.25 years.

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Note 11 – Earnings Per Share

The earnings per share – both basic and diluted – are included below as of March 31 (in thousands except for share and per share data):

|  | Quarters Ended March 31, |            |
|--|--------------------------|------------|
|  | 2018                     | 2017       |
| Basic earnings per share:  |                          |            |
| Weighted-average common shares outstanding   | 29,659,454               | 29,560,521 |
| Net income   | \$ 9,489                 | \$ 4,427   |
| Basic earnings per share   | \$ 0.32                  | \$ 0.15    |
| Diluted earnings per share:  |                          |            |
| Weighted-average common shares outstanding   | 29,659,454               | 29,560,521 |
| Dilutive effect of unvested restricted awards <sup>1</sup>   | 472,936                  | 378,112    |
| Dilutive effect of stock options and warrants  | 36,358                   | 2,317      |
| Diluted average common shares outstanding  | 30,168,748               | 29,940,950 |
| Net Income   | \$ 9,489                 | \$ 4,427   |
| Diluted earnings per share   | \$ 0.31                  | \$ 0.15    |
| Number of antidilutive options and warrants excluded from the diluted earnings per share calculation | -                        | 900,839    |

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

The above earnings per share calculation also includes a warrant for 815,339 shares of common stock, at an exercise price of \$13.43 per share, that was outstanding as of March 31, 2018, as it is considered dilutive. The same warrant was not included as of March 31, 2017, because the warrant was anti-dilutive. The ten-year warrant was issued in 2009, and was sold at auction by the U.S. Treasury in June 2013 to a third party investor.

Note 12 – Regulatory &amp; Capital Matters

The Bank is subject to the risk-based capital regulatory guidelines, which include the methodology for calculating the risk-weighted Bank assets, developed by the Office of the Comptroller of the Currency (the “OCC”) and the other bank

regulatory agencies. In connection with the current economic environment, the Bank's current level of nonperforming assets and the risk-based capital guidelines, the Bank's Board of Directors has determined that the Bank should maintain a Tier 1 leverage capital ratio at or above eight percent (8%) and a total risk-based capital ratio at or above twelve percent (12%). At March 31, 2018, the Bank exceeded those thresholds.

At March 31, 2018, the Bank's Tier 1 capital leverage ratio was 11.19%, an increase of 40 basis points from December 31, 2017, and is well above the 8.00% objective. The Bank's total capital ratio was 14.51%, an increase of 73 basis points from December 31, 2017, and also well above the objective of 12.00%.

Bank holding companies are required to maintain minimum levels of capital in accordance with capital guidelines implemented by the Board of Governors of the Federal Reserve System. The general bank and holding company capital adequacy guidelines are shown in the accompanying table, as are the capital ratios of the Company and the Bank, as of March 31, 2018, and December 31, 2017.

In July 2013, the U.S. federal banking authorities issued final rules (the "Basel III Rules") establishing more stringent regulatory capital requirements for U.S. banking institutions, which went into effect on January 1, 2015. A detailed discussion of the Basel III Rules is included in Part I, Item 1 of the Company's Form 10-K for the year ended December 31, 2017, under the heading "Supervision and Regulation."

At March 31, 2018, and December 31, 2017, the Company, on a consolidated basis, exceeded the minimum thresholds to be considered "well capitalized" under current regulatory defined capital ratios.

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Capital levels and industry defined regulatory minimum required levels are as follows:

|  | Actual<br>Amount | Ratio  | Minimum Capital<br>Adequacy with Capital<br>Conservation Buffer if<br>applicable <sup>1</sup> |         | To Be Well<br>Capitalized Under<br>Prompt Corrective<br>Action Provisions <sup>2</sup> |        |
|--|------------------|--------|---|---------|--|--------|
|  |                  |        | Amount  | Ratio   | Amount   | Ratio  |
| March 31, 2018                                       |                  |        |   |         |  |        |
| Common equity tier 1 capital to risk weighted assets |                  |        |   |         |  |        |
| Consolidated   | \$ 189,150       | 9.82 % | \$ 122,793  | 6.375 % | N/A  | N/A    |
| Old Second Bank                                      | 260,159          | 13.56  | 122,309   | 6.375   | \$ 124,707   | 6.50 % |
| Total capital to risk weighted assets                |                  |        |   |         |  |        |
| Consolidated   | 261,536          | 13.58  | 190,182   | 9.875   | N/A  | N/A    |
| Old Second Bank                                      | 278,342          | 14.51  | 189,430   | 9.875   | 191,828  | 10.00  |
| Tier 1 capital to risk weighted assets               |                  |        |   |         |  |        |
| Consolidated   | 243,353          | 12.63  | 151,734   | 7.875   | N/A  | N/A    |
| Old Second Bank                                      | 260,159          | 13.56  | 151,088   | 7.875   | 153,486  | 8.00   |
| Tier 1 capital to average assets                     |                  |        |   |         |  |        |
| Consolidated   | 243,353          | 10.44  | 93,239  | 4.00    | N/A  | N/A    |
| Old Second Bank                                      | 260,159          | 11.19  | 92,997  | 4.00    | 116,246  | 5.00   |
| December 31, 2017                                    |                  |        |   |         |  |        |
| Common equity tier 1 capital to risk weighted assets |                  |        |   |         |  |        |
| Consolidated   | \$ 179,853       | 9.25 % | \$ 111,801  | 5.750 % | N/A  | N/A    |
| Old Second Bank                                      | 249,417          | 12.88  | 111,347   | 5.750   | \$ 125,870   | 6.50 % |
| Total capital to risk weighted assets                |                  |        |   |         |  |        |
| Consolidated   | 251,383          | 12.93  | 179,837   | 9.250   | N/A  | N/A    |
| Old Second Bank                                      | 266,873          | 13.78  | 179,142   | 9.250   | 193,667  | 10.00  |
| Tier 1 capital to risk weighted assets               |                  |        |   |         |  |        |
| Consolidated   | 233,927          | 12.03  | 140,978   | 7.250   | N/A  | N/A    |
| Old Second Bank                                      | 249,417          | 12.88  | 140,394   | 7.250   | 154,917  | 8.00   |
| Tier 1 capital to average assets                     |                  |        |   |         |  |        |
| Consolidated   | 233,927          | 10.08  | 92,828  | 4.00    | N/A  | N/A    |

|                 |         |       |        |      |         |      |
|-----------------|---------|-------|--------|------|---------|------|
| Old Second Bank | 249,417 | 10.79 | 92,462 | 4.00 | 115,578 | 5.00 |
|-----------------|---------|-------|--------|------|---------|------|

1 As of March 31, 2018, amounts are shown inclusive of a capital conservation buffer of 1.875%; as compared to December 31, 2017, of 1.25%.

2 The Bank exceeded the general minimum regulatory requirements to be considered “well capitalized.”

#### Dividend Restrictions

In addition to the above requirements, banking regulations and capital guidelines generally limit the amount of dividends that may be paid by a bank without prior regulatory approval. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year’s profits, combined with the retained profit of the previous two years, subject to the capital requirements described above. Pursuant to the Basel III rules that came into effect January 1, 2015, the Bank must keep a buffer of 0.625% for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter of minimum capital requirements in order to avoid additional limitations on capital distributions and certain other payments.

#### Note 13 – Fair Value Measurements

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

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

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

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

The majority of securities available-for-sale are valued by external pricing services or dealer market participants and are classified in Level 2 of the fair value hierarchy. Both market and income valuation approaches are utilized. Quarterly, the Company evaluates the methodologies used by the external pricing services or dealer market participants to develop the fair values to determine whether the results of the valuations are representative of an exit price in the Company's principal markets and an appropriate representation of fair value. The Company uses the following methods and significant assumptions to estimate fair value:

- Government-sponsored agency debt securities are primarily priced using available market information through processes such as benchmark spreads, market valuations of like securities, like securities groupings and matrix pricing.
- Other government-sponsored agency securities, MBS and some of the actively traded real estate mortgage investment conduits and collateralized mortgage obligations are priced using available market information including benchmark yields, prepayment speeds, spreads, volatility of similar securities and trade date.
- State and political subdivisions are largely grouped by characteristics (e.g., geographical data and source of revenue in trade dissemination systems). Because some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities.
- Auction rate securities are priced using market spreads, cash flows, prepayment speeds, and loss analytics. Therefore, the valuations of auction rate asset-backed securities are considered Level 2 valuations.
- Asset-backed collateralized loan obligations were priced using data from a pricing matrix supported by our bond accounting service provider and are therefore considered Level 2 valuations.
- Annually every security holding is priced by a pricing service independent of the regular and recurring pricing services used. The independent service provides a measurement to indicate if the price assigned by the regular service is within or outside of a reasonable range. Management reviews this report and applies judgment in adjusting calculations at year end related to securities pricing.

- Residential mortgage loans available for sale in the secondary market are carried at fair market value. The fair value of loans held-for-sale is determined using quoted secondary market prices.
- Lending related commitments to fund certain residential mortgage loans, e.g., residential mortgage loans with locked interest rates to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors, as well as forward commitments for future delivery of MBS are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including prices for MBS from the date of the commitment and do not typically involve significant judgments by management.
  - The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.
    - Interest rate swap positions, both assets and liabilities, are based on valuation pricing models using an income approach reflecting readily observable market parameters such as interest rate yield curves.
  - The fair value of impaired loans with specific allocations of the allowance for loan and lease losses is essentially based on recent real estate appraisals or the fair value of the collateralized asset. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are made in the appraisal process by the appraisers to reflect differences between the available comparable sales and income data. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.
  - Nonrecurring adjustments to certain commercial and residential real estate properties classified as OREO are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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

The tables below present the balance of assets and liabilities at March 31, 2018, and December 31, 2017, respectively, measured by the Company at fair value on a recurring basis:

|  | March 31, 2018 |            |           | Total      |
|--|----------------|------------|-----------|------------|
|  | Level 1        | Level 2    | Level 3   |            |
| Assets:  |                |            |           |            |
| Securities available-for-sale  |                |            |           |            |
| U.S. Treasury  | \$ 3,895       | \$ -       | \$ -      | \$ 3,895   |
| U.S. government agencies   | -              | 12,730     | -         | 12,730     |
| U.S. government agencies mortgage-backed                               | -              | 13,844     | -         | 13,844     |
| States and political subdivisions                                      | -              | 259,013    | 26,527    | 285,540    |
| Corporate bonds  | -              | 703        | -         | 703        |
| Collateralized mortgage obligations                                    | -              | 61,648     | 2,096     | 63,744     |
| Asset-backed securities  | -              | 110,870    | -         | 110,870    |
| Collateralized loan obligations  | -              | 59,616     | -         | 59,616     |
| Loans held-for-sale  | -              | 2,426      | -         | 2,426      |
| Mortgage servicing rights  | -              | -          | 7,541     | 7,541      |
| Interest rate swap agreements  | -              | 2,017      | -         | 2,017      |
| Mortgage banking derivatives   | -              | 229        | -         | 229        |
| Total  | \$ 3,895       | \$ 523,096 | \$ 36,164 | \$ 563,155 |
| Liabilities:   |                |            |           |            |
| Interest rate swap agreements, including risk participation agreements | \$ -           | \$ 2,025   | \$ -      | \$ 2,025   |
| Total  | \$ -           | \$ 2,025   | \$ -      | \$ 2,025   |

|                               | December 31, 2017 |         |         | Total    |
|-------------------------------|-------------------|---------|---------|----------|
|                               | Level 1           | Level 2 | Level 3 |          |
| Assets:                       |                   |         |         |          |
| Securities available-for-sale |                   |         |         |          |
| U.S. Treasury                 | \$ 3,947          | \$ -    | \$ -    | \$ 3,947 |
| U.S. government agencies      | -                 | 13,061  | -       | 13,061   |



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|  |          |            |           |            |
|--|----------|------------|-----------|------------|
| U.S. government agencies mortgage-backed | -        | 12,214     | -         | 12,214     |
| States and political subdivisions        | -        | 263,831    | 14,261    | 278,092    |
| Corporate bonds                          | -        | 833        | -         | 833        |
| Collateralized mortgage obligations      | -        | 63,671     | 2,268     | 65,939     |
| Asset-backed securities                  | -        | 112,932    | -         | 112,932    |
| Collateralized loan obligations          | -        | 54,421     | -         | 54,421     |
| Loans held-for-sale                      | -        | 4,067      | -         | 4,067      |
| Mortgage servicing rights                | -        | -          | 6,944     | 6,944      |
| Interest rate swap agreements            | -        | 727        | -         | 727        |
| Mortgage banking derivatives             | -        | 238        | -         | 238        |
| Total                                    | \$ 3,947 | \$ 525,995 | \$ 23,473 | \$ 553,415 |

Liabilities:

|  |      |          |      |          |
|--|------|----------|------|----------|
| Interest rate swap agreements, including risk participation agreements | \$ - | \$ 2,014 | \$ - | \$ 2,014 |
| Total  | \$ - | \$ 2,014 | \$ - | \$ 2,014 |





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In addition to the above, Level 3 fair value measurement included \$26.6 million for state and political subdivisions representing various local municipality securities and \$2.1 million of collateralized mortgage obligations at March 31, 2018. Both of these were classified as securities available-for-sale, and were valued using a discount based on market spreads of similar assets, but the liquidity premium was an unobservable input. The state and political subdivisions securities balance in Level 3 fair value at December 31, 2017, was \$14.3 million and collateralized mortgage obligation balance in Level 3 was \$2.3 million at December 31, 2017. Both of these were classified as securities available-for-sale, and were valued using a discount based on market spreads of similar assets, but the liquidity premium was an unobservable input.

