OLD SECOND BANCORP INC
Form 10-Q
May 13, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2014
OR
o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For transition period from ________to______

Commission File Number 0 -10537

OLD SECOND BANCORP, INC.
(Exact name of Registrant as specified in its charter)

Delaware	**36-3143493**
(State or other jurisdiction of incorporation or organization)	(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)

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 x No o

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 x No o

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

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

Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date: As of May 9, 2014, the Registrant had outstanding 29,442,508 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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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

	(Unaudited) March 31, 2014	December 31, 2013
Assets		
Cash and due from banks	$ 40,245	$ 33,210
Interest bearing deposits with financial institutions	14,242	14,450
Cash and cash equivalents	54,487	47,660
Securities available-for-sale, at fair value	400,212	372,191
Securities held-to-maturity, at amortized cost	264,298	256,571
Federal Home Loan Bank and Federal Reserve Bank stock	10,292	10,292
Loans held-for-sale	2,507	3,822
Loans	1,111,237	1,101,256
Less: allowance for loan losses	25,476	27,281
Net loans	1,085,761	1,073,975
Premises and equipment, net	45,716	46,005
Other real estate owned	40,220	41,537
Mortgage servicing rights, net	5,614	5,807
Core deposit intangible, net	665	1,177
Bank-owned life insurance (BOLI)	55,768	55,410
Deferred tax assets, net	74,453	75,303
Other assets	19,426	14,284
Total assets	$ 2,059,419	$ 2,004,034
Liabilities		
Deposits:		
Noninterest bearing demand	$ 387,090	$ 373,389
Interest bearing:		
Savings, NOW, and money market	872,521	836,300
Time	464,670	472,439
Total deposits	1,724,281	1,682,128
Securities sold under repurchase agreements	23,212	22,560
Other short-term borrowings	20,000	5,000
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	500
Other liabilities	38,560	42,776
Total liabilities	1,909,931	1,856,342
Stockholders Equity		
Preferred stock	73,000	72,942
Common stock	18,840	18,830
Additional paid-in capital	66,297	66,212
Retained earnings	94,693	92,549

Accumulated other comprehensive loss		(7,493)		(7,038)
Treasury stock		(95,849)		(95,803)
Total stockholders equity		149,488		147,692
Total liabilities and stockholders equity	$	2,059,419	$	2,004,034

	March 31, 2014		December 31, 2013	
	Preferred Stock	Common Stock	Preferred Stock	Common Stock
Par value	$ 1	$ 1	$ 1	$ 1
Liquidation value	1,000	n/a	1,000	n/a
Shares authorized	300,000	60,000,000	300,000	60,000,000
Shares issued	73,000	18,839,734	73,000	18,829,734
Shares outstanding	73,000	13,917,508	73,000	13,917,108
Treasury shares	-	4,922,226	-	4,912,626

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Operations

(In thousands, except share data)

	(Unaudited) Three Months Ended March 31, 2014	(Unaudited) Three Months Ended March 31, 2013
Interest and dividend income		
Loans, including fees	$ 12,938	$ 14,914
Loans held-for-sale	25	41
Securities:		
Taxable	3,502	2,298
Tax-exempt	148	119
Dividends from Federal Reserve Bank and Federal Home Loan Bank stock	76	76
Interest bearing deposits with financial institutions	15	42
Total interest and dividend income	16,704	17,490
Interest expense		
Savings, NOW, and money market deposits	199	228
Time deposits	1,321	1,853
Securities sold under repurchase agreements	1	1
Other short-term borrowings	1	19
Junior subordinated debentures	1,387	1,287
Subordinated debt	196	196
Notes payable and other borrowings	4	4
Total interest expense	3,109	3,588
Net interest and dividend income	13,595	13,902
Loan loss reserve release	(1,000)	(2,500)
Net interest and dividend income after loan loss reserve release	14,595	16,402
Noninterest income		
Trust income	1,459	1,491
Service charges on deposits	1,720	1,677
Secondary mortgage fees	112	230
Mortgage servicing (loss) gain, net of changes in fair value	(47)	244
Net gain on sales of mortgage loans	662	1,976
Securities (losses) gains, net	(69)	1,453
Increase in cash surrender value of bank-owned life insurance	358	407
Debit card interchange income	830	792
Other income	1,296	1,737
Total noninterest income	6,321	10,007
Noninterest expense		
Salaries and employee benefits	9,101	9,032
Occupancy expense, net	1,481	1,279
Furniture and equipment expense	983	1,144
FDIC insurance	279	1,035
General bank insurance	489	849
Amortization of core deposit	512	525
Advertising expense	303	166
Debit card interchange expense	378	344
Legal fees	257	323
Other real estate expense, net	1,008	3,097
Other expense	2,725	3,144
Total noninterest expense	17,516	20,938
Income before income taxes	3,400	5,471

Income tax expense		1,198		-
Net income		2,202		5,471
Preferred stock dividends and accretion of discount		1,572		1,289
Net income available to common shareholders	$	630	$	4,182
Share and per share information:				
Basic income per share	$	0.04	$	0.30
Diluted income per share		0.04		0.30
Dividends paid per share		-		-

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(In thousands)

	(Unaudited) Three Months Ended March 31,	
	2014	**2013**
Net income	$ 2,202	$ 5,471
Total unrealized holding losses on available-for-sale securities arising during the period	(1,089)	(35)
Related tax benefit	448	17
Holding losses after tax	(641)	(18)
Less: Reclassification adjustment for the net gains and losses realized during the period		
Net realized (losses) gains	(69)	1,453
Income tax benefit (expense) on net realized gains	28	(596)
Net realized (losses) gains after tax	(41)	857
Other comprehensive loss on available-for-sale securities	(600)	(875)
Accretion of net unrealized holding gains on held-to-maturity transferred from available-for-sale securities	247	-
Related tax expense	(102)	-
Other comprehensive income on held-to-maturity securities	145	-
Total other comprehensive loss	(455)	(875)
Total comprehensive income	$ 1,747	$ 4,596

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In thousands)

	(Unaudited) Three Months Ended March 31, 2014	2013
Cash flows from operating activities		
Net income	$ 2,202	$ 5,471
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization of leasehold improvement	644	746
Change in market value on mortgage servicing rights	304	106
Loan loss reserve release	(1,000)	(2,500)
Gain on recapture of restricted stock	-	(612)
Provision for deferred tax expense	1,168	-
Originations of loans held-for-sale	(19,764)	(53,138)
Proceeds from sales of loans held-for-sale	21,592	57,755
Net gain on sales of mortgage loans	(662)	(1,976)
Increase in cash surrender value of bank-owned life insurance	(358)	(407)
Change in accrued interest receivable and other assets	(6,238)	(5,215)
Change in accrued interest payable and other liabilities	(3,082)	634
Net discount (accretion)/premium amortization on securities	(474)	414
Securities losses (gains), net	69	(1,453)
Amortization of core deposit, net	512	525
Tax effect on vesting of restricted stock	29	-
Stock based compensation	66	14
Net gain on sale of other real estate owned	(386)	(181)
Provision for other real estate owned losses	436	1,987
Net gain on disposal of fixed assets	-	(5)
Net cash (used in) provided by operating activities	(4,942)	2,165
Cash flows from investing activities		
Proceeds from maturities and calls including pay down of securities available-for-sale	2,361	18,055
Proceeds from sales of securities available-for-sale	31,781	231,155
Purchases of securities available-for-sale	(62,931)	(240,190)
Proceeds from maturities and calls including pay down of securities held-to-maturity	1,893	-
Purchases of securities held-to-maturity	(9,220)	-
Net change in loans	(15,474)	26,971
Improvements in other real estate owned	-	(50)
Proceeds from sales of other real estate owned	5,955	11,842
Proceeds from disposition of fixed assets	-	6
Net purchases of premises and equipment	(355)	(1,123)
Net cash (used in) provided by investing activities	(45,990)	46,666
Cash flows from financing activities		
Net change in deposits	42,153	1,037
Net change in securities sold under repurchase agreements	652	2,927
Net change in other short-term borrowings	15,000	(100,000)
Purchase of treasury stock	(46)	(185)
Net cash provided by (used in) financing activities	57,759	(96,221)
Net change in cash and cash equivalents	6,827	(47,390)
Cash and cash equivalents at beginning of period	47,660	128,507
Cash and cash equivalents at end of period	$ 54,487	$ 81,117

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

	(Unaudited) Three Months Ended March 31,	
Supplemental cash flow information	**2014**	**2013**
Interest paid for deposits	$ 1,584	$ 2,124
Interest paid for borrowings	202	225
Noncash transfer of loans to other real estate owned	4,688	6,985
Noncash transfer of loans to securities available-for-sale	-	5,329
Accretion on preferred stock warrants	58	261
Fair value difference on recapture of restricted stock	-	43

See accompanying notes to consolidated financial statements.

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Changes in

Stockholders Equity

(In thousands)

(Unaudited)

	Common Stock	Preferred Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Stockholders Equity
Balance, December 31, 2012	$ 18,729	$ 71,869	$ 66,189	$ 12,048	$ (1,327)	$ (94,956)	$ 72,552
Net income				5,471			5,471
Change in net unrealized loss on securities available-for-sale, net of $613 tax effect					(875)		(875)
Change in restricted stock	51		(51)				-
Recapture of restricted stock			(43)			(569)	(612)
Stock based compensation			14				14
Purchase of treasury stock						(185)	(185)
		261		(772)			(511)

Preferred stock accretion and declared dividends							
Balance, March 31, 2013	$ 18,780	$ 72,130	$ 66,109	$ 16,747	$ (2,202)	$ (95,710)	$ 75,854
Balance, December 31, 2013	$ 18,830	$ 72,942	$ 66,212	$ 92,549	$ (7,038)	$ (95,803)	$ 147,692
Net income				2,202			2,202
Change in net unrealized loss on securities, net of $318 tax effect					(455)		(455)
Change in restricted stock	10		(10)				-
Tax effect from vesting of restricted stock			29				29
Stock based compensation			66				66
Purchase of treasury stock						(46)	(46)
Preferred stock accretion and declared dividends		58		(58)			-
Balance, March 31, 2014	$ 18,840	$ 73,000	$ 66,297	$ 94,693	$ (7,493)	$ (95,849)	$ 149,488

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 March 31, 2014, are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. 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, 2013. 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 generally accepted accounting principles in the United States (GAAP) and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the 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, 2013. 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.

