

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

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0 -10537

**OLD SECOND BANCORP, INC.**

(Exact name of Registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

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

**37 South River Street, Aurora, Illinois 60507**

(Address of principal executive offices) (Zip Code)

**(630) 892-0202**

(Registrant's telephone number, including area code)

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

Yes  No

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

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

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

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

Yes  No

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

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**OLD SECOND BANCORP, INC.**

Form 10-Q Quarterly Report

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

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

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

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

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

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

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

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

See accompanying notes to consolidated financial statements.



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

(In thousands)

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

**Supplemental cash flow information**

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

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

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

See accompanying notes to consolidated financial statements.

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**Old Second Bancorp, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

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

**Note 1 Summary of Significant Accounting Policies**

The accounting policies followed in the preparation of the interim financial statements are consistent with those used in the preparation of the annual financial information. The interim financial statements reflect all normal and recurring adjustments, which are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended June 30, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. These interim financial statements should be read in conjunction with the audited financial statements and notes included in Old Second Bancorp, Inc.'s (the Company) annual report on Form 10-K for the year ended December 31, 2011. Unless otherwise indicated, amounts in the tables contained in the notes are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

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

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

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

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

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

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**Note 2 Securities**

**Investment Portfolio Management**

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

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

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

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

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

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

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

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

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





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

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

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

Uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for certain investments, particularly the CDO. In the case of the CDO fair value measurement, management included a risk premium adjustment as of June 30, 2012, to reflect an estimated yield that a market participant would demand because of uncertainty in cash flows, based on incomplete and sporadic levels of market activity. Accordingly, management continues to designate these securities as level 3 securities as described in Note 12 of this quarterly report as of June 30, 2012. Management did not have the intent to sell the above securities and it is more likely than not the Company will not sell the securities before recovery of its cost basis.

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

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

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

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

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Major classifications of loans were as follows:

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

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

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

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

**December 31, 2011**

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

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

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

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

### **Credit Quality Indicators:**

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

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

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

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

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

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

**June 30, 2012**

|                                    | Pass         | Special<br>Mention | Substandard 1 | Doubtful | Total        |
|------------------------------------|--------------|--------------------|---------------|----------|--------------|
| Commercial                         | \$ 86,830    | \$ 4,456           | \$ 1,409      | \$ -     | \$ 92,695    |
| Real estate - commercial           |              |                    |               |          |              |
| Owner occupied general purpose     | 116,221      | 4,893              | 12,147        | -        | 133,261      |
| Owner occupied special purpose     | 139,707      | 5,880              | 23,746        | -        | 169,333      |
| Non-owner occupied general purpose | 95,441       | 20,607             | 30,243        | -        | 146,291      |
| Non-owner occupied special purpose | 86,120       | 6,495              | 1,520         | -        | 94,135       |
| Retail Properties                  | 31,643       | 4,524              | 17,479        | -        | 53,646       |
| Farm                               | 22,964       | 3,148              | 2,278         | -        | 28,390       |
| Real estate - construction         |              |                    |               |          |              |
| Homebuilder                        | 3,764        | 2,741              | 7,268         | -        | 13,773       |
| Land                               | 5,772        | -                  | 3,146         | -        | 8,918        |
| Commercial speculative             | 2,587        | -                  | 12,642        | -        | 15,229       |
| All other                          | 16,130       | 2,885              | 129           | -        | 19,144       |
| Real estate - residential          |              |                    |               |          |              |
| Investor                           | 131,224      | 18,705             | 19,198        | -        | 169,127      |
| Owner occupied                     | 114,603      | 493                | 13,412        | -        | 128,508      |
| Revolving and junior leins         | 144,782      | 410                | 4,324         | -        | 149,516      |
| Consumer                           | 3,314        | -                  | 7             | -        | 3,321        |
| All other                          | 12,627       | 220                | -             | -        | 12,847       |
| Total                              | \$ 1,013,729 | \$ 75,457          | \$ 148,948    | \$ -     | \$ 1,238,134 |

**December 31, 2011**

|                                    | Pass         | Special Mention | Substandard 1 | Doubtful | Total        |
|------------------------------------|--------------|-----------------|---------------|----------|--------------|
| Commercial                         | \$ 94,456    | \$ 3,350        | \$ 2,380      | \$ -     | \$ 100,186   |
| Real estate - commercial           |              |                 |               |          |              |
| Owner occupied general purpose     | 115,175      | 11,695          | 24,036        | -        | 150,906      |
| Owner occupied special purpose     | 154,650      | 5,254           | 29,323        | -        | 189,227      |
| Non-owner occupied general purpose | 102,178      | 19,292          | 39,311        | -        | 160,781      |
| Non-owner occupied special purpose | 85,931       | 6,017           | 17,291        | -        | 109,239      |
| Retail Properties                  | 26,391       | 11,660          | 20,381        | -        | 58,432       |
| Farm                               | 26,629       | 5,605           | 3,673         | -        | 35,907       |
| Real estate - construction         |              |                 |               |          |              |
| Homebuilder                        | 4,206        | 2,905           | 11,807        | -        | 18,918       |
| Land                               | 3,755        | 3,032           | 3,214         | -        | 10,001       |
| Commercial speculative             | 1,306        | -               | 18,734        | -        | 20,040       |
| All other                          | 17,448       | 303             | 4,726         | -        | 22,477       |
| Real estate - residential          |              |                 |               |          |              |
| Investor                           | 119,494      | 28,478          | 33,140        | -        | 181,112      |
| Owner occupied                     | 118,658      | 271             | 19,383        | -        | 138,312      |
| Revolving and junior leins         | 151,928      | 821             | 5,027         | -        | 157,776      |
| Consumer                           | 3,776        | -               | 13            | -        | 3,789        |
| All other                          | 10,755       | 1,127           | -             | -        | 11,882       |
| Total                              | \$ 1,036,736 | \$ 99,810       | \$ 232,439    | \$ -     | \$ 1,368,985 |

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





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Impaired loans by class of loan as of June 30, 2012 were as follows:

|   | As of June 30, 2012    |                                |                      | Six Months Ended<br>June 30, 2012 |                                  |
|---|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>       |                        |                                |                      |                                   |                                  |
| Commercial                                      | \$ 597                 | \$ 639                         | \$ -                 | \$ 555                            | \$ -                             |
| Commercial real estate                          |                        |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 4,092                  | 4,538                          | -                    | 4,425                             | -                                |
| Owner occupied special purpose                  | 8,435                  | 9,531                          | -                    | 10,521                            | -                                |
| Non-owner occupied general purpose              | 16,029                 | 20,826                         | -                    | 12,165                            | 135                              |
| Non-owner occupied special purpose              | 497                    | 640                            | -                    | 938                               | -                                |
| Retail properties                               | 5,462                  | 8,343                          | -                    | 5,024                             | -                                |
| Farm  | 2,081                  | 2,087                          | -                    | 1,580                             | -                                |
| Construction                                    |                        |                                |                      |                                   |                                  |
| Homebuilder                                     | 6,394                  | 11,200                         | -                    | 8,533                             | 55                               |
| Land  | 721                    | 1,491                          | -                    | 1,373                             | -                                |
| Commercial speculative                          | 6,403                  | 10,397                         | -                    | 7,976                             | -                                |
| All other                                       | 96                     | 319                            | -                    | 2,202                             | -                                |
| Residential                                     |                        |                                |                      |                                   |                                  |
| Investor  | 3,455                  | 12,581                         | -                    | 3,218                             | -                                |
| Owner occupied                                  | 9,592                  | 12,093                         | -                    | 10,736                            | 93                               |
| Revolving and junior liens                      | 1,752                  | 2,188                          | -                    | 1,621                             | 1                                |
| Consumer  | -                      | -                              | -                    | -                                 | -                                |
| Total impaired loans with no recorded allowance | 65,606                 | 96,873                         | -                    | 70,867                            | 284                              |
| <b>With an allowance recorded</b>               |                        |                                |                      |                                   |                                  |
| Commercial                                      | 494                    | 551                            | 239                  | 573                               | -                                |
| Commercial real estate                          |                        |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 1,999                  | 2,768                          | 346                  | 4,992                             | -                                |
| Owner occupied special purpose                  | 3,799                  | 5,764                          | 411                  | 3,879                             | -                                |
| Non-owner occupied general purpose              | 9,490                  | 12,081                         | 519                  | 8,943                             | -                                |
| Non-owner occupied special purpose              | -                      | -                              | -                    | 217                               | -                                |
| Retail properties                               | 7,320                  | 10,480                         | 1,319                | 9,316                             | -                                |
| Farm  | 197                    | 197                            | 112                  | 346                               | -                                |
| Construction                                    |                        |                                |                      |                                   |                                  |
| Homebuilder                                     | 2,376                  | 3,665                          | 51                   | 2,290                             | -                                |
| Land  | -                      | -                              | -                    | -                                 | -                                |
| Commercial speculative                          | 4,223                  | 5,465                          | 1,182                | 4,446                             | -                                |
| All other                                       | -                      | -                              | -                    | 190                               | -                                |
| Residential                                     |                        |                                |                      |                                   |                                  |
| Investor  | 10,176                 | 10,637                         | 940                  | 11,231                            | -                                |
| Owner occupied                                  | 5,511                  | 6,040                          | 508                  | 6,942                             | 63                               |
| Revolving and junior liens                      | 1,386                  | 1,404                          | 720                  | 1,369                             | -                                |
| Consumer  | -                      | -                              | -                    | -                                 | -                                |
| Total impaired loans with a recorded allowance  | 46,971                 | 59,052                         | 6,347                | 54,734                            | 63                               |
| Total impaired loans                            | \$ 112,577             | \$ 155,925                     | \$ 6,347             | \$ 125,601                        | \$ 347                           |

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Impaired loans by class of loans were as follows:

|   | As of December 31, 2011 |                                |                      | Six Months Ended<br>June 30, 2011 |                                  |
|---|-------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
|   | Recorded<br>Investment  | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>       |                         |                                |                      |                                   |                                  |
| Commercial                                      | \$ 512                  | \$ 560                         | \$ -                 | \$ 177                            | \$ -                             |
| Commercial real estate                          |                         |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 4,759                   | 6,538                          | -                    | 6,542                             | -                                |
| Owner occupied special purpose                  | 12,606                  | 15,862                         | -                    | 12,486                            | -                                |
| Non-owner occupied general purpose              | 8,301                   | 11,734                         | -                    | 10,809                            | 76                               |
| Non-owner occupied special purpose              | 1,380                   | 1,545                          | -                    | 2,852                             | 15                               |
| Retail properties                               | 4,586                   | 5,920                          | -                    | 10,290                            | 129                              |
| Farm  | 1,078                   | 1,198                          | -                    | 907                               | -                                |
| Construction                                    |                         |                                |                      |                                   |                                  |
| Homebuilder                                     | 10,672                  | 17,643                         | -                    | 16,636                            | 67                               |
| Land  | 2,025                   | 6,222                          | -                    | 8,270                             | 8                                |
| Commercial speculative                          | 9,549                   | 27,134                         | -                    | 6,102                             | -                                |
| All other                                       | 4,309                   | 6,576                          | -                    | 5,030                             | -                                |
| Residential                                     |                         |                                |                      |                                   |                                  |
| Investor  | 2,981                   | 11,927                         | -                    | 8,443                             | 10                               |
| Owner occupied                                  | 11,880                  | 13,487                         | -                    | 14,248                            | 136                              |
| Revolving and junior liens                      | 1,489                   | 1,693                          | -                    | 1,184                             | 2                                |
| Consumer  | -                       | -                              | -                    | 4                                 | -                                |
| Total impaired loans with no recorded allowance | 76,127                  | 128,039                        | -                    | 103,980                           | 443                              |
| <b>With an allowance recorded</b>               |                         |                                |                      |                                   |                                  |
| Commercial                                      | 653                     | 740                            | 392                  | 3,352                             | -                                |
| Commercial real estate                          |                         |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 7,985                   | 8,291                          | 1,397                | 10,000                            | -                                |
| Owner occupied special purpose                  | 3,958                   | 5,448                          | 407                  | 9,713                             | -                                |
| Non-owner occupied general purpose              | 8,397                   | 9,942                          | 2,187                | 11,750                            | -                                |
| Non-owner occupied special purpose              | 434                     | 437                            | 98                   | 5,367                             | -                                |
| Retail properties                               | 11,311                  | 12,389                         | 3,506                | 14,883                            | -                                |
| Farm  | 496                     | 496                            | 28                   | -                                 | -                                |
| Construction                                    |                         |                                |                      |                                   |                                  |
| Homebuilder                                     | 2,204                   | 2,816                          | 376                  | 7,792                             | -                                |
| Land  | -                       | -                              | -                    | 5,622                             | -                                |
| Commercial speculative                          | 4,668                   | 5,371                          | 1,683                | 10,615                            | -                                |
| All other                                       | 380                     | 422                            | 225                  | 381                               | -                                |
| Residential                                     |                         |                                |                      |                                   |                                  |
| Investor  | 12,287                  | 12,844                         | 1,808                | 9,950                             | 9                                |
| Owner occupied                                  | 8,373                   | 9,762                          | 626                  | 9,203                             | 92                               |
| Revolving and junior liens                      | 1,352                   | 1,656                          | 321                  | 860                               | -                                |
| Consumer  | -                       | -                              | -                    | -                                 | -                                |
| Total impaired loans with a recorded allowance  | 62,498                  | 70,614                         | 13,054               | 99,488                            | 101                              |
| Total impaired loans                            | \$ 138,625              | \$ 198,653                     | \$ 13,054            | \$ 203,468                        | \$ 544                           |

Troubled debt restructurings ( TDR ) 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 does participate in the U.S. Department of the Treasury s (the Treasury ) Home Affordable Modification Program ( HAMP ) which gives qualifying homeowners an opportunity to refinance into more affordable monthly payments.

The specific allocation of the allowance for loan losses on TDR is determined by either discounting the modified cash flows at the original effective rate of the loan before modification or is based on the

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underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. 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 losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. The allowance for loan losses also includes an allowance based on a loss migration analysis for each loan category for loans that are not individually evaluated for specific impairment. All loans charged-off, including TDR charged-off, are factored into this calculation by portfolio segment.

TDR outstanding by class are summarized as follows:

|                                     | As of June 30, 2012                    |                        |                                 |                        |
|-------------------------------------|--|------------------------|---------------------------------|------------------------|
|                                     | TDR Modifications<br>Accruing interest |                        | TDR Modifications<br>Nonaccrual |                        |
|                                     | # of<br>contracts                      | Recorded<br>investment | # of<br>contracts               | Recorded<br>investment |
| <b>Troubled debt restructurings</b> |  |                        |                                 |                        |
| Commercial                          | -                                      | \$ -                   | 1                               | \$ 17                  |
| Real estate - commercial            |  |                        |                                 |                        |
| Owner occupied special purpose      | -                                      | -                      | 1                               | 359                    |
| Non-owner occupied general purpose  | 2                                      | 3,754                  | 4                               | 4,513                  |
| Non-owner occupied special purpose  | -                                      | -                      | 2                               | 497                    |
| Real estate - construction          |  |                        |                                 |                        |
| Homebuilder                         | 2                                      | 2,683                  | 1                               | 1,342                  |
| Commercial speculative              | -                                      | -                      | 1                               | 425                    |
| Real estate - residential           |  |                        |                                 |                        |
| Investor                            | -                                      | -                      | 4                               | 1,108                  |
| Owner occupied                      | 35                                     | 5,571                  | 19                              | 3,034                  |
| Revolving and junior liens          | 1                                      | 61                     | -                               | -                      |
|                                     | 40                                     | \$ 12,069              | 33                              | \$ 11,295              |

|                                     | As of December 31, 2011                |                        |                                 |                        |
|-------------------------------------|--|------------------------|---------------------------------|------------------------|
|                                     | TDR Modifications<br>Accruing interest |                        | TDR Modifications<br>Nonaccrual |                        |
|                                     | # of<br>contracts                      | Recorded<br>investment | # of<br>contracts               | Recorded<br>investment |
| <b>Troubled debt restructurings</b> |  |                        |                                 |                        |
| Commercial                          | -                                      | \$ -                   | 1                               | \$ 17                  |
| Real estate - commercial            |  |                        |                                 |                        |
| Owner occupied general purpose      | -                                      | -                      | 2                               | 147                    |
| Owner occupied special purpose      | -                                      | -                      | 2                               | 377                    |
| Non-owner occupied general purpose  | 2                                      | 3,805                  | 4                               | 2,488                  |
| Non-owner occupied special purpose  | -                                      | -                      | 1                               | 434                    |
| Real estate - construction          |  |                        |                                 |                        |
| Homebuilder                         | 2                                      | 2,683                  | 6                               | 4,474                  |
| Land                                | -                                      | -                      | 1                               | 737                    |
| Commercial speculative              | -                                      | -                      | 1                               | 65                     |
| Real estate - residential           |  |                        |                                 |                        |
| Investor                            | 1                                      | 157                    | 6                               | 1,931                  |
| Owner occupied                      | 34                                     | 5,194                  | 30                              | 5,519                  |
|                                     | 39                                     | \$ 11,839              | 54                              | \$ 16,189              |