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

The Company may be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with GAAP. These assets consist of impaired loans and OREO. For assets measured at fair value on a nonrecurring basis at March 31, 2018, and December 31, 2017, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

|   | March 31, 2018 |         |           | Total     |
|---|----------------|---------|-----------|-----------|
|   | Level 1        | Level 2 | Level 3   |           |
| Impaired loans <sup>1</sup>               | \$ -           | \$ -    | \$ 8,934  | \$ 8,934  |
| Other real estate owned, net <sup>2</sup> | -              | -       | 7,063     | 7,063     |
| Total                                     | \$ -           | \$ -    | \$ 15,997 | \$ 15,997 |

<sup>1</sup> Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans; had a carrying amount of \$9.5 million and a valuation allowance of \$588,000 resulting in a increase of specific allocations within the allowance for loan and lease losses of \$444,000 for the three months ended March 31, 2018.

<sup>2</sup> OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of \$7.1 million, which is made up of the outstanding balance of \$16.1 million, net of a valuation allowance of \$8.1 million and participations of \$937,000 at March 31, 2018.

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|   | Level 1 | Level 2 | Level 3   | Total     |
|---|---------|---------|-----------|-----------|
| Impaired loans <sup>1</sup>               | \$ -    | \$ -    | \$ 5,113  | \$ 5,113  |
| Other real estate owned, net <sup>2</sup> | -       | -       | 8,371     | 8,371     |
| Total                                     | \$ -    | \$ -    | \$ 13,484 | \$ 13,484 |

<sup>1</sup> Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans; had a carrying amount of \$5.3 million and a valuation allowance of \$144,000, resulting in an increase of specific allocations within the allowance for loan and lease losses of \$856,000 for the year December 31, 2017.

<sup>2</sup> OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of \$8.4 million, which is made up of the outstanding balance of \$17.5 million, net of a valuation allowance of \$8.2 million and participations of \$937,000, at December 31, 2017.

The Company has estimated the fair values of these assets based primarily on Level 3 inputs. OREO and impaired loans are generally valued using the fair value of collateral provided by third party appraisals. These valuations include assumptions related to cash flow projections, discount rates, and recent comparable sales. The numerical ranges of unobservable inputs for these valuation assumptions are not meaningful.

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## Note 14 – Fair Values of Financial Instruments

The estimated fair values approximate carrying amount for all items except those described in the following table. Securities available-for-sale fair values are based upon market prices or dealer quotes, and if no such information is available, on the rate and term of the security. The carrying value of FHLBC stock approximates fair value as the stock is nonmarketable and can only be sold to the FHLBC or another member institution at par. FHLBC stock is carried at cost and considered a Level 2 fair value. For March 31, 2018, the fair values of loans and leases are estimated on an exit price basis incorporating discounts for credit, liquidity and marketability factors. This is not comparable with the fair value disclosures for December 31, 2017, which were estimated using an entrance price basis. For December 31, 2017, fair values of variable rate loans and leases with no significant change in credit risk were based on carrying values. The fair values of other loans and leases were estimated using discounted cash flow analyses which used interest rates being offered for loans and leases with similar terms to borrowers of similar credit quality. The fair value of time deposits is estimated using discounted future cash flows at current rates offered for deposits of similar remaining maturities. The fair values of borrowings were estimated based on interest rates available to the Company for debt with similar terms and remaining maturities. The fair value of off balance sheet volume is not considered material.

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

|  | March 31, 2018     |               |            |         |           |
|--|--------------------|---------------|------------|---------|-----------|
|  | Carrying<br>Amount | Fair<br>Value | Level 1    | Level 2 | Level 3   |
| Financial assets:  |                    |               |            |         |           |
| Cash and due from banks                                  | \$ 29,478          | \$ 29,478     | \$ 29,478  | \$ -    | \$ -      |
| Interest bearing deposits with<br>financial institutions | 18,394             | 18,394        | 18,394     | -       | -         |
| Securities available-for-sale                            | 550,942            | 550,942       | 3,895      | 518,424 | 28,623    |
| FHLBC and FRBC Stock                                     | 7,468              | 7,468         | -          | 7,468   | -         |
| Loans held-for-sale                                      | 2,426              | 2,426         | -          | 2,426   | -         |
| Loans, net   | 1,583,624          | 1,556,714     | -          | -       | 1,556,714 |
| Accrued interest receivable                              | 9,114              | 9,114         | -          | 9,114   | -         |
| Financial liabilities:                                   |                    |               |            |         |           |
| Noninterest bearing deposits                             | \$ 582,766         | \$ 582,766    | \$ 582,766 | \$ -    | \$ -      |

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|   |           |           |        |           |   |
|---|-----------|-----------|--------|-----------|---|
| Interest bearing deposits                   | 1,379,282 | 1,372,909 | -      | 1,372,909 | - |
| Securities sold under repurchase agreements | 41,366    | 41,366    | -      | 41,366    | - |
| Other short-term borrowings                 | 45,000    | 45,000    | -      | 45,000    | - |
| Junior subordinated debentures              | 57,650    | 59,471    | 33,267 | 26,204    | - |
| Senior notes                                | 44,083    | 46,743    | -      | 46,743    | - |
| Interest rate swap agreements               | 7         | 7         | -      | 7         | - |
| Borrowing interest payable                  | 792       | 792       | -      | 792       | - |
| Deposit interest payable                    | 632       | 632       | -      | 632       | - |

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|   | December 31, 2017 |            | Level 1    | Level 2   | Level 3   |
|---|-------------------|------------|------------|-----------|-----------|
|   | Carrying Amount   | Fair Value |            |           |           |
| <b>Financial assets:</b>                              |                   |            |            |           |           |
| Cash and due from banks                               | \$ 37,444         | \$ 37,444  | \$ 37,444  | \$ -      | \$ -      |
| Interest bearing deposits with financial institutions | 18,389            | 18,389     | 18,389     | -         | -         |
| Securities available-for-sale                         | 541,439           | 541,439    | 3,947      | 520,963   | 16,529    |
| FHLBC and FRBC Stock                                  | 10,168            | 10,168     | -          | 10,168    | -         |
| Loans held-for-sale                                   | 4,067             | 4,067      | -          | 4,067     | -         |
| Loans, net  | 1,600,161         | 1,586,722  | -          | -         | 1,586,722 |
| Accrued interest receivable                           | 8,595             | 8,595      | -          | 8,595     | -         |
| <b>Financial liabilities:</b>                         |                   |            |            |           |           |
| Noninterest bearing deposits                          | \$ 572,404        | \$ 572,404 | \$ 572,404 | \$ -      | \$ -      |
| Interest bearing deposits                             | 1,350,521         | 1,346,339  | -          | 1,346,339 | -         |
| Securities sold under repurchase agreements           | 29,918            | 29,918     | -          | 29,918    | -         |
| Other short-term borrowings                           | 115,000           | 115,000    | -          | 115,000   | -         |
| Junior subordinated debentures                        | 57,639            | 59,471     | 33,267     | 26,204    | -         |
| Subordinated debenture                                | 44,058            | 46,743     | -          | 46,743    | -         |
| Interest rate swap agreements                         | 1,287             | 1,287      | -          | 1,287     | -         |
| Borrowing interest payable                            | 140               | 140        | -          | 140       | -         |
| Deposit interest payable                              | 631               | 631        | -          | 631       | -         |

## Note 15 – Derivatives, Hedging Activities and Financial Instruments with Off-Balance Sheet Risk

## Risk Management Objective of Using Derivatives

The Company is exposed to certain risk arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk



primarily by managing the amount, sources, and duration of its assets and liabilities and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's loan portfolio.

#### Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable-rate amounts from a counterparty in exchange for the Company making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount. During 2018, such derivatives were used to hedge the variable cash flows associated with existing variable-rate borrowings.

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in Accumulated Other Comprehensive Income and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are received on the Company's variable-rate borrowings. During the next twelve months, the Company estimates that an additional \$117,308 will be reclassified as a reduction to interest expense.

#### Non-designated Hedges

Derivatives not designated as hedges are not speculative and result from a service the Company provides to certain customers. The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting derivatives that the Company executes with a third party, such that

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the Company minimizes its net risk exposure resulting from such transactions. As the interest rate derivatives associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer derivatives and the offsetting derivatives are recognized directly in earnings.

## Disclosure of Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the Balance Sheet as of March 31, 2018 and December 31, 2017.

## Fair Value of Derivative Instruments

|   | Number of Transactions | Notional Amount \$ | Asset Derivatives      |               |                         |               | Liability Derivatives  |               |                         |               |
|---|------------------------|--------------------|------------------------|---------------|-------------------------|---------------|------------------------|---------------|-------------------------|---------------|
|   |                        |                    | As of March 31, 2018   |               | As of December 31, 2017 |               | As of March 31, 2018   |               | As of December 31, 2017 |               |
|   |                        |                    | Balance Sheet Location | Fair Value \$ | Balance Sheet Location  | Fair Value \$ | Balance Sheet Location | Fair Value \$ | Balance Sheet Location  | Fair Value \$ |
| Derivatives designated as hedging instruments       |                        |                    |                        |               |                         |               |                        |               |                         |               |
| Interest Rate Products                              | 1                      | 25,774             | Other Assets           | -             | Other Assets            | -             | Other Liabilities      | 7             | Other Liabilities       | 1,287         |
| Total derivatives designated as hedging instruments |                        |                    |                        | -             |                         | -             |                        | 7             |                         | 1,287         |
| Derivatives not                                     |                        |                    |                        |               |                         |               |                        |               |                         |               |

designated  
as hedging  
instruments

|  |   |        |                 |   |                 |   |                      |    |                      |       |
|--|---|--------|-----------------|---|-----------------|---|----------------------|----|----------------------|-------|
| Interest<br>Rate<br>Products   | 2 | 51,548 | Other<br>Assets | 7 | Other<br>Assets | - | Other<br>Liabilities | 7  | Other<br>Liabilities | 1,287 |
| Other<br>Contracts   | 3 | 15,908 | Other<br>Assets | - | Other<br>Assets | - | Other<br>Liabilities | 7  | Other<br>Liabilities | 13    |
| Total<br>derivatives<br>not<br>designated<br>as hedging<br>instruments |   |        |                 | 7 |                 | - |                      | 14 |                      | 1,301 |

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Disclosure of the Effect of Fair Value and Cash Flow Hedge Accounting on Accumulated Other Comprehensive Income

The table below presents the effect of cash flow hedge accounting on Accumulated Other Comprehensive Income as of March 31, 2018, and December 31, 2017.

## The Effect of Fair Value and Cash Flow Hedge Accounting on Accumulated Other Comprehensive Income

| Derivatives in Subtopic<br>815-20 Hedging<br>Relationships | Amount of Gain or (Loss)<br>Recognized in OCI on<br>Derivative |                                    | Location of Gain or (Loss)<br>Reclassified from<br>Accumulated OCI into<br>Income | Amount of Gain or (Loss)<br>Reclassified from<br>Accumulated OCI into<br>Income |                                    |
|--|--|------------------------------------|---|---|------------------------------------|
|  | Quarter<br>Ended<br>March 31,<br>2018                          | Year Ended<br>December 31,<br>2017 |   | Quarter<br>Ended<br>March 31,<br>2018   | Year Ended<br>December 31,<br>2017 |
| Derivatives in Cash Flow Hedging Relationships:            |  |                                    |   |   |                                    |
| Interest Rate Products                                     | \$ 1,206   | \$ (504)                           | Interest income   | \$ (74)   | \$ (211)                           |
| Total  | \$ 1,206   | \$ (504)                           |   | \$ (74)   | \$ (211)                           |

## Tabular Disclosure of the Effect of Fair Value and Cash Flow Hedge Accounting on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the Income Statement as of March 31, 2018, and December 31, 2017.