Recent Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11 *Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists. ASU 2013-11* amended existing guidance related to the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. These amendments provide that an unrecognized tax benefit, or a portion thereof, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. These amendments are effective for interim and annual reporting periods beginning after December 15, 2013, and are incorporated in the financial statements contained in this report. The effect of adopting this standard does not have a material effect on the Company s operating results or financial condition.

In January 2014, the FASB issued ASU No. 2014-04 *Receivables Troubled Debt Restructurings by Creditors (Subtopic 310-40) Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. ASU 2014-04 is intended to reduce diversity in practice by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate

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property recognized. ASU 2014-04 requires a creditor to reclassify a collateralized consumer mortgage loan to real estate property upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in the ASU are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The adoption of this standard is not expected to have a material effect to the Company s operating results or financial condition.

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 and composition of the portfolio reflects liquidity needs, loan demand and interest income objectives.

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

Investments are comprised of debt securities and non-marketable equity investments. Securities available-for-sale are carried at fair value. Unrealized gains and losses, net of tax, on securities available-for-sale are reported as a separate component of equity. This balance sheet component changes as interest rates and market conditions change. Unrealized gains and losses are not included in the calculation of regulatory capital.

Securities held-to-maturity are carried at amortized cost and the discount or premium created in the 2013 transfer from available-for-sale securities or at the time of purchase thereafter is accreted or amortized to the maturity or expected payoff date but not an earlier call. In accordance with GAAP, the Company has the positive intent and ability to hold the securities to maturity. The Company has followed and will follow GAAP accounting on all securities holdings.

Nonmarketable equity investments include Federal Home Loan Bank of Chicago (FHLBC) stock and Federal Reserve Bank (Reserve Bank) stock. FHLBC stock was recorded at a value of $5.5 million at March 31, 2014, and December 31, 2013. Reserve Bank stock was recorded at $4.8 million at March 31, 2014, and December 31, 2013. Our FHLBC stock is necessary to maintain our continued access to FHLBC advances.

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The following table summarizes the amortized cost and fair value of securities at March 31, 2014, and December 31, 2013, and the corresponding amounts of gross unrealized gains and losses:

March 31, 2014:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available-for-Sale				
U.S. Treasury	$ 1,544	$ -	$ (4)	$ 1,540
U.S. government agencies	1,731	-	(66)	1,665
States and political subdivisions	26,215	408	(164)	26,459
Corporate bonds	31,625	31	(384)	31,272
Collateralized mortgage obligations	54,628	82	(3,586)	51,124
Asset-backed securities	289,583	2,465	(3,896)	288,152
Total Securities Available-for-Sale	$ 405,326	$ 2,986	$ (8,100)	$ 400,212
Securities Held-to-Maturity				
U.S. government agency mortgage-backed	$ 35,292	$ 634	$ -	$ 35,926
Collateralized mortgage obligations	229,006	1,665	(2,347)	228,324
Total Securities Held-to-Maturity	$ 264,298	$ 2,299	$ (2,347)	$ 264,250

December 31, 2013:	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available-for-Sale				
U.S. Treasury	$ 1,549	$ -	$ (5)	$ 1,544
U.S. government agencies	1,738	-	(66)	1,672
States and political subdivisions	16,382	629	(217)	16,794
Corporate bonds	15,733	17	(648)	15,102
Collateralized mortgage obligations	66,766	256	(3,146)	63,876
Asset-backed securities	274,118	2,168	(3,083)	273,203
Total Securities Available-for-Sale	$ 376,286	$ 3,070	$ (7,165)	$ 372,191

Securities Held-to-Maturity				
U.S. government agency mortgage-backed	$ 35,268	$ 45	$ (73)	$ 35,240
Collateralized mortgage obligations	221,303	643	(2,858)	219,088
Total Securities Held-to-Maturity	$ 256,571	$ 688	$ (2,931)	$ 254,328

The fair value, amortized cost and weighted average yield of debt securities at March 31, 2014, by contractual maturity, were as follows. Securities not due at a single maturity date, primarily mortgage-backed securities (MBS), collateralized mortgage obligations and asset-backed securities, are shown separately. Of note, the Company sold previously owned collateralized debt obligations in late 2013.

Securities Available-for-Sale	Amortized Cost	Weighted Average Yield	Fair Value
Due in one year or less	$ 10,708	1.63%	$ 10,723
Due after one year through five years	6,233	2.97%	6,507
Due after five years through ten years	11,887	2.90%	11,563
Due after ten years	32,287	2.89%	32,143
	61,115	2.68%	60,936
Collateralized mortgage obligations	54,628	2.41%	51,124
Asset-backed securities	289,583	1.48%	288,152
	$ 405,326	1.79%	$ 400,212
Securities Held-to-Maturity			
Mortgage-backed and collateralized mortgage obligations	$ 264,298	3.08%	$ 264,250

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Securities with unrealized losses at March 31, 2014, and December 31, 2013, 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):

March 31, 2014	Less than 12 months in an unrealized loss position			Greater than 12 months in an unrealized loss position			Total		
Securities Available-for-Sale	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value
U.S. Treasury	1	$ 4	$ 1,540	-	$ -	$ -	1	$ 4	$ 1,540
U.S. government agencies	-	-	-	1	66	1,665	1	66	1,665
States and political subdivisions	5	164	5,044	-	-	-	5	164	5,044
Corporate bonds	6	250	17,575	1	134	1,869	7	384	19,444
Collateralized mortgage obligations	2	1,323	13,127	1	2,263	21,468	3	3,586	34,595
Asset-backed securities	14	2,153	98,638	2	1,743	27,661	16	3,896	126,299
	28	$ 3,894	$ 135,924	5	$ 4,206	$ 52,663	33	$ 8,100	$ 188,587
Securities Held-to-Maturity									
Collateralized mortgage obligations	14	$ 2,347	$ 116,404	-	$ -	$ -	14	$ 2,347	$ 116,404
	14	$ 2,347	$ 116,404	-	$ -	$ -	14	$ 2,347	$ 116,404

December 31, 2013	Less than 12 months in an unrealized loss position			Greater than 12 months in an unrealized loss position			Total		
Securities Available-for-Sale	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value
U.S. Treasury	1	$ 5	$ 1,544	-	$ -	$ -	1	$ 5	$ 1,544
U.S. government agencies	-	-	-	1	66	1,672	1	66	1,672
States and political subdivisions	6	217	4,625	-	-	-	6	217	4,625
Corporate bonds	4	429	10,493	2	219	2,796	6	648	13,289
Collateralized mortgage obligations	5	3,146	54,021	-	-	-	5	3,146	54,021
Asset-backed securities	11	2,836	99,466	2	247	6,368	13	3,083	105,834
	27	$ 6,633	$ 170,149	5	$ 532	$ 10,836	32	$ 7,165	$ 180,985

Securities Held-to-Maturity

U.S. government agency mortgage-backed	6	$ 73	$ 19,134	-	$ -	$ -	6	$ 73	$ 19,134
Collateralized mortgage obligations	19	2,858	156,632	-	-	-	19	2,858	156,632
	25	$ 2,931	$ 175,766	-	$ -	$ -	25	$ 2,931	$ 175,766

Recognition of other-than-temporary impairment was not necessary in the three months ended March 31, 2014, or the year ended December 31, 2013. The changes in fair value related primarily to interest rate fluctuations. Our review of other-than-temporary impairment confirmed no credit quality deterioration.

Note 3 Loans

Major classifications of loans were as follows:

	March 31, 2014	December 31, 2013
Commercial	$ 98,321	$ 94,736
Real estate - commercial	579,297	560,233
Real estate - construction	32,016	29,351
Real estate - residential	375,781	390,201
Consumer	2,837	2,760
Overdraft	301	628
Lease financing receivables	9,227	10,069
Other	13,019	12,793
	1,110,799	1,100,771
Net deferred loan fees and cost	438	485
	$ 1,111,237	$ 1,101,256

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

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required, will vary from liquid assets to real estate. The Company s access to collateral, in the event of borrower default, is assured through adherence to state lending laws, the Company s lending standards and credit monitoring procedures. The Bank generally makes loans solely within its market area. There are no significant concentrations of loans where the customers ability to honor loan terms is dependent upon a single economic sector although the real estate related categories listed above represent 88.8% and 89.0% of the portfolio at March 31, 2014, and December 31, 2013, respectively.