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TDR that were modified during the period are summarized as follows:

|  | TDR Modifications<br>Three months ended 6/30/12 |   |  | TDR Modifications<br>Six months ended 6/30/12 |   |  |
|--|---|---|--|---|---|--|
|  | # of<br>contracts                               | Pre-modification<br>recorded investment | Post-modification<br>recorded investment | # of<br>contracts                             | Pre-modification<br>recorded investment | Post-modification<br>recorded investment |
| <b>Accruing interest:</b>  |   |   |  |   |   |  |
| <b>Troubled debt<br/>restructurings</b>                              |   |   |  |   |   |  |
| Real estate - residential<br>Owner occupied<br>Deferral <sup>1</sup> | -   | \$ -                                    | \$ -                                     | 1   | \$ 108                                  | \$ 108                                   |
| Revolving and junior liens<br>HAMP <sup>2</sup>                      | 1   | 117                                     | 61                                       | 1   | 117                                     | 61                                       |
|  | 1   | \$ 117                                  | \$ 61                                    | 2   | \$ 225                                  | \$ 169                                   |

|   | TDR Modifications<br>Three months ended 6/30/12 |   |  | TDR Modifications<br>Six months ended 6/30/12 |   |  |
|---|---|---|--|---|---|--|
|   | # of<br>contracts                               | Pre-modification<br>recorded investment | Post-modification<br>recorded investment | # of<br>contracts                             | Pre-modification<br>recorded investment | Post-modification<br>recorded investment |
| <b>Nonaccrual:</b>  |   |   |  |   |   |  |
| <b>Troubled debt<br/>restructurings</b>                         |   |   |  |   |   |  |
| Real estate - commercial<br>Interest <sup>3</sup>               | 1   | \$ 2,921                                | \$ 2,772                                 | 1   | \$ 2,921                                | \$ 2,772                                 |
| Bifurcate <sup>4</sup>  | 1   | 209                                     | 207                                      | 1   | 209                                     | 207                                      |
| Real estate - construction<br>Interest <sup>3</sup>             | -   | -                                       | -  | 1   | 425                                     | 460                                      |
| Real estate - residential<br>Investor<br>Bifurcate <sup>4</sup> | 1   | 337                                     | 90                                       | 1   | 337                                     | 90                                       |
|   | 3   | \$ 3,467                                | \$ 3,069                                 | 4   | \$ 3,892                                | \$ 3,529                                 |

1 Deferral: Refers to the deferral of principal

2 HAMP: Home Affordable Modification Program

3 Interest: Interest rate concession below normal market

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

TDR 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 within 12 months of restructure for the three months or six months ending June 30, 2012. The following table presents TDR that defaulted during the periods shown and were restructured within the 12 month period prior to default:

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| Troubled debt restructurings that<br>Subsequently Defaulted | TDR Default Activity<br>Three Months ending 6/30/11 |   | TDR Default Activity<br>Six Months ending 6/30/11 |   |
|---|---|---|---|---|
|   | # of<br>contracts                                   | Pre-modification outstanding<br>recorded investment | # of<br>contracts                                 | Pre-modification outstanding<br>recorded investment |
| Real estate - construction                                  | 1   | \$  | 1   | \$  |
| Commercial speculative                                      |   |   |   |   |
| Real estate - residential                                   |   |   |   |   |
| Investor  | -   | -   | 1   |   |
| Owner occupied  | 6   | 928   | 11  | 1,804   |
|   | 7   | \$  | 13  | \$  |
|   |   |   |   | 2,068   |

Table of Contents**Note 4 Allowance for Loan Losses**

Changes in the allowance for loan losses by segment of loans based on method of impairment for the six months ended June 30, 2012, were as follows:

|                                       | Commercial | Real Estate<br>Commercial <sup>1</sup> | Real Estate<br>Construction | Real Estate<br>Residential | Consumer | Unallocated | Total        |
|---------------------------------------|------------|--|-----------------------------|----------------------------|----------|-------------|--------------|
| <b>Allowance for credit losses:</b>   |            |  |                             |                            |          |             |              |
| Beginning balance                     | \$ 5,070   | \$ 30,770                              | \$ 7,937                    | \$ 6,335                   | \$ 884   | \$ 1,001    | \$ 51,997    |
| Charge-offs                           | 108        | 12,339                                 | 3,342                       | 5,186                      | 277      | -           | 21,252       |
| Recoveries                            | 10         | 1,622                                  | 1,171                       | 233                        | 221      | -           | 3,257        |
| Provision                             | (189)      | 3,713                                  | (265)                       | 2,759                      | 235      | 31          | 6,284        |
| Ending balance                        | \$ 4,783   | \$ 23,766                              | \$ 5,501                    | \$ 4,141                   | \$ 1,063 | \$ 1,032    | \$ 40,286    |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Individually evaluated for impairment | \$ 239     | \$ 2,707                               | \$ 1,233                    | \$ 2,168                   | \$ -     | \$ -        | \$ 6,347     |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Collectively evaluated for impairment | \$ 4,544   | \$ 21,059                              | \$ 4,268                    | \$ 1,973                   | \$ 1,063 | \$ 1,032    | \$ 33,939    |
| <b>Financing receivables:</b>         |            |  |                             |                            |          |             |              |
| Ending balance                        | \$ 92,695  | \$ 625,056                             | \$ 57,064                   | \$ 447,151                 | \$ 3,321 | \$ 12,847   | \$ 1,238,134 |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Individually evaluated for impairment | \$ 1,091   | \$ 59,401                              | \$ 20,213                   | \$ 31,872                  | \$ -     | \$ -        | \$ 112,577   |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Collectively evaluated for impairment | \$ 91,604  | \$ 565,655                             | \$ 36,851                   | \$ 415,279                 | \$ 3,321 | \$ 12,847   | \$ 1,125,557 |

<sup>1</sup> As of June 30, 2012, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$28.2 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$2.9 million at June 30, 2012.



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Changes in the allowance for loan losses by segment of loans based on method of impairment for the six months ended June 30, 2011, were as follows:

|                                       | Commercial | Real Estate<br>Commercial I | Real Estate<br>Construction | Real Estate<br>Residential | Consumer | Unallocated | Total        |
|---------------------------------------|------------|-----------------------------|-----------------------------|----------------------------|----------|-------------|--------------|
| <b>Allowance for credit losses:</b>   |            |                             |                             |                            |          |             |              |
| Beginning balance                     | \$ 6,764   | \$ 42,242                   | \$ 18,344                   | \$ 6,999                   | \$ 880   | \$ 1,079    | \$ 76,308    |
| Charge-offs                           | 155        | 11,077                      | 5,199                       | 3,384                      | 264      | -           | 20,079       |
| Recoveries                            | 44         | 3,066                       | 618                         | 1,339                      | 222      | -           | 5,289        |
| Provision                             | (987)      | 2,545                       | (438)                       | 3,263                      | (19)     | 136         | 4,500        |
| Ending balance                        | \$ 5,666   | \$ 36,776                   | \$ 13,325                   | \$ 8,217                   | \$ 819   | \$ 1,215    | \$ 66,018    |
| Ending balance:                       |            |                             |                             |                            |          |             |              |
| Individually evaluated for impairment | \$ 743     | \$ 7,616                    | \$ 6,548                    | \$ 4,346                   | \$ -     | \$ -        | \$ 19,253    |
| Ending balance:                       |            |                             |                             |                            |          |             |              |
| Collectively evaluated for impairment | \$ 4,923   | \$ 29,160                   | \$ 6,777                    | \$ 3,871                   | \$ 819   | \$ 1,215    | \$ 46,765    |
| <b>Financing receivables:</b>         |            |                             |                             |                            |          |             |              |
| Ending balance                        | \$ 123,205 | \$ 765,599                  | \$ 94,529                   | \$ 519,907                 | \$ 4,361 | \$ 22,805   | \$ 1,530,406 |
| Ending balance:                       |            |                             |                             |                            |          |             |              |
| Individually evaluated for impairment | \$ 3,393   | \$ 83,802                   | \$ 52,882                   | \$ 38,995                  | \$ 2     | \$ -        | \$ 179,074   |
| Ending balance:                       |            |                             |                             |                            |          |             |              |
| Collectively evaluated for impairment | \$ 119,812 | \$ 681,797                  | \$ 41,647                   | \$ 480,912                 | \$ 4,359 | \$ 22,805   | \$ 1,351,332 |

1 As of June 30, 2011, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$100.9 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$14.6 million at June 30, 2011.

## **Note 5 Other Real Estate Owned**

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

|   | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2012                           | 2011      | 2012                         | 2011      |
| <u>Other real estate owned</u>          |                                |           |                              |           |
| Balance at beginning of period          | \$ 101,680                     | \$ 85,570 | \$ 93,290                    | \$ 75,613 |
| Property additions                      | 3,432                          | 11,062    | 19,350                       | 30,513    |
| Development improvements                | 197                            | 145       | 515                          | 2,167     |
| Less:                                   |                                |           |                              |           |
| Property disposals, net of gains/losses | 10,342                         | 10,057    | 15,688                       | 19,180    |
| Period valuation adjustments            | 5,296                          | 4,109     | 7,796                        | 6,502     |

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|                          |    |        |    |        |    |        |    |        |
|--------------------------|----|--------|----|--------|----|--------|----|--------|
| Balance at end of period | \$ | 89,671 | \$ | 82,611 | \$ | 89,671 | \$ | 82,611 |
|--------------------------|----|--------|----|--------|----|--------|----|--------|

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Activity in the valuation allowance was as follows:

|                                 | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---------------------------------|--------------------------------|-----------|------------------------------|-----------|
|                                 | 2012                           | 2011      | 2012                         | 2011      |
| Balance at beginning of period  | \$ 23,994                      | \$ 21,883 | \$ 23,462                    | \$ 22,220 |
| Provision for unrealized losses | 5,127                          | 4,109     | 7,627                        | 6,434     |
| Reductions taken on sales       | (1,821)                        | (4,488)   | (3,789)                      | (7,218)   |
| Other adjustments               | 169                            | -         | 169                          | 68        |
| Balance at end of period        | \$ 27,469                      | \$ 21,504 | \$ 27,469                    | \$ 21,504 |

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

|                                 | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|---------------------------------|--------------------------------|----------|------------------------------|----------|
|                                 | 2012                           | 2011     | 2012                         | 2011     |
| Gain on sales, net              | \$ (355)                       | \$ (402) | \$ (378)                     | \$ (636) |
| Provision for unrealized losses | 5,127                          | 4,109    | 7,627                        | 6,434    |
| Operating expenses              | 1,661                          | 1,842    | 3,815                        | 4,831    |
| Less:                           |                                |          |                              |          |
| Lease revenue                   | 911                            | 957      | 2,090                        | 1,477    |
|                                 | \$ 5,522                       | \$ 4,592 | \$ 8,974                     | \$ 9,152 |

**Note 6 Deposits**

Major classifications of deposits were as follows:

|  | June 30, 2012 | December 31, 2011 |
|--|---------------|-------------------|
| Noninterest bearing demand                     | \$ 412,635    | \$ 361,963        |
| Savings  | 213,634       | 196,870           |
| NOW accounts                                   | 272,330       | 275,957           |
| Money market accounts                          | 314,236       | 288,508           |
| Certificates of deposit of less than \$100,000 | 347,789       | 390,530           |
| Certificates of deposit of \$100,000 or more   | 209,400       | 226,953           |
|  | \$ 1,770,024  | \$ 1,740,781      |

**Note 7 Borrowings**

The following table is a summary of borrowings as of June 30, 2012, and December 31, 2011, and junior subordinated debentures are discussed in detail in Note 8:

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|   | June 30, 2012 |         | December 31, 2011 |
|---|---------------|---------|-------------------|
| Securities sold under repurchase agreements | \$            | 13,802  | \$ 901            |
| Junior subordinated debentures              |               | 58,378  | 58,378            |
| Subordinated debt                           |               | 45,000  | 45,000            |
| Notes payable and other borrowings          |               | 500     | 500               |
|   | \$            | 117,680 | \$ 104,779        |

The Company enters into sales of securities under agreements to repurchase (repurchase agreements) which generally mature within 1 to 90 days from the transaction date. These repurchase agreements are treated as financings and were secured by mortgage-backed securities with a carrying amount of \$20.0 and

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\$3.7 million at June 30, 2012, and December 31, 2011, respectively. The securities sold under agreements to repurchase consisted of U.S. government agencies and mortgage-backed securities during the two-year reporting period.

The Company's borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC and are generally limited to the lesser of 35% of total assets or 60% of the book value of certain mortgage loans. The Bank owned FHLBC stock of \$7.4 million at June 30, 2012 and had total funding availability of \$62.5 million with no outstanding advances. At December 31, 2011, there were no outstanding advances on the FHLBC stock of \$9.3 million and funding availability of \$48.4 million. The Company has also established borrowing capacity at the FRB that was not used at either June 30, 2012, or December 31, 2011. The Company currently has \$70.8 million of borrowing capacity at the FRB at the current secondary rate of 1.25%.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with Bank of America. That credit facility, which began in January 2008, was originally comprised of a \$30.5 million senior debt facility, which included a \$30.0 million revolving line that matured on March 31, 2010, and \$500,000 in term debt (together, the Senior Debt), as well as \$45.0 million of subordinated debt (the Subordinated Debt). The Subordinated Debt and the term debt portions of the Senior Debt mature on March 31, 2018. The interest rate on the Senior Debt resets quarterly and at the Company's option, based on the Lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the Subordinated Debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The Company had no principal outstanding balance on the Bank of America senior line of credit when it matured, but did have \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in Subordinated Debt at the end of both December 31, 2011 and June 30, 2012. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the agreement, as described therein. The agreement also contains certain customary representations and warranties as well as financial covenants. At June 30, 2012, the Company continued to be out of compliance with two of the financial covenants. The agreement provides that upon an event of default as the result of the Company's failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line and the term debt by 200 basis points, (iii) declare the Senior Debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal amount of the Senior Debt is the \$500,000 in term debt. Because the Subordinated Debt is treated as Tier 2 capital for regulatory capital purposes, the agreement does not provide the lender with any rights of acceleration or other remedies with regard to the Subordinated Debt upon an event of default caused by the Company's failure to comply with a financial covenant. In November 2009, the lender provided notice to the Company that it was invoking the default rate. This action by the lender resulted in nominal additional interest expense as it only applies to the \$500,000 of outstanding term debt.

**Note 8 Junior Subordinated Debentures**

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



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

Under the terms of the subordinated debentures issued to each of Old Second Capital Trust I and II, the Company is allowed to defer payments of interest for 20 quarterly periods without default or penalty, but such amounts will continue to accrue. Also during the deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Series B Fixed Rate Cumulative Perpetual Preferred Stock (the Series B Preferred Stock) as discussed in Note 15. In August of 2010, the Company elected to defer regularly scheduled interest payments on the \$58.4 million of junior subordinated debentures. Because of the deferral on the subordinated debentures, the trusts will defer regularly scheduled dividends on the trust preferred securities. Both of the debentures issued by the Company are recorded on the Consolidated Balance Sheets as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Operations. The total accumulated unpaid interest on the junior subordinated debentures including compounded interest from July 1, 2010 on the deferred payments total \$9.2 million at June 30, 2012.

**Note 9 Long-Term Incentive Plan**

The Long-Term Incentive Plan (the Incentive Plan) authorizes the issuance of up to 1,908,332 shares of the Company's common stock, including the granting of qualified stock options, non-qualified stock options, restricted stock, restricted stock units, and stock appreciation rights. Total shares issuable under the plan were 10,925 at June 30, 2012. Stock based awards may be granted to selected directors and officers or employees at the discretion of the board of directors. There were no stock options granted in the first half of 2012 or 2011. All stock options are granted for a term of ten years.

Generally, restricted stock and restricted stock units vest three years from the grant date, but the Company's Board of Directors has discretionary authority to change some terms including the amount of time until vest date. Awards under the Incentive Plan become fully vested upon a merger or change in control of the Company.

Total compensation cost that has been charged against income for those plans was \$66,000 in the second quarter of 2012 and \$153,000 in the first half of 2012.

There were no stock options exercised during the second quarter of 2012 or 2011. The Company did not grant any options of the Company's common stock during either of those periods. There was no unrecognized compensation cost related to nonvested stock options granted under the Incentive Plan as of June 30, 2012. Total unrecognized compensation cost related to nonvested stock options granted under the Incentive Plan was \$4,000 as of June 30, 2011 and was recognized over a weighted-average period of 0.58 years.





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A summary of stock option activity in the Incentive Plan 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 at January 1, 2012 | 500,000  | \$ 27.34                                 |   |                              |
| Canceled                                 | (7,500)  | 25.67                                    |   |                              |
| Ending outstanding at June 30, 2012      | 492,500  | \$ 27.36                                 | 3.05  | \$ -                         |
| Exercisable at end of period             | 492,500  | \$ 27.36                                 | 3.05  | \$ -                         |
| Beginning outstanding at January 1, 2011 | 614,832  | \$ 25.81                                 |   |                              |
| Canceled                                 | (21,500) | 27.73                                    |   |                              |
| Ending outstanding at June 30, 2011      | 593,332  | \$ 25.74                                 | 3.58  | \$ -                         |
| Exercisable at end of period             | 589,332  | \$ 25.87                                 | 3.56  | \$ -                         |

Under the Incentive Plan, restricted stock was granted beginning in 2005 and the grant of restricted units began in February 2009. Both of these restricted awards have voting and dividend rights and are subject to forfeiture until certain restrictions have lapsed including employment for a specific period. There were no restricted awards issued during the second quarter of 2012 or the second quarter of 2011. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award at issue date.