## Location and Amount of Gain or (Loss) Recognized in Income on Fair Value and Cash Flow Hedging Relationships

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|  | Quarter Ended March<br>31, 2018 |                              | Year Ended<br>December 31,<br>2017 |                              |
|--|---------------------------------|------------------------------|------------------------------------|------------------------------|
|  | Interest<br>Income<br>(Expense) | Other<br>Income<br>(Expense) | Interest<br>Income<br>(Expense)    | Other<br>Income<br>(Expense) |
| Total amounts of income and expense line items presented in the statement of financial performance in which the effects of fair value or cash flow hedges are recorded | \$ (74)                         | \$ -                         | \$ (211)                           | \$ -                         |
| The effects of fair value and cash flow hedging:   |                                 |                              |                                    |                              |
| Gain or (loss) on cash flow hedging relationships in Subtopic 815-20   |                                 |                              |                                    |                              |
| Interest contracts   |                                 |                              |                                    |                              |
| Amount of gain or (loss) reclassified from accumulated other comprehensive income into income  | (74)                            | -                            | (211)                              | -                            |

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Disclosure of the Effect of Derivatives Not Designated as Hedging Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments that are not designated as hedging instruments on the Income Statement as of March 31, 2018, and December 31, 2017.

## Derivatives Not Designated as Hedging Instruments under Subtopic 815-20

|                        | Location of Gain or (Loss)<br>Recognized in Income on<br>Derivative | Amount of Gain or (Loss)<br>Recognized in Income on Derivative |                                    |
|------------------------|---|--|------------------------------------|
|                        |   | Quarter Ended<br>March 31,<br>2018                             | Year Ended<br>December 31,<br>2017 |
| Interest Rate Products | Other income / (expense)  | \$ -   | \$ -                               |
| Other Contracts        | Other income / (expense)  | 6  | 161                                |
| Total                  |   | \$ 6   | \$ 161                             |
| Fee Income             | Other income / (expense)  | \$ -   | \$ -                               |

## Credit-risk-related Contingent Features

For derivative transactions involving counterparties who are lending customers of the Company, the derivative credit exposure is managed through the normal credit review and monitoring process, which may include collateralization, financial covenants and/or financial guarantees of affiliated parties. Agreements with such customers require that losses associated with derivative transactions receive payment priority from any funds recovered should a customer default and ultimate disposition of collateral or guarantees occur.

Credit exposure to broker/dealer counterparties is managed through agreements with each derivative counterparty that require collateralization of fair value gains owed by such counterparties. Some small degree of credit exposure exists due to timing differences between when a gain may occur and the subsequent point in time that collateral is delivered to secure that gain. This is monitored by the Company and procedures are in place to minimize this exposure. Such

agreements also require the Company to collateralize counterparties in circumstances wherein the fair value of the derivatives result in loss to the Company.

Other provisions of such agreements include the definition of certain events that may lead to the declaration of default and/or the early termination of the derivative transaction(s):

- if the Company either defaults or is capable of being declared in default on any of its indebtedness (exclusive of deposit obligations), then the Company could also be declared in default on its derivative obligations.
- if a merger occurs that materially changes the Company's creditworthiness in an adverse manner.
- If certain specified adverse regulatory actions occur, such as the issuance of a Cease and Desist Order, or citations for actions considered Unsafe and Unsound or that may lead to the termination of deposit insurance coverage by the Federal Deposit Insurance Corporation.

As of March 31, 2018, the fair value of derivatives in a net liability position, which includes accrued interest but excludes any adjustment for nonperformance risk, related to these agreements was \$0. As of March 31, 2018, the Company has not posted any collateral related to these agreements.

The Bank also issues letters of credit, which are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit are essentially the same as that involved in extending loan commitments to our customers. In addition to customer related commitments, the Company is responsible for letters of credit commitments that relate to properties held in OREO. The following table represents the Company's contractual commitments due to letters of credit as of March 31, 2018, and December 31, 2017.

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The following table is a summary of letter of credit commitments (in thousands):

|                         | March 31, 2018 |           |           | December 31, 2017 |           |           |
|-------------------------|----------------|-----------|-----------|-------------------|-----------|-----------|
|                         | Fixed          | Variable  | Total     | Fixed             | Variable  | Total     |
| Letters of credit:      |                |           |           |                   |           |           |
| Borrower:               |                |           |           |                   |           |           |
| Financial standby       | \$ 292         | \$ 4,152  | \$ 4,444  | \$ 177            | \$ 3,770  | \$ 3,947  |
| Commercial standby      | -              | 354       | 354       | -                 | 354       | 354       |
| Performance standby     | 241            | 7,092     | 7,333     | 241               | 7,594     | 7,835     |
|                         | 533            | 11,598    | 12,131    | 418               | 11,718    | 12,136    |
| Non-borrower:           |                |           |           |                   |           |           |
| Performance standby     | -              | 142       | 142       | -                 | 142       | 142       |
| Total letters of credit | \$ 533         | \$ 11,740 | \$ 12,273 | \$ 418            | \$ 11,860 | \$ 12,278 |





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

#### Overview

The following management's discussion and analysis presents information concerning our financial condition as of March 31, 2018, as compared to December 31, 2017, and the results of operations for the quarters ended March 31, 2018, and March 31, 2017. This discussion and analysis is best read in conjunction with our consolidated financial statements as well as the financial and statistical data appearing elsewhere in this report and our Form 10-K for the year ended December 31, 2017. The results of operations for the quarter ended March 31, 2018, are not necessarily indicative of future results.

In this report, unless the context suggests otherwise, references to the "Company," "we," "us," and "our" mean the combined business of Old Second Bancorp, Inc. and its subsidiary bank, Old Second National Bank (the "Bank").

We have made, and will continue to make, various forward-looking statements with respect to financial and business matters. Comments regarding our business that are not historical facts are considered forward-looking statements that involve inherent risks and uncertainties. Actual results may differ materially from those contained in these forward-looking statements. For additional information regarding our cautionary disclosures, see the "Cautionary Note Regarding Forward-Looking Statements" on page 3 of this report.

#### Business Overview

The Company is a banking holding company headquartered in Aurora, Illinois. Through our wholly-owned subsidiary bank, Old Second National Bank, a national banking organization also headquartered in Aurora, Illinois, we offer a wide range of financial services through our 29 banking centers located in Cook, Kane, Kendall, DeKalb, DuPage, LaSalle and Will counties in Illinois. These banking centers offer access to a full range of traditional retail and commercial banking services including treasury management operations as well as fiduciary and wealth management services. We focus our business on establishing and maintaining relationships with our clients while maintaining a commitment to provide for the financial services needs of the communities in which we operate. We emphasize relationships with individual customers as well as small to medium-sized businesses throughout our market area. We also have extensive wealth management services, which includes a registered investment advisory platform in addition to trust administration and trust services related to personal and corporate trusts and employee benefit plan administration services.

#### Financial Overview

Our community-focused banking franchise experienced revenue growth in the first quarter of 2018, as compared to the fourth and first quarters of 2017, and we believe we are positioned for further growth as we continue to serve our customers' needs in a competitive economic environment. While industry and regulatory developments in the past few years have made it challenging to attain the levels of profitability and growth reflected prior to the economic recession of 2007-2009, we are continuing to seek to provide value to our customers and the communities in which we operate, by executing on growth opportunities in our local markets and developing new banking relationships.

The following provides an overview of some of the factors impacting our financial performance for the first quarter of 2018:

- Net income for the first quarter of 2018 was \$9.5 million, or \$0.31 per diluted share, compared to \$4.4 million, or \$0.15 per diluted share, for the first quarter of 2017.
- Net interest and dividend income was \$19.6 million for the first quarter of 2018, compared to \$17.5 million for the quarter ended March 31, 2017.
- Noninterest income was \$8.5 million for the first quarter of 2018, which reflects an increase of \$1.5 million, or 21.0%, compared to the first quarter of 2017.
- Noninterest expense was \$17.4 million for the first quarter of 2018, which reflects a decrease of \$700,000, or 3.9%, from the first quarter of 2017.
- Asset quality remained consistent, with nonperforming loans as a percent of total loans of 0.8% as of both March 31, 2018 and March 31, 2017.
- Income tax expense declined due to the enactment of the "Tax Cuts and Jobs Act," which was effective as of January 1, 2018 and lowered the Federal corporate income tax rate to 21%, as well as income tax credits that were recorded in the first quarter of 2018 due to the vesting of restricted stock awards.

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### Recent Developments

On April 20, 2018, the Company completed its previously announced acquisition of Greater Chicago Financial Corp., and its wholly-owned bank subsidiary, ABC Bank. In connection with the merger, Greater Chicago Financial Corp merged with and into the Company, with the Company as the surviving company in the merger. Immediately following the merger, ABC Bank, an Illinois state-chartered bank and wholly owned subsidiary of Greater Chicago Financial Corp., merged with and into the Bank, with the Bank as the surviving bank. With the acquisition of ABC Bank, we acquired four branches in the Chicago, Illinois, metropolitan area.

### Critical Accounting Policies

The Company's consolidated financial statements are prepared based on the application of accounting policies in accordance with generally accepted accounting principles ("GAAP") and follow general practices within the banking industry. These policies require the reliance on estimates and assumptions, which may prove inaccurate or are subject to variations. Changes in underlying factors, assumptions, or estimates could have a material impact on the Company's future financial condition and results of operations. The most critical of these significant accounting policies are the policies related to the allowance for loan and lease losses, fair valuation methodologies and income taxes. 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 consolidated financial statements.

The Company's significant accounting policies are more fully described in Note 1 to the audited consolidated financial statements contained in our Annual Report on Form 10-K for the year ended December 31, 2017, and the more significant assumptions and estimates made by management are more fully described in "Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies" in our Annual Report on Form 10-K for the year ended December 31, 2017. There were no material changes to the Company's significant accounting policies or the estimates made pursuant to those policies during the most recent quarter.

### Non-GAAP Financial Measures

This report contains references to financial measures that are not defined in GAAP. Such non-GAAP financial measures include the presentation of net interest income and net interest income to interest earning assets on a tax equivalent ("TE") basis, our adjusted efficiency ratio and our tangible common equity to tangible assets ratio. Management believes that the presentation of these non-GAAP financial measures (a) provides important supplemental information that contributes to a proper understanding of our operating performance, (b) enables a more complete understanding of factors and trends affecting our business, and (c) allows investors to evaluate our performance in a manner similar to management, the financial services industry, bank stock analysts, and bank regulators. Management uses non-GAAP measures as follows: in the preparation of our operating budgets, monthly financial performance reporting, and in our presentation to investors of our performance. However, we acknowledge

that these non-GAAP financial measures have a number of limitations. Limitations associated with non-GAAP financial measures include the risk that persons might disagree as to the appropriateness of items comprising these measures and that different companies might calculate these measures differently. These disclosures should not be considered an alternative to our GAAP results. A reconciliation of non-GAAP financial measures to the most directly comparable GAAP financial measures is presented below or alongside the first instance where each non-GAAP financial measure is used.

## Results of Operations

Our net income before taxes was \$11.5 million in the first quarter of 2018, compared to \$6.5 million in the first quarter of 2017. This increase primarily reflects a \$2.5 million increase in net interest and dividend income, a \$722,000 release of the allowance for loan and lease losses, an increase of \$1.5 million in noninterest income and a \$700,000 decrease in noninterest expense. The increase in noninterest income in the first quarter of 2018, compared to the first quarter of 2017, was driven primarily by a \$1.0 million death benefit received on a BOLI claim in the first quarter of 2018, as well as increases in mortgage servicing rights interest rate driven mark to market adjustments. The decrease in noninterest expense in the first quarter of 2018, compared to the first quarter of 2017, was primarily due to reductions in salaries and employee benefits costs due primarily to an executive retirement payout in the first quarter of 2017, as well as a decrease in OREO related costs as the OREO portfolio declined year over year.

Management has remained diligent in reviewing our loan portfolio to analyze and to determine if charge-offs are required. In the first quarter of 2018, management's review of the loan portfolio concluded that a release of the allowance for loan and lease losses of \$722,000 should be recorded as a result of a recovery received from an insurance claim on a loan charged-off in a prior year, as well as no net growth in the loan portfolio since year end 2017. Management determined the allowance for loan and lease losses was adequate and appropriate for estimated incurred losses at March 31, 2018, upon the release of the allowance noted above. Neither a release of the allowance for loan and lease losses nor an additional loan and lease loss provision was deemed necessary for the like 2017 quarter.