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

March 31, 2014	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Nonaccrual	Total Loans	Recorded Investment 90 days or Greater Past Due and Accruing
Commercial	$ 254	$ -	$ -	$ 254	$ 107,270	$ 24	$ 107,548	$ -
Real estate - commercial								
Owner occupied general purpose	-	-	-	-	124,778	3,624	128,402	-
Owner occupied special purpose	247	-	472	719	163,871	7,018	171,608	472
Non-owner occupied general purpose	400	-	-	400	129,574	7,692	137,666	-
Non-owner occupied special purpose	-	-	-	-	83,172	642	83,814	-
Retail properties	-	-	-	-	38,373	3,071	41,444	-
Farm	-	-	-	-	16,363	-	16,363	-
Real estate - construction								
Homebuilder	-	-	-	-	3,434	102	3,536	-
Land	-	-	-	-	4,403	209	4,612	-
Commercial speculative	-	-	-	-	13,385	1,913	15,298	-
All other	73	-	-	73	7,833	664	8,570	-
Real estate - residential								
Investor	1,586	96	223	1,905	134,766	3,653	140,324	223
Owner occupied	2,676	-	430	3,106	105,744	5,336	114,186	430
Revolving and junior liens	325	75	-	400	118,145	2,726	121,271	-
Consumer	-	-	-	-	2,837	-	2,837	-
All other1	-	-	-	-	13,758	-	13,758	-
	$ 5,561	$ 171	$ 1,125	$ 6,857	$ 1,067,706	$ 36,674	$ 1,111,237	$ 1,125

December 31, 2013	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Nonaccrual	Total Loans	Recorded Investment 90 days or Greater Past Due and Accruing
Commercial	$ -	$ -	$ -	$ -	$ 104,778	$ 27	$ 104,805	$ -
Real estate - commercial								
Owner occupied general purpose	290	526	-	816	117,938	3,180	121,934	-
Owner occupied special purpose	511	-	-	511	164,277	7,671	172,459	-
Non-owner occupied general purpose	218	-	-	218	132,331	5,708	138,257	-
	-	-	-	-	73,325	661	73,986	-

Non-owner occupied special purpose								
Retail properties	-	-	-	-	34,034	3,144	37,178	-
Farm	-	-	-	-	16,419	-	16,419	-
Real estate - construction								
Homebuilder	-	-	-	-	3,515	168	3,683	-
Land	-	-	-	-	4,436	209	4,645	-
Commercial speculative	-	-	-	-	11,235	1,913	13,148	-
All other	32	-	-	32	7,404	439	7,875	-
Real estate - residential								
Investor	581	171	-	752	140,926	6,615	148,293	-
Owner occupied	4,414	308	87	4,809	106,184	5,967	116,960	87
Revolving and junior liens	650	76	-	726	121,013	3,209	124,948	-
Consumer	5	-	-	5	2,755	-	2,760	-
All other1	-	-	-	-	13,906	-	13,906	-
	$ 6,701	$ 1,081	$ 87	$ 7,869	$ 1,054,476	$ 38,911	$ 1,101,256	$ 87

1. The All other class includes overdrafts and net deferred loan fees and costs.

Credit Quality Indicators:

The Company categorizes loans into credit risk categories based on current financial information, overall debt service coverage, comparison against industry averages, historical payment experience, and current economic trends. Each loan and loan relationship is examined for additional review, if needed. This analysis covers loans with outstanding loans or commitments greater than $50,000 and excludes

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homogeneous loans such as home equity line of credit and residential mortgages. Loans with a classified risk rating are reviewed quarterly regardless of size or loan type. The Company uses the following definitions for classified risk ratings:

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

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

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

Credits that are not covered by the definitions above are pass credits, which are not considered to be adversely rated.

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Credit Quality Indicators by class of loans were as follows:

March 31, 2014	Pass	Special Mention	Substandard 1	Doubtful	Total
Commercial	$ 99,815	$ 7,278	$ 455	$ -	$ 107,548
Real estate - commercial					
Owner occupied general purpose	117,120	6,215	5,067	-	128,402
Owner occupied special purpose	163,134	1,231	7,243	-	171,608
Non-owner occupied general purpose	123,330	3,556	10,780	-	137,666
Non-owner occupied special purpose	73,389	9,783	642	-	83,814
Retail Properties	34,568	2,975	3,901	-	41,444
Farm	16,363	-	-	-	16,363
Real estate - construction					
Homebuilder	3,434	-	102	-	3,536
Land	4,403	-	209	-	4,612
Commercial speculative	9,843	-	5,455	-	15,298
All other	7,876	30	664	-	8,570
Real estate - residential					
Investor	131,509	1,141	7,674	-	140,324
Owner occupied	107,339	-	6,847	-	114,186
Revolving and junior liens	117,238	388	3,645	-	121,271
Consumer	2,837	-	-	-	2,837
All other	13,758	-	-	-	13,758
Total	$ 1,025,956	$ 32,597	$ 52,684	$ -	$ 1,111,237

December 31, 2013	Pass	Special Mention	Substandard 1	Doubtful	Total
Commercial	$ 96,371	$ 7,953	$ 481	$ -	$ 104,805
Real estate - commercial					
Owner occupied general purpose	105,683	9,048	7,203	-	121,934
Owner occupied special purpose	162,586	1,968	7,905	-	172,459
Non-owner occupied general purpose	122,844	1,826	13,587	-	138,257
Non-owner occupied special purpose	59,674	9,840	4,472	-	73,986
Retail Properties	30,059	2,989	4,130	-	37,178
Farm	16,419	-	-	-	16,419
Real estate - construction					
Homebuilder	1,745	1,770	168	-	3,683
Land	4,436	-	209	-	4,645
Commercial speculative	7,674	3,561	1,913	-	13,148
All other	7,109	32	734	-	7,875
Real estate - residential					
Investor	135,136	3,407	9,750	-	148,293
Owner occupied	109,261	-	7,699	-	116,960
Revolving and junior liens	120,589	388	3,971	-	124,948
Consumer	2,759	-	1	-	2,760
All other	13,906	-	-	-	13,906
Total	$ 996,251	$ 42,782	$ 62,223	$ -	$ 1,101,256

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 were as follows:

	As of March 31, 2014			Quarter Ended March 31, 2014	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded					
Commercial	$ 24	$ 32	$ -	$ 26	$ -
Commercial real estate					
Owner occupied general purpose	2,592	3,144	-	2,567	1
Owner occupied special purpose	4,869	6,147	-	4,120	-
Non-owner occupied general purpose	8,345	9,821	-	6,886	15
Non-owner occupied special purpose	642	909	-	652	-
Retail properties	3,071	3,738	-	3,107	-
Farm	-	-	-	-	-
Construction					
Homebuilder	1,893	2,395	-	1,955	28
Land	209	310	-	209	-
Commercial speculative	1,913	2,550	-	1,325	-
All other	295	326	-	150	-
Residential					
Investor	3,362	5,007	-	4,673	1
Owner occupied	10,000	11,429	-	9,589	47
Revolving and junior liens	2,288	3,286	-	2,030	1
Consumer	-	-	-	-	-
Total impaired loans with no recorded allowance	39,503	49,094	-	37,289	93
With an allowance recorded					
Commercial	-	-	-	-	-
Commercial real estate					
Owner occupied general purpose	1,122	1,152	462	926	-
Owner occupied special purpose	2,149	2,342	211	3,225	-
Non-owner occupied general purpose	-	-	-	469	-
Non-owner occupied special purpose	-	-	-	-	-
Retail properties	-	-	-	-	-
Farm	-	-	-	-	-
Construction					
Homebuilder	-	-	-	84	-
Land	-	-	-	-	-
Commercial speculative	-	-	-	588	-
All other	369	400	194	402	-
Residential					

Investor	344	419	130	514	-
Owner occupied	214	276	30	890	2
Revolving and junior liens	497	560	220	997	-
Consumer	-	-	-	-	-
Total impaired loans with a recorded allowance	4,695	5,149	1,247	8,095	2
Total impaired loans	$ 44,198	$ 54,243	$ 1,247	$ 45,384	$ 95

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Impaired loans by class of loans were as follows:

	As of December 31, 2013			Quarter Ended March 31, 2013	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded					
Commercial	$ 27	$ 34	$ -	$ 169	$ -
Commercial real estate					
Owner occupied general purpose	2,543	3,006	-	4,333	1
Owner occupied special purpose	3,371	4,117	-	5,855	-
Non-owner occupied general purpose	5,428	6,709	-	12,797	44
Non-owner occupied special purpose	661	919	-	472	-
Retail properties	3,144	3,811	-	7,031	-
Farm	-	-	-	2,467	-
Construction					
Homebuilder	2,016	2,016	-	3,876	31
Land	209	308	-	127	-
Commercial speculative	738	742	-	2,126	-
All other	4	35	-	66	-
Residential					
Investor	5,984	8,338	-	6,437	-
Owner occupied	9,179	10,451	-	9,425	57
Revolving and junior liens	1,771	2,313	-	1,300	1
Consumer	-	-		11	-
Total impaired loans with no recorded allowance	35,075	42,799	-	56,492	134
With an allowance recorded					
Commercial	-	-	-	317	-
Commercial real estate					
Owner occupied general purpose	730	792	264	956	-
Owner occupied special purpose	4,300	4,702	759	5,090	-
Non-owner occupied general purpose	939	1,030	129	2,649	-
Non-owner occupied special purpose	-	-	-	501	-
Retail properties	-	-	-	2,658	-
Farm	-	-	-	-	-
Construction					
Homebuilder	168	604	76	13	-
Land	-	-	-	127	-
Commercial speculative	1,175	1,808	17	3,844	-
All other	436	468	262	516	-
Residential					
Investor	684	913	160	2,779	-
Owner occupied	1,565	1,831	170	4,927	6
Revolving and junior liens	1,498	1,848	558	2,448	-
Consumer	-	-	-	-	-

Total impaired loans with a recorded allowance		11,495		13,996		2,395	26,825		6
Total impaired loans	$	46,570	$	56,795	$	2,395	$ 83,317	$	140

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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 a reduction in interest rates, extension of term, deferral 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 TDRs is determined either by discounting the modified cash flows at the original effective rate of the loan before modification or is based on the 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 TDRs charged-off, are factored into this calculation by portfolio segment.

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

	TDR Modifications Three months ending March 31, 2014				
	# of contracts		Pre-modification recorded investment		Post-modification recorded investment
Troubled debt restructurings					
Real estate - commercial					
Other1	2	$	1,320	$	1,191
Real estate - residential					
Owner occupied					
HAMP2	1		102		76
Deferral3	1		237		127
	4	$	1,659	$	1,394

	TDR Modifications Three months ending March 31, 2013				
	# of contracts		Pre-modification recorded investment		Post-modification recorded investment
Troubled debt restructurings					
Real estate - residential					
Owner occupied					
Deferral3	1	$	137	$	137
	1	$	137	$	137

1 Other: Change of terms from bankruptcy court

2 HAMP: Home Affordable Modification Program

3 Deferral: Refers to the deferral of principal

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TDRs are classified as being in default when they fail to be in compliance with the modified terms. The following table presents TDRs that defaulted during the periods shown and were restructured within the 12 month period prior to default. There was no TDR default activity for the three months ending March 31, 2014.