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

|                        | June 30, 2012 |   | June 30, 2011 |   |
|------------------------|---------------|---|---------------|---|
|                        | Shares        | Weighted<br>Average<br>Grant Date<br>Fair Value | Shares        | Weighted<br>Average<br>Grant Date<br>Fair Value |
| Nonvested at January 1 | 426,192       | \$ 4.15   | 464,298       | \$ 6.76   |
| Granted                | 60,000        | 1.25  | 141,320       | 1.06  |
| Vested                 | (144,976)     | 7.14  | (98,770)      | 10.71   |
| Forfeited              | (13,296)      | 3.28  | (61,129)      | 4.65  |
| Nonvested at June 30   | 327,920       | \$ 2.33   | 445,719       | \$ 4.37   |

Total unrecognized compensation cost of restricted awards was \$227,000 as of June 30, 2012, which is expected to be recognized over a weighted-average period of 1.08 years. Total unrecognized compensation cost of restricted awards was \$978,000 as of June 30, 2011, which was expected to be recognized over a weighted-average period of 1.13 years.

**Note 10 Earnings (Loss) Per Share**

The earnings (loss) per share is included below as of June 30 (in thousands except for share data):

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|   | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|---|--------------------------------|------------|------------------------------|------------|
|   | 2012                           | 2011       | 2012                         | 2011       |
| Basic earnings (loss) per share:  |                                |            |                              |            |
| Weighted-average common shares outstanding  | 14,084,328                     | 14,034,991 | 14,063,936                   | 14,004,599 |
| Weighted-average common shares less stock based awards                                  | 13,883,008                     | 13,789,971 | 13,869,174                   | 13,779,969 |
| Weighted-average common shares stock based awards                                       | 327,920                        | 446,249    | 334,361                      | 445,053    |
| Net income (loss)   | \$ 1,252                       | \$ 1,013   | \$ (1,716)                   | \$ (2,107) |
| Dividends and accretion of discount on preferred shares                                 | 1,238                          | 1,175      | 2,461                        | 2,334      |
| Net earnings (loss) available to common shareholders                                    | 14                             | (162)      | (4,177)                      | (4,441)    |
| Undistributed earnings (loss)   | 14                             | (162)      | (4,177)                      | (4,441)    |
| Basic earnings (loss) per share common undistributed loss                               | 0.00                           | (0.01)     | (0.29)                       | (0.31)     |
| Basic earnings (loss) per share   | \$ 0.00                        | \$ (0.01)  | \$ (0.29)                    | \$ (0.31)  |
| Diluted earnings (loss) per share:  |                                |            |                              |            |
| Weighted-average common shares outstanding  | 14,084,328                     | 14,034,991 | 14,063,936                   | 14,004,599 |
| Dilutive effect of restricted shares <sup>1</sup>                                       | 126,600                        | 201,229    | 139,599                      | 220,423    |
| Diluted average common shares outstanding   | 14,210,928                     | 14,236,220 | 14,203,535                   | 14,225,022 |
| Net earnings (loss) available to common stockholders                                    | \$ 14                          | \$ (162)   | \$ (4,177)                   | \$ (4,441) |
| Diluted earnings (loss) per share   | \$ 0.00                        | \$ (0.01)  | \$ (0.29)                    | \$ (0.31)  |
| Number of antidilutive options excluded from the diluted earnings per share calculation | 1,313,839                      | 1,408,671  | 1,313,839                    | 1,408,671  |

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

**Note 11 Regulatory & Capital Matters**

On May 16, 2011, the Bank, the wholly-owned banking subsidiary of the Company, entered into a Stipulation and Consent to the Issuance of a Consent Order (the "Consent Order") with the OCC. Pursuant to the Consent Order, the Bank has agreed to take certain actions and operate in compliance with the Consent Order's provisions during its terms.

Under the terms of the Consent Order, the Bank is required to, among other things: (i) adopt and adhere to a three-year written strategic plan that establishes objectives for the Bank's overall risk profile, earnings performance, growth, balance sheet mix, off-balance sheet activities, liability structure, capital adequacy, reduction in nonperforming assets and product development; (ii) adopt and maintain a capital plan; (iii) by September 30, 2011, achieve and thereafter maintain a total risk-based capital ratio of at least 11.25% and a Tier 1 capital ratio of at least 8.75%; (iv) seek approval of the OCC prior to paying any dividends on its capital stock; (v) develop a program to reduce the Bank's credit risk; (vi) obtain or update appraisals on certain loans secured by real estate; (vii) implement processes to ensure that real estate valuations conform to applicable standards; (viii) take certain actions related to credit and collateral exceptions; (ix) reaffirm the Bank's liquidity risk management program; and (x) appoint a compliance committee of the Bank's Board of Directors to help ensure the Bank's compliance with the Consent Order. The Bank is also required to submit certain reports to the OCC with respect to the foregoing requirements.

Both capital ratio objectives in the OCC agreement have been exceeded since June 30, 2011. At June 30, 2012, the Bank's leverage ratio was 9.35%, an increase of one basis point from December 31, 2011, and 60 basis points above the objective the Bank had agreed with the OCC to maintain of 8.75%. The Bank's total capital ratio was 13.25%, up 28 basis points from December 31, 2011, and 200 basis points above the

objective of 11.25%.

On July 22, 2011, the Company entered into a Written Agreement with the FRB (the "Written Agreement"). Pursuant to the Written Agreement, the Company has agreed to take certain actions and operate in compliance with the Written Agreement's provisions during its term.

Under the terms of the Written Agreement, the Company is required to, among other things: (i) serve as a source of strength to the Bank, including ensuring that the Bank complies with the Consent Order it entered into with the OCC on May 16, 2011; (ii) refrain from declaring or paying any dividend, or taking dividends or other payments representing a reduction in the Bank's capital, each without the prior written

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consent of the FRB and the Director of the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System (the Director); (iii) refrain, along with its nonbank subsidiaries, from making any distributions on subordinated debentures or trust preferred securities without the prior written consent of the FRB and the Director; (iv) refrain, along with its nonbank subsidiaries, from incurring, increasing or guaranteeing any debt, and from purchasing or redeeming any shares of its capital stock, each without the prior written consent of the FRB; (v) provide the FRB with a written plan to maintain sufficient capital at the Company on a consolidated basis; (vi) provide the FRB with a projection of the Company's planned sources and uses of cash; (vii) comply with certain regulatory notice provisions pertaining to the appointment of any new director or senior executive officer, or the changing of responsibilities of any senior executive officer; and (viii) comply with certain regulatory restrictions on indemnification and severance payments. The Company is also required to submit certain reports to the FRB with respect to the foregoing requirements.

Bank holding companies are required to maintain minimum levels of capital in accordance with Federal Reserve Capital guidelines. The general bank and holding company capital adequacy guidelines are described in the accompanying table, as are the capital ratios of the Company and the Bank, as of June 30, 2012, and December 31, 2011. These ratios are calculated on a consistent basis with the ratios disclosed in the most recent filings with the regulatory agencies.

The federal bank regulatory agencies recently issued joint proposed rules that would implement an international capital accord called Basel III, developed by the Basel Committee on Banking Supervision, a committee of central banks and bank supervisors. The proposed rules would apply to all depository organizations in the United States and most of their parent companies and would increase minimum capital ratios, add a new minimum common equity ratio, add a new capital conservation buffer, and would change the risk-weightings of certain assets for the purposes of calculating certain capital ratios. The proposed changes, if implemented, would be phased in from 2013 through 2019. Management is currently assessing the effect of the proposed rules on the Company and the Bank's capital position. Various banking associations and industry groups are providing comments on the proposed rules to the regulators and it is unclear when the final rules will be adopted and what changes, if any, may be made to the proposed rules.

At June 30, 2012, the Company, on a consolidated basis, exceeded the minimum thresholds to be considered adequately capitalized under current regulatory defined capital ratios. The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Generally, if adequately capitalized, regulatory approval is not required to accept brokered deposits. However, the Bank is limited in the amount of brokered deposits that it can hold pursuant to the Consent Order.

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Capital levels and industry defined regulatory minimum required levels:

|  | Actual     |        | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized <sup>1</sup> |       |
|--|------------|--------|--|-------|--|-------|
|  | Amount     | Ratio  | Amount   | Ratio | Amount   | Ratio |
| <b>June 30, 2012</b>                   |            |        |  |       |  |       |
| Total capital to risk weighted assets  |            |        |  |       |  |       |
| Consolidated                           | \$ 188,454 | 12.33% | \$ 122,273   | 8.00% | N/A  | N/A   |
| Old Second Bank                        | 202,322    | 13.25  | 122,157  | 8.00  | 152,696  | 10.00 |
| Tier 1 capital to risk weighted assets |            |        |  |       |  |       |
| Consolidated                           | 94,230     | 6.16   | 61,188   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 182,985    | 11.99  | 61,046   | 4.00  | 91,569   | 6.00  |
| Tier 1 capital to average assets       |            |        |  |       |  |       |
| Consolidated                           | 94,230     | 4.81   | 78,362   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 182,985    | 9.35   | 78,282   | 4.00  | 97,853   | 5.00  |
| <b>December 31, 2011</b>               |            |        |  |       |  |       |
| Total capital to risk weighted assets  |            |        |  |       |  |       |
| Consolidated                           | \$ 191,439 | 12.38% | \$ 123,709   | 8.00% | N/A  | N/A   |
| Old Second Bank                        | 200,716    | 12.97  | 123,803  | 8.00  | 154,754  | 10.00 |
| Tier 1 capital to risk weighted assets |            |        |  |       |  |       |
| Consolidated                           | 95,986     | 6.21   | 61,827   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 180,981    | 11.70  | 61,874   | 4.00  | 92,811   | 6.00  |
| Tier 1 capital to average assets       |            |        |  |       |  |       |
| Consolidated                           | 95,986     | 4.98   | 77,097   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 180,981    | 9.34   | 77,508   | 4.00  | 96,885   | 5.00  |

<sup>1</sup> The Bank exceeded the general minimum regulatory requirements to be considered well capitalized and is in full compliance with heightened capital ratios that it has agreed to maintain with the OCC contained within the Consent Order. However, as a result of continuing to be under the Consent Order, the Bank is formally considered adequately capitalized.

The Company's credit facility with Bank of America includes \$45.0 million in Subordinated Debt. That debt obligation continues to qualify as Tier 2 regulatory capital. In addition, the trust preferred securities continue to qualify as Tier 1 regulatory capital, and the Company treats the maximum amount of this security type allowable under regulatory guidelines as Tier 1 capital. As of June 30, 2012, trust preferred proceeds of \$24.7 million qualified as Tier 1 regulatory capital and \$31.9 million qualified as Tier 2 regulatory capital. As of December 31, 2011, trust preferred proceeds of \$25.9 million qualified as Tier 1 regulatory capital and \$30.7 million qualified as Tier 2 regulatory capital.

### **Dividend Restrictions and Deferrals**

In addition to the above requirements, banking regulations and capital guidelines generally limit the amount of dividends that may be paid by a Bank without prior regulatory approval. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's profits, combined with the retained profit of the previous two years, subject to the capital requirements described above. As a result of the December 31, 2011 operating loss, funds were no longer available for the payment of dividends by the Bank to the Company and this restriction continued at June 30, 2012.

As discussed in Note 8, as of June 30, 2012, the Company had \$58.4 million of junior subordinated debentures held by two statutory business trusts that it controls. The Company has the right to defer interest payments, which are approximately \$4.9 million each year, on the debentures for a period of up to 20 consecutive quarters, and elected to begin such a deferral period in August 2010. However, all deferred

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interest must be paid before the Company may pay dividends on its capital stock. Therefore, the Company will not be able to pay dividends on its common stock until all deferred interest on these debentures has been paid in full. The total amount of such deferred and unpaid interest as of June 30, 2012, was \$9.2 million.

Furthermore, as with the debentures discussed above, the Company is prohibited from paying dividends on its common stock unless it has fully paid all accrued dividends on the Series B Preferred Stock. In August 2010, it also began to defer the payment of dividends on such preferred stock. Therefore, in addition to paying all the accrued and unpaid distributions on the debentures set forth above, the Company must also fully pay the Treasury all accrued and unpaid dividends on the Series B Preferred Stock before it may reinstate the payment of dividends on the common stock. The total amount of deferred Series B Preferred Stock dividends as of June 30, 2012, was \$7.1 million. However, agreements with the OCC and the FRB contain restrictions on dividend payments.

Further detail on the subordinated debentures, the Series B Preferred Stock and the deferral of interest and dividends thereon is described in Notes 8 and 15.

**Note 12 Fair Value Option and Fair Value Measurements**

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

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

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

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

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

- Securities available-for-sale are valued primarily by a third party pricing agent and both the market and income valuation approaches are implemented using the following types of inputs:



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- o U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.
- o Government-sponsored agency debt securities are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.
- Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMOs are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.
- Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.
- State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Because some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities and could be valued with level 3 measurements.
- Collateralized debt obligations are collateralized by trust preferred security issuances of other financial institutions. Uncertainty in the financial markets in the periods presented has resulted in

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reduced liquidity for these investment securities, which continued to affect market pricing in the period presented. To reflect an appropriate fair value measurement, management included a risk premium adjustment to provide an estimate of the yield that a market participant would demand because of uncertainty in cash flows in the discounted cash flow analysis. Management initially made that adjustment to Level 3 valuation at June 30, 2009, because the level of market activity for CDO securities is incomplete and sporadic, information on orderly sale transactions was not generally available.

- Asset-backed securities are priced using a single expected cash flow stream model.
- Marketable equity securities are priced using available market information.
- Residential mortgage loans eligible for sale in the secondary market are carried at fair market value. The fair value of loans held for sale is determined using quoted secondary market prices.
- Lending related commitments to fund certain residential mortgage loans (interest rate locks) to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors as well as forward commitments for future delivery of mortgage-backed securities are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices from the date of the commitment and do not typically involve significant judgments by management.
- The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.
- Interest rate swap positions, both assets and liabilities, are based on a valuation pricing model using an income approach based upon readily observable market parameters such as interest rate yield curves.
- Both the credit valuation reserve on current interest rate swap positions and on receivables related to unwound customer interest rate swap positions was determined based upon management's estimate of the amount of credit risk exposure, including available collateral protection and/or by utilizing an estimate related to a probability of default as indicated in the Bank credit policy. Such adjustments would result in a Level 3 classification.
- The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.
- Other Real Estate Owned: 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 generally 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 June 30, 2012, and December 31, 2011, respectively, which are measured by the Company at fair value on a recurring basis:

|   | June 30, 2012    |                   |                  |                   |
|---|------------------|-------------------|------------------|-------------------|
|   | Level 1          | Level 2           | Level 3          | Total             |
| <b>Assets:</b>  |                  |                   |                  |                   |
| Investment securities available-for-sale                                  |                  |                   |                  |                   |
| U.S. Treasury   | \$ 1,515         | \$ -              | \$ -             | \$ 1,515          |
| U.S. government agencies  | -                | 44,623            | -                | 44,623            |
| U.S. government agency mortgage-backed                                    | -                | 95,208            | -                | 95,208            |
| States and political subdivisions   | -                | 13,920            | 138              | 14,058            |
| Corporate Bonds   | -                | 35,267            | -                | 35,267            |
| Collateralized mortgage obligations                                       | -                | 62,387            | -                | 62,387            |
| Asset-backed securities   | 51,752           | 84,922            | -                | 136,674           |
| Collateralized debt obligations   | -                | -                 | 9,163            | 9,163             |
| Loans held-for-sale   | -                | 6,445             | -                | 6,445             |
| Mortgage servicing rights   | -                | -                 | 3,531            | 3,531             |
| Other assets (Interest rate swap agreements net of swap credit valuation) | -                | 2,606             | (69)             | 2,537             |
| Other assets (Forward MBS)  | -                | 910               | -                | 910               |
| <b>Total</b>  | <b>\$ 53,267</b> | <b>\$ 346,288</b> | <b>\$ 12,763</b> | <b>\$ 412,318</b> |
| <b>Liabilities:</b>   |                  |                   |                  |                   |
| Other liabilities (Interest rate swap agreements)                         | \$ -             | \$ 2,606          | \$ -             | \$ 2,606          |
| Other liabilities (Interest rate lock commitments to borrowers)           | -                | 16                | -                | 16                |
| <b>Total</b>  | <b>\$ -</b>      | <b>\$ 2,622</b>   | <b>\$ -</b>      | <b>\$ 2,622</b>   |

|   | December 31, 2011 |                   |                  |                   |
|---|-------------------|-------------------|------------------|-------------------|
|   | Level 1           | Level 2           | Level 3          | Total             |
| <b>Assets:</b>  |                   |                   |                  |                   |
| Investment securities available-for-sale                                  |                   |                   |                  |                   |
| U.S. Treasury   | \$ 1,524          | \$ -              | \$ -             | \$ 1,524          |
| U.S. government agencies  | -                 | 43,398            | -                | 43,398            |
| U.S. government agency mortgage-backed                                    | -                 | 154,007           | -                | 154,007           |
| States and political subdivisions   | -                 | 13,671            | 138              | 13,809            |
| Corporate Bonds   | -                 | 31,389            | -                | 31,389            |
| Collateralized mortgage obligations                                       | -                 | 25,122            | -                | 25,122            |
| Asset-backed securities   | -                 | 28,341            | -                | 28,341            |
| Collateralized debt obligations   | -                 | -                 | 9,974            | 9,974             |
| Loans held-for-sale   | -                 | 12,806            | -                | 12,806            |
| Mortgage servicing rights   | -                 | -                 | 3,487            | 3,487             |
| Other assets (Interest rate swap agreements net of swap credit valuation) | -                 | 3,152             | (80)             | 3,072             |
| Other assets (Forward MBS)  | -                 | 107               | -                | 107               |
| <b>Total</b>  | <b>\$ 1,524</b>   | <b>\$ 311,993</b> | <b>\$ 13,519</b> | <b>\$ 327,036</b> |
| <b>Liabilities:</b>   |                   |                   |                  |                   |
| Other liabilities (Interest rate swap agreements)                         | \$ -              | \$ 3,152          | \$ -             | \$ 3,152          |
| Other liabilities (Interest rate lock commitments to borrowers)           | -                 | 50                | -                | 50                |
| <b>Total</b>  | <b>\$ -</b>       | <b>\$ 3,202</b>   | <b>\$ -</b>      | <b>\$ 3,202</b>   |

At March 31, 2012, \$3.3 million in asset-backed securities were reported in level 1 using their purchased price. Subsequently, these securities have been included in level 2 using a third party pricing service. Similarly, at June 30, 2012 \$51.8 million in asset backed securities are reported

in level 1 using their purchase price.