Earnings for the first quarter of 2018 were \$0.31 per diluted share on \$9.5 million of net income, as compared to \$0.15 per diluted share on net income of \$4.4 million for the first quarter of 2017. Earnings in the 2018 period, compared to the like 2017 period, were

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positively impacted by recoveries on a few nonperforming credits in the first quarter of 2018, as well as the favorable impact of a rising interest rate environment. The performance of our loan portfolio, the impact of the restructuring of our securities portfolio into higher yielding instruments and organic loan growth in the year over year period also contributed to the increase in earnings for the 2018 period.

Net Interest Income

Net interest income, which is our primary source of earnings, is the difference between interest income earned on interest-earning assets, such as loans and investment securities, as well as accretion income on purchased loans, and interest incurred on interest-bearing liabilities, such as deposits and borrowings. Net interest income depends upon the relative mix of interest-earning assets and interest-bearing liabilities, the ratio of interest-earning assets to total assets and of interest-bearing liabilities to total funding sources, and movements in market interest rates. The Company's net interest income can be significantly influenced by a variety of factors, including overall loan demand, economic conditions, credit risk, the amount of nonearning assets including nonperforming loans and OREO, the amounts of and rates at which assets and liabilities reprice, variances in prepayment of loans and securities, early withdrawal of deposits, exercise of call options on borrowings or securities, a general rise or decline in interest rates, changes in the slope of the yield-curve, and balance sheet growth or contraction.

Net interest and dividend income increased by \$2.1 million from \$17.5 million for the quarter ended March 31, 2017, to \$19.6 million for the quarter ended March 31, 2018. Tax equivalent interest and dividend income increased by \$2.6 million from \$21.1 million for the three months ended March 31, 2017, to \$23.7 million for the three months ended March 31, 2018. Average earning assets for the three months ended March 31, 2018, reflected an increase of \$28.3 million compared to the fourth quarter of 2017, and an increase of \$104.0 million, to \$2.17 billion, compared to the like average for the first quarter of 2017. Total average loans, including loans held-for-sale, totaled \$1.60 billion in the first quarter of 2018, which reflected an increase of \$3.3 million compared to the fourth quarter of 2017, and an increase of \$115.7 compared to the first quarter of 2017. Our interest and dividend income increased \$2.5 million, or 12.3%, in the three months ended March 31, 2018, compared to the first quarter of 2017, primarily driven by growth in the loan portfolio due to select nonperforming loan interest recoveries as well as the rising interest rate environment in the 2018 period. In addition, the average yield on our securities portfolio increased by 43 basis points in the year over year period due to the reposition of our portfolio into higher yielding tax exempt securities. Our average tax exempt securities portfolio increased by \$138.1 million in the first quarter of 2018, as compared to the first quarter of 2017.

Quarterly average interest bearing liabilities increased \$31.4 million, or 2.0%, as of March 31, 2018, compared to March 31, 2017. Growth from the prior year like period was due to an increase in the average balances of securities sold under repurchase agreements, as well as other borrowed funds, which consist of FHLBC advances. The FHLBC advances were impacted by the higher interest rate environment in the first quarter of 2018, reflecting a cost of funds of 1.53% compared to 1.24% for the fourth quarter of 2017 and 0.76% for the first quarter of 2017. The rate on our junior subordinated debentures declined in the first quarter of 2018, compared to the first quarter of 2017, due to the rate conversion on the debt from fixed to floating rate at three month LIBOR plus 150 basis points on June 15, 2017. Upon conversion to a floating rate, we initiated a cash flow hedge that resulted in a reduction in the

total interest rate paid on the debt from 6.77% prior to June 15, 2017, to 4.41% as of March 31, 2018. This rate conversion and hedge resulted in a reduction of \$157,000 of expense related to our interest on our junior subordinated debt in the first quarter of 2018 compared to the first quarter of 2017.

Our net interest margin (on a tax-equivalent basis), expressed as a percentage of average earning assets, was 3.76% in the first quarter of 2018, reflecting no change from the fourth quarter of 2017, and an increase of 22 basis points from the first quarter of 2017. The average tax-equivalent yield on earning assets increased to 4.42% for the first quarter of 2018, compared to 4.33% for the fourth quarter of 2017 and 4.08% for the first quarter of 2017. Increases in net interest margin and yield on average earning assets for the first quarter of 2018 as compared to the first quarter of 2017 was attributable to growth in loan volumes and rates, as well as the restructuring of our securities portfolio into higher yielding tax exempt holdings, as discussed above. The cost of funds on interest bearing liabilities was 0.90% for the first quarter of 2018, 0.84% for the fourth quarter of 2017, and 0.80% for the first quarter of 2017. The increase in our cost of funds in each period was driven by the rising interest rate environment, specifically impacting the rates on newly issued time deposits and FHLBC advances.

Management continued to observe competitive pressure to maintain reduced interest rates on loans retained at renewal. While the Bank prices loans to achieve certain return on equity targets, significant competition for both commercial and industrial as well as commercial real estate loans has put pressure on loan yields, and our stringent underwriting standards limit our ability to make higher-yielding loans.

The following tables set forth certain information relating to the Company's average consolidated balance sheets and reflect the yield on average earning assets and cost of average interest bearing liabilities for the periods indicated. These yields reflect the related interest, on an annualized basis, divided by the average balance of assets or liabilities over the applicable period. Average balances are derived from daily balances. For purposes of discussion, net interest income and net interest income to total earning assets on the following tables have been adjusted to a non-GAAP tax equivalent ("TE") basis using a marginal rate of 21% in 2018 and 35% in 2017 to more appropriately compare returns on tax-exempt loans and securities to other earning assets.

Table of ContentsANALYSIS OF AVERAGE BALANCES,  
TAX EQUIVALENT INTEREST AND RATES

(In thousands - unaudited)

|   | Quarters Ended<br>March 31, 2018 |          |           | December 31, 2017  |          |           | March 31, 2017     |          |           |
|---|----------------------------------|----------|-----------|--------------------|----------|-----------|--------------------|----------|-----------|
|   | Average<br>Balance               | Interest | Rate<br>% | Average<br>Balance | Interest | Rate<br>% | Average<br>Balance | Interest | Rate<br>% |
| Assets  |                                  |          |           |                    |          |           |                    |          |           |
| Interest bearing deposits with financial institutions | \$ 13,819                        | \$ 49    | 1.44      | \$ 13,147          | \$ 43    | 1.28      | \$ 12,121          | \$ 23    | 0.76      |
| Securities:   |                                  |          |           |                    |          |           |                    |          |           |
| Taxable   | 269,330                          | 2,170    | 3.27      | 281,096            | 2,208    | 3.14      | 422,124            | 2,963    | 2.81      |
| Non-taxable (TE)                                      | 279,831                          | 2,609    | 3.78      | 243,813            | 2,694    | 4.42      | 141,773            | 1,403    | 3.96      |
| Total securities                                      | 549,161                          | 4,779    | 3.53      | 524,909            | 4,902    | 3.74      | 563,897            | 4,366    | 3.10      |
| Dividends from FHLBC and FRBC                         | 8,920                            | 106      | 4.82      | 8,842              | 99       | 4.48      | 7,614              | 85       | 4.47      |
| Loans and loans held-for-sale <sup>1</sup>            | 1,602,947                        | 18,767   | 4.75      | 1,599,672          | 18,585   | 4.55      | 1,487,226          | 16,655   | 4.48      |
| Total interest earning assets                         | 2,174,847                        | 23,701   | 4.42      | 2,146,570          | 23,629   | 4.33      | 2,070,858          | 21,129   | 4.08      |
| Cash and due from banks                               | 29,776                           | -        | -         | 30,972             | -        | -         | 33,585             | -        | -         |
| Allowance for loan and lease losses                   | (18,263)                         | -        | -         | (17,002)           | -        | -         | (16,292)           | -        | -         |
| Other noninterest bearing assets                      | 166,507                          | -        | -         | 181,484            | -        | -         | 192,836            | -        | -         |
| Total assets  | \$ 2,352,867                     |          |           | \$ 2,342,024       |          |           | \$ 2,280,987       |          |           |
| Liabilities and Stockholders' Equity                  |                                  |          |           |                    |          |           |                    |          |           |
|   | \$ 429,301                       | \$ 176   | 0.17      | \$ 420,073         | \$ 108   | 0.10      | \$ 426,606         | \$ 101   | 0.10      |



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|                 |              |           |      |              |           |      |              |           |      |
|-----------------|--------------|-----------|------|--------------|-----------|------|--------------|-----------|------|
| NOW             |              |           |      |              |           |      |              |           |      |
| accounts        |              |           |      |              |           |      |              |           |      |
| Money market    |              |           |      |              |           |      |              |           |      |
| accounts        | 275,334      | 109       | 0.16 | 277,883      | 95        | 0.14 | 283,619      | 83        | 0.12 |
| Savings         |              |           |      |              |           |      |              |           |      |
| accounts        | 266,363      | 59        | 0.09 | 260,852      | 52        | 0.08 | 259,384      | 39        | 0.06 |
| Time deposits   | 382,422      | 1,175     | 1.25 | 383,011      | 1,146     | 1.19 | 394,388      | 979       | 1.01 |
| Interest        |              |           |      |              |           |      |              |           |      |
| bearing         |              |           |      |              |           |      |              |           |      |
| deposits        | 1,353,420    | 1,519     | 0.46 | 1,341,819    | 1,401     | 0.41 | 1,363,997    | 1,202     | 0.36 |
| Securities sold |              |           |      |              |           |      |              |           |      |
| under           |              |           |      |              |           |      |              |           |      |
| repurchase      |              |           |      |              |           |      |              |           |      |
| agreements      | 40,275       | 79        | 0.80 | 27,664       | 7         | 0.10 | 29,805       | 2         | 0.03 |
| Other           |              |           |      |              |           |      |              |           |      |
| short-term      |              |           |      |              |           |      |              |           |      |
| borrowings      | 87,444       | 329       | 1.53 | 84,728       | 269       | 1.24 | 56,111       | 106       | 0.76 |
| Junior          |              |           |      |              |           |      |              |           |      |
| subordinated    |              |           |      |              |           |      |              |           |      |
| debentures      | 57,645       | 927       | 6.52 | 57,633       | 929       | 6.45 | 57,597       | 1,084     | 7.53 |
| Senior notes    | 44,071       | 672       | 6.18 | 44,046       | 672       | 6.10 | 43,978       | 673       | 6.12 |
| Total interest  |              |           |      |              |           |      |              |           |      |
| bearing         |              |           |      |              |           |      |              |           |      |
| liabilities     | 1,582,855    | 3,526     | 0.90 | 1,555,890    | 3,278     | 0.84 | 1,551,488    | 3,067     | 0.80 |
| Noninterest     |              |           |      |              |           |      |              |           |      |
| bearing         |              |           |      |              |           |      |              |           |      |
| deposits        | 554,624      | -         | -    | 556,010      | -         | -    | 525,454      | -         | -    |
| Other           |              |           |      |              |           |      |              |           |      |
| liabilities     | 13,969       | -         | -    | 26,037       | -         | -    | 25,061       | -         | -    |
| Stockholders'   |              |           |      |              |           |      |              |           |      |
| equity          | 201,419      | -         | -    | 204,087      | -         | -    | 178,984      | -         | -    |
| Total           |              |           |      |              |           |      |              |           |      |
| liabilities and |              |           |      |              |           |      |              |           |      |
| stockholders'   |              |           |      |              |           |      |              |           |      |
| equity          | \$ 2,352,867 |           |      | \$ 2,342,024 |           |      | \$ 2,280,987 |           |      |
| Net interest    |              |           |      |              |           |      |              |           |      |
| income (TE)     |              | \$ 20,175 |      |              | \$ 20,351 |      |              | \$ 18,062 |      |
| Net interest    |              |           |      |              |           |      |              |           |      |
| income (TE)     |              |           |      |              |           |      |              |           |      |
| to total        |              |           |      |              |           |      |              |           |      |
| earning assets  |              |           | 3.76 |              |           | 3.76 |              |           | 3.54 |
| Interest        |              |           |      |              |           |      |              |           |      |
| bearing         |              |           |      |              |           |      |              |           |      |
| liabilities to  |              |           |      |              |           |      |              |           |      |
| earning assets  | 72.78        | %         |      | 72.48        | %         |      | 74.92        | %         |      |

1 Interest income from loans is shown on a tax equivalent basis, which is a non-GAAP financial measure, as discussed in the table on page 41, and includes fees of \$182,000, \$636,000 and \$513,000 for the first quarter of 2018, the fourth quarter of 2017 and the first quarter of 2017, respectively. Nonaccrual loans are included in the above-stated average balances.