	TDR Default Activity Three Months ending 3/31/14		TDR Default Activity Three Months ending 3/31/13	
Troubled debt restructurings that Subsequently Defaulted	# of contracts	Pre-modification outstanding recorded investment	# of contracts	Pre-modification outstanding recorded investment
Real estate - residential				
Investor	-	$ -	1	$ 155
	-	$ -	1	$ 155

Note 4 Allowance for Loan Losses

Changes in the allowance for loan losses by segment of loans based on method of impairment for the three months ended March 31, 2014, were as follows:

	Commercial	Real Estate Commercial1	Real Estate Construction	Real Estate Residential	Consumer	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 2,250	$ 16,763	$ 1,980	$ 2,837	$ 1,439	$ 2,012	$27,281
Charge-offs	4	329	68	849	110	-	1,360
Recoveries	15	141	37	250	112	-	555
Provision (release)	65	(2,509)	49	30	54	1,311	(1,000)
Ending balance	$ 2,326	$ 14,066	$ 1,998	$ 2,268	$ 1,495	$ 3,323	$ 25,476
Ending balance: Individually evaluated for impairment	$ -	$ 673	$ 194	$ 380	$ -	$ -	$ 1,247
Ending balance: Collectively evaluated for impairment	$ 2,326	$ 13,393	$ 1,804	$ 1,888	$ 1,495	$ 3,323	$ 24,229
Financing receivables:							
Ending balance	$ 107,548	$ 579,297	$ 32,016	$ 375,781	$ 2,837	$ 13,758	$ 1,111,237
Ending balance: Individually evaluated for impairment	$ 24	$ 22,790	$ 4,679	$ 16,705	$ -	$ -	$ 44,198
Ending balance: Collectively evaluated for impairment	$ 107,524	$ 556,507	$ 27,337	$ 359,076	$ 2,837	$ 13,758	$ 1,067,039

1 As of March 31, 2014, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled $5.6 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was $412,000 at March 31, 2014.

The Company s allowance for loan loss is calculated in accordance with GAAP and relevant supervisory guidance. All management estimates were made in light of observable trends within the loan portfolio segments, market conditions and established credit review administration practices.

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Changes in the allowance for loan losses by segment of loans based on method of impairment for the quarter ended March 31, 2013, were as follows:

	Commercial	Real Estate Commercial1	Real Estate Construction	Real Estate Residential	Consumer	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 4,517	$ 20,100	$ 3,837	$ 4,535	$ 1,178	$ 4,430	$ 38,597
Charge-offs	254	508	4	585	172	-	1,523
Recoveries	19	2,724	770	404	143	-	4,060
(Release) provision	(509)	(3,051)	(874)	(383)	65	2,252	(2,500)
Ending balance	$ 3,773	$ 19,265	$ 3,729	$ 3,971	$ 1,214	$ 6,682	$ 38,634
Ending balance: Individually evaluated for impairment	$ 68	$ 2,000	$ 1,039	$ 1,931	$ -	$ -	$ 5,038
Ending balance: Collectively evaluated for impairment	$ 3,705	$ 17,265	$ 2,690	$ 2,040	$ 1,214	$ 6,682	$ 33,596
Financing receivables:							
Ending balance	$ 92,906	$ 566,349	$ 40,698	$ 394,599	$ 2,908	$ 15,842	$ 1,113,302
Ending balance: Individually evaluated for impairment	$ 210	$ 42,036	$ 9,810	$ 25,593	$ -	$ -	$ 77,649
Ending balance: Collectively evaluated for impairment	$ 92,696	$ 524,313	$ 30,888	$ 369,006	$ 2,908	$ 15,842	$ 1,035,653

1 As of March 31, 2013, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled $21.8 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was $3.1 million at March 31, 2013.

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 March 31, 2014	2013
Balance at beginning of period	$ 41,537	$ 72,423
Property additions	4,688	6,985
Development improvements	-	50
Less:		

Property disposals, net of gains/losses	5,569	11,661
Period valuation adjustments	436	2,134
Other real estate owned	$ 40,220	$ 65,663

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Activity in the valuation allowance was as follows:

	Three Months Ended March 31,	
	2014	2013
Balance at beginning of period	$ 22,284	$ 31,454
Provision for unrealized losses	436	1,987
Reductions taken on sales	(2,647)	(2,622)
Other adjustments	(589)	147
Balance at end of period	$ 19,484	$ 30,966

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

	Three Months Ended March 31,	
	2014	2013
Gain on sales, net	$ (386)	$ (181)
Provision for unrealized losses	436	1,987
Operating expenses	1,237	1,699
Less:		
Lease revenue	279	408
	$ 1,008	$ 3,097

Note 6 Deposits

Major classifications of deposits were as follows:

	March 31, 2014	December 31, 2013
Noninterest bearing demand	$ 387,090	$ 373,389
Savings	244,944	228,589
NOW accounts	309,385	297,852
Money market accounts	318,192	309,859
Certificates of deposit of less than $100,000	282,569	288,345
Certificates of deposit of $100,000 or more	182,101	184,094
	$ 1,724,281	$ 1,682,128

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Note 7 Borrowings

The following table is a summary of borrowings as of March 31, 2014, and December 31, 2013. Junior subordinated debentures are discussed in detail in Note 8:

	March 31, 2014	December 31, 2013
Securities sold under repurchase agreements	$ 23,212	$ 22,560
FHLBC advances	20,000	5,000
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	500
	$ 147,090	$ 131,438

The Company enters into deposit sweep transactions where the transaction amounts are secured by pledged securities. These transactions consistently mature within 1 to 90 days from the transaction date and are governed by sweep repurchase agreements. All sweep repurchase agreements are treated as financings secured by U. S. government agencies and collateralized mortgage-backed securities and had a carrying amount of $23.2 million at March 31, 2014, and $22.6 million at December 31, 2013. The fair value of the pledged collateral was $38.8 million and $39.2 million at March 31, 2014 and December 31, 2013, respectively. At March 31, 2014, there were no customers with secured balances exceeding 10% of stockholders equity.

The Company s borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC and total borrowings are generally limited to the lower of 35% of total assets or 60% of the book value of certain mortgage loans. As of March 31, 2014, the Bank took an advance of $20.0 million at 0.13% interest on the FHLBC stock valued at $5.5 million and collateralized by securities with a fair value of $75.8 million and loans with a principal balance of $55.3 million, which carry a combined collateral value of $110.4 million. This advance matured on April 1, 2014, and was repaid according to its terms. The Company still has excess collateral value of $89.1 million available to secure additional borrowings.

One of the Company s most significant borrowing relationships continued to be the $45.5 million credit facility with a correspondent bank. That credit began in January 2008 and was originally composed of a $30.5 million senior debt facility, which included $500,000 in term debt and $45.0 million of subordinated debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly and, at the Company s option, is based on 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. The Company terminated the senior line of credit. The Company had $500,000 in principal outstanding in term debt and $45.0 million in principal outstanding in subordinated debt at March 31, 2014 and December 31, 2013. 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. Pursuant to the Written Agreement (the Written Agreement) the Company entered into with the Reserve Bank, the Company was required to receive the Reserve Bank s approval prior to making any interest payments on the subordinated debt. In January 2014, the Reserve Bank notified the Company that the Written Agreement was terminated.

The agreement governing the credit facility contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company. The senior debt agreement also contains certain customary representations and warranties and financial covenants. At March 31, 2014, the Company was out of compliance with one of the financial covenants contained within the credit agreement. Prior to 2013, the Company had been out of compliance with two of the financial covenants. The agreement provides that noncompliance is an event of default and as the result

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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 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. However, the total outstanding principal amount of the senior debt is the $500,000 in term debt, and because the subordinated debt is treated as Tier 2 capital, the agreement does not provide the lender with any additional rights of acceleration or other remedies upon an event of default caused by the Company s failure to comply with a financial covenant.

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

The Company issued an additional $25.0 million of cumulative trust preferred securities through a private placement completed by an additional unconsolidated subsidiary, Old Second Capital Trust II, in April 2007. 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 Old Second Capital Trust II in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

Under the terms of the subordinated debentures issued to each of Old Second Capital Trust I and II, the Company can elect to defer interest payments 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 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 deferred regularly scheduled dividends on the trust preferred securities. On April 21, 2014, the Company paid all outstanding interest on the trust preferred securities to the trustees for payment to holders as of the next record date set forth in the indentures and terminated the deferral period. Both of the debentures issued by the Company are disclosed on the Consolidated Balance Sheet as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Income. The total accumulated unpaid interest on the junior subordinated debentures including compounded interest from July 1, 2010 on the deferred payments, totaled $18.4 million at March 31, 2014. In order to terminate the deferral period, the Company paid all accumulated and unpaid interest on the trust preferred securities through the next payment date set forth in the indentures, which totaled $19.7 million.

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 45,368 at March 31, 2014. 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 quarter of 2014 or 2013. All stock options are granted for a term of ten years.

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Total compensation cost that has been charged for those plans was $66,000 in the first quarter of 2014 and $14,000 in the first quarter of 2013.

There were no stock options exercised during the first quarter of 2014 or 2013. There is no unrecognized compensation cost related to nonvested stock options of the Company s common stock as of March 31, 2014.

A summary of stock option activity in the Incentive Plan is as follows for the quarter ended March 31, 2014:

March 31, 2014	Shares		Weighted Average Exercise Price	Weighted-Average Remaining Contractual Term (years)		Aggregate Intrinsic Value
Beginning outstanding	325,500	$	29.56			
Canceled	-		-			
Ending outstanding	325,500	$	29.56	2.3	$	-
Exercisable at end of quarter	325,500	$	29.56	2.3	$	-

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 the vest date. Awards under the Incentive Plan are fully vested upon a merger or change in control of the Company.

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 first quarter of 2014 or during the first quarter of 2013. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award at the date of issuance.

A summary of changes in the Company s nonvested restricted awards follows for the quarter ended March 31, 2014:

	March 31, 2014		
	Restricted Stock Shares and Units		Weighted Average Grant Date Fair Value
Nonvested at January 1	185,500	$	2.95
Granted	-		-
Vested	(25,000)		2.06
Forfeited	-		-

Nonvested at March 31	160,500	$	3.09

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The total unrecognized compensation cost of restricted awards is $303,000 as of March 31, 2014. The Company expects to recognize this cost over a weighted-average period of 1.99 years. The total unrecognized compensation cost of restricted awards was $31,000 as of March 31, 2013. The Company expects to recognize this cost over a weighted-average period of 0.81 years.