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

|   | Six months ended June 30, 2012            |                                   |                           |                              |
|---|---|-----------------------------------|---------------------------|------------------------------|
|   | Investment securities available-for- sale |                                   |                           |                              |
|   | Collateralized Debt Obligations           | States and Political Subdivisions | Mortgage Servicing Rights | Interest Rate Swap Valuation |
| Beginning balance January 1, 2012               | \$ 9,974                                  | \$ 138                            | \$ 3,487                  | \$ (80)                      |
| Transfers into Level 3                          | -   | -                                 | -                         | -                            |
| Transfers out of Level 3                        | -   | -                                 | -                         | -                            |
| Total gains or losses                           |   |                                   |                           |                              |
| Included in earnings (or changes in net assets) | 80  | -                                 | (835)                     | 11                           |
| Included in other comprehensive income          | (829)                                     | -                                 | -                         | -                            |
| Purchases, issuances, sales, and settlements    |   |                                   |                           |                              |
| Purchases                                       | -   | -                                 | -                         | -                            |
| Issuances                                       | -   | -                                 | 879                       | -                            |
| Settlements                                     | (62)                                      | -                                 | -                         | -                            |
| Expirations                                     | -   | -                                 | -                         | -                            |
| Ending balance June 30, 2012                    | \$ 9,163                                  | \$ 138                            | \$ 3,531                  | \$ (69)                      |

Six months ended June 30, 2011

|   | Investment securities available-for- sale |                                 |                                   |                           |                              |                              |
|---|---|---------------------------------|-----------------------------------|---------------------------|------------------------------|------------------------------|
|   | Equity Securities                         | Collateralized Debt Obligations | States and political subdivisions | Mortgage Servicing Rights | Interest Rate Swap Valuation | Risk Participation Agreement |
| Beginning balance January 1, 2011               | \$ 6                                      | \$ 11,073                       | \$ 3,000                          | \$ 3,897                  | \$ (108)                     | \$ (38)                      |
| Transfers into Level 3                          | -   | -                               | -                                 | -                         | -                            | -                            |
| Transfers out of Level 3                        | -   | -                               | (3,000)                           | -                         | -                            | -                            |
| Total gains or losses                           |   |                                 |                                   |                           |                              |                              |
| Included in earnings (or changes in net assets) | -   | 69                              | -                                 | (500)                     | (43)                         | 38                           |
| Included in other comprehensive income          | 2   | 617                             | -                                 | -                         | -                            | -                            |
| Purchases, issuances, sales, and settlements    |   |                                 |                                   |                           |                              |                              |
| Purchases                                       | -   | -                               | -                                 | -                         | -                            | -                            |
| Issuances                                       | -   | -                               | -                                 | 621                       | -                            | -                            |
| Settlements                                     | -   | (69)                            | -                                 | -                         | -                            | -                            |
| Expirations                                     | -   | -                               | -                                 | -                         | -                            | -                            |
| Ending balance June 30, 2011                    | \$ 8                                      | \$ 11,690                       | \$ -                              | \$ 4,018                  | \$ (151)                     | \$ -                         |

**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 other real estate owned. For assets measured at fair value on a nonrecurring basis on hand at June 30, 2012, and December 31, 2011, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

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|   | June 30, 2012 |         |            |            |
|---|---------------|---------|------------|------------|
|   | Level 1       | Level 2 | Level 3    | Total      |
| Impaired loans <sup>1</sup>               | \$ -          | \$ -    | \$ 39,392  | \$ 39,392  |
| Other real estate owned, net <sup>2</sup> | -             | -       | 89,671     | 89,671     |
| <b>Total</b>                              | \$ -          | \$ -    | \$ 129,063 | \$ 129,063 |

<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. These loans had a carrying amount of \$45.7 million, with a valuation allowance of \$6.3 million, resulting in a decrease of specific allocations within the allowance for loan losses of \$6.7 million for the six months ending June 30, 2012.

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2 OREO, measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of \$89.7 million, which is made up of the outstanding balance of \$117.1 million, net of a valuation allowance of \$27.5 million, at June 30, 2012, resulting in a charge to expense of \$7.6 million for the six months ended June 30, 2012.

|   | December 31, 2011 |         |            | Total      |
|---|-------------------|---------|------------|------------|
|   | Level 1           | Level 2 | Level 3    |            |
| Impaired loans <sup>1</sup>               | \$ -              | \$ -    | \$ 51,075  | \$ 51,075  |
| Other real estate owned, net <sup>2</sup> | -                 | -       | 93,290     | 93,290     |
| Total                                     | \$ -              | \$ -    | \$ 144,365 | \$ 144,365 |

1 Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans. These loans had a carrying amount of \$64.1 million, with a valuation allowance of \$13.0 million, resulting in a decrease of specific allocations within the allowance for loan losses of \$9.9 million for the year ending December 31, 2011.

2 OREO is measured at the lower of carrying or fair value less costs to sell and had a net carrying amount of \$93.3 million, which is made up of the outstanding balance of \$116.8 million, net of a valuation allowance of \$23.5 million, at December 31, 2011, resulting in a charge to expense of \$15.1 million for the year ended December 31, 2011.

**Note 13 Financial Instruments with Off-Balance Sheet Risk and Derivative Transactions**

To meet the financing needs of its customers, the Bank, as a subsidiary of the Company, is a party to various financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans as well as financial standby, performance standby and commercial letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan commitments and letters of credit are represented by the dollar amount of those instruments. Management generally uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on-balance-sheet instruments.

**Interest Rate Swaps**

The Company also has interest rate derivative positions to assist with risk management that are not designated as hedging instruments. These derivative positions relate to transactions in which the Bank enters into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. Due to financial covenant violations relating to nonperforming loans, the Bank had \$5.1 million in investment securities pledged to support interest rate swap activity with two correspondent financial institutions at June 30, 2012. The Bank had \$5.2 million in investment securities pledged to support interest rate swap activity with a correspondent financial institution at December 31, 2011. In connection with each transaction, the Bank agrees to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Bank agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to effectively convert a variable rate loan to a fixed rate loan and is also part of the Company's interest rate risk management strategy. Because the Bank acts as an intermediary for the client, changes in the fair value of the underlying

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derivative contracts offset each other and do not generally impact the results of operations. Fair value measurements include an assessment of credit risk related to the client's ability to perform on their contract position, however, and valuation estimates related to that exposure are discussed in Note 12 above. At June 30, 2012, the notional amount of non-hedging interest rate



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swaps was \$115.7 million with a weighted average maturity of 1.74 years. At December 31, 2011, the notional amount of non-hedging interest rate swaps was \$117.8 million with a weighted average maturity of 2.24 years. The Bank offsets derivative assets and liabilities that are subject to a master netting arrangement.

The Bank also grants mortgage loan interest rate lock commitments to borrowers, subject to normal loan underwriting standards. The interest rate risk associated with these loan interest rate lock commitments is managed by entering into contracts for future deliveries of loans as well as selling forward mortgage-backed securities contracts. Loan interest rate lock commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments to originate residential mortgage loans held-for-sale and forward commitments to sell residential mortgage loans or forward MBS contracts are considered derivative instruments and changes in the fair value are recorded to mortgage banking income. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices from the date of the commitment.

The following table presents derivatives not designated as hedging instruments as of June 30, 2012:

|  | Notional or Contractual Amount | Asset Derivatives      |            | Liability Derivatives  |            |
|--|--------------------------------|------------------------|------------|------------------------|------------|
|  |                                | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts net of credit valuation | \$ 115,728                     | Other Assets           | \$ 2,537   | Other Liabilities      | \$ 2,606   |
| Commitments <sup>1</sup>                             | 259,944                        | Other Assets           | 910        | N/A                    | -          |
| Forward contracts <sup>2</sup>                       | 40,500                         | N/A                    | -          | Other Liabilities      | 16         |
| Total  |                                |                        | \$ 3,447   |                        | \$ 2,622   |

<sup>1</sup> Includes unused loan commitments, interest rate lock commitments, forward rate lock, and mortgage-backed securities commitments.

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

The following table presents derivatives not designated as hedging instruments as of December 31, 2011:

|  | Notional or Contractual Amount | Asset Derivatives      |            | Liability Derivatives  |            |
|--|--------------------------------|------------------------|------------|------------------------|------------|
|  |                                | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts net of credit valuation | \$ 117,756                     | Other Assets           | \$ 3,072   | Other Liabilities      | \$ 3,152   |
| Commitments <sup>1</sup>                             | 237,970                        | Other Assets           | 107        | N/A                    | -          |
| Forward contracts <sup>2</sup>                       | 26,000                         | N/A                    | -          | Other Liabilities      | 50         |
| Total  |                                |                        | \$ 3,179   |                        | \$ 3,202   |

Includes unused loan commitments, interest rate lock commitments and forward rate lock and mortgage-backed securities commitments.

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2 Includes forward MBS contracts and forward loan contracts.

The Bank also issues letters of credit, which are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit is 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 June 30, 2012, and December 31, 2011.

|   | June 30, 2012 |    | December 31, 2011 |
|---|---------------|----|-------------------|
| Commitments to extend credit: borrowers |               |    |                   |
| Financial standby letters of credit     | \$ 3,382      | \$ | 2,837             |
| Performance standby letters of credit   | 6,231         |    | 8,554             |
| Commercial letters of credit            | 51            |    | 375               |
| Total letters of credit: borrowers      | 9,664         |    | 11,766            |
| Commitments to extend credit: other     |               |    |                   |
| Financial standby letters of credit     | 550           |    | 550               |
| Performance standby letters of credit   | 1,212         |    | 2,324             |
| Commercial letters of credit            | -             |    | -                 |
| Total letters of credit: other          | 1,762         |    | 2,874             |
| Total letters of credit                 |               |    |                   |
| Financial standby letters of credit     | 3,932         |    | 3,387             |
| Performance standby letters of credit   | 7,443         |    | 10,878            |
| Commercial letters of credit            | 51            |    | 375               |
| Total letters of credit                 | \$ 11,426     | \$ | 14,640            |

**Note 14 Fair Values of Financial Instruments**

The estimated fair values approximate carrying amount for all items except those described in the following table. Investment security fair values are based upon market prices or dealer quotes, and if no such information is available, on the rate and term of the security. The fair value of the collateralized debt obligations included in investment securities includes a risk premium adjustment to provide an estimate of the amount that a market participant would demand because of uncertainty in cash flows and the methods for determining fair value of securities as discussed in detail in Note 12. It is not practicable to determine the fair value of FHLBC stock due to restrictions on transferability. Fair values of loans were estimated for portfolios of loans with similar financial characteristics, such as type and fixed or variable interest rate terms. Cash flows were discounted using current rates at which similar loans would be made to borrowers with similar ratings and for similar maturities. The fair value of time deposits is estimated using discounted future cash flows at current rates offered for deposits of similar remaining maturities. The fair values of borrowings were estimated based on interest rates available to the Company for debt with similar terms and remaining maturities. The fair value of off-balance sheet items is not considered material.

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

|   | Carrying<br>Amount | Fair<br>Value | June 30, 2012 |           |           |
|---|--------------------|---------------|---------------|-----------|-----------|
|   |                    |               | Level 1       | Level 2   | Level 3   |
| <b>Financial assets:</b>                              |                    |               |               |           |           |
| Cash, due from banks and federal funds sold           | \$ 45,015          | \$ 45,015     | \$ 45,015     | \$ -      | \$ -      |
| Interest bearing deposits with financial institutions | 85,014             | 85,014        | 85,014        | -         | -         |
| Securities available-for-sale                         | 398,895            | 398,895       | 53,267        | 336,327   | 9,301     |
| FHLBC and FRB Stock                                   | 12,177             | 12,177        | -             | -         | 12,177    |
| Bank-owned life insurance                             | 53,416             | 53,416        | -             | 53,416    | -         |
| Loans held for sale                                   | 6,445              | 6,445         | -             | 6,445     | -         |
| Loans, net  | 1,197,848          | 1,227,552     | -             | -         | 1,227,552 |
| Accrued interest receivable                           | 5,146              | 5,146         | -             | 5,146     | -         |
| <b>Financial liabilities:</b>                         |                    |               |               |           |           |
| Noninterest bearing deposits                          | \$ 412,635         | \$ 412,635    | \$ 412,635    | \$ -      | \$ -      |
| Interest bearing deposits                             | 1,357,389          | 1,360,820     | -             | 1,360,820 | -         |
| Securities sold under repurchase agreements           | 13,802             | 13,802        | -             | 13,802    | -         |
| Junior subordinated debentures                        | 58,378             | 28,030        | 16,628        | 11,402    | -         |
| Subordinated debenture                                | 45,000             | 22,080        | -             | 22,080    | -         |
| Note payable and other borrowings                     | 500                | 270           | -             | 270       | -         |
| Borrowing interest payable                            | 9,232              | 9,232         | 5,447         | 3,785     | -         |
| Deposit interest payable                              | 1,191              | 1,191         | -             | 1,191     | -         |

|   | Carrying<br>Amount | Fair<br>Value | December 31, 2011 |           |           |
|---|--------------------|---------------|-------------------|-----------|-----------|
|   |                    |               | Level 1           | Level 2   | Level 3   |
| <b>Financial assets:</b>                              |                    |               |                   |           |           |
| Cash, due from banks and federal funds sold           | \$ 2,692           | \$ 2,692      | \$ 2,692          | \$ -      | \$ -      |
| Interest bearing deposits with financial institutions | 48,257             | 48,257        | 48,257            | -         | -         |
| Securities available-for-sale                         | 307,564            | 307,564       | 1,524             | 295,928   | 10,112    |
| FHLBC and FRB Stock                                   | 14,050             | 14,050        | -                 | -         | 14,050    |
| Bank-owned life insurance                             | 52,595             | 52,595        | -                 | 52,595    | -         |
| Loans held for sale                                   | 12,806             | 12,806        | -                 | 12,806    | -         |
| Loans, net  | 1,316,988          | 1,352,335     | -                 | -         | 1,352,335 |
| Accrued interest receivable                           | 5,708              | 5,708         | -                 | 5,708     | -         |
| <b>Financial liabilities:</b>                         |                    |               |                   |           |           |
| Noninterest bearing deposits                          | \$ 361,963         | \$ 361,963    | \$ 361,963        | \$ -      | \$ -      |
| Interest bearing deposits                             | 1,378,818          | 1,382,663     | -                 | 1,382,663 | -         |
| Securities sold under repurchase agreements           | 901                | 901           | -                 | 901       | -         |
| Junior subordinated debentures                        | 58,378             | 22,203        | 13,172            | 9,031     | -         |
| Subordinated debenture                                | 45,000             | 24,532        | -                 | 24,532    | -         |
| Note payable and other borrowings                     | 500                | 260           | -                 | 260       | -         |
| Borrowing interest payable                            | 6,815              | 6,815         | 4,006             | 2,809     | -         |
| Deposit interest payable                              | 1,718              | 1,718         | -                 | 1,718     | -         |

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**Note 15 Preferred Stock**

The Series B Preferred Stock was issued as part of the TARP Capital Purchase Program as implemented by the Treasury. The Series B Preferred Stock qualifies as Tier 1 capital and pays cumulative dividends on the liquidation preference amount on a quarterly basis at a rate of 5% per annum for the first five years, and 9% per annum thereafter. Concurrent with issuing the Series B Preferred Stock, the Company issued to the Treasury a ten year warrant to purchase 815,339 shares of the Company's Common Stock at an exercise price of \$13.43 per share.

Subsequent to the Company's receipt of the \$73.0 million in proceeds from the Treasury in the first quarter of 2009, the proceeds were allocated between the preferred stock and warrants that were issued. The warrants were classified as equity, and the allocation was based on their relative fair values in accordance with accounting guidance. The fair value was determined for both the preferred stock and the warrants as part of the allocation process in the amounts of \$68.2 million and \$4.8 million, respectively.

As discussed in Note 11, in August 2010 the Company suspended quarterly cash dividends on its outstanding Series B Preferred Stock. Further, as discussed in Note 11, the Company has elected to defer interest payments on certain of its subordinated debentures. During the period in which preferred stock dividends are deferred, such dividends continue to accrue. The Company did not pay dividends for an aggregate of six quarters and the holder has the right to appoint representatives to the Company's board of directors. As of January 2012, the Treasury began sending an observer to the Company's board of directors meetings. The Treasury has indicated that it intends to appoint two directors to our board sometime during 2012. The terms of the Series B Preferred Stock also prevent the Company from paying cash dividends or generally repurchasing its common stock while Series B Preferred Stock dividends are in arrears. The total amount of such unpaid and deferred Series B Preferred Stock dividends as of June 30, 2012 was \$7.1 million.