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## Reconciliation of Tax-Equivalent Non-GAAP Financial Measures

Net interest income and net interest income to earning assets have been adjusted to a non-GAAP TE basis using a marginal rate of 21% for 2018 and 35% for 2017 to more appropriately compare returns on tax-exempt loans and securities to other earning assets. The table below provides a reconciliation of each non-GAAP TE measure to the GAAP equivalent for the periods indicated:

|                                 | Quarters Ended    |                      |                   |   |  |
|---------------------------------|-------------------|----------------------|-------------------|---|--|
|                                 | March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 |   |  |
| Net Interest Margin             |                   |                      |                   |   |  |
| Interest income (GAAP)          | \$ 23,142         | \$ 22,664            | \$ 20,616         |   |  |
| Taxable-equivalent adjustment:  |                   |                      |                   |   |  |
| Loans                           | 11                | 22                   | 22                |   |  |
| Securities                      | 548               | 943                  | 491               |   |  |
| Interest income (TE)            | 23,701            | 23,629               | 21,129            |   |  |
| Interest expense (GAAP)         | 3,526             | 3,278                | 3,067             |   |  |
| Net interest income (TE)        | \$ 20,175         | \$ 20,351            | \$ 18,062         |   |  |
| Net interest income (GAAP)      | \$ 19,616         | \$ 19,386            | \$ 17,549         |   |  |
| Average interest earning assets | \$ 2,174,847      | \$ 2,146,570         | \$ 2,070,858      |   |  |
| Net interest margin (GAAP)      | 3.66              | % 3.58               | % 3.44            | % |  |
| Net interest margin (TE)        | 3.76              | % 3.76               | % 3.54            | % |  |

## Noninterest Income and Expense

The following table details the major components of noninterest income for the periods presented:

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| Noninterest Income<br>(dollars in thousands)            | Quarters Ended    |                      |                   | 1st Quarter 2018<br>Percent Change From |                   |
|---|-------------------|----------------------|-------------------|---|-------------------|
|   | March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 | December 31,<br>2017                    | March 31,<br>2017 |
| Trust income  | \$ 1,495          | \$ 1,639             | \$ 1,458          | (8.8)                                   | 2.5               |
| Service charges on deposits                             | 1,592             | 1,765                | 1,618             | (9.8)                                   | (1.6)             |
| Residential mortgage banking<br>revenue                 |                   |                      |                   |   |                   |
| Secondary mortgage fees                                 | 162               | 182                  | 176               | (11.0)                                  | (8.0)             |
| Mortgage servicing rights mark to<br>market gain (loss) | 305               | (46)                 | (133)             | N/M                                     | N/M               |
| Mortgage servicing income                               | 452               | 448                  | 435               | 0.9                                     | 3.9               |
| Net gain on sales of mortgage loans                     | 917               | 1,088                | 1,147             | (15.7)                                  | (20.1)            |
| Total residential mortgage banking<br>revenue           | 1,836             | 1,672                | 1,625             | 9.8                                     | 13.0              |
| Securities gain (loss), net                             | 35                | 639                  | (136)             | (94.5)                                  | 125.7             |
| Increase in cash surrender value of<br>BOLI             | 248               | 361                  | 359               | (31.3)                                  | (30.9)            |
| Death benefit realized on BOLI                          | 1,026             | -                    | -                 | N/M                                     | N/M               |
| Debit card interchange income                           | 1,012             | 1,069                | 975               | (5.3)                                   | 3.8               |
| Gain on disposal and transfer of<br>fixed assets        | -                 | -                    | (2)               | N/M                                     | N/M               |
| Other income  | 1,261             | 1,039                | 1,131             | 21.4                                    | 11.5              |
| Total noninterest income                                | \$ 8,505          | \$ 8,184             | \$ 7,028          | 3.9                                     | 21.0              |

N/M - Not meaningful

Noninterest income for the first quarter of 2018 increased \$321,000, or 3.9%, compared to the fourth quarter of 2017, and increased \$1.5 million, or 21.0%, compared to the first quarter of 2017.

The increase in noninterest income in the first quarter of 2018, compared to the fourth quarter of 2017, was primarily due to a \$1.0 million death benefit realized on BOLI due to the death of a covered employee in February 2018, partially offset by decreases in trust income, services charges on deposits and securities gains in the first quarter of 2018, compared to the fourth quarter of 2017.

The increase in noninterest income in the first quarter of 2018, compared to the first quarter of 2017, was primarily due to the \$1.0 million death benefit realized on BOLI due to the death of a covered employee in February 2018. Our mortgage banking revenues

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also increased \$211,000 in the first quarter of 2018, compared to the like 2017 quarter, due primarily to the rising interest rate environment increasing mortgage servicing rights mark to market valuations. The \$130,000 increase in other income for the first quarter of 2018, compared to the like 2017 quarter, was driven by fees recovered related to the prior year's loan and OREO related legal fees incurred as well as refunds of prior years' telecom expenses recorded.

The following table details the major components of noninterest expense for the periods presented:

| Noninterest Expense<br>(dollars in thousands)     | Quarters Ended    |                      |                   | 1st Quarter 2018<br>Percent Change From |                   |
|---|-------------------|----------------------|-------------------|---|-------------------|
|   | March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 | December 31,<br>2017                    | March 31,<br>2017 |
| Salaries  | \$ 7,335          | \$ 7,363             | \$ 8,057          | (0.4)                                   | (9.0)             |
| Officers incentive                                | 787               | 204                  | 465               | 285.8                                   | 69.2              |
| Benefits and other                                | 2,085             | 1,346                | 2,051             | 54.9                                    | 1.7               |
| Total salaries and employee benefits              | 10,207            | 8,913                | 10,573            | 14.5                                    | (3.5)             |
| Occupancy, furniture and equipment expense        | 1,558             | 1,441                | 1,566             | 8.1                                     | (0.5)             |
| Computer and data processing                      | 1,344             | 1,104                | 1,090             | 21.7                                    | 23.3              |
| FDIC insurance                                    | 156               | 146                  | 148               | 6.8                                     | 5.4               |
| General bank insurance                            | 251               | 251                  | 270               | -                                       | (7.0)             |
| Amortization of core deposit intangible asset     | 21                | 22                   | 25                | (4.5)                                   | (16.0)            |
| Advertising expense                               | 341               | 412                  | 386               | (17.2)                                  | (11.7)            |
| Debit card interchange expense                    | 281               | 296                  | 349               | (5.1)                                   | (19.5)            |
| Legal fees  | 159               | 200                  | 104               | (20.5)                                  | 52.9              |
| Other real estate owned expense, net              | 173               | 237                  | 709               | (27.0)                                  | (75.6)            |
| Other expense                                     | 2,863             | 3,169                | 2,834             | (9.7)                                   | 1.0               |
| Total noninterest expense                         | \$ 17,354         | \$ 16,191            | \$ 18,054         | 7.2                                     | (3.9)             |
| Efficiency ratio (GAAP)                           | 63.41             | % 59.16              | % 70.08           | %                                       |                   |
| Adjusted efficiency ratio (non-GAAP) <sup>1</sup> | 60.50             | % 56.49              | % 66.97           | %                                       |                   |

N/M - Not meaningful

<sup>1</sup> The adjusted efficiency ratio shown in the table above is a non-GAAP financial measure calculated as noninterest expense, excluding OREO expenses, amortization of core deposits and acquisition costs, divided by the sum of net interest income on a fully tax equivalent basis, total noninterest income less net gains and losses on securities and

includes a tax equivalent adjustment on the increase in cash surrender value of BOLI and the BOLI death benefit recorded.

See the section entitled “Reconciliation of Adjusted Efficiency Ratio Non-GAAP Financial Measures” on page 43 for a reconciliation of this non-GAAP measure to the most comparable GAAP equivalent.

Noninterest expense for the first quarter of 2018 increased \$1.2 million, or 7.2%, compared to the fourth quarter of 2017, but declined \$700,000 or 3.9%, compared to the first quarter of 2017.

The increase in noninterest expense in the first quarter of 2018, compared to the fourth quarter of 2017, was primarily attributable to higher levels of salaries and employee benefit expenses in 2018 due to reversals in accruals for officer incentives that occurred in the fourth quarter of 2017 and higher payroll taxes in the first quarter of 2018. We also had an increase in computer and data processing costs in 2018 of \$240,000, compared to the fourth quarter 2017, which included acquisition related data processing costs of \$163,000 related to our acquisition of Greater Financial Chicago Corp. These increases were partially offset by reduced OREO related costs in 2018, compared to the fourth quarter of 2017, as our OREO portfolio balance continued to decline.

The decrease in noninterest expense in the first quarter of 2018, compared to the first quarter of 2017, was primarily attributable to a \$536,000 reduction in OREO related costs as our OREO portfolio balance continued to decline, and a \$366,000 reduction in salary related costs due primarily to a one-time executive retirement expense in the first quarter of 2017 of \$298,000. These reductions were partially offset by a \$254,000 increase in computer and data processing costs in 2018, compared to the first quarter 2017, which included acquisition related data processing costs of \$163,000 related to our acquisition of Greater Financial Chicago Corp.

Other expenses for the periods presented have remained relatively consistent, as continued efficiencies with our operational processes have contributed to maintaining these components of noninterest expenses with less significant variation.

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## Reconciliation of Adjusted Efficiency Ratio Non-GAAP Financial Measures

|  | Quarters Ended    |                      |                   |
|--|-------------------|----------------------|-------------------|
|  | March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 |
| Efficiency Ratio   |                   |                      |                   |
| Noninterest expense  | \$ 17,354         | \$ 16,191            | \$ 18,054         |
| Less amortization of core deposit                          | 21                | 22                   | 25                |
| Less other real estate expense, net                        | 173               | 237                  | 709               |
| Less transition related executive costs                    | -                 | -                    | 298               |
| Less acquisition related costs                             | 246               | 65                   | -                 |
| Adjusted noninterest expense                               | 16,914            | 15,867               | 17,022            |
| Net interest income (GAAP)                                 | 19,616            | 19,386               | 17,549            |
| Taxable-equivalent adjustment:                             |                   |                      |                   |
| Loans  | 11                | 22                   | 22                |
| Securities   | 548               | 943                  | 491               |
| Net interest income (TE)                                   | 20,175            | 20,351               | 18,062            |
| Noninterest income   | 8,505             | 8,184                | 7,028             |
| Taxable-equivalent adjustment:                             |                   |                      |                   |
| Increase in cash surrender value of BOLI (TE)              | 339               | 194                  | 193               |
| Noninterest income (TE)                                    | 8,844             | 8,378                | 7,221             |
| Less death benefit related to BOLI                         | 1,026             | -                    | -                 |
| Less securities gain (loss), net                           | 35                | 639                  | (136)             |
| Adjusted noninterest income, plus net interest income (TE) | \$ 27,958         | \$ 28,090            | \$ 25,419         |
| Efficiency ratio (GAAP)                                    | 63.41             | % 59.16              | % 70.08           |
| Adjusted efficiency ratio (non-GAAP)                       | 60.50             | % 56.49              | % 66.97           |

## Income Taxes

The Company recorded a tax expense of \$2.0 million on \$11.5 million pre-tax income for the first quarter of 2018, compared to an income tax expense of \$13.1 million in the fourth quarter of 2017 and \$2.1 million of income tax expense in the first quarter of 2017. The effective tax rate for the first quarter of 2018 was 17.4%, a decrease from 32.1% in the first quarter of 2017. Lower tax rates were effective in 2018 due to the "Tax Cuts and Jobs Act" which was signed into law in December 2017, and resulted in the federal corporate tax rate being reduced to 21% from 35%. In addition, the impact of the law resulted in the reduction of our deferred tax asset, which is reflected in income tax expense for the fourth quarter of 2017. We recorded an income tax expense credit of \$483,000 in the first quarter of 2018 related to the vesting of restricted stock awards; this credit also contributed to the reduction of the effective tax rate for the quarter. Income tax expense reflected all relevant statutory tax rates and GAAP accounting.

There were no significant changes in the Company's ability to utilize the deferred tax assets during the quarter ended March 31, 2018. The Company has no valuation reserve on the deferred tax assets as of March 31, 2018.

#### Financial Condition

Total assets decreased \$16.9 million from \$2.38 billion as of December 31, 2017, to \$2.37 billion at March 31, 2018, due primarily to a reduction in net loan balances as payoffs outpaced loan growth. Total loans decreased \$15.8 million, or 1.0%, when compared to December 31, 2017. The securities portfolio ended the first quarter of 2018 at \$550.9 million, an increase of \$9.5 million from \$541.4 million at December 31, 2017, and a decrease of \$60.1 million from March 31, 2017.