Note 10 Earnings Per Share

Earnings per share is included below as of March 31 (in thousands except for share data):

	Three Months Ended March 31,			
		2014		2013
Basic earnings per share:				
Weighted-average common shares outstanding		13,921,023		14,076,114
Weighted-average common shares less stock based awards		13,912,523		13,947,454
Weighted-average common shares stock based awards		169,111		210,069
Net earnings	$	2,202	$	5,471
Dividend and accretion on preferred shares		1,572		1,289
Net earnings available to common stockholders		630		4,182
Common stock dividends		-		-
Un-vested share-based payment awards		-		-
Undistributed earnings		630		4,182
Basic earnings per share common undistributed earnings		0.04		0.30
Basic earnings per share of common stock	$	0.04	$	0.30
Diluted earnings per share:				
Weighted-average common shares outstanding		13,921,023		14,076,114
Dilutive effect of nonvested restricted awards[1]		160,611		81,409
Diluted average common shares outstanding		14,081,634		14,157,523
Net earnings available to common stockholders	$	630	$	4,182
Diluted earnings per share	$	0.04	$	0.30
Number of antidilutive options excluded from the diluted earnings per share calculation		1,140,839		1,224,839

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

The above earnings per share calculation did not include a warrant for 815,339 shares of common stock that was outstanding as of March 31, 2014, and March 31, 2013 because they were anti-dilutive. Of note, the warrant was sold at auction by the U.S. Treasury in June, 2013.

Note 11 - Regulatory & Capital Matters

The Bank is subject to the risk-based capital regulatory guidelines, which include the methodology for calculating the risk-weighted Bank assets, developed by the Office of the Comptroller of the Currency (the OCC) and the other bank regulatory agencies. In connection with the current economic environment, the Bank s current level of nonperforming assets and the risk-based capital guidelines, the Bank s board of directors has determined that the Bank should maintain a Tier 1 leverage capital ratio at or above eight percent (8%) and a total risk-based capital ratio at or above twelve percent (12%). The Bank currently exceeds those thresholds.

The Bank exceeded both board of directors capital ratio objectives. At March 31, 2014, the Bank s Tier 1 capital leverage ratio was 11.12%, up 15 basis points from December 31, 2013 and well above the 8.00% objective. The Bank s total capital ratio was 17.83%, down 21 basis points from December 31, 2013, and also well above the 12.00% objective.

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On July 22, 2011, the Company entered into a Written Agreement with the Reserve Bank designed to maintain the financial soundness of the Company. Pursuant to the Written Agreement, the Company took certain actions and operated in compliance with the Written Agreement s provisions during its term. On January 17, 2014, the Reserve Bank terminated the Written Agreement. Although the Written Agreement has been terminated, the Company expects that it will continue to seek approval from the Reserve Bank prior to paying any dividends on its capital stock and incurring any additional indebtedness.

Bank holding companies are required to maintain minimum levels of capital in accordance with Reserve Bank capital guidelines. The general bank and holding company capital adequacy guidelines are shown in the accompanying table, as are the capital ratios of the Company and the Bank, as of March 31, 2014, and December 31, 2013. These ratios are consistent with the ratios disclosed in the most recent filings with the regulatory agencies.

At March 31, 2014, the Company, on a consolidated basis, exceeded the minimum thresholds for adequately capitalized organizations under regulatory definitions. The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies.

Capital levels and industry defined regulatory minimum required levels:

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized 1	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
March 31, 2014						
Total capital to risk weighted assets						
Consolidated	$ 207,702	15.87%	$ 104,702	8.00%	N/A	N/A
Old Second Bank	232,590	17.83	104,359	8.00	130,449	10.00
Tier 1 capital to risk weighted assets						
Consolidated	141,943	10.85	52,329	4.00	N/A	N/A
Old Second Bank	216,180	16.58	52,154	4.00	78,232	6.00
Tier 1 capital to average assets						
Consolidated	141,943	7.29	77,884	4.00	N/A	N/A
Old Second Bank	216,180	11.12	77,763	4.00	97,203	5.00
December 31, 2013						
Total capital to risk weighted assets						
Consolidated	$ 200,139	15.88%	$ 100,826	8.00%	N/A	N/A
Old Second Bank	227,467	18.04	100,872	8.00	126,090	10.00
Tier 1 capital to risk weighted assets						
Consolidated	134,199	10.65	50,403	4.00	N/A	N/A
Old Second Bank	211,568	16.78	50,433	4.00	75,650	6.00
Tier 1 capital to average assets						
Consolidated	134,199	6.96	77,126	4.00	N/A	N/A
Old Second Bank	211,568	10.97	77,144	4.00	96,430	5.00

1 The Bank exceeded the general minimum regulatory requirements to be considered well 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 March 31, 2014, trust preferred proceeds of $52.3 million qualified as Tier 1 regulatory capital and $4.3 million qualified as Tier 2 regulatory capital. As of December 31, 2013, trust preferred proceeds of $51.6 million qualified as

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Tier 1 regulatory capital and $5.0 million qualified as Tier 2 regulatory capital. All of the Series B Stock qualified as Tier 1 regulatory capital as of March 31, 2014, and December 31, 2013. See Note 17 for a discussion of Series B Stock repurchased by the Company on April 28, 2014.

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 discussed in Note 8, as of March 31, 2014, 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 on the debentures for a period of up to 20 consecutive quarters, and elected to begin such a deferral in August 2010. However, all deferred 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 March 31, 2014, was $18.4 million.

On April 21, 2014, the Company paid the accumulated unpaid interest and terminated the deferral period. In order to terminate the deferral period, the Company paid all accumulated and unpaid interest on the trust preferred securities through the next payment date set forth in the indentures, which totaled $19.7 million. The interest will not be immediately paid by the indenture trustees to the securities holders. Instead, the indenture trustees will hold interest payments in irrevocable deposit accounts. The interest will be paid by the trustees on the next applicable payment dates in June, 2014 under the indentures to the holders of the securities on the record dates set forth in the appropriate indentures.

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 Stock. In August 2010, it also began to defer the payment of dividends on such Series B Stock. Therefore, in addition to paying all the accrued and unpaid distributions on the debentures set forth above, the Company must also fully pay all deferred and unpaid dividends on the Series B Stock before it may reinstate the payment of dividends on the common stock. The total amount of deferred and unpaid Series B Stock dividends as of March 31, 2014, was $14.8 million.

On April 15, 2014, the Company declared a dividend of approximately $15.8 million on its Series B Stock to stockholders of record on May 1, 2014, with the dividend to be paid on May 15, 2014.

On April 28, 2014, the Company repurchased 25,669 shares of the Series B Stock from certain holders, which included certain of the Company s directors, at a repurchase price of 94.75% of the per share liquidation value, or $947.50 per share, for a total price of approximately $24.3 million. The Company paid $22.9 million to a large private investor and an additional $1.4 million to Company directors for these purchases. The holders of such shares waived their rights to any dividends on the Series B Stock, and such holders will not receive any part of the declared dividend on the Series B Stock.

Further detail on the subordinated debentures, the Series B Stock and the deferral of interest and dividends thereon is described in Notes 8, 15 and 17.

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 by

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the Company also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Three levels of inputs that may be used to measure fair value are:

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

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

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

Transfers between levels are deemed to have occurred at the end of the reporting period. For the quarters ended March 31, 2014 and 2013 there were no significant transfers between levels.

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

- Government-sponsored agency debt securities are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.

- Other government-sponsored agency securities, MBS, real estate mortgage investment conduits, collateralized mortgage obligations and non-auction rate asset-backed securities are priced using available market information including benchmark yields, prepayment speeds, spreads, volatility of similar securities and trade date.

- State and political subdivisions are largely grouped by characteristics (e.g., geographical data and source of revenue in trade dissemination systems). Because some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities.

- During 2013, asset-backed auction rate securities were acquired and priced using data from dealer market participants until December 31, 2013. At December 31, 2013 to present and including asset-backed auction rate securities acquired in 2014, the Company utilized pricing data from a nationally recognized valuation firm providing specialized securities valuation services. Therefore, the valuation of auction rate asset-backed securities are considered Level 3 valuations.

- 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, e.g. residential mortgage loans with locked interest rates to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors as well as forward commitments for future delivery of MBS are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including prices for MBS from the date of the commitment and do not typically involve significant judgments by management.

- The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount

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rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.

- Interest rate swap positions, both assets and liabilities, are based on valuation pricing models using an income approach reflecting readily observable market parameters such as interest rate yield curves.
- Both the credit valuation reserve on current interest rate swap positions and on receivables related to unwound customer interest rate swap positions were determined based upon management s estimate of the amount of credit risk exposure, including by 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 essentially 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 made in the appraisal process by the appraisers to reflect differences between the available comparable sales and income data. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.
- Nonrecurring adjustments to certain commercial and residential real estate properties classified as OREO are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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

The tables below present the balance of assets and liabilities at March 31, 2014, and December 31, 2013, respectively, as measured by the Company at fair value on a recurring basis:

	March 31, 2014			
	Level 1	Level 2	Level 3	Total
Assets:				
Investment securities available-for-sale				
U.S. Treasury	$ 1,540	$ -	$ -	$ 1,540
U.S. government agencies	-	1,665	-	1,665
States and political subdivisions	-	26,334	125	26,459
Corporate bonds	-	31,272	-	31,272
Collateralized mortgage obligations	-	51,124	-	51,124
Asset-backed securities		129,814	158,338	288,152
Loans held-for-sale	-	2,507	-	2,507
Mortgage servicing rights	-	-	5,614	5,614
Other assets (Interest rate swap agreements net of swap credit valuation)	-	125	(1)	124
Other assets (Mortgage banking derivatives)	-	320	-	320
Total	$ 1,540	$ 243,161	$ 164,076	$ 408,777
Liabilities:				
Other liabilities (Interest rate swap agreements)	$ -	$ 125	$ -	$ 125
Total	$ -	$ 125	$ -	$ 125