Pursuant to the terms of the TARP Capital Purchase Program, the ability of the Company to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, shares of its Common Stock is subject to restrictions, including a restriction against increasing dividends from the immediately preceding quarter prior to issuance. The redemption, purchase or other acquisition of trust preferred securities of the Company or its affiliates is also restricted. These restrictions will terminate on the earlier of (a) the third anniversary of the date of issuance of the Preferred Stock, (b) the date on which the Series B Preferred Stock has been redeemed in whole or (c) the Treasury has transferred all of the Series B Preferred Stock to third parties.

The TARP Capital Purchase Program also subjects the Company to certain of the executive compensation limitations included in the Emergency Economic Stabilization Act of 2008 ( EESA ). In connection with the issuance of the Series B Preferred Stock and warrants, the Company's Senior Executive Officers (as defined in the Securities Purchase Agreement, dated January 16, 2009, by and between Old Second Bancorp, Inc. and the Treasury) (i) voluntarily waived any claim against Treasury or the Company for any changes to such officer's compensation or benefits that are required to comply with the regulation issued by Treasury under the TARP Capital Purchase Program as well as EESA and acknowledged that the regulation may require modification of the compensation, bonus, incentive and other benefit plans, arrangements and policies and agreements as they relate to the period Treasury owns the Series B Preferred Stock of the Company; and (ii) entered into a letter with the Company amending the benefit plans with respect to such Senior Executive Officers as may be necessary, during the period that Treasury owns the Preferred Stock of the Company, as necessary to comply with Section 111(b) of EESA.

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

**Overview**

Old Second Bancorp, Inc. (the Company) is a financial services company with its main headquarters located in Aurora, Illinois. The Company is the holding company of Old Second National Bank (the Bank), a national banking organization headquartered in Aurora, Illinois and provides commercial and retail banking services, as well as a full complement of trust and wealth management services. The Company has offices located in Cook, Kane, Kendall, DeKalb, DuPage, LaSalle and Will counties in Illinois. The following management's discussion and analysis is presented to provide information concerning our financial condition as of June 30, 2012, as compared to December 31, 2011, and the results of operations for the three-month and six-month periods ended June 30, 2012 and 2011. This discussion and analysis should be read in conjunction with our consolidated financial statements and the financial and statistical data appearing elsewhere in this report and our 2011 Form 10-K.

The ongoing weakness in the financial sector and economy, particularly as it relates to credit costs associated with real estate in the Company's market areas, continues to directly affect borrowers' ability to repay their loans. This has resulted in a continued elevated, but improving, level of nonperforming loans. Overall economic weakness is reflected in the Company's operating results, and management remains vigilant in analyzing the loan portfolio quality, making an appropriate loan loss provision and making decisions to charge-off loans. The Company recorded a \$6.3 million provision for loan losses and a net loss of \$1.7 million prior to preferred stock dividends and accretion in the first half of 2012. This compared to a \$4.5 million provision for loan losses and a net loss of \$2.1 million prior to preferred stock dividends and accretion for the same period in 2011.

**Results of Operations**

The net income for the second quarter of 2012 was \$1.3 million, or \$0.00 earnings per diluted share, as compared with \$1.0 million in net income, or \$0.01 loss per diluted share, in the second quarter of 2011. The net loss for the first half of 2012 was \$1.7 million or \$0.29 loss per diluted share, as compared to \$2.1 million in net loss, or \$0.31 of loss per diluted share in the first half of 2011. The Company recorded a \$6.3 million provision for loan losses in the first half of 2012, which included an addition of \$200,000 in the second quarter. Net loan charge-offs totaled \$18.0 million in the first half of 2012, which included \$7.5 million of net charge-offs in the second quarter. The provision for loan losses in the first half of 2011 was \$4.5 million, which included an addition of \$500,000 in the second quarter of 2011. Net loan charge-offs totaled \$14.8 million in the first half of 2011, which included \$7.6 million of net charge-offs in the second quarter of 2011. The net income available to common stockholders was \$14,000 for the second quarter of 2012 and a loss of \$4.2 million for the first half of 2012, as compared to net loss available to common shareholders of \$162,000 and \$4.4 million, respectively, for the same periods in 2011.

***Net Interest Income***

Net interest and dividend income decreased \$2.2 million, from \$33.0 million in the first half of 2011, to \$30.8 million in the first half of 2012. Average earning assets decreased \$144.8 million, or 7.7%, to \$1.75 billion from the first half of 2011 to the first half of 2012, as management continued to emphasize asset quality and funded new loan originations continued to be limited. The \$293.0 million decrease in year to date

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average loans and loans held-for-sale was primarily due to the ongoing lower funded demand from qualified borrowers in the Bank's market area, charge-off activity, and movement of loan assets to OREO as well as maturities and payments on performing loans. To utilize available liquid funds, management continued to increase securities available-for-sale in the first half of 2012 to 20.1% of total assets up from

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15.8% at the end of 2011 and 7.3% at June 30, 2011. At the same time, management reduced deposits that had previously provided funding for those assets by emphasizing relationship banking rather than single service customers. As a result, average interest bearing liabilities decreased \$133.3 million, or 8.2%, during the same period. The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, increased from 3.54% in the first half of 2011 to 3.57% in the first half of 2012. The average tax-equivalent yield on earning assets decreased from 4.69% in the first half of 2011 to 4.46%, or 23 basis points, in the first half of 2012. The 2012 first half earning asset tax equivalent yield received benefit from collection of previously reversed or unrecognized interest on loans that returned to performing status during the period. The first half 2012 earning asset tax equivalent yield would have been 4.35% without this benefit. At the same time, however, the cost of funds on interest bearing liabilities decreased from 1.41% to 1.13%, or 28 basis points, helping to offset the decrease in yield. The decrease in average earning assets and movement to lower yielding securities in 2012 were the main causes of decreased interest income.

Net interest income decreased \$784,000 from \$16.5 million in the second quarter of 2011 to \$15.7 million in the second quarter of 2012. The decrease in average earning assets on a quarterly comparative basis was \$114.5 million, or 6.2%, from June 30, 2011 to June 30, 2012 due in part to continued low demand from qualified borrowers as well as charge-off and OREO activity in the quarter. Average interest bearing liabilities decreased \$98.4 million, or 6.2%, during the same period. The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, increased from 3.59% in the second quarter of 2011 to 3.65% in the second quarter of 2012. The average tax-equivalent yield on earning assets decreased from 4.72% in the second quarter of 2011 to 4.52% in the second quarter of 2012, or 20 basis points. The 2012 second quarter earning asset tax equivalent yield received benefit from collection of previously reversed or unrecognized interest on loans that returned to performing status during the period. The second quarter 2012 earning asset tax equivalent yield would have been 4.32% without this benefit. The cost of interest-bearing liabilities also decreased from 1.39% to 1.09%, or 20 basis points, in the same period. Consistent with the year to date margin trend, the decreased overall average earning assets and the movement to lower yielding securities combined with the repricing of interest bearing assets and liabilities in a lower interest rate environment decreased interest income to a greater degree than it decreased interest expense.

Management, in order to evaluate and measure performance, uses certain non-GAAP performance measures and ratios. This includes tax-equivalent net interest income (including its individual components) and net interest margin (including its individual components) to total average interest-earning assets. Management believes that these measures and ratios provide users of the financial information with a more accurate view of the performance of the interest-earning assets and interest-bearing liabilities and of the Company's operating efficiency for comparison purposes. Other financial holding companies may define or calculate these measures and ratios differently. See the tables and notes below for supplemental data and the corresponding reconciliations to GAAP financial measures for the three and six-month periods ended June 30, 2012 and 2011.

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



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ANALYSIS OF AVERAGE BALANCES,  
TAX EQUIVALENT INTEREST AND RATES

Three Months ended June 30, 2012 and 2011

(Dollar amounts in thousands - unaudited)

|  | 2012               |           |       | 2011               |           |       |
|--|--------------------|-----------|-------|--------------------|-----------|-------|
|  | Average<br>Balance | Interest  | Rate  | Average<br>Balance | Interest  | Rate  |
| <b>Assets</b>  |                    |           |       |                    |           |       |
| Interest bearing deposits                                    | \$ 56,486          | \$ 35     | 0.25% | \$ 112,817         | \$ 69     | 0.24% |
| Federal funds sold   | -                  | -         | -     | 689                | 1         | 0.57  |
| Securities:  |                    |           |       |                    |           |       |
| Taxable  | 364,475            | 1,856     | 2.04  | 130,853            | 885       | 2.71  |
| Non-taxable (tax equivalent)                                 | 11,165             | 157       | 5.62  | 12,974             | 195       | 6.01  |
| Total securities   | 375,640            | 2,013     | 2.14  | 143,827            | 1,080     | 3.00  |
| Dividends from FRB and FHLB stock                            | 12,382             | 77        | 2.49  | 14,050             | 74        | 2.11  |
| Loans and loans held-for-sale 1                              | 1,293,446          | 17,688    | 5.41  | 1,581,059          | 20,845    | 5.22  |
| Total interest earning assets                                | 1,737,954          | 19,813    | 4.52  | 1,852,442          | 22,069    | 4.72  |
| Cash and due from banks                                      | 34,279             | -         | -     | 34,953             | -         | -     |
| Allowance for loan losses                                    | (48,353)           | -         | -     | (75,276)           | -         | -     |
| Other non-interest bearing assets                            | 240,075            | -         | -     | 236,660            | -         | -     |
| Total assets   | \$ 1,963,955       |           |       | \$ 2,048,779       |           |       |
| <b>Liabilities and Stockholders Equity</b>                   |                    |           |       |                    |           |       |
| NOW accounts   | \$ 279,205         | \$ 67     | 0.10% | \$ 263,919         | \$ 113    | 0.17% |
| Money market accounts  | 310,497            | 135       | 0.17  | 298,090            | 187       | 0.25  |
| Savings accounts   | 214,873            | 52        | 0.10  | 195,547            | 72        | 0.15  |
| Time deposits  | 576,099            | 2,342     | 1.64  | 724,453            | 3,791     | 2.10  |
| Interest bearing deposits                                    | 1,380,674          | 2,596     | 0.76  | 1,482,009          | 4,163     | 1.13  |
| Securities sold under repurchase agreements                  | 4,636              | 1         | 0.09  | 2,046              | -         | -     |
| Other short-term borrowings                                  | 3,132              | 1         | 0.13  | 2,802              | -         | -     |
| Junior subordinated debentures                               | 58,378             | 1,220     | 8.36  | 58,378             | 1,133     | 7.76  |
| Subordinated debt  | 45,000             | 224       | 1.97  | 45,000             | 206       | 1.81  |
| Notes payable and other borrowings                           | 500                | 4         | 3.16  | 500                | 4         | 3.16  |
| Total interest bearing liabilities                           | 1,492,320          | 4,046     | 1.09  | 1,590,735          | 5,506     | 1.39  |
| Non-interest bearing deposits                                | 373,869            | -         | -     | 357,082            | -         | -     |
| Other liabilities  | 26,774             | -         | -     | 21,708             | -         | -     |
| Stockholders equity  | 70,992             | -         | -     | 79,254             | -         | -     |
| Total liabilities and stockholders equity                    | \$ 1,963,955       |           |       | \$ 2,048,779       |           |       |
| Net interest income (tax equivalent)                         |                    | \$ 15,767 |       |                    | \$ 16,563 |       |
| Net interest income (tax equivalent) to total earning assets |                    |           | 3.65% |                    |           | 3.59% |
| Interest bearing liabilities to earning assets               | 85.87%             |           |       | 85.87%             |           |       |

1. Interest income from loans is shown on a tax equivalent basis as discussed below and includes fees of \$519,000 and \$705,000 for the second quarter of 2012 and 2011, respectively. Nonaccrual loans are included in the above stated average balances.



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ANALYSIS OF AVERAGE BALANCES,  
TAX EQUIVALENT INTEREST AND RATES

Six Months ended June 30, 2012 and 2011

(Dollar amounts in thousands - unaudited)

|  | 2012               |           |       | 2011               |           |       |
|--|--------------------|-----------|-------|--------------------|-----------|-------|
|  | Average<br>Balance | Interest  | Rate  | Average<br>Balance | Interest  | Rate  |
| <b>Assets</b>  |                    |           |       |                    |           |       |
| Interest bearing deposits                                    | \$ 50,252          | \$ 60     | 0.24% | \$ 112,958         | \$ 139    | 0.24% |
| Federal funds sold   | -                  | -         | -     | 1,075              | 1         | 0.19  |
| Securities:  |                    |           |       |                    |           |       |
| Taxable  | 345,681            | 3,354     | 1.94  | 129,521            | 1,763     | 2.72  |
| Non-taxable (tax equivalent)                                 | 10,872             | 316       | 5.81  | 13,970             | 414       | 5.93  |
| Total securities   | 356,553            | 3,670     | 2.06  | 143,491            | 2,177     | 3.03  |
| Dividends from FRB and FHLB stock                            | 12,854             | 151       | 2.35  | 13,875             | 143       | 2.06  |
| Loans and loans held-for-sale 1                              | 1,325,558          | 35,462    | 5.29  | 1,618,586          | 42,125    | 5.18  |
| Total interest earning assets                                | 1,745,217          | 39,343    | 4.46  | 1,889,985          | 44,585    | 4.69  |
| Cash and due from banks                                      | 25,344             | -         | -     | 34,917             | -         | -     |
| Allowance for loan losses                                    | (49,857)           | -         | -     | (77,034)           | -         | -     |
| Other non-interest bearing assets                            | 240,031            | -         | -     | 237,456            | -         | -     |
| Total assets   | \$ 1,960,735       |           |       | \$ 2,085,324       |           |       |
| <b>Liabilities and Stockholders Equity</b>                   |                    |           |       |                    |           |       |
| NOW accounts   | \$ 278,141         | \$ 139    | 0.10% | \$ 267,983         | \$ 252    | 0.19% |
| Money market accounts  | 305,629            | 301       | 0.20  | 303,647            | 506       | 0.34  |
| Savings accounts   | 210,019            | 114       | 0.11  | 190,234            | 190       | 0.20  |
| Time deposits  | 584,830            | 4,947     | 1.70  | 755,025            | 7,784     | 2.08  |
| Interest bearing deposits                                    | 1,378,619          | 5,501     | 0.80  | 1,516,889          | 8,732     | 1.16  |
| Securities sold under repurchase agreements                  | 3,156              | 1         | 0.06  | 1,901              | -         | -     |
| Other short-term borrowings                                  | 6,648              | 4         | 0.12  | 2,918              | -         | -     |
| Junior subordinated debentures                               | 58,378             | 2,417     | 8.28  | 58,378             | 2,246     | 7.69  |
| Subordinated debt  | 45,000             | 461       | 2.03  | 45,000             | 409       | 1.81  |
| Notes payable and other borrowings                           | 500                | 8         | 3.16  | 500                | 8         | 3.18  |
| Total interest bearing liabilities                           | 1,492,301          | 8,392     | 1.13  | 1,625,586          | 11,395    | 1.41  |
| Non-interest bearing deposits                                | 370,815            | -         | -     | 358,755            | -         | -     |
| Other liabilities  | 24,367             | -         | -     | 20,590             | -         | -     |
| Stockholders equity  | 73,252             | -         | -     | 80,393             | -         | -     |
| Total liabilities and stockholders equity                    | \$ 1,960,735       |           |       | \$ 2,085,324       |           |       |
| Net interest income (tax equivalent)                         |                    | \$ 30,951 |       |                    | \$ 33,190 |       |
| Net interest income (tax equivalent) to total earning assets |                    |           | 3.57% |                    |           | 3.54% |
| Interest bearing liabilities to earning assets               | 85.51%             |           |       | 86.01%             |           |       |

1. Interest income from loans is shown on a tax equivalent basis as discussed below and includes fees of \$936,000 and \$1.2 million for the first six months of 2012 and 2011, respectively. Nonaccrual loans are included in the above stated average balances.