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| Securities<br>(in thousands)                    | As of<br>March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 | March 31, 2018<br>Percent Change From |                   |
|---|----------------------------|----------------------|-------------------|---------------------------------------|-------------------|
|   |                            |                      |                   | December 31,<br>2017                  | March 31,<br>2017 |
| Securities available-for-sale, at<br>fair value |                            |                      |                   |                                       |                   |
| U.S. Treasuries                                 | \$ 3,895                   | \$ 3,947             | \$ -              | (1.3)                                 | N/M               |
| U.S. government agencies                        | 12,730                     | 13,061               | -                 | (2.5)                                 | N/M               |
| U.S. government agencies<br>mortgage-backed     | 13,844                     | 12,214               | 38,558            | 13.3                                  | (64.1)            |
| States and political subdivisions               | 285,540                    | 278,092              | 219,507           | 2.7                                   | 30.1              |
| Corporate bonds                                 | 703                        | 833                  | 12,540            | (15.6)                                | (94.4)            |
| Collateralized mortgage<br>obligations          | 63,744                     | 65,939               | 108,324           | (3.3)                                 | (41.2)            |
| Asset-backed securities                         | 110,870                    | 112,932              | 139,886           | (1.8)                                 | (20.7)            |
| Collateralized loan obligations                 | 59,616                     | 54,421               | 92,239            | 9.5                                   | (35.4)            |
| Total securities                                | \$ 550,942                 | \$ 541,439           | \$ 611,054        | 1.8                                   | (9.8)             |

N/M - Not meaningful

Available-for-sale security purchases during the first quarter of 2018 and year over year periods were primarily tax exempt state and political subdivisions securities. This portfolio repositioning was performed to enhance overall asset yield due to the rising interest rate environment. During the first quarter of 2018 security sales resulted in net realized gains of \$35,000, as compared to net realized gains of \$639,000 for the fourth quarter of 2017 and net realized losses of \$136,000 for the first quarter of 2017.

## Loans

Total loans were \$1.60 billion as of March 31, 2018, a decrease of \$15.8 million from the total as of December 31, 2017. The decrease in total loans was due to significant payoffs occurring in the first quarter of 2018, including payoffs of three large nonperforming credits which totaled \$6.3 million. We continued to diversify our loan portfolio driving growth in commercial loans in the first quarter of 2018 compared to December 31, 2017 and March 31, 2017. We also purchased a \$20.0 million home equity portfolio from TCF Bank in the first quarter of 2018, which contributed to the total residential real estate growth of \$12.4 million from December 31, 2017 to March 31, 2018.

Total loans increased \$113.8 million from March 31, 2017, to March 31, 2018, due to organic loan growth in commercial, real estate-construction, leases, and real estate-residential loans, and the home equity portfolio purchases from TCF Bank in the first quarter of 2018 and the second quarter of 2017 of \$20.0 million and \$16.7 million,

respectively.

| Loans<br>(in thousands)    | As of<br>March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 | March 31, 2018<br>Percent Change From |                   |
|----------------------------|----------------------------|----------------------|-------------------|---------------------------------------|-------------------|
|                            |                            |                      |                   | December 31,<br>2017                  | March 31,<br>2017 |
| Commercial                 | \$ 281,134                 | \$ 272,851           | \$ 233,922        | 3.0                                   | 20.2              |
| Leases                     | 66,344                     | 68,325               | 64,607            | (2.9)                                 | 2.7               |
| Real estate - commercial   | 713,422                    | 750,991              | 713,358           | (5.0)                                 | 0.0               |
| Real estate - construction | 91,479                     | 85,162               | 87,049            | 7.4                                   | 5.1               |
| Real estate - residential  | 438,610                    | 426,230              | 373,477           | 2.9                                   | 17.4              |
| Consumer                   | 2,120                      | 2,774                | 2,913             | (23.6)                                | (27.2)            |
| Other                      | 7,725                      | 10,609               | 11,835            | (27.2)                                | (34.7)            |
|                            | 1,600,834                  | 1,616,942            | 1,487,161         | (1.0)                                 | 7.6               |
| Net deferred loan costs    | 978                        | 680                  | 860               | 43.8                                  | 13.7              |
| Total loans                | \$ 1,601,812               | \$ 1,617,622         | \$ 1,488,021      | (1.0)                                 | 7.6               |

The quality of the loan portfolio is impacted not only by the Company's credit decisions but also by the economic health of the communities in which the Company operates. As the Company is located in a corridor with significant open space and undeveloped real estate, real estate lending (including commercial, residential, and construction) has been and continues to be a sizeable portion of the portfolio. These categories comprised 77.6% of the portfolio as of March 31, 2018, compared to 78.0% of the portfolio as of December 31, 2017. The Company continues to oversee and manage its loan portfolio in accordance with interagency guidance on risk management.

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## Asset Quality

The Company recorded a release of the allowance for loan and lease losses of \$722,000 in the first quarter of 2018. On a quarterly basis, management estimates the amount required and records the appropriate provision expense or release to maintain an adequate reserve for all potential and estimated loan losses.

Nonperforming loans consist of nonaccrual loans, performing restructured accruing loans and loans 90 days or greater past due. Remediation work continues in all segments. Nonperforming loans decreased by \$2.8 million at March 31, 2018, from \$15.6 million at December 31, 2017, and increased by \$268,000 from \$12.5 million at March 31, 2017. Credit metrics continue to be relatively stable regarding nonperforming loan levels, and management is carefully monitoring loans considered to be in a classified status. Nonperforming loans as a percent of total loans decreased to 1.2% as of March 31, 2018, from 1.5% as of December 31, 2017, and 1.7% as of March 31, 2017. The distribution of the Company's nonperforming loans is shown in the following table.

| Nonperforming Loans<br>(in thousands) | As of             |                      |                   | March 31, 2018<br>Percent Change From |                   |
|---------------------------------------|-------------------|----------------------|-------------------|---------------------------------------|-------------------|
|                                       | March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 | December 31,<br>2017                  | March 31,<br>2017 |
| Real estate-construction              | \$ 197            | \$ 201               | \$ 274            | (2.0)                                 | (28.1)            |
| Real estate-residential:              |                   |                      |                   |                                       |                   |
| Investor                              | 361               | 372                  | 749               | (3.0)                                 | (51.8)            |
| Multifamily                           | -                 | 4,723                | -                 | (100.0)                               | N/M               |
| Owner occupied                        | 5,176             | 4,964                | 5,349             | 4.3                                   | (3.2)             |
| Revolving and junior liens            | 2,301             | 1,890                | 2,150             | 21.7                                  | 7.0               |
| Real estate-commercial, nonfarm       | 4,740             | 3,289                | 3,283             | 44.1                                  | 44.4              |
| Real estate-commercial, farm          | -                 | -                    | -                 | N/M                                   | N/M               |
| Commercial                            | -                 | -                    | 225               | -                                     | (100.0)           |
| Leases                                | -                 | 178                  | 484               | (100.0)                               | (100.0)           |
| Other                                 | 17                | 7                    | 10                | 142.9                                 | 70.0              |
| Total nonperforming loans             | \$ 12,792         | \$ 15,624            | \$ 12,524         | (18.1)                                | 2.1               |

N/M - Not meaningful



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| Loan Charge-offs, net of recoveries<br>(in thousands) | Quarters Ended    |                            |                      |                            |                   |                            |
|---|-------------------|----------------------------|----------------------|----------------------------|-------------------|----------------------------|
|   | March 31,<br>2018 | % of<br>Total <sup>1</sup> | December 31,<br>2017 | % of<br>Total <sup>1</sup> | March 31,<br>2017 | % of<br>Total <sup>1</sup> |
| Commercial  | \$ (1)            | 0.1                        | \$ (12)              | 4.9                        | \$ (1)            | (0.2)                      |
| Leases  | 5                 | (0.3)                      | -                    | -                          | 117               | 28.1                       |
| Real estate-commercial, nonfarm                       |                   |                            |                      |                            |                   |                            |
| Owner general purpose                                 | (41)              | 2.8                        | -                    | -                          | -                 | -                          |
| Owner special purpose                                 | (21)              | 1.4                        | -                    | -                          | (5)               | (1.2)                      |
| Non-owner general purpose                             | (313)             | 21.6                       | (37)                 | 15.0                       | 250               | 60.0                       |
| Non-owner special purpose                             | (1)               | 0.1                        | -                    | -                          | (6)               | (1.4)                      |
| Retail properties                                     | (87)              | 6.0                        | 9                    | (3.7)                      | -                 | -                          |
| Total real estate-commercial, nonfarm                 | (463)             | 31.9                       | (28)                 | 11.3                       | 239               | 57.4                       |
| Real estate-construction                              |                   |                            |                      |                            |                   |                            |
| Homebuilder   | 2                 | (0.1)                      | (93)                 | 37.8                       | (17)              | (4.1)                      |
| Land  | (4)               | 0.3                        | (1)                  | 0.4                        | -                 | -                          |
| Commercial speculative                                | (18)              | 1.2                        | -                    | -                          | -                 | -                          |
| All other   | 1                 | (0.1)                      | (194)                | 78.9                       | 3                 | 0.7                        |
| Total real estate-construction                        | (19)              | 1.3                        | (288)                | 117.1                      | (14)              | (3.4)                      |
| Real estate-residential                               |                   |                            |                      |                            |                   |                            |
| Investor  | (30)              | 2.1                        | 64                   | (26.0)                     | (1)               | (0.2)                      |
| Multifamily   | (175)             | 12.1                       | (13)                 | 5.3                        | (9)               | (2.2)                      |
| Owner occupied  | (766)             | 52.8                       | 18                   | (7.3)                      | (2)               | (0.5)                      |
| Revolving and junior liens                            | (20)              | 1.4                        | (30)                 | 12.2                       | 65                | 15.5                       |
| Total real estate-residential                         | (991)             | 68.4                       | 39                   | (15.8)                     | 53                | 12.6                       |
| Consumer  | 17                | (1.2)                      | 47                   | (19.1)                     | 25                | 6.0                        |
| Other   | 3                 | (0.2)                      | (4)                  | 1.6                        | (2)               | (0.5)                      |
| Net (recoveries) / charge-offs                        | \$ (1,449)        | 100.0                      | \$ (246)             | 100.0                      | \$ 417            | 100.0                      |

<sup>1</sup> Represents the percentage of net charge-offs attributable to each category of loans.

Net recoveries for the first quarter of 2018 were \$1.4 million, compared to net charge-offs of \$417,000 for the first quarter of 2017, reflecting continuing management attention to credit quality. We have continued our conservative loan valuations and aggressive recovery efforts on prior charge-offs.

The following table shows classified assets by segment for the following periods.

| Classified Loans<br>(in thousands) | As of             |                      |                   | March 31, 2018<br>Percent Change From |                   |
|------------------------------------|-------------------|----------------------|-------------------|---------------------------------------|-------------------|
|                                    | March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 | December 31,<br>2017                  | March 31,<br>2017 |
| Commercial                         | \$ -              | \$ -                 | \$ 1,999          | N/M                                   | N/M               |
| Leases                             | 610               | 825                  | 1,163             | (26.1)                                | (47.5)            |
| Real estate-commercial, nonfarm    | 6,098             | 7,262                | 7,784             | (16.0)                                | (21.7)            |
| Real estate-commercial, farm       | 2,439             | 2,486                | 1,315             | (1.9)                                 | 85.5              |
| Real estate-construction           | 371               | 376                  | 451               | (1.3)                                 | (17.7)            |
| Real estate-residential:           |                   |                      |                   |                                       |                   |
| Investor                           | 436               | 448                  | 908               | (2.7)                                 | (52.0)            |
| Multifamily                        | -                 | 4,723                | -                 | (100.0)                               | N/M               |
| Owner occupied                     | 5,476             | 5,266                | 5,923             | 4.0                                   | (7.5)             |
| Revolving and junior liens         | 2,038             | 1,899                | 2,193             | 7.3                                   | (7.1)             |
| Consumer                           | 18                | 20                   | 11                | (10.0)                                | N/M               |
| Total classified loans             | 17,486            | 23,305               | 21,747            | (25.0)                                | (19.6)            |
| Other real estate owned            | 7,063             | 8,371                | 13,481            | (15.6)                                | (47.6)            |
| Total classified assets            | \$ 24,549         | \$ 31,676            | \$ 35,228         | (22.5)                                | (30.3)            |
| N/M - Not meaningful               |                   |                      |                   |                                       |                   |

Classified loans include nonaccrual, performing troubled debt restructurings and all other loans considered substandard. Classified assets include both classified loans and OREO. Loans classified as substandard are inadequately protected by either the current net worth and ability to meet payment obligations of the obligor, or by the collateral pledged to secure the loan, if any. These loans have a

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well-defined weakness or weaknesses that jeopardize the liquidation of the debt and carry the distinct possibility that the Company will sustain some loss if deficiencies remain uncorrected.