	December 31, 2013			
	Level 1	Level 2	Level 3	Total
Assets:				
Investment securities available-for-sale				
U.S. Treasury	$ 1,544	$ -	$ -	$ 1,544
U.S. government agencies	-	1,672	-	1,672
States and political subdivisions	-	16,669	125	16,794
Corporate bonds	-	15,102	-	15,102
Collateralized mortgage obligations	-	63,876	-	63,876
Asset-backed securities		119,066	154,137	273,203
Loans held-for-sale	-	3,822	-	3,822
Mortgage servicing rights	-	-	5,807	5,807
Other assets (Interest rate swap agreements net of swap credit valuation)	-	229	(6)	223
Other assets (Mortgage banking derivatives)	-	315	-	315
Total	$ 1,544	$ 220,751	$ 160,063	$ 382,358
Liabilities:				
Other liabilities (Interest rate swap agreements)	$ -	$ 229	$ -	$ 229
Total	$ -	$ 229	$ -	$ 229

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

	Three months ended March 31, 2014			
	Securities available-for-sale			
	Asset-Backed	States and Political Subdivisons	Mortgage Servicing Rights	Interest Rate Swap Valuation
Beginning balance January 1, 2014	$ 154,137	$ 125	$ 5,807	$ (6)
Transfers into Level 3	-	-	-	-
Total gains or losses				
Included in earnings (or changes in net assets)	226	-	111	5
Included in other comprehensive income	(315)	-	-	-
Purchases, issuances, sales, and settlements				
Purchases	4,290	-	-	-
Issuances	-	-	(304)	-
Ending balance March 31, 2014	$ 158,338	$ 125	$ 5,614	$ (1)

	Three months ended March 31, 2013				
	Securities available-for-sale				
	Collateralized Debt Obligations	Asset-Backed	States and Political Subdivisons	Mortgage Servicing Rights	Interest Rate Swap Valuation
Beginning balance January 1, 2013	$ 9,957	$ -	$ 132	$ 4,116	$ (47)
Transfers into Level 3	-	106,028	-	-	-
Transfers out of Level 3	-		-	-	-
Total gains or losses					
Included in earnings (or changes in net assets)	42	-	-	(106)	14
Included in other comprehensive income	692	-	-	-	-
Purchases, issuances, sales, and settlements					
Issuances	-	-	-	459	-
Settlements	(64)	-	-	-	-
Ending balance March 31, 2013	$ 10,627	$ 106,028	$ 132	$ 4,469	$ (33)

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The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of March 31, 2014:

Measured at fair value on a recurring basis:	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Input	Weighted Average of Inputs
Mortgage Servicing rights	5,614	Discounted Cash Flow	Discount Rate	9.8-12.0%	10.2%
			Prepayment Speed	3.7-36.34%	10.3%
Interest Rate Swap Valuation	(1)	Management estimate of credit risk exposure	Probability of Default	5.0-20.0%	12.6%
Asset-backed securities	158,338	Discounted Cash Flow with comparable transaction yields	Credit Risk Premium	0.9%-1.2%	1.1%
			Liquidity Discount	4.1-4.7%	4.5%

The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of December 31, 2013:

Measured at fair value on a recurring basis:	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Input	Weighted Average of Inputs
Mortgage Servicing rights	$ 5,807	Discounted Cash Flow	Discount Rate	10.2%	10.2%
			Prepayment Speed	9.7%	9.7%
Interest Rate Swap Valuation	(6)	Management estimate of credit risk exposure	Probability of Default	5.0-20.0%	12.5%
Asset-backed securities	154,137	Discounted Cash Flow with comparable transaction yields	Credit Risk Premium	1.1-1.5%	1.2%
			Liquidity Discount	4.5-5.1%	4.9%

The $125,000 on the States and political subdivisions line at March 31, 2014, represents a security from a small, local municipality. This is categorized as a Level 3 security based on the payment stream received by the Company from the municipality. That payment stream is otherwise an unobservable input.

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

The Company may be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with GAAP. These assets consist of impaired loans and OREO. For assets measured at fair value on a nonrecurring basis on hand at March 31, 2014, and December 31, 2013, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

	March 31, 2014			
	Level 1	Level 2	Level 3	Total
Impaired loans[1]	$ -	$ -	$ 3,375	$ 3,375
Other real estate owned, net[2]	-	-	40,220	40,220
Total	$ -	$ -	$ 43,595	$ 43,595

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, had a carrying amount of $4.6

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million, with a valuation allowance of $1.2 million, resulting in a decrease of specific allocations within the provision for loan losses of $1.1 million for the quarter ending March 31, 2014. The carrying value of loans fully charged off is zero.

2 OREO is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of $40.2 million, which is made up of the outstanding balance of $61.5 million, net of a valuation allowance of $19.5 million and participations of $1.8 million, at March 31, 2014, resulting in a charge to expense of $436,000 for the quarter ended March 31, 2014.

	December 31, 2013							
	Level 1		Level 2		Level 3		Total	
Impaired loans[1]	$	-	$	-	$	9,103	$	9,103
Other real estate owned, net[2]		-		-		41,537		41,537
Total	$	-	$	-	$	50,640	$	50,640

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, had a carrying amount of $11.5 million, with a valuation allowance of $2.4 million, resulting in a decrease of specific allocations within the provision for loan losses of $3.9 million for the year ending December 31, 2013. The carrying value of loans fully charged-off is zero.

2 OREO is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of $41.5 million, which is made up of the outstanding balance of $65.9 million, net of a valuation allowance of $22.3 million and participations of $2.1 million, at December 31, 2013, resulting in a charge to expense of $8.3 million for the year ended December 31, 2013.

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

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 credit exposure for loan commitments and letters of credit is 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 not designated as hedging instruments. These derivative positions relate to transactions in which the Bank enters into an interest rate swap agreement with a client while at the same time entering into an offsetting

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interest rate swap with another financial institution. Due to financial covenant violations relating to nonperforming loans, the Bank had $3.1 million in investment securities pledged to support interest rate swap activity with three correspondent financial institutions at March 31, 2014 and December 31, 2013. In connection with each transaction, the Bank agreed 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 agreed 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 convert a variable rate loan to a fixed rate loan and is 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 derivative contracts offset each other and do not generally affect 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 March 31, 2014, the notional amount of non-hedging interest rate swaps was $41.7 million with a weighted average maturity of 1.5 years. At December 31, 2013, the notional amount of non-hedging interest rate swaps was $51.9 million with a weighted average maturity of 1.5 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 with 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 mortgage-backed securities contracts are considered derivative instruments and changes in the fair value are recorded to mortgage banking revenue. 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 March 31, 2014, and periodic changes in the values of the interest rate swaps are reported in other noninterest income. Periodic changes in the value of the forward contracts related to mortgage loan origination are reported in the net gain on sales of mortgage loans.

		Asset Derivatives		Liability Derivatives	
	Notional or Contractual Amount	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate swap contracts net of credit valuation	$ 41,707	Other Assets	$ 124	Other Liabilities	$ 125
Commitments[1]	218,172	Other Assets	320	N/A	-
Forward contracts[2]	13,000	N/A	-	Other Liabilities	-
Total			$ 444		$ 125

[1]Includes unused loan commitments and interest rate lock commitments.

[2]Includes forward MBS contracts and forward loan contracts.

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The following table presents derivatives not designated as hedging instruments as of December 31, 2013.

	Notional or Contractual Amount	Asset Derivatives Balance Sheet Location	Asset Derivatives Fair Value	Liability Derivatives Balance Sheet Location	Liability Derivatives Fair Value
Interest rate swap contracts net of credit valuation	$ 51,877	Other Assets	$ 223	Other Liabilities	$ 229
Commitments[1]	206,965	Other Assets	315	N/A	-
Forward contracts[2]	11,500	N/A	-	Other Liabilities	-
Total			$ 538		$ 229

[1]Includes unused loan commitments and interest rate lock commitments.

[2]Includes forward MBS 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 are essentially the same as that involved in extending loan commitments to our customers.

In addition to customer related commitments, the Company is responsible for letters of credit commitments that relate to properties held in OREO. The following table represents the Company s contractual commitments due to letters of credit as of March 31, 2014, and December 31, 2013.

The following table is a summary of financial instrument commitments (in thousands):

	March 31, 2014			December 31, 2013		
	Fixed	Variable	Total	Fixed	Variable	Total
Letters of credit:						
Borrower:						
Financial standby	$ 5	$ 4,314	$ 4,319	$ 10	$ 3,886	$ 3,896
Commercial standby	-	49	49	-	51	51
Performance standby	416	6,058	6,474	1,580	2,723	4,303
	421	10,421	10,842	1,590	6,660	8,250
Nonborrower:						
Performance standby	-	622	622	-	867	867
	-	622	622	-	867	867

Total letters of credit	$	421	$	11,043	$	11,464	$	1,590	$	7,527	$	9,117

Note 14 Fair Values of Financial Instruments

The estimated fair values of financial instruments 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 carrying value of FHLBC stock approximates fair value as the stock is nonmarketable and can only be sold to the FHLBC or another member institution at par. During the years ended December 31, 2013, and 2012, the Company participated in multiple redemptions with the FHLBC and using the redemption

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values as the carrying value, FHLBC stock was transferred to a Level 2 fair value as of December 31, 2012. The Company had no redemptions in the first quarter of 2014. 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 volume is not considered material.