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

|   | Effect of Tax Equivalent Adjustment<br>Three Months Ended<br>June 30, |              | Effect of Tax Equivalent Adjustment<br>Six Months Ended<br>June 30, |              |
|---|---|--------------|---|--------------|
|   | 2012  | 2011         | 2012  | 2011         |
| Interest income (GAAP)                                    | \$ 19,736   | \$ 21,980    | \$ 39,186   | \$ 44,406    |
| Taxable equivalent adjustment - loans                     | 22  | 21           | 46  | 34           |
| Taxable equivalent adjustment - securities                | 55  | 68           | 111   | 145          |
| Interest income (TE)                                      | 19,813  | 22,069       | 39,343  | 44,585       |
| Less: interest expense (GAAP)                             | 4,046   | 5,506        | 8,392   | 11,395       |
| Net interest income (TE)                                  | \$ 15,767   | \$ 16,563    | \$ 30,951   | \$ 33,190    |
| Net interest and income (GAAP)                            | \$ 15,690   | \$ 16,474    | \$ 30,794   | \$ 33,011    |
| Average interest earning assets                           | \$ 1,737,954  | \$ 1,852,442 | \$ 1,745,217  | \$ 1,889,985 |
| Net interest income to total interest earning assets      | 3.63%   | 3.57%        | 3.55%   | 3.52%        |
| Net interest income to total interest earning assets (TE) | 3.65%   | 3.59%        | 3.57%   | 3.54%        |

***Provision for Loan Losses***

In the first half of 2012, the Company recorded a \$6.3 million provision for loan losses, which included an addition of \$200,000 in the second quarter. In the first half of 2011, the provision for loan losses was \$4.5 million, which included an addition of \$500,000 in the second quarter. Provisions for loan losses are made to provide for probable and estimable losses inherent in the loan portfolio. Nonperforming loans decreased to \$112.6 million at June 30, 2012 from \$138.9 million at December 31, 2011, and \$179.4 million at June 30, 2011. Charge-offs, net of recoveries, totaled \$18.0 million and \$14.8 million in the first six months of 2012 and 2011, respectively. Net charge-offs totaled \$7.5 million in the second quarter of 2012 and \$7.6 million in the second quarter of 2011. The distribution of the Company's gross charge-off activity for the periods indicated is detailed in the first table below and the distribution of the Company's remaining nonperforming loans and related specific allocations at June 30, 2012 are included in the following table:

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| Loan Charge-offs, Gross<br>(in thousands) | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2012                           | 2011      | 2012                         | 2011      |
| Real estate-construction                  |                                |           |                              |           |
| Homebuilder                               | \$ 287                         | \$ 1,149  | \$ 1,094                     | \$ 1,654  |
| Land                                      | -                              | 1,583     | 20                           | 3,014     |
| Commercial speculative                    | 1,515                          | 488       | 1,965                        | 488       |
| All other                                 | 138                            | 9         | 263                          | 43        |
| Total real estate-construction            | 1,940                          | 3,229     | 3,342                        | 5,199     |
| Real estate-residential                   |                                |           |                              |           |
| Investor                                  | 1,911                          | 960       | 3,091                        | 1,086     |
| Owner occupied                            | 450                            | 1,198     | 1,218                        | 2,054     |
| Revolving and junior liens                | 534                            | 62        | 877                          | 244       |
| Total real estate-residential             | 2,895                          | 2,220     | 5,186                        | 3,384     |
| Real estate-commercial, nonfarm           |                                |           |                              |           |
| Owner general purpose                     | 318                            | 577       | 1,192                        | 3,236     |
| Owner special purpose                     | 97                             | 311       | 2,474                        | 1,632     |
| Non-owner general purpose                 | 3,373                          | 2,760     | 4,503                        | 2,943     |
| Non-owner special purpose                 | 124                            | 101       | 124                          | 862       |
| Retail properties                         | 147                            | 1,634     | 4,046                        | 2,404     |
| Total real estate-commercial, nonfarm     | 4,059                          | 5,383     | 12,339                       | 11,077    |
| Real estate-commercial, farm              | -                              | -         | -                            | -         |
| Commercial                                | 98                             | 10        | 108                          | 155       |
| Other                                     | 138                            | 150       | 277                          | 264       |
|   | \$ 9,130                       | \$ 10,992 | \$ 21,252                    | \$ 20,079 |

The distribution of the Company's nonperforming loans as of June 30, 2012, is included in the chart below (in thousands):

**Nonperforming loans  
as of June 30, 2012**

|                                 | Nonaccrual<br>Total 1 | 90 Days or<br>More Past<br>Due<br>(Accruing) | Restructured<br>Loans<br>(Accruing) | Total Non<br>performing<br>Loans | % Non<br>Performing<br>Loans | Specific<br>Allocation |
|---------------------------------|-----------------------|--|-------------------------------------|----------------------------------|------------------------------|------------------------|
| Real estate-construction        | \$ 17,530             | \$ -   | \$ 2,683                            | \$ 20,213                        | 18.0%                        | \$ 1,233               |
| Real estate-residential:        |                       |  |                                     |                                  |                              |                        |
| Investor                        | 13,631                | -  | -                                   | 13,631                           | 12.1%                        | 940                    |
| Owner occupied                  | 9,532                 | -  | 5,571                               | 15,103                           | 13.4%                        | 508                    |
| Revolving and junior liens      | 3,077                 | -  | 61                                  | 3,138                            | 2.8%                         | 720                    |
| Real estate-commercial, nonfarm | 53,369                | -  | 3,754                               | 57,123                           | 50.7%                        | 2,595                  |
| Real estate-commercial, farm    | 2,278                 | -  | -                                   | 2,278                            | 2.0%                         | 112                    |
| Commercial                      | 1,091                 | -  | -                                   | 1,091                            | 1.0%                         | 239                    |
|                                 | \$ 100,508            | \$ -   | \$ 12,069                           | \$ 112,577                       | 100.0%                       | \$ 6,347               |

1 Nonaccrual loans included a total of \$11.3 million in restructured loans. Component balances are \$1.8 million in real estate construction, \$5.4 million in real estate-commercial nonfarm, \$1.1 million is in real estate - residential investor, \$3.0 million is in real estate - owner occupied and \$17,000 in Commercial.

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Classified loans (reflecting a management decision to change to a definition of classified as substandard and TDR accruing to more closely reflect our regulator's definition) have decreased \$150.4 million or 49.2% from a year ago and \$82.7 million or 34.7% from December 31, 2011. Classified loans are summarized in the table below (in thousands):

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|                            | <b>Classified Loans</b> |            |            |
|----------------------------|-------------------------|------------|------------|
|                            | 6/30/2012               | 12/31/2011 | 6/30/2011  |
| Commercial                 | \$ 1,409                | \$ 2,380   | \$ 11,676  |
| Real estate - commercial   | 87,413                  | 134,015    | 170,452    |
| Real estate - construction | 25,180                  | 40,476     | 60,172     |
| Real estate - residential  | 41,430                  | 61,234     | 63,480     |
| Consumer                   | 7                       | 13         | 20         |
|                            | \$ 155,439              | \$ 238,118 | \$ 305,800 |

**Commercial Real Estate**

Commercial Real Estate Nonfarm ( CRE ) remained the largest component of nonperforming loans at \$57.1 million, or 50.7% of total nonperforming loans. The dollar volume of nonperforming CRE loans is down from \$64.0 million at December 31, 2011 and \$82.7 million at June 30, 2011. These decreases resulted from loans moving to OREO during these periods, loans paying off and loans upgraded as a result of improved performance. The class components of the CRE segment at June 30, 2012, were as follows (dollars in thousands):

**Real Estate - Commercial Nonfarm**

|                                    | Nonaccrual<br>Total | 90 Days or<br>More Past<br>Due<br>(Accruing) | Restructured<br>Loans<br>(Accruing) | Total Non<br>performing<br>Loans | % Non<br>performing<br>CRE Loans | Specific<br>Allocation |
|------------------------------------|---------------------|--|-------------------------------------|----------------------------------|----------------------------------|------------------------|
| Owner occupied general purpose     | \$ 6,091            | \$ -   | \$ -                                | \$ 6,091                         | 10.7%                            | \$ 346                 |
| Owner occupied special purpose     | 12,234              | -  | -                                   | 12,234                           | 21.4%                            | 411                    |
| Non-owner occupied general purpose | 21,765              | -  | 3,754                               | 25,519                           | 44.7%                            | 519                    |
| Non-owner occupied special purpose | 497                 | -  | -                                   | 497                              | 0.9%                             | -                      |
| Retail properties                  | 12,782              | -  | -                                   | 12,782                           | 22.3%                            | 1,319                  |
|                                    | \$ 53,369           | \$ -   | \$ 3,754                            | \$ 57,123                        | 100.0%                           | \$ 2,595               |

Portfolio loans secured by retail property, primarily retail strip malls, continue to experience the most financial stress as vacancies and lower rents to secure tenants hampered successful retail mall performance. This class accounted for 9.0% of all CRE loans and 22.3% of all nonperforming CRE loans at June 30, 2012. Second quarter 2012 charge-offs in the retail segment totaled \$147,000. However, there can be no guarantee that actual losses in this category, and all other categories discussed in this section, will not exceed such amount.

Non-owner occupied, general purpose loans include credits that are collateralized by office, warehouse, and industrial properties and represented 24.5% of total CRE loans, and 44.7% of nonperforming CRE loans at the end of the second quarter of 2012. Second quarter 2012 charge-offs in this category were \$3.4 million, with most of the charge-offs coming from fully allocated credits, and management estimated that \$519,000 of specific allocation was sufficient coverage for the remaining loss exposure at June 30, 2012.

The owner occupied special purpose category had loans totaling \$169.3 million, representing 28.4% of all CRE loans. With \$12.2 million of these loans nonperforming at June 30, 2012, these loans accounted for 21.4% of total nonperforming CRE. Special purpose owner occupied credits include loans collateralized by property types such as gas stations, health and fitness centers, golf courses, restaurants, and medical office buildings. Charge-offs in the second quarter of 2012 totaled \$97,000 in this loan category and management estimated that the specific allocation



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of \$411,000 was sufficient coverage for the remaining loss exposure at June 30, 2012.

As of June 30, 2012, owner occupied general purpose loans comprised 22.3% of CRE, and 10.7% of nonperforming CRE loans. Charge-offs totaled \$318,000 in the second quarter of 2012, and management

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estimated that a specific allocation total of \$346,000 was sufficient coverage for the remaining loss exposure at June 30, 2012.

Non-owner occupied special purpose loans represented 15.8% of the CRE portfolio, and 0.9% of nonperforming CRE loans at the end of the second quarter of 2012. In the second quarter there were charge-offs of \$124,000 recorded and no specific allocation, management estimates that this was sufficient coverage for the remaining loss exposure at June 30, 2012.

In addition to the specific allocations detailed above, management estimates include a higher risk commercial real estate pool loss factor for certain CRE loans. These loans typically have a deficiency in cash flow coverage from the property securing the credit, but other supporting factors such as liquidity, guarantor capacity, sufficient global cash flow coverage or cooperation from the borrower is evident to support the credit. These deficiencies in cash flow coverage are typically attributable to vacancy that is expected to be temporary or reduced operating income from the owner-occupant due to cyclical impacts from the recession. The pool also includes cases where the property securing the credit has adequate cash flow coverage, but the borrower has other economic stress indicators to warrant heightened risk treatment. Due to a 58.6% decline in the balance of loans in this pool, management estimated a reduction of reserves of \$4.8 million in the first half of 2012 compared to December 31, 2011.

**Construction and Development**

At June 30, 2012, nonperforming construction and development ( C & D ) loans totaled \$20.2 million, or 18.0% of total nonperforming loans. This is a decrease of \$13.6 million from \$33.8 million at December 31, 2011, and a decrease of \$32.7 million from \$52.9 million at June 30, 2011. Of the \$57.1 million of total C & D loans in the portfolio, 35.4% of all construction loans were nonperforming as of June 30, 2012, as compared to 47.3% at December 31, 2011, and 55.9% at June 30, 2011. Total C & D charge-offs for the second quarter of 2012 were \$1.9 million, as compared to \$3.2 million in the second quarter 2011. Following all charge-off activity, management estimated that specific allocations of \$1.2 million were sufficient coverage for the remaining loss exposure in this segment at June 30, 2012. The majority of the Bank's C & D loans are located in suburban Chicago markets, predominantly in the far western and southwestern suburbs. The Bank's loan exposure to credits secured by homebuilder inventory is down 53.4% from a year ago.

Management closely monitors the performing loans that have been rated as special mention or substandard but that are still accruing interest. While some additional adverse migration is still possible, management believes that the remaining performing C & D borrowers have demonstrated sufficient operating strength through an extended period of weak construction to avoid classification as an impaired credit at June 30, 2012. As a result, management believes future losses in the construction segment will generally continue to trend downward. In addition to reviewing the operating performance of the borrowers when reviewing allowance estimates, management also continues to update underlying collateral valuation estimates to reflect the aggregate estimated credit exposure.

**Residential Real Estate**

Nonperforming 1-4 family owner occupied residential mortgages to consumers totaled \$15.1 million, or 13.4% of the nonperforming loan total as of June 30, 2012. This segment totaled \$20.3 million in nonperforming loans at December 31, 2011, compared to \$21.6 million at June 30, 2011. While Kendall, Kane and Will counties experienced high rates of foreclosure in both 2012 and 2011, the Bank has recently experienced relatively stable or somewhat improved nonperforming totals. The majority of all residential mortgage loans originated today are sold on the

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secondary market. Of the nonperforming loans in this category, \$5.6 million, or 36.9%, are to homeowners enrolled in the Bank's foreclosure avoidance program and are classified as restructured at June 30, 2012. The typical concessions granted in these cases were small and temporary rate reductions and a reduced monthly payment with the expectation that these borrowers resume normal performance on their obligations when their earnings situation improves. The usual profile of

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these borrowers includes a decrease in household income resulting from a change or loss of employment. The remaining nonperforming loans in the 1-4 family residential category are in nonaccrual status and most cases are in various stages of foreclosure. Management believes that deterioration in the segment relates primarily to the high rate of unemployment in our market areas offset by some reductions from loans moved to OREO or upgraded as borrowers become once again employed. In addition, a significant portion of these nonperforming loans were supported by private mortgage insurance, and, at June 30, 2012, management estimated that a specific allocation of \$508,000 was adequate loss coverage following the \$450,000 of charge-offs that occurred during the quarter. At June 30, 2012, there were no loans that were greater than 90 days past due and were still accruing interest in this portfolio segment. Additionally, at June 30, 2012, loans 30 to 89 days past due and still accruing totaled \$1.0 million which was an improvement from \$4.0 million at December 31, 2011, and from \$1.3 million at June 30, 2011.

Nonperforming residential investor loans at June 30, 2012 consisted of multi-family (\$9.7 million) and 1-4 family properties (\$3.9 million) for a total of \$13.6 million, or 12.1% of the nonperforming loans total. This was a decrease from \$15.3 million at December 31, 2011, and \$15.0 million at June 30, 2011. Following the second quarter charge-off of \$1.9 million, management estimated that a total specific allocation of \$940,000 would provide sufficient loss reserves at June 30, 2012, for the remaining risk in this category. The multi-family and rental market segment is showing improved credit metrics as higher occupancy rates have driven stronger net operating income.

**Other**

The remaining nonperforming credits included \$1.1 million in commercial loans, \$3.1 million in consumer home equity and second mortgage loans and \$2.3 million in farmland and agricultural loans. These loan categories have shown stable credit characteristics and losses have been minimal during this economic cycle. At June 30, 2012, management estimated that a total specific allocation of \$239,000 on the commercial portfolio, \$112,000 in farmland and agricultural loans would be sufficient loss coverage for the remaining risk in those nonperforming credits, and \$720,000 was sufficient loss coverage for the consumer home equity and second mortgage loan segment. These estimated amounts were following charge-offs in the second quarter of 2012 of \$98,000 in commercial and industrial loans, and \$534,000 in consumer home equity loans.

**Other Troubled Loans**

Loans that were classified as performing but 30 to 89 days past due and still accruing interest decreased to \$6.4 million at June 30, 2012, from \$12.1 million at December 31, 2011, and \$8.4 million at June 30, 2011. At June 30, 2012, loans 30 to 89 days past due consisted of \$1.0 million in 1-4 family owner occupied mortgages, \$1.5 million in commercial real estate credits, \$1.5 million in residential investor credits, \$243,000 in construction and development, \$319,000 in commercial loans, \$6,000 in consumer loans and \$1.9 million in home equity loans. Troubled debt restructurings ( TDR ) in accrual status total \$12.1 million, which was a slight increase from \$11.8 million TDR from December 31, 2011 and a decrease from \$18.6 million from June 30, 2011. Accruing TDRs included \$5.6 million in 1-4 family owner occupied mortgages in the foreclosure avoidance program discussed previously, \$2.7 million in restructured residential lot inventory loans to builders, \$61,000 in revolving and junior liens mortgages, and \$3.8 million in non-owner occupied commercial real estate.

Nonaccrual TDR loans totaled \$11.3 million as of June 30, 2012. These credits, which have not demonstrated a sustained period of financial performance, are primarily due to bankruptcy or continued deterioration in the borrowers' financial situation. Management is pursuing liquidation strategies for many of these loans. Management estimated that specific allocations of \$408,000 at June 30, 2012, were sufficient coverage for the remaining loss exposure in this category.

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The coverage ratio of the allowance for loan losses to nonperforming loans was 35.8% as of June 30, 2012, which was a decrease from 37.4% as of December 31, 2011. A decrease of \$26.4 million, or 19.0%, in

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nonperforming loans in the six months, along with reductions in both specific reserves and management factor reserves drove the overall coverage ratio reduction. Management updated the estimated specific allocations in the second quarter after receiving more recent appraisal collateral valuations or information on cash flow trends related to the impaired credits. The estimated general allocations decreased by \$5.0 million from December 31, 2011, as the overall loan balances subject to general factors decreased at June 30, 2012. Management determined the estimated amount to provide in the allowance for loan losses based upon a number of factors, including loan growth or contraction, the quality and composition of the loan portfolio and loan loss experience. The latter item was also weighted more heavily based upon recent loss experience. The C & D portfolio has had diminished adverse migration and the remaining credits are exhibiting more stable credit characteristics. Management estimates adequate reserves have been established for the remaining risk of loss in the C & D portfolio.

Management regularly reviews the performance of the higher risk pool within CRE loans, and adjusts the population and the related loss factors taking into account adverse market trends including collateral valuation as well as its assessments of the credits in that pool. Those assessments capture management's estimate of the potential for adverse migration to an impaired status as well as its estimation of what the potential valuation impact from that migration would be if it were to occur. The amount of assets subject to this pool factor decreased by 58.6% in the second quarter as compared to December 31, 2011. In addition, compared to December 31, 2011, management decreased the loss factor assigned to this pool by 1.0% based on risk characteristics of the remaining credits. Management has also observed that many stresses in those credits were generally attributable to cyclical economic events that were showing some signs of stabilization. Those signs included a reduction in loan migration to watch status, as well as a decrease in 30 to 89 day past due loans and some stabilization in values of certain properties.