Total classified loans and total classified assets both declined as of March 31, 2018, from the levels at December 31, 2017 and March 31, 2017. Management monitors a ratio of classified assets to the sum of Bank Tier 1 capital and the allowance for loan and lease losses as another measure of overall change in loan related asset quality, which is referred to as the “classified assets ratio.” The classified assets ratio decreased to 8.82% for the period ended March 31, 2018, from 11.84% as of December 31, 2017, and 14.49% as of March 31, 2017, due to the collection of a few large nonperforming credits in 2018.

## Allowance for Loan and Lease Losses

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

|   | Quarters Ended    |                      |                   |
|---|-------------------|----------------------|-------------------|
|   | March 31,<br>2018 | December 31,<br>2017 | March 31,<br>2017 |
| Allowance at beginning of period              | \$ 17,461         | \$ 16,465            | \$ 16,158         |
| Charge-offs:                                  |                   |                      |                   |
| Commercial                                    | 16                | 5                    | 1                 |
| Leases  | 5                 | -                    | 117               |
| Real estate - commercial                      | (96)              | 9                    | 274               |
| Real estate - construction                    | (16)              | -                    | 4                 |
| Real estate - residential                     | (33)              | 169                  | 195               |
| Consumer                                      | 91                | 124                  | 100               |
| Other   | 8                 | 1                    | -                 |
| Total charge-offs                             | (25)              | 308                  | 691               |
| Recoveries:                                   |                   |                      |                   |
| Commercial                                    | 17                | 17                   | 2                 |
| Leases  | -                 | -                    | -                 |
| Real estate - commercial                      | 367               | 37                   | 35                |
| Real estate - construction                    | 3                 | 288                  | 18                |
| Real estate - residential                     | 958               | 130                  | 142               |
| Consumer                                      | 74                | 77                   | 75                |
| Other   | 5                 | 5                    | 2                 |
| Total recoveries                              | 1,424             | 554                  | 274               |
| Net (recoveries) / charge-offs                | (1,449)           | (246)                | 417               |
| (Release) provision for loan and lease losses | (722)             | 750                  | -                 |
| Allowance at end of period                    | \$ 18,188         | \$ 17,461            | \$ 15,741         |

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|  |              |   |              |   |              |   |
|--|--------------|---|--------------|---|--------------|---|
| Average total loans (exclusive of loans held-for-sale) | \$ 1,600,594 |   | \$ 1,596,928 |   | \$ 1,484,556 |   |
| Net (recoveries) / charge-offs to average loans        | (0.09)       | % | (0.02)       | % | 0.03         | % |
| Allowance at period end to average loans               | 1.14         | % | 1.09         | % | 1.06         | % |
| Ending balance: Individually evaluated for impairment  | \$ 588       |   | \$ 144       |   | \$ 803       |   |
| Ending balance: Collectively evaluated for impairment  | \$ 17,600    |   | \$ 17,317    |   | \$ 14,938    |   |

Total charge-offs for the quarter ended March 31, 2018, reflected a negative balance due to the unearned net loan fees on loans charged off in prior periods being taken as a charge-off reduction in the current period, compared to \$691,000 for the quarter ended March 31, 2017. Total recoveries for the quarter ended March 31, 2018, were \$1.4 million compared to \$274,000 for the quarter ended March 31, 2017. The coverage ratio of the allowance for loan and lease losses to nonperforming loans was 142.2% as of March 31, 2018, which was an increase from the coverage ratio of 111.8% as of December 31, 2017, and 125.7% coverage ratio as of March 31, 2017. When measured as a percentage of average loans as of March 31, 2018, our total allowance for loan and lease losses increased to 1.14% of average loans from 1.09% as of December 31, 2017, and 1.06% as of March 31, 2017. The total allowance for loan and lease losses as a percent of total period end loans was 1.19% as of March 31, 2018, excluding the loans acquired from the Talmer branch acquisition, which are effectively “reserved” for potential future losses in the remaining \$694,000 credit mark component of the purchase accounting discount recorded. In addition, \$750,000 within the March 31, 2018, allowance for loan and lease losses total of \$18.2 million is reserved for any purchased non-credit impaired portfolio losses that may potentially be incurred due to losses related to the loans acquired from the Talmer branch acquisition. In management’s judgment, an adequate allowance for estimated losses has been established for inherent losses at March 31, 2018, and general changes in lending policy, procedures and staffing, as well as other external factors. However, there can be no assurance that actual losses will not exceed the estimated amounts



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in the future, based on unforeseen economic events, changes in business climates and the condition of collateral at the time of default and repossession.

## Other Real Estate Owned

As of March 31, 2018, OREO decreased to \$7.1 million, compared to \$8.4 million at December 31, 2017, and \$13.5 million at March 31, 2017. There were no additions to the OREO portfolio in the first quarter of 2018. The \$1.3 million OREO reduction for the quarter is due to five property sales. Valuation write-downs continued with an expense of \$112,000 recorded on five properties in the first quarter of 2018, compared to \$318,000 of valuation write-downs recorded in the first quarter of 2017.

| OREO<br>(in thousands)        | Quarters Ended    |                      | March 31,<br>2017 | March 31, 2018<br>Percent Change From<br>December 31, 2017 |                   |
|-------------------------------|-------------------|----------------------|-------------------|--|-------------------|
|                               | March 31,<br>2018 | December 31,<br>2017 |                   | March 31,<br>2017  | March 31,<br>2017 |
| Beginning balance             | \$ 8,371          | \$ 9,024             | \$ 11,916         | (7.2)  | (29.7)            |
| Property additions            | -                 | -                    | 3,416             | N/M  | N/M               |
| Property improvements         | 59                | -                    | -                 | N/M  | N/M               |
| Less:                         |                   |                      |                   |  |                   |
| Property disposals            | 1,255             | 575                  | 1,533             | 118.3  | (18.1)            |
| Period valuation adjustments  | 112               | 78                   | 318               | 43.6   | (64.8)            |
| Total other real estate owned | \$ 7,063          | \$ 8,371             | \$ 13,481         | (15.6)   | (47.6)            |

N/M - Not meaningful

In management's judgment, the property valuation allowance as established presents OREO at current estimates of fair value less estimated costs to sell; however, there can be no assurance that additional losses will not be incurred on disposals or upon updates to valuations in the future. Of note, properties valued in total at \$4.8 million, or approximately 67.8% of total OREO at March 31, 2018, have been in OREO for five years or more. The appropriate regulatory approval has been obtained for any OREO properties held in excess of five years.

OREO Properties by Type  
(in thousands)

March 31, 2018      December 31, 2017      March 31, 2017

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|                                     | Amount   | % of<br>Total | Amount   | % of<br>Total | Amount    | % of<br>Total |
|-------------------------------------|----------|---------------|----------|---------------|-----------|---------------|
| Single family residence             | \$ 257   | 4 %           | \$ 900   | 11 %          | \$ 1,328  | 10 %          |
| Lots (single family and commercial) | 5,332    | 75 %          | 5,329    | 63 %          | 6,687     | 49 %          |
| Vacant land                         | 479      | 7 %           | 479      | 6 %           | 636       | 5 %           |
| Multi-family                        | -        | 0 %           | -        | 0 %           | 94        | 1 %           |
| Commercial property                 | 995      | 14 %          | 1,663    | 20 %          | 4,736     | 35 %          |
| Total OREO properties               | \$ 7,063 | 100%          | \$ 8,371 | 100%          | \$ 13,481 | 100%          |

Deposits and Borrowings

| Deposits<br>(in thousands)                                | As of             |                      | March 31,<br>2017 | March 31, 2018<br>Percent Change From |                   |
|---|-------------------|----------------------|-------------------|---------------------------------------|-------------------|
|   | March 31,<br>2018 | December 31,<br>2017 |                   | December 31,<br>2017                  | March 31,<br>2017 |
| Noninterest bearing demand                                | \$ 582,766        | \$ 572,404           | \$ 559,666        | 1.8                                   | 4.1               |
| Savings   | 274,029           | 262,220              | 266,007           | 4.5                                   | 3.0               |
| NOW accounts  | 442,119           | 429,448              | 439,276           | 3.0                                   | 0.6               |
| Money market accounts                                     | 281,860           | 276,082              | 286,417           | 2.1                                   | (1.6)             |
| Certificates of deposit of less than<br>\$100,000         | 216,843           | 216,493              | 222,754           | 0.2                                   | (2.7)             |
| Certificates of deposit of \$100,000<br>through \$250,000 | 123,132           | 122,489              | 105,728           | 0.5                                   | 16.5              |
| Certificates of deposit of more than<br>\$250,000         | 41,299            | 43,789               | 57,306            | (5.7)                                 | (27.9)            |
| Total deposits  | \$ 1,962,048      | \$ 1,922,925         | \$ 1,937,154      | 2.0                                   | 1.3               |

Total deposits were \$1.96 billion as of March 31, 2018, which reflects a \$39.1 million increase from total deposits of \$1.92 billion as of December 31, 2017, and an increase of \$24.9 million over the \$1.94 billion as of March 31, 2017. Total noninterest bearing demand accounts increased \$10.4 million, or 1.8%, in the first three months of 2018, while certificates of deposit reflected a decrease of \$1.5 million, or 0.4%, for the same period. Growth in deposits in the first quarter of 2018 was attributed to seasonal tax refunds, as

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well as strong commercial demand deposit growth stemming from operational fund increases as well as growth in commercial loan clients over the past year. The total deposit growth of 1.3% in the year over year period is indicative of the increase in commercial treasury relationships over the past year.

In addition to deposits, the Bank obtained funding from other sources in all periods presented. Securities sold under repurchase agreements totaled \$41.4 million at March 31, 2018, an increase from \$29.9 million at December 31, 2017. The Bank also recorded an advance of \$45.0 million from the FHLBC at March 31, 2018, as compared to \$115.0 million outstanding from the FHLBC as of December 31, 2017.

The Company is indebted on senior notes totaling \$44.1 million, net of deferred issuance costs, which were issued in the fourth quarter of 2016. These notes mature in December 2026, and include interest payable semi-annually at 5.75% for five years. Beginning December 2021, the interest becomes payable quarterly at three month LIBOR plus 385 basis points. The Company is also indebted on \$57.7 million, net of deferred issuance costs, of junior subordinated debentures, which are related to the trust preferred securities issued by its two statutory trust subsidiaries, Old Second Capital Trust I and Old Second Capital Trust II (“Trust II”). The Trust II issuance converted from fixed to floating rate at three month LIBOR plus 150 basis points on June 15, 2017. Upon conversion to a floating rate, we initiated a cash flow hedge which resulted in the total interest rate paid on debt of 4.41% as of March 31, 2018, as compared to 6.77%, which was the rate paid during the period prior to the June 15, 2017, rate reset.

Capital

As of March 31, 2018, total stockholders’ equity was \$204.0 million, which was an increase of \$3.7 million from \$200.4 million as of December 31, 2017. This increase is directly attributable to first quarter 2018 net income of \$9.5 million partially offset by an accumulated other comprehensive net loss of \$5.1 million, and \$296,000 of dividends paid to common shareholders in 2018 year to date.

The Company’s total stockholders’ equity continues to include \$4.8 million related to the value of a ten-year warrant to purchase shares of its common stock, with an exercise price of \$13.43 per share. This warrant was issued in January 2009 as part of the Company’s Series B preferred stock issuance; all preferred stock issued was redeemed as of September 30, 2015. A discussion of the 2009 issuance, including this warrant, is included in Item 7, “Management’s Discussion and Analysis of Financial Condition and Results of Operations” of the Company’s Form 10-K for the year ended December 31, 2017, under the heading “Capital”.