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

	March 31, 2014				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and due from banks	$ 40,245	$ 40,245	$ 40,245	$ -	$ -
Interest bearing deposits with financial institutions	14,242	14,242	14,242	-	-
Securities available-for-sale	400,212	400,212	1,540	240,209	158,463
Securities held-to-maturity	264,298	264,250		264,250	
FHLBC and FRB Stock	10,292	10,292	-	10,292	-
Bank-owned life insurance	55,768	55,768	-	55,768	-
Loans held for sale	2,507	2,507	-	2,507	-
Loans, net	1,085,761	1,085,205	-		1,085,205
Accrued interest receivable	4,536	4,536	-	4,536	-
Financial liabilities:					
Noninterest bearing deposits	$ 387,090	$ 387,090	$ 387,090	$ -	$ -
Interest bearing deposits	1,337,191	1,338,614	-	1,338,614	-
Securities sold under repurchase agreements	23,212	23,212	-	23,212	-
Other short-term borrowings	20,000	20,000	-	20,000	-
Junior subordinated debentures	58,378	70,185	41,635	28,550	-
Subordinated debenture	45,000	40,512	-	40,512	-
Note payable and other borrowings	500	431	-	431	-
Borrowing interest payable	18,425	18,425	10,955	7,470	-
Deposit interest payable	698	698	-	698	-

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	December 31, 2013				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and due from banks	$ 33,210	$ 33,210	$ 33,210	$ -	$ -
Interest bearing deposits with financial institutions	14,450	14,450	14,450	-	-
Securities available-for-sale	372,191	372,191	1,544	216,385	154,262
Securities held-to-maturity	256,571	254,328		254,328	
FHLBC and FRB Stock	10,292	10,292	-	10,292	-
Bank-owned life insurance	55,410	55,410	-	55,410	-
Loans held for sale	3,822	3,822	-	3,822	-
Loans, net	1,073,975	1,072,837	-	-	1,072,837
Accrued interest receivable	4,248	4,248	-	4,248	-
Financial liabilities:					
Noninterest bearing deposits	$ 373,389	$ 373,389	$ 373,389	$ -	$ -
Interest bearing deposits	1,308,739	1,312,476	-	1,312,476	-
Securities sold under repurchase agreements	22,560	22,560	-	22,560	-
Other short-term borrowings	5,000	5,000	-	5,000	
Junior subordinated debentures	58,378	67,053	39,777	27,276	-
Subordinated debenture	45,000	39,896	-	39,896	-
Note payable and other borrowings	500	423	-	423	-
Borrowing interest payable	17,037	17,037	10,122	6,915	-
Deposit interest payable	762	762	-	762	-

Note 15 Preferred Stock

The Company s Series B Stock was issued to Treasury as part of the Treasury s Troubled Asset Relief Program and Capital Purchase Program (the CPP). The Series B 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 effective in February 2014. Concurrent with issuing the Series B 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 Company allocated the proceeds between the Series B Stock and warrants that were issued. The Company recorded the warrant 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 Series B Stock and the warrant as part of the allocation process in the amounts of $68.2 million and $4.8 million, respectively.

As discussed in Note 11, on August 31, 2010, the Company announced that it would begin deferring quarterly cash dividends on its outstanding Series B Stock. Further, as discussed in Note 8 and Note 11, the Company also elected to defer interest payments on certain of its subordinated debentures. However, under the terms of the Series B Stock, if the Company fails to pay dividends for an aggregate of six quarters on the Series B Stock, whether or not consecutive, the holders have the right to appoint representatives to the Company s board of directors. As the Company elected to defer dividends for more than six quarters, a new director was appointed by the Treasury to join the board during the fourth quarter of 2012. The terms of the Series B Stock also prevent the Company from paying cash dividends or generally repurchasing its common stock while Series B Stock dividends are in arrears. The total amount of unpaid and deferred Series B Stock dividends as of March 31, 2014, was $14.8 million.

The Treasury sold all of the Series B Stock held to third parties, including certain of our directors, in auctions that were completed in the first quarter of 2013. The Treasury also sold the warrant to a third

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party at a subsequent auction. Upon completion by Treasury of the auction, the Company s board affirmed the director appointed by Treasury to ongoing board membership, and the Series B director was elected by the holders of the Series B Stock at the Company s 2013 annual meeting. At March 31, 2014, the Company carried $73.0 million of Series B Stock in total stockholders equity. At December 31, 2013, the Company carried $72.9 million of Series B Stock in total stockholders equity.

As a result of the completed auctions, the Company s Board elected to stop accruing the dividend on the Series B Stock in the first quarter 2013. Previously, the Company had accrued the dividend on the Series B Stock quarterly throughout the deferral period. Given the discount reflected in the results of the auction, the board believed that the Company would be able to repurchase the Series B Stock in the future at a price less than the face amount of the Series B Stock and the accrued and unpaid dividends. Therefore, the Company did not fully accrue the dividend on the Series B Stock in the first quarter and did not accrue for it in subsequent quarters. The Company has continued to evaluate whether accruing dividends on the remaining Series B Stock is appropriate. The Company currently intends to declare and pay future dividends on these shares.

On April 28, 2014, the Company repurchased Series B Stock at an agreed upon price reached in private negotiations. Payments of $24.3 million resulted in repurchase of 25,669 shares of Series B Stock. See Note 17 for additional information.

Note 16 Income Taxes

Income tax expense for year to date March 31, 2014 and March 31, 2013 was as follows:

	March 31, 2014	March 31, 2013
Current federal	$ 23	$ -
Current state	7	-
Deferred federal	889	1,500
Deferred state	279	328
Change in valuation allowance	-	(1,828)
	$ 1,198	$ -

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The following were the components of the deferred tax assets and liabilities as of March 31, 2014 and December 31, 2013:

	March 31, 2014	December 31, 2013
Allowance for loan losses	$ 11,527	$ 12,725
Deferred compensation	792	788
Amortization of core deposit intangible assets	1,822	1,656
Goodwill amortization/impairment	14,859	15,252
Stock option expense	589	583
OREO write downs	9,062	10,041
Federal net operating loss (NOL) carryforward	29,272	28,023
State net operating loss (NOL) carryforward	12,146	11,847
Deferred tax credit	1,444	1,444
Other assets	560	1,166
Total deferred tax assets	82,073	83,525
Accumulated depreciation on premises and equipment	(938)	(1,035)
Accretion on securities	(8)	(8)
Mortgage servicing rights	(2,485)	(2,571)
State tax benefits	(6,896)	(6,994)
Other liabilities	(175)	(178)
Total deferred tax liabilities	(10,502)	(10,786)
Net deferred tax asset before valuation allowance	71,571	72,739
Tax effect on net unrealized losses on securities	5,245	4,927
Valuation allowance	(2,363)	(2,363)
Net deferred tax asset	$ 74,453	$ 75,303

At March 31, 2014, the Company had $83.6 million federal net operating loss carryforward of which, $25.3 million expires in 2030, $31.4 million expires in 2031, $8.6 million expires in 2032, $14.7 million expires in 2033, and $3.6 million expires in 2034. The Company had $127.9 million state net operating loss carryforward of which, $29.4 million expires in 2021, $95.3 million expires in 2025, and $3.2 million expires in 2026. In addition, the Company had a $1.4 million alternative minimum tax credit subject to indefinite carryforward.

The components of the provision for deferred income tax expense were as follows:

	March 31, 2014	March 31, 2013
Allowance for loan losses	$ 1,198	$ 823
Deferred Compensation	(4)	(13)
Amortization of core deposit intangible assets	(166)	(172)
Stock option expense	(6)	226
OREO write downs	979	2,873
Federal net operating loss carryforward	(1,249)	(1,829)
State net operating loss carryforward	(299)	(551)
Depreciation	(97)	14
Net premiums and discounts on securities	-	20
Mortgage servicing rights	(86)	156
Goodwill amortization/impairment	393	392
State tax benefits	(98)	(115)
Change in valuation allowance	-	(1,828)
Other, net	603	4

Total deferred tax expense	$	1,168	$	-

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Effective tax rates differ from federal statutory rates applied to financial statement loss due to the following:

	March 31, 2014		March 31, 2013	
Tax at statutory federal income tax rate	$	1,190	$	1,915
Nontaxable interest income, net of disallowed interest deduction		(67)		(51)
BOLI income		(125)		(143)
State income taxes, net of federal benefit		186		291
General business credit		-		(15)
Change in valuation allowance		-		(1,828)
Deficiency from restricted stock		-		76
Other, net		14		(245)
Tax at effective tax rate	$	1,198	$	-

Note 17 Subsequent Events

In April 2014, the Company received net proceeds of over $64.0 million from a public offering of 15,525,000 shares of its common stock. As previously disclosed, the Company used the proceeds in part to pay approximately $19.7 million in accrued but unpaid interest on its subordinated debentures and has approved$15.8 million to pay the accumulated but unpaid dividend on the Series B Stock. The Company also used approximately $24.3 million of the proceeds to repurchase 25,669 shares of its Series B Stock from certain holders, which included certain of the Company s directors. The remaining proceeds will be used for general corporate purposes. As a result of the repurchase of the Series B Stock, the Company will record an income statement benefit. This benefit will be reflected in the Company s second quarter consolidated statements of operations.

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

Overview

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 March 31, 2014, as compared to December 31, 2013, and the results of operations for the three months ended March 31, 2014, and 2013. This discussion and analysis is most comprehensively read in conjunction with our consolidated financial statements as well as the financial and statistical data appearing elsewhere in this report and our 2013 Form 10-K.

In the markets where the Company primarily operates, economies continued to recover in an uneven fashion. The economies in these markets continued to show gradual improvement in the first quarter of 2014 as did the national financial infrastructure. Real estate markets in the Company s market areas are well short of robust and continue to pressure borrower financial strength. This has resulted in still elevated, but improved and improving levels of nonperforming loans and other real estate owned. Management remains vigilant in analyzing loan portfolio quality and making decisions to charge-off loans. To that end, the Company recognized improved asset quality by recording a $1.0 million loan loss reserve release in the quarter with net income of $2.2 million prior to Series B Stock dividends in the period. This compared to a $2.5 million loan loss reserve release and a net income of $5.5 million prior to Series B Stock dividends for the same period in 2013. The $1.0 million loan loss reserve release for the period was appropriate in light of ongoing improvements in loan portfolio quality.

Net income of $3.4 million (before taxes) in the first quarter of 2014 compares to $5.5 million for the first quarter of 2013. In addition to the larger loan loss reserve release in first quarter 2013, last year s quarter included stronger net interest income and significantly stronger residential mortgage banking revenue as well as $1.5 million in securities gains compared to nominal securities losses in the 2014 first quarter.