The above changes in estimates were made by management to be consistent with observable trends within loan portfolio segments and in conjunction with market conditions and credit review administration activities. Several environmental factors are evaluated on an ongoing basis and are included in the assessment of the adequacy of the allowance for loan losses. When measured as a percentage of loans outstanding, the total allowance for loan losses decreased from 4.3% of total loans as of June 30, 2011, to 3.3% of total loans at June 30, 2012. In management's judgment, an adequate allowance for estimated losses has been established; however, there can be no assurance that actual losses will not exceed the estimated amounts in the future.

As discussed above, nonperforming loans include loans in nonaccrual status, troubled debt restructurings, and loans past due ninety days or more and still accruing interest. The comparative nonperforming loan totals and related disclosures as well as other nonperforming assets for the period ended June 30, 2012, and December 31, 2011, were as follows:

|  | June 30, 2012 | December 31, 2011 |
|--|---------------|-------------------|
| Nonaccrual loans (including restructured)                  | \$ 100,508    | \$ 126,786        |
| Accruing restructured loans                                | 12,069        | 11,839            |
| Loans 90 days or more past due and still accruing interest | -             | 318               |

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

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Finally, the Bank has added a final step in resolution of selected loan charge off decisions. On selected transactions, the Bank and the customer enter a deficiency note agreement whereby the customer agrees to pay the Bank both agreed upon principle balance and interest at a negotiated rate. While many of these notes show little or no payment activity, some reflect customer repayment. All notes are carried as off balance sheet assets (original balance of \$2.48 million with

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current balance of \$1.99 million at July 10, 2012) and all payments received are reflected as loan recoveries.

**Other Real Estate**

Other real estate owned ( OREO ) net of valuation reserve totaled \$89.7 million at June 30, 2012 or a decrease of \$3.6 million from December 31, 2011. Disposition activity and valuation write downs in the second quarter exceeded additions to OREO assets, leading to an overall decrease of \$12.0 million from OREO assets of \$101.7 million at March 31, 2012. In the second quarter of 2012, management successfully converted collateral securing problem loans to properties ready for disposition, spent as needed on development improvements, transacted asset dispositions and recorded valuation adjustments as shown below in thousands. As a result, holdings in all categories, including vacant land suitable for farming, single family residences, lots suitable for development, multi-family and commercial property declined in the quarter. Overall, a net gain on sale of \$355,000 was realized in second quarter 2012.

|                              | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|------------------------------|--------------------------------|-----------|------------------------------|-----------|
|                              | 2012                           | 2011      | 2012                         | 2011      |
| Beginning balance            | \$ 101,680                     | \$ 85,570 | \$ 93,290                    | \$ 75,613 |
| Property additions           | 3,432                          | 11,062    | 19,350                       | 30,513    |
| Development improvements     | 197                            | 145       | 515                          | 2,167     |
| Less:                        |                                |           |                              |           |
| Property disposals           | 10,342                         | 10,057    | 15,688                       | 19,180    |
| Period valuation adjustments | 5,296                          | 4,109     | 7,796                        | 6,502     |
| Other real estate owned      | \$ 89,671                      | \$ 82,611 | \$ 89,671                    | \$ 82,611 |

The OREO valuation reserve increased to \$27.5 million, which is 23.5% of gross OREO at June 30, 2012. The valuation reserve represented 20.7% of gross OREO at June 30, 2011. In management's judgment, an adequate property valuation allowance has been established; however, there can be no assurance that actual valuation losses will not exceed the estimated amounts in the future.

**Noninterest Income**

Noninterest income increased \$1.0 million, or 10.6%, to \$10.4 million during the second quarter of 2012 compared to \$9.4 million during the same period in 2011. For the first half of 2012, noninterest income increased by \$2.5 million, or 13.8%, to \$20.9 million compared to \$18.3 million for the same period in 2011. Trust income decreased by \$252,000, or 14.7%, and by \$385,000, or 11.0%, for the second quarter and first half of 2012, respectively. The Company's reduction in trust revenues, for both the quarter and six month year over year periods, was largely caused by three key client departures. Service charge income from deposit accounts decreased for both the quarter and year, primarily due to decreases in volume of overdraft fees. Total mortgage banking income in the second quarter of 2012, including net gain on sales of mortgage loans, secondary market fees, and servicing income, was \$2.3 million, an increase of \$1.2 million from the second quarter of 2011. Mortgage banking income for the first half of the year also increased by \$2.5 million, or 84.8%, from the 2011 level, reflecting continued strong demand for mortgage loans through the first half of 2012 as interest rates remained at historically low levels.



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Realized gains on securities totaled \$692,000 in the second quarter and \$793,000 in the first half of 2012 as the securities portfolio was revised to reduce levels of mortgage backed securities with inherent prepayment risk. Gains in 2012 compare to \$512,000 and \$651,000 in the second quarter and first half of 2011. Bank owned life insurance ( BOLI ) income decreased \$108,000, or 24.9% and \$76,000, or 8.5% in the second quarter and first half of 2012, respectively, over the same periods in 2011, as the rates of return decreased on the underlying insurance and insurance related investments. Debit card interchange income increased for both the second quarter and first half of 2012 as the volume of consumer card activity continued to increase when compared to 2011. Lease revenue received from OREO properties, which

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partially offsets OREO expenses included in noninterest expense, decreased \$46,000 in the second quarter of this year when compared to the 2011 second quarter but increased \$613,000 in the first half of 2012 compared to the same period in 2011. Net gains on disposition of OREO properties decreased by \$47,000, to \$355,000 in the second quarter of 2012, and by \$258,000, to \$378,000 in the first half of 2012 as property sales continued in an improved but still stressed market in the current year. Other noninterest income decreased \$88,000, or 6.0%, for the second quarter and by \$361,000, or 12.4%, for the first half of 2012 largely due to a decrease in retail brokerage fees.

*Noninterest Expense*

Noninterest expense was \$24.6 million during the second quarter of 2012, an increase of \$276,000, from \$24.4 million in the second quarter of 2011. Noninterest expense totaled \$47.1 million during the first half of 2012, a decrease of \$1.9 million, or 3.8%, from \$49.0 million in the second half of 2011. The increase in salaries and benefits expense was \$243,000, or 2.8%, and \$363,000, or 2.1% when comparing the second quarter and first half of 2012, respectively, to the same periods in 2011. The increase in salaries and benefits expense resulted primarily from an increase in salary expense as we fully staffed the special asset group, hired loan officers and recognized incentive compensation. Salary expense increases were partially offset by decreases in employee benefits expense. The number of full time equivalent employees was 487 at the second quarter of 2012 as compared to 490 at the same time last year.

Federal Deposit Insurance Corporation ( FDIC ) costs decreased \$84,000, or 7.5%, and \$823,000, or 28.9%, for the second quarter and first half of 2012, respectively, as compared to the prior year. The new methodology for the assessment calculation changed effective with the second quarter of 2011. The revised assessment approach applies to an adjusted average asset base rather than insured deposits, which contributed to the lower Bank assessment. In addition, the lower asset base that has resulted from the overall management strategy also served to lower this expense.

General bank insurance increased \$15,000 and \$36,000 for the second quarter and first half of 2012 when compared to the same periods in 2011 reflecting this year's insurance renewal programs. Advertising expense increased by \$77,000, or 41.2%, and \$162,000, or 38.6%, in the second quarter and first half of 2012, respectively, when compared to the same periods in 2011. Legal fees decreased \$270,000 and \$528,000 in a quarterly and year to date comparison as a result of a management program to control rates charged by law firms providing services, and were primarily related to loan workouts.

OREO expense increased \$837,000 in the second quarter and \$177,000 in the first half of 2012 compared to the same periods in 2011. The increase for both the quarterly and year to date periods were primarily due to increases in valuation expense of \$1.0 million and \$1.2 million, respectively. This increase was partially offset by decreased expenses incurred in administering OREO property taxes and insurance, which had decreases of \$298,000 and \$1.3 million for the second quarter and first half of 2012, respectively, due to the selected successful property tax appeals and some relief in property tax levies. Other noninterest expense decreased \$320,000, or 9.6%, from \$3.3 million in the second quarter of 2011 to \$3.0 million in the same period of 2012. Other expense decreased \$555,000, or 8.5%, from \$6.6 million in the first half of 2011 to \$6.0 million in the same period of 2012.

*Income Taxes*

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The Company did not record an income tax benefit for the first six months of 2012, despite a \$1.7 million pre-tax loss during that period, due to the establishment of a valuation allowance against the Company's deferred tax assets which was first established as of December 31, 2010. Under generally accepted accounting principles, income tax benefits and the related tax assets are only allowed to be recognized if they will more likely than not be fully realized. As a result, at June 30, 2012 the net amount of the Company's deferred tax assets related to operations has been reduced to zero. The Company's effective tax rate for the first six months ending June 30, 2012, and 2011 was 0%.

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The determination of the realizability of the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, available tax planning strategies, and assessments of the current and future economic and business conditions. Management considered both positive and negative evidence regarding the ultimate realizability of the deferred tax assets, which is largely dependent upon the ability to derive benefits based upon future taxable income. Management determined that realization of the deferred tax asset was not more likely than not as required by accounting principles and established a valuation allowance at December 31, 2010, to reflect this judgment. A deferred tax asset related to accumulated other comprehensive loss resulting from the net unrealized loss on available-for-sale securities increased to \$2.8 million at June 30, 2012, from \$2.6 million at December 31, 2011. An increase in rates will generally cause a decrease in the fair value of individual securities and results in changes in unrealized loss on available-for-sale securities, while a decrease in rates generally causes an increase in fair value at a point in time. In addition to the impact of rate changes upon pricing, uncertainty in the financial markets can cause reduced liquidity for certain investments and those changes are discussed in detail in Note 2 to the consolidated financial statements. Management has both the ability and intent to retain an investment in available-for-sale securities. In each future accounting period, the Company's management will reevaluate whether the current conditions in conjunction with positive and negative evidence support a change in the valuation allowance against its deferred tax assets. Any such subsequent reduction in the estimated valuation allowance would lower the amount of income tax expense recognized in the Company's consolidated statements of operations in future periods.

**Financial Condition**

Total assets increased \$44.2 million, or 2.3%, from December 31, 2011, to close at \$1.99 billion as of June 30, 2012. Loans decreased by \$130.9 million, or 9.6%, as management continued to emphasize capital management and credit quality, and overall demand from qualified borrowers remained weak. At the same time, loan charge-off activity reduced balances and collateral that previously secured loans moved to OREO. OREO decreased \$3.6 million, or 3.9% at June 30, 2012. Available-for-sale securities increased by \$91.3 million for the first six months ended June 30, 2012.

The core deposit intangible asset related to the Heritage Bank acquisition in February 2008 was \$8.9 million at acquisition as compared to \$4.2 million as of June 30, 2012. Management performed an annual review of the core deposit and other intangible assets as of November 30, 2011. Based upon that review and ongoing quarterly monitoring, management determined there was no impairment of other intangible assets as of June 30, 2012. No assurance can be given that future impairment tests will not result in a charge to earnings.

**Loans**

Total loans were \$1.24 billion as of June 30, 2012, a decrease of \$130.9 million from \$1.37 billion as of December 31, 2011. The decrease was primarily attributable to the continued declining demand from qualified borrowers, but also included loan charge-offs, net of recoveries, of \$18.0 million in the first half of 2012. See the Provision for Loan Loss and Other Troubled Loans sections in the Management Discussion and Analysis of Financial Condition for additional detail on the Allowance for Loan Losses for the period of December 31, 2011, through June 30, 2012. The largest changes by loan type included decreases in commercial real estate, real estate construction and residential real estate loans of \$79.4 million, \$14.4 million and \$30.0 million, or 11.3%, 20.1% and 6.3%, respectively.

The quality of the loan portfolio is in large part a reflection of the economic health of the communities in which the Company operates, and the local economy has been affected by the overall decline in economic conditions that has been experienced nationwide. The adverse economic conditions continue to affect the Midwest region in particular and financial markets generally. Real estate related activity, including valuations and transactions, continues to experience distress. Because the Company is located in a



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growth 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 91.2% of the portfolio as of June 30, 2012 compared to 91.5% of the portfolio as of December 31, 2011. The Company continues to oversee and manage its loan portfolio to avoid unnecessarily high credit concentrations in accordance with interagency guidance on risk management. Consistent with that commitment and management's response to the Consent Order with the OCC, management updated its asset diversification plan and policy and anticipates that the percentage of real estate lending to the overall portfolio should reflect these plans and policies. Management had previously reorganized the lending function by targeted business units and has placed increased emphasis upon commercial and industrial lending in particular. This action included strategic additions and changes to staff as well as a prior realignment of resources. Commercial loans decreased \$8.0 million, or 8.2%, while consumer loans decreased only \$468,000, or 12.4%, respectively, from December 31, 2011 to June 30, 2012. Almost all of these decreases were attributable to decreased demand from qualified borrowers.

*Securities*

Securities available-for-sale totaled \$398.9 million as of June 30, 2012, an increase of \$91.3 million, or 29.7%, from \$307.6 million as of December 31, 2011. Management utilized otherwise available liquid funds to accomplish this increase. The largest category increases were in collateralized mortgage-backed and asset-backed securities. Collateralized mortgage-backed and asset-backed securities increased \$37.3 million and \$108.3 million, respectively, in the first half of 2012.

The Company's portfolio of mortgage-backed securities with single-family residential collateral has been reduced. Management expects that the historically low interest rate environment may prompt increased repayment activity on these securities.

Recent purchase activity has involved variable rate bonds backed by student loans that were at least 97% guaranteed by the U. S. Department of Education. At April 30, 2012, 15.1% of the portfolio was in these types of securities. This percentage rose to 20.7% at May 31, 2012 and 23.4% at June 15, 2012.

Other recent purchases include mortgage backed securities and collateralized mortgage obligations backed by multi-family residential loans. Management anticipates lower prepayment risk with the specific securities purchased.

The net unrealized losses, net of deferred tax benefit, in the portfolio increased by \$263,000 from \$3.7 million as of December 31, 2011 to \$4.0 million as of June 30, 2012. Additional information related to securities available-for-sale is found in Note 2.

*Deposits and Borrowings*

Total deposits increased \$29.2 million, or 1.7%, during the six months ended June 30, 2012, to close at \$1.77 billion. The deposit segments that increased in this period were noninterest bearing demand, savings and money markets, which increased by \$50.7 million, \$16.8 million and \$25.7 million, or 14.0%, 8.5% and 8.9%, respectively. The Bank received a large deposit to noninterest bearing demand in late June 2012. Subsequent to the end of the quarter, this deposit is no longer on the Bank's balance sheet. At the same time, NOW accounts decreased by \$3.6

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million, or 1.3%. Time deposits decreased \$60.3 million or 9.8% due to management's pricing strategy discouraging customers with a single service relationship at the Bank. Market interest rates decreased generally and the average cost of interest bearing deposits decreased from 1.16% in the first half of 2011, to 0.80%, or 36 basis points, in the same period of 2012. Similarly, the average total cost of interest bearing liabilities decreased 28 basis points from 1.41% in the first half of 2011 to 1.13% in the first half of 2012.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with Bank of America. That credit facility began in January 2008 and was originally composed of a \$30.5 million Senior Debt facility including \$500,000 in term debt (collectively the Senior

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Debt ), as well as \$45.0 million of Subordinated Debt. The Subordinated Debt and the term debt portion of the Senior Debt mature on March 31, 2018. The line of credit portion of the Senior Debt facility matured on March 31, 2010. The interest rate on the Senior Debt resets quarterly, and is based on, at the Company's option, either the lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the Subordinated Debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The Company had no principal outstanding balance on the senior line of credit when it matured, but did have \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in Subordinated Debt at the end of both December 31, 2011, and June 30, 2012. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the agreement, as described therein. The agreement also contains certain customary representations and warranties as well as financial covenants. At June 30, 2012, the Company continued to be out of compliance with two of the financial covenants contained within the credit agreement. The agreement provides that upon an event of default as the result of the Company's failure to comply with a financial covenant, relating to the Senior Debt, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line of the term debt by 200 basis points, (iii) declare the Senior Debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal amount of the Senior Debt is the \$500,000 in term debt. Because the Subordinated Debt is treated as Tier 2 capital for regulatory capital purposes, the Agreement does not provide the lender with any rights of acceleration or other remedies with regard to the Subordinated Debt upon an event of default caused by the Company's failure to comply with a financial covenant. In November 2009, the lender invoked the default rate, thereby increasing the rate on the term debt by 200 basis points resulting in nominal additional interest expense as the default rate only applies to the \$500,000 of outstanding senior term debt.

The Company increased its securities sold under repurchase agreements \$12.9 million from December 31, 2011. These balances increased in response to customer request for pledged security on new deposits.

**Capital**

As of June 30, 2012, total stockholders' equity was \$70.1 million, which was a decrease of \$3.9 million, or 5.2%, from \$74.0 million as of December 31, 2011. This decrease was primarily attributable to the net loss from operations in the first quarter of 2012. As of June 30, 2012, the Company's regulatory ratios of total capital to risk weighted assets, Tier 1 capital to risk weighted assets and Tier 1 leverage decreased slightly to 12.33%, 6.16%, and 4.81%, respectively, compared to 12.38%, 6.21%, and 4.98%, respectively, at December 31, 2011. The Company, on a consolidated basis, exceeded the minimum ratios to be deemed adequately capitalized under regulatory defined capital ratios at June 30, 2012. The same capital ratios at the Bank were 13.25%, 11.99%, and 9.35%, respectively, at June 30, 2012, compared to 12.97%, 11.70%, and 9.34%, at December 31, 2011. The Bank's ratios exceeded the heightened capital ratios agreed to in the OCC Consent Order of May 2011.