The following table shows the regulatory capital ratios and the current well capitalized regulatory requirements for the Company and the Bank as of the dates indicated:

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|                                    | Well-Capitalized(1) | March 31,<br>2018 | December 31,<br>2017 |       |       |
|------------------------------------|---------------------|-------------------|----------------------|-------|-------|
| The Company                        |                     |                   |                      |       |       |
| Common equity tier 1 capital ratio | N/A                 | 9.82              | %                    | 9.25  | %     |
| Total risk-based capital ratio     | N/A                 | 13.58             | %                    | 12.93 | %     |
| Tier 1 risk-based capital ratio    | N/A                 | 12.63             | %                    | 12.03 | %     |
| Tier 1 leverage ratio              | N/A                 | 10.44             | %                    | 10.08 | %     |
| The Bank                           |                     |                   |                      |       |       |
| Common equity tier 1 capital ratio | 6.50                | %                 | 13.56                | %     | 12.88 |
| Total risk-based capital ratio     | 10.00               | %                 | 14.51                | %     | 13.78 |
| Tier 1 risk-based capital ratio    | 8.00                | %                 | 13.56                | %     | 12.88 |
| Tier 1 leverage ratio              | 5.00                | %                 | 11.19                | %     | 10.79 |

(1) Prompt corrective action provisions are only applicable at the Bank level.

The Company, on a consolidated basis, exceeded the minimum capital ratios to be deemed “well capitalized” as of March 31, 2018, pursuant to the capital requirements in effect at that time. All ratios conform to the regulatory calculation requirements in effect as of the date noted. In addition to the above regulatory ratios, the Company’s GAAP common equity to asset ratio, which is used as a performance measurement for capital analysis and peer comparisons, increased from 8.41% at December 31, 2017 to 8.62% at March 31, 2018. The Company’s non-GAAP tangible common equity to tangible assets ratio, which management also considers a valuable performance measurement for capital analysis, increased from 8.07% at December 31, 2017 to 8.28% at March 31, 2018.

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## Reconciliation of Tangible Common Equity to Tangible Assets Ratio Non-GAAP Measure

The Company's GAAP tangible common equity to tangible assets ratio was 8.28% at March 31, 2018, compared to 8.06% as of December 31, 2017.

| (in thousands)                            | As of March 31,<br>2018 |              | As of December 31,<br>2017 |              |      |   |      |   |
|---|-------------------------|--------------|----------------------------|--------------|------|---|------|---|
|   | GAAP                    | Non-GAAP     | GAAP                       | Non-GAAP     |      |   |      |   |
| Tangible common equity                    |                         |              |                            |              |      |   |      |   |
| Total Equity                              | \$ 204,001              | \$ 204,001   | \$ 200,350                 | \$ 200,350   |      |   |      |   |
| Less: Intangible assets                   | 8,901                   | 8,796        | 8,922                      | 8,813        |      |   |      |   |
| Tangible common equity                    | \$ 195,100              | \$ 195,205   | \$ 191,428                 | \$ 191,537   |      |   |      |   |
| Tangible assets                           |                         |              |                            |              |      |   |      |   |
| Total assets                              | \$ 2,366,485            | \$ 2,366,485 | \$ 2,383,429               | \$ 2,383,429 |      |   |      |   |
| Less: Goodwill and intangible assets      | 8,901                   | 8,796        | 8,922                      | 8,813        |      |   |      |   |
| Tangible assets                           | \$ 2,357,584            | \$ 2,357,689 | \$ 2,374,507               | \$ 2,374,616 |      |   |      |   |
| Common equity to total assets             | 8.62                    | %            | 8.62                       | %            | 8.41 | % | 8.41 | % |
| Tangible common equity to tangible assets | 8.28                    | %            | 8.28                       | %            | 8.06 | % | 8.07 | % |

The non-GAAP intangible asset exclusion reflects the 80% core deposit limitation per Basel III guidelines within risk based capital calculations, and is useful for the Company when reviewing risk based capital ratios and equity performance metrics.

## Liquidity

Liquidity is the Company's ability to fund operations, to meet depositor withdrawals, to provide for customers' credit needs, and to meet maturing obligations and existing commitments. The liquidity of the Company principally depends on cash flows from operating activities, investment in and maturity of assets, changes in balances of deposits and borrowings, and its ability to borrow funds. The Company monitors its borrowing capacity at the FHLBC as part of its liquidity management process as supervised by the Asset and Liability Committee ("ALCO") and reviewed by the Board of Directors.

Net cash inflows from operating activities were \$9.0 million during the first three months of 2018, compared with net cash inflows of \$6.7 million in the same period in 2017. Proceeds from sales of loans held-for-sale, net of funds used to originate loans held-for-sale, were a source of inflows for the first three months of 2018 and 2017. Interest paid, net of interest received, combined with changes in other assets and liabilities were a source of outflows for the first three months of 2018 and 2017. The management of investing and financing activities, as well as market conditions, determines the level and the stability of net interest cash flows. Management's policy is to mitigate the impact of changes in market interest rates to the extent possible, as part of the balance sheet management process.

Net cash inflows from investing activities were \$3.3 million in the first three months of 2018, compared to net cash outflows of \$87.2 million in the same period in 2017. In the first three months of 2018, securities transactions accounted for net outflows of \$16.3 million, and the principal change on loans accounted for net inflows of \$17.2 million due to payoffs. Proceeds from claims on BOLI, net of premiums paid, accounted for net inflows of \$1.2 million. In the first three months of 2017, securities transactions accounted for net outflows of \$75.9 million, and net principal disbursed on loans accounted for net outflows of \$12.7 million. Proceeds from sales of OREO accounted for \$1.3 million and \$1.6 million in investing cash inflows for the first three months of 2018 and 2017, respectively.

Net cash outflows from financing activities in the first three months of 2018 were \$20.2 million, compared with net cash inflows of \$93.9 million in the first three months of 2017. Net deposit inflows in the first three months of 2018 were \$39.1 million compared to net deposit inflows of \$70.4 million in the first three months of 2017. Other short-term borrowings had net cash outflows related to FHLBC advances of \$70.0 million in the first three months of 2018 and inflows of \$15.0 million in the first three months of 2017. Changes in securities sold under repurchase agreements accounted for \$11.4 million and \$9.0 million in net inflows in the first three months of 2018 and 2017, respectively.

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Cash and cash equivalents for the three months ended March 31, 2018, totaled \$47.9 million, as compared to \$60.7 million as of March 31, 2017. The reduction in the cash balance over the past year primarily reflects the deployment of funds commensurate with loan growth.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest Rate Risk

As part of its normal operations, the Company is subject to interest-rate risk on the assets it invests in (primarily loans and securities) and the liabilities it funds (primarily customer deposits and borrowed funds), as well as its ability to manage such risk. Fluctuations in interest rates may result in changes in the fair market values of the Company's financial instruments, cash flows, and net interest income. Like most financial institutions, the Company has an exposure to changes in both short-term and long-term interest rates.

In March 2018, the Federal Reserve raised short-term interest rates by 0.25%. There is a general market expectation that the Federal Reserve will move short-term interest rates higher up to two more times during 2018. Generally, Federal Reserve actions have not had a significant impact on long-term rates, although Federal Reserve officials have announced a schedule to end reinvestment in their securities portfolio starting in October 2017 which result in increases in long-term rates. The Company manages interest rate risk within guidelines established by policy which limits the amount of rate exposure. In practice, interest rate risk exposure is maintained well within those guidelines and does not pose a material risk to the future earnings of the Company.

The Company manages various market risks in its normal course of operations, including credit, liquidity risk, and interest-rate risk. Other types of market risk, such as foreign currency exchange risk and commodity price risk, do not arise in the normal course of the Company's business activities and operations. In addition, since the Company does not hold a trading portfolio, it is not exposed to significant market risk from trading activities. The Company's interest rate risk exposures at March 31, 2018 and December 31, 2017, are outlined in the table below.

The Company's net income can be significantly influenced by a variety of external factors, including: overall economic conditions, policies and actions of regulatory authorities, the amounts of and rates at which assets and liabilities reprice, variances in prepayment of loans and securities other than those that are assumed, early withdrawal of deposits, exercise of call options on borrowings or securities, competition, a general rise or decline in interest rates, changes in the slope of the yield-curve, changes in historical relationships between indices (such as LIBOR and prime), and balance sheet growth or contraction. The Company's ALCO seeks to manage interest rate risk under a variety of rate environments by structuring the Company's balance sheet and off-balance sheet positions, which includes interest rate swap derivatives as discussed in Note 15 of the financial statements included in this quarterly report. The risk is monitored and managed within approved policy limits.

The Company utilizes simulation analysis to quantify the impact of various rate scenarios on net interest income. Specific cash flows, repricing characteristics, and embedded options of the assets and liabilities held by the Company are incorporated into the simulation model. Earnings at risk is calculated by comparing the net interest income of a stable interest rate environment to the net interest income of a different interest rate environment in order to determine the percentage change. As of December 31, 2017, the Company had modest amounts of earnings gains (in both dollars and percentage) should interest rates rise, and limited earnings reductions should interest rates fall. The change in income across the various interest rate scenarios as of March 2018 were similar to those of December 2017, with slightly greater rising-rate earnings gains and falling-rate earnings reductions. Loan growth during the quarter was primarily funded by increases in deposits. Overall, management considers current level of interest rate risk to be moderate, but intends to continue closely monitoring changes in that risk in case corrective actions might be needed in the future. The Federal Funds rate and the Bank's prime rate increased by 0.25% during the quarter to 1.75% and 4.75% respectively.

The following table summarizes the effect on annual income before income taxes based upon an immediate increase or decrease in interest rates of 0.5%, 1%, and 2% and no change in the slope of the yield curve.

| (dollars in thousands) | Analysis of Net Interest Income Sensitivity |   |            |   |            |   |          |   |          |   |          |   |
|------------------------|---|---|------------|---|------------|---|----------|---|----------|---|----------|---|
|                        | Immediate Changes in Rates                  |   |            |   |            |   |          |   |          |   |          |   |
|                        | (2.0)                                       | % | (1.0)      | % | (0.5)      | % | 0.5      | % | 1.0      | % | 2.0      | % |
| March 31, 2018         |   |   |            |   |            |   |          |   |          |   |          |   |
| Dollar change          | \$ (10,595)                                 |   | \$ (5,151) |   | \$ (2,261) |   | \$ 1,488 |   | \$ 2,928 |   | \$ 5,571 |   |
| Percent change         | (12.9)                                      | % | (6.3)      | % | (2.8)      | % | 1.8      | % | 3.6      | % | 6.8      | % |
| December 31, 2017      |   |   |            |   |            |   |          |   |          |   |          |   |
| Dollar change          | \$ (9,447)                                  |   | \$ (5,272) |   | \$ (2,382) |   | \$ 1,375 |   | \$ 2,764 |   | \$ 5,273 |   |
| Percent change         | (12.0)                                      | % | (6.7)      | % | (3.0)      | % | 1.7      | % | 3.5      | % | 6.7      | % |



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

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended, as of March 31, 2018. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of March 31, 2018, the Company's internal controls were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities and Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified.

There were no changes in the Company's internal controls over financial reporting during the quarter ended March 31, 2018, that have materially affected, or are reasonably likely to affect, the Company's internal control over financial reporting.

The design of any system of controls and procedures is based in part upon certain assumptions about the likelihood of future events. There can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions, regardless of how remote.

PART II - OTHER INFORMATION

Item 1. Legal Proceedings

The Company and its subsidiaries, from time to time, are involved in collection suits in the ordinary course of business against its debtors and are defendants in legal actions arising from normal business activities. Management, after consultation with legal counsel, believes that the ultimate liabilities, if any, resulting from these actions will not

have a material adverse effect on the financial position of the Bank or on the consolidated financial position of the Company.

Item 1.A. Risk Factors

There have been no material changes from the risk factors set forth in Part I, Item 1.A. "Risk Factors," of the Company's Form 10-K for the year ended December 31, 2017.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable

Item 5. Other Information

None.

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Item 6. Exhibits

Exhibits:

- 10.1 Executive Annual Incentive Plan dated February 19, 2018 (incorporated by reference to Exhibit 10.1 of our Current Report on Form 8-K filed on February 23, 2018).
- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a).
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a).
- 32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets at March 31, 2018, and December 31, 2017; (ii) Consolidated Statements of Income for the three months ended March 31, 2018 and 2017; (iii) Consolidated Statements of Stockholders' Equity for the three months ended March 31, 2018 and 2017; (iv) Consolidated Statements of Cash Flows for the three months ended March 31, 2018 and 2017; and (v) Notes to Consolidated Financial Statements, tagged as blocks of text and in detail.\*

\* As provided in Rule 406T of Regulation S-T, these interactive data files shall not be deemed "filed" for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934 as amended, or otherwise subject to liability under those sections.

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SIGNATURES

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

OLD SECOND  
BANCORP, INC.

~~BY~~ James L. Eccher  
James L. Eccher  
President and  
Chief Executive  
Officer  
(principal  
executive officer)

~~BY~~ Bradley S.  
Adams  
Bradley S. Adams  
Executive Vice  
President and  
Chief Financial  
Officer  
(principal financial  
and accounting  
officer)

DATE: May 8, 2018