The federal bank regulatory agencies recently issued joint proposed rules that would implement an international capital accord called Basel III, developed by the Basel Committee on Banking Supervision, a committee of central banks and bank supervisors. The proposed rules would apply to all depository organizations in the United States and most of their parent companies and would increase minimum capital ratios, add a new minimum common equity ratio, add a new capital conservation buffer, and would change the risk weightings of certain assets for the purposes of calculating certain capital ratios. The proposed changes, if implemented, would be phased in from 2013 through 2019. Management is currently assessing the effect of the proposed rules on the Company and the Bank's capital position. Various banking





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associations and industry groups are providing comments on the proposed rules to the regulators and it is unclear when the final rules will be adopted and what changes, if any, may be made to the proposed rules.

In July 2011, the Company also entered into a written agreement ( Written Agreement ) with the FRB designed to maintain the financial soundness of the Company. Key provisions of the Written Agreement include restrictions on the Company's payment of dividends on its capital stock, restrictions on its taking of dividends or other payments from the Bank that reduce the Bank's capital, restrictions on subordinated debenture and trust preferred security distributions, restrictions on incurring additional debt or repurchasing stock, capital planning provisions, requirements to submit cash flow projections to the FRB, requirements to comply with certain notice provisions pertaining to changes in directors or senior management, requirements to comply with regulatory restrictions on indemnification and severance payments, and requirements to submit certain reports to the FRB. The Written Agreement also calls for the Company to serve as a source of strength for the Bank, including ensuring that the Bank complies with the OCC Consent Order of May 2011.

As announced and implemented in the third quarter of 2010, the Company elected to defer regularly scheduled interest payments on \$58.4 million of junior subordinated debentures related to the trust preferred securities issued by its two statutory trust subsidiaries, Old Second Capital Trust I and Old Second Capital Trust II (collectively the Trust Preferred Securities ). Because of the deferral on the subordinated debentures, the trusts will defer regularly scheduled dividends on their trust preferred securities. The total accumulated interest on the Trust Preferred Securities including compounded interest from July 1, 2010 on the deferred payments totaled \$9.2 million at June 30, 2012.

The Company has also suspended quarterly cash dividends on its Series B Preferred Stock, issued to the Treasury in connection with the Company's participation in the TARP Capital Purchase Program as well as suspending dividends on its outstanding common stock. The dividend payments have been deferred since November 15, 2010, and while in deferral these dividends are compounded quarterly. The accumulated Series B Preferred Stock dividends declared and accrued totaled \$7.1 million at June 30, 2012 and are reflected as a reduction to capital even though not paid.

Under the terms of the Subordinated Debentures, the Company is allowed to defer payments of interest for 20 quarterly periods on the Trust Preferred Securities without default or penalty, but such amounts will continue to accrue. Also during the deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Series B Preferred Stock. Under the terms of the Series B Preferred Stock, the Company is required to pay dividends on a quarterly basis at a rate of 5% per year for the first five years, after which the dividend rate automatically increases to 9%. Dividend payments on the Series B Preferred Stock may be deferred without default, but the dividend is cumulative and therefore will continue to accrue and, if the Company fails to pay dividends for an aggregate of six quarters, whether or not consecutive, the holder has the right to appoint representatives to the Company's board of directors. As of January 2012, the Treasury began sending an observer to the Company's board of directors meetings. The Treasury has indicated that it intends to appoint two directors to our board sometime during 2012.

The terms of the Series B Preferred Stock also prevent the Company from paying cash dividends on or repurchasing its common stock while Series B Preferred Stock dividends are in arrears. Pursuant to the terms of the Written Agreement discussed above, the Company must seek regulatory approval prior to resuming payments on its Subordinated Debentures and Series B Preferred Stock.

In addition to the above regulatory ratios, the non-GAAP tangible common equity to tangible assets and the Tier 1 common equity to risk-weighted assets also decreased to (0.27)% and (0.12)%, respectively, at June 30, 2012 as compared to (0.08)% and (0.05)%, respectively, at December 31, 2011. Management also discloses these non-GAAP ratios to be consistent with industry practice and the table below provides an enumeration of the components of each those non-GAAP equity ratios disclosed above to the most comparable GAAP equivalent.



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|   | (unaudited)<br>As of June 30,<br>2012 | (unaudited)<br>As of June 30,<br>2011 | (unaudited)<br>December 31,<br>2011 |
|---|---------------------------------------|---------------------------------------|-------------------------------------|
|   | (dollars in thousands)                |                                       |                                     |
| <b>Tier 1 capital</b>   |                                       |                                       |                                     |
| Total stockholders' equity  | \$ 70,147                             | \$ 80,974                             | \$ 74,002                           |
| Tier 1 adjustments:   |                                       |                                       |                                     |
| Trust preferred securities  | 24,704                                | 27,851                                | 25,901                              |
| Cumulative other comprehensive loss                                 | 3,965                                 | 2,579                                 | 3,702                               |
| Disallowed intangible assets  | (4,233)                               | (5,090)                               | (4,678)                             |
| Disallowed deferred tax assets                                      | -                                     | (1,805)                               | (2,592)                             |
| Other   | (353)                                 | (402)                                 | (349)                               |
| Tier 1 capital  | \$ 94,230                             | \$ 104,107                            | \$ 95,986                           |
| <b>Total capital</b>  |                                       |                                       |                                     |
| Tier 1 capital  | \$ 94,230                             | \$ 104,107                            | \$ 95,986                           |
| Tier 2 additions:   |                                       |                                       |                                     |
| Allowable portion of allowance for loan losses                      | 19,370                                | 21,059                                | 19,736                              |
| Additional trust preferred securities disallowed for tier 1 capital | 31,921                                | 28,774                                | 30,724                              |
| Subordinated debt   | 45,000                                | 45,000                                | 45,000                              |
| Tier 2 additions subtotal   | 96,291                                | 94,833                                | 95,460                              |
| Allowable Tier 2  | 94,230                                | 94,833                                | 95,460                              |
| Other Tier 2 capital components                                     | (6)                                   | (7)                                   | (7)                                 |
| Total capital   | \$ 188,454                            | \$ 198,933                            | \$ 191,439                          |
| <b>Tangible common equity</b>                                       |                                       |                                       |                                     |
| Total stockholders' equity  | \$ 70,147                             | \$ 80,974                             | \$ 74,002                           |
| Less: Preferred equity  | 71,358                                | 70,385                                | 70,863                              |
| Intangible assets   | 4,233                                 | 5,090                                 | 4,678                               |
| Tangible common equity  | \$ (5,444)                            | \$ 5,499                              | \$ (1,539)                          |
| <b>Tier 1 common equity</b>   |                                       |                                       |                                     |
| Tangible common equity  | \$ (5,444)                            | \$ 5,499                              | \$ (1,539)                          |
| Tier 1 adjustments:   |                                       |                                       |                                     |
| Cumulative other comprehensive loss                                 | 3,965                                 | 2,579                                 | 3,702                               |
| Other   | (353)                                 | (2,207)                               | (2,941)                             |
| Tier 1 common equity  | \$ (1,832)                            | \$ 5,871                              | \$ (778)                            |
| <b>Tangible assets</b>  |                                       |                                       |                                     |
| Total assets  | \$ 1,985,658                          | \$ 1,981,409                          | \$ 1,941,418                        |
| Less:   |                                       |                                       |                                     |
| Intangible assets   | 4,233                                 | 5,090                                 | 4,678                               |
| Tangible assets   | \$ 1,981,425                          | \$ 1,976,319                          | \$ 1,936,740                        |
| <b>Total risk-weighted assets</b>                                   |                                       |                                       |                                     |
| On balance sheet  | \$ 1,484,939                          | \$ 1,590,575                          | \$ 1,511,815                        |
| Off balance sheet   | 43,730                                | 49,219                                | 34,824                              |
| Total risk-weighted assets  | \$ 1,528,669                          | \$ 1,639,794                          | \$ 1,546,639                        |
| <b>Average assets</b>   |                                       |                                       |                                     |
| Total average assets for leverage                                   | \$ 1,959,369                          | \$ 2,041,482                          | \$ 1,925,953                        |

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In addition, management believes the presentation of other financial measures such as core earnings, which excludes taxes, provisions for loan losses, income and expenses associated with other real estate owned, and other nonrecurring items as detailed immediately below, provides useful supplemental

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information that is helpful in understanding our financial results. Management considers this information useful since certain items such as provisions for loan losses and other real estate owned activities in the current credit cycle are well above historic levels. These disclosures should not be viewed as substitutes for the results determined to be in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies (in thousands).

|  | (unaudited)<br>As of and for the<br>Three Months Ended<br>June 30, |            | (unaudited)<br>As of and for the<br>Six Months Ended<br>June 30, |            |
|--|--|------------|--|------------|
|  | 2012   | 2011       | 2012   | 2011       |
| <b>Core earnings</b>                   |  |            |  |            |
| Pretax earnings (loss)                 | \$ 1,252   | \$ 1,013   | \$ (1,716)   | \$ (2,107) |
| Excluding impact of:                   |  |            |  |            |
| Other real estate owned, net of income | 5,522  | 4,592      | 8,974  | 9,152      |
| Provision for loan losses              | 200  | 500        | 6,284  | 4,500      |
| Litigation related income              | (3)  | -          | (119)  | -          |
| <i>Core Earnings</i>                   | \$ 6,971   | \$ 6,105   | \$ 13,423  | \$ 11,545  |
| <b>Earnings per core diluted share</b> |  |            |  |            |
| Average diluted number of shares       | 14,210,928   | 14,236,220 | 14,203,535   | 14,255,022 |
| <i>Core diluted earnings per share</i> | \$ 0.49  | \$ 0.43    | \$ 0.95  | \$ 0.81    |

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

*Liquidity and Market Risk*

Liquidity is the Company's ability to fund operations, to meet depositor withdrawals, to provide for customer's credit needs, and to meet maturing obligations and existing commitments. The liquidity of the Company principally depends on cash flows from net operating activities, including pledging requirements, investment in and maturity of assets, changes in balances of deposits and borrowings, and its ability to borrow funds. The Company monitors and tests borrowing capacity as part of its liquidity management process. Additionally, the \$73.0 million cash proceeds from the Treasury discussed above is a source of liquidity that became available to the Company in January 2009.

Net cash inflows from operating activities were \$17.9 million during the first half of 2012, compared with net cash inflows of \$11.3 million in the same period in 2011. Proceeds from sales of loans held-for-sale, net of funds used to originate loans held-for-sale, continued to be a source of inflow for both of the first half of 2012 and 2011. Interest received, net of interest paid, combined with changes in other assets and liabilities were a source of outflow for both of the first half of 2012 and 2011. 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 \$19.1 million in the first half of 2012, compared to \$135.9 million in the same period in 2011. In 2012, securities transactions accounted for a net outflow of \$91.5 million, and net principal received on loans accounted for net inflows of \$93.5 million. Proceeds from sales of OREO accounted for \$16.1 million and \$19.8 million in investing cash inflows for the first half of 2012 and 2011, respectively. Investing cash outflows for investment in OREO were \$515,000 in the first half of 2012 as compared to \$2.2 million in the same period in 2011.

Net cash inflows from financing activities in the first half of 2012 were \$42.1 million compared with net cash outflow of \$140.2 million in the first half of 2011. Net deposit inflows in the first half of 2012 were \$29.2 million compared to net deposit outflows of \$139.5 million in the first half of 2011. Changes in securities sold under repurchase agreements accounted for \$12.9 million in net inflows and \$687,000 in net outflows, respectively, in the first half of 2012 and 2011.

Beginning in late 2010, the Bank entered an advantageous program to place customer funds with correspondent institutions. The initial funding for these correspondent relationships came largely from Treasury Management deposits and totaled \$68.4 million at December 31, 2010. Placing these funds at the correspondent institutions provided benefits both to the Bank and to the Bank's customers. The correspondent programs provided customers with a beneficial interest rate on their deposit as well as a share of a fee paid to the Bank. The Bank retained a share of the fee and was able to continue important public entity and business relationships at a time when the Bank's profitability and reputation were under heightened stress.

Over the course of 2011, balances in these programs were \$54.8 million, \$129.3 million, \$145.4 million, and \$110.9 million at March 31, June 30, September 30, and December 31, respectively. Balance changes over this time reflect both customer activity and application of this program by the Bank for balance sheet deleveraging while maintaining strong liquidity in a historically low rate environment. At March 31, 2012, and June 30, 2012, the recorded balances under this program were \$78.5 million and \$92.9 million, respectively, again reflecting customer

activity and Bank balance sheet deleveraging programs.

Under the Terms of the OCC Consent Order (discussed in Note 11 of the Notes to Consolidated Financial Statements), the Bank has agreed to reaffirm its liquidity risk management program. Management has a well defined liquidity management program reflecting sound liquidity risk supervision through the Asset and Liability Committee process and Board review. Important elements of the program cover base operating liquidity, a liquid asset cushion, contingency funding strategies to address liquidity shortfalls in



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emergency situations and periodic stress testing. This program also covers liquidity management for the Company.

***Interest Rate Risk***

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

The Company manages various market risks in its normal course of operations, including credit, liquidity 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 from June 30, 2012 and December 31, 2011 are outlined in the table below.

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

The Company utilizes simulation analysis to quantify the impact of various rate scenarios on net interest income. Specific cash flows, repricing characteristics, and embedded options of the assets and liabilities held by the Company are incorporated into the simulation model. Earnings at risk is calculated by comparing the net interest income of a stable interest rate environment to the net interest income of a different interest rate environment in order to determine the percentage change. Due to the significant declines in interest rates that have occurred during the first half of 2012, management sees no value in interest rate scenarios that represent declines of 0.5% or more. Consequently, for 2012 periods, net interest income sensitivity is currently only calculated for interest rate increases. Compared to December 31, 2011 the Company had slightly less earnings gains if interest rates should rise. This was largely due to minor balance sheet changes that occurred during the quarter, along with model assumption changes to reflect the Company's belief that rates on non-maturity deposits might be more responsive to increases in market interest rates. Federal Funds rates and the Bank's prime rate were stable throughout the second quarter of 2012, at 0.25% and 3.25%, respectively.

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



Table of Contents**Analysis of Net Interest Income Sensitivity**

|                          | -2.0% | -1.0% | Immediate Changes in Rates |          | 1.0%     | 2.0%     |
|--------------------------|-------|-------|----------------------------|----------|----------|----------|
|                          |       |       | -0.5%                      | 0.5%     |          |          |
| <b>June 30, 2012</b>     |       |       |                            |          |          |          |
| Dollar change            | N/A   | N/A   | N/A                        | \$ 800   | \$ 1,840 | \$ 3,816 |
| Percent change           | N/A   | N/A   | N/A                        | +1.5%    | +3.6%    | +7.4%    |
| <b>December 31, 2011</b> |       |       |                            |          |          |          |
| Dollar change            | N/A   | N/A   | \$ (1,172)                 | \$ 1,196 | \$ 2,327 | \$ 4,628 |
| Percent change           | N/A   | N/A   | -2.0%                      | +2.1%    | +4.0%    | +8.0%    |

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 June 30, 2012. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2012, 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 control over financial reporting during the quarter ended June 30, 2012, that have materially affected, or are reasonably likely to affect, the Company's internal control over financial reporting.

**Forward-looking Statements**

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as believe, expect, anticipate, plan, intend, estimate, will, would, could, should or other similar expressions. Additionally, all statements in this document, including forward-looking statements,

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speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

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

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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

On February 17, 2011, a former employee filed a purported class action complaint in the U.S. District Court for the Northern District of Illinois on behalf of participants and beneficiaries of the Old Second Bancorp, Inc. Employees' 401(k) Savings Plan and Trust alleging that the Company, the Bank, the Employee Benefits Committee of Old Second Bancorp, Inc. and certain of the Company's officers and employees violated certain disclosure requirements and fiduciary duties established under the Employee Retirement Income Security Act of 1974, as amended (ERISA). The complaint seeks equitable and as-of-yet unquantified monetary relief. The Company believes that it, its affiliates and its officers and employees have acted, and continue to act, in compliance with ERISA law with respect to these matters. The parties agreed to enter mediation which occurred on May 3, 2012. This initial discussion did not produce meaningful progress toward resolution. On June 29, 2012, the Company filed an updated motion to dismiss. The court set a ruling date of August 22, 2012 on that motion. With assistance from outside counsel, the Company will evaluate additional steps to be taken to successfully conclude this dispute.

In addition to the matter described above, 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, 2011. Please refer to that section of the Company's Form 10-K for disclosures regarding the risks and uncertainties related to the Company's business.

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

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

N/A

**Item 5. Other Information**

None

**Item 6. Exhibits**

**Exhibits:**

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

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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 June 30, 2012 and December 31, 2011; (ii) Consolidated Statements of Operations for the three and six months ended June 30, 2012 and June 30, 2011; (iii) Consolidated Statements of Stockholders' Equity for the six months ended June 30, 2012 and June 30, 2011; (iv) Consolidated Statements of Cash Flows for the six months ended June 30, 2012 and June 30, 2011; 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 Section 13 or 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

OLD SECOND BANCORP, INC.

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

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

DATE: August 14, 2012