In April, 2014 the Company concluded a successful capital raise issuing 15,525,000 common shares with net proceeds in excess of $64.0 million. To date proceeds have been used to pay $19.7 million accrued but previously unpaid interest on trust preferred securities and to repurchase certain shares of Series B Stock. On April 28, 2014 the Company repurchased Series B Stock at an agreed upon price reached in private negotiations. Payments of $22.9 million were made to a large private investor with other payments totaling $1.4 million made to directors of the Company. See Note 17 for additional information. In May, 2014 the Company will apply proceeds to pay the accumulated but unpaid dividends on Series B Stock. Any remaining proceeds will be used for general corporate purposes including payment for various services required during the offering.

Results of Operations

Earnings per share for the first quarter of 2014 was $.04 per diluted share on $2.2 million of net income. This compares to $.30 per diluted share, on net income of $5.5 million for the first quarter of 2013. The net income available to common stockholders was $630,000 for the first quarter of 2014 after preferred stock dividends and accretion of $1.6 million. The first quarter 2014 preferred stock dividend incorporates an increase in the dividend rate from 5% to 9% in February 2014. First quarter 2013 net income available to common stockholders was $4.2

million for the first quarter of 2013 after Series B Stock dividends and accretion of $1.3 million.

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Net Interest Income

Net interest and dividend income decreased $307,000, from $13.9 million for the quarter ended March 31, 2013, to $13.6 million for the quarter ended March 31, 2014. Average earning assets decreased $6.6 million, or 0.4%, from a total of $1.78 billion in the first quarter of 2013. Management continued to emphasize asset quality. New loan originations while improved continued to be limited, business leader confidence remained moderate and the competitive landscape was intense in our markets. Average loans, including loans held for sale, decreased $37.3 million from the first quarter of 2013 to the first quarter of 2014. On a linked quarter basis, average loan volume, including loans held for sale, increased $31.2 million reversing a 2013 trend of declining volume of this metric.

Management continues to develop loan pipelines and expects that pipeline volume will generate future loan growth. As loan volume continues measured but slow paced growth, management increased total securities in the first quarter of 2014 to 32.3% of total assets up from 31.4% at the end of 2013 to utilize available liquid funds.

The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, decreased from 3.18% in the first quarter of 2013 to 3.13% in the first quarter of 2014. The average tax-equivalent yield on earning assets decreased from 3.94% in the first quarter of 2013 to 3.79% in the first quarter of 2014. For the same comparative period, the cost of funds on interest bearing liabilities decreased from 0.95% to 0.86% providing some offset to the decrease in earning asset yield.

The growth of lower yielding securities (average balance up again in the first quarter period on a linked quarter basis continuing a 2013 trend of increasing volume of this metric) and reductions in higher yielding loans were the main causes of decreased net interest income. Period loan yields are reflective of competitive pressures on new loan yield. Additionally, management continued to see pressure to reduce interest rates on loans retained at renewal and found it necessary to accept rate concessions to keep the business.

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-month periods ended March 31, 2014, and 2013.

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 the disclosed 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 March 31, 2014, and 2013

(Dollar amounts in thousands - unaudited)

	2014			2013		
	Average Balance	Interest	Rate	Average Balance	Interest	Rate
Assets						
Interest bearing deposits	$ 23,775	$ 15	0.25%	$ 68,995	$ 42	0.24%
Securities:						
Taxable	616,433	3,502	2.27	548,231	2,298	1.68
Non-taxable (tax equivalent)	18,561	228	4.91	10,002	183	7.32
Total securities	634,994	3,730	2.35	558,233	2,481	1.78
Dividends from FRB and FHLB stock	10,292	76	2.95	11,202	76	2.71
Loans and loans held-for-sale [1]	1,106,409	12,988	4.70	1,143,666	14,971	5.24
Total interest earning assets	1,775,470	16,809	3.79	1,782,096	17,570	3.94
Cash and due from banks	29,901	-	-	29,913	-	-
Allowance for loan losses	(27,102)	-	-	(38,994)	-	-
Other noninterest bearing assets	236,356	-	-	203,417	-	-
Total assets	$ 2,014,625			$ 1,976,432		
Liabilities and Stockholders Equity						
NOW accounts	$ 303,553	$ 64	0.09%	$ 291,051	$ 64	0.09%
Money market accounts	314,803	94	0.12	329,377	123	0.15
Savings accounts	234,353	41	0.07	221,889	41	0.07
Time deposits	468,138	1,321	1.14	505,685	1,853	1.49
Interest bearing deposits	1,320,847	1,520	0.47	1,348,002	2,081	0.63
Securities sold under repurchase agreements	24,539	1	0.02	20,264	1	0.02
Other short-term borrowings	4,111	1	0.10	43,833	19	0.17
Junior subordinated debentures	58,378	1,387	9.50	58,378	1,287	8.82
Subordinated debt	45,000	196	1.74	45,000	196	1.74
Notes payable and other borrowings	500	4	3.20	500	4	3.20
Total interest bearing liabilities	1,453,375	3,109	0.86	1,515,977	3,588	0.95
Noninterest bearing deposits	373,711	-	-	353,476	-	-
Other liabilities	38,966	-	-	33,585	-	-
Stockholders equity	148,573	-	-	73,394	-	-
Total liabilities and stockholders equity	$ 2,014,625			$ 1,976,432		
Net interest income (tax equivalent)		$ 13,700			$ 13,982	
Net interest income (tax equivalent) to total earning assets			3.13%			3.18%
Interest bearing liabilities to earning assets	81.86%			85.07%		

1. Interest income from loans is shown on a TE basis as discussed below and includes fees of $550,000 and $671,000 for the first quarter of 2014 and 2013, respectively. Nonaccrual loans are included in the above-stated average balances.

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As indicated previously, the Company adjusts net interest income and net interest income to earning assets to a non-GAAP TE basis using a marginal rate of 35% to more appropriately compare returns on TE 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 Three Months Ended March 31,			
		2014		2013
Interest income (GAAP)	$	16,704	$	17,490
Taxable equivalent adjustment - loans		25		16
Taxable equivalent adjustment - securities		80		64
Interest income (TE)		16,809		17,570
Less: interest expense (GAAP)		3,109		3,588
Net interest income (TE)	$	13,700	$	13,982
Net interest and income (GAAP)	$	13,595	$	13,902
Average interest earning assets	$	1,775,470	$	1,782,096
Net interest income to total interest earning assets		3.11%		3.16%
Net interest income to total interest earning assets (TE)		3.13%		3.18%

Provision for Loan Losses / Loan Loss Reserve Release

The Company s $1.0 million loan loss reserve release in the first quarter of 2014 compares to a $2.5 million reserve release in the first quarter of 2013. The provision for loan loss creates a reserve for probable and estimable losses inherent in the loan portfolio. Reserve releases reflect management s measured decision that probable and estimable losses have been reduced. On a quarterly basis, management estimates the amount required and records the appropriate provision or release to maintain an adequate reserve for these potential and estimated loan losses. The $1.0 million loan loss reserve release in the first quarter of 2014 continues a 2013 trend of quarterly reserve releases. In each quarter of 2013, management concluded that quarterly releases were justified with quarterly amounts ranging from $1.8 million to $2.5 million.

Nonperforming loans decreased to $38.6 million at March 31, 2014 from $39.8 million at December 31, 2013. Net charge-offs totaled $805,000 in first quarter 2014 while net recoveries totaled $2.5 million for the first quarter of 2013. The distribution of the Company s remaining nonperforming loans are included in the following table.

	Nonperforming Loans as of			March 31, 2014 Dollar change From	
(in thousands)	**March 31, 2014**	**December 31, 2013**	**March 31, 2013**	**December 31, 2013**	**March 31, 2013**

[redacted]

[redacted]

Nonperforming loans consist of nonaccrual loans, nonperforming restructured accruing loans and loans 90 days or greater past due. The only increase of significance in nonperforming loans since

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December 31, 2013 was in the real estate commercial, nonfarm segment as migration of loans to nonaccrual were in excess of upgrades and migration to OREO. Remediation work continues in all segments. Importantly, new migration to nonaccrual continues to be minimal.

Loan Charge-offs, net of recoveries (in thousands)	**Three Months Ended March 31, 2014**	**December 31, 2013**	**March 31, 2013**
Real estate-construction			
Homebuilder	$ (35)	$ -	$ 3
Land	1	(1)	(1)
Commercial speculative	-	62	(767)
All other	65	1	(1)
Total real estate-construction	31	62	(766)
Real estate-residential			
Investor	92	547	(149)
Owner occupied	8	(15)	(19)
Revolving and junior liens	499	139	349
Total real estate-residential	599	671	181
Real estate-commercial, nonfarm			
Owner general purpose	-	-	(19)
Owner special purpose	259	(3)	117
Non-owner general purpose	18	(1,258)	(317)
Non-owner special purpose	-	-	(824)
Retail properties	(89)	296	(1,173)
Total real estate-commercial, nonfarm	188	(965)	(2,216)
Real estate-commercial, farm	-	-	-
Commercial	(11)	(7)	235
Other	(2)	5	29
	$ 805	$ (234)	$ (2,537)

Charge-offs for the first quarter 2014 were, in many instances, from previously established specific reserves on nonaccrual loans deemed uncollectible. Gross charge-offs for the first quarter of 2014 were $1.4 million compared to $1.5 million for the first quarter of 2013 and $1.9 million for the fourth quarter of 2013 reflecting our efforts to improve loan quality in better but still challenging markets. Recoveries were $555,000, $4.1 million and $2.1 million for the same time periods, respectively.

		Classified loans as of		**March 31, 2013 Dollar Change From**	
(in thousands)	**March 31, 2014**	**December 31, 2013**	**March 31, 2013**	**December 31, 2013**	**March 31, 2013**
Real estate-construction	$ 6,430	$ 3,024	$ 12,656	$ 3,406	$ (6,226)
Real estate-residential:					
Investor	7,674	9,750	8,913	(2,076)	(1,239)
Owner occupied	6,847	7,699	10,463	(852)	(3,616)
Revolving and junior liens	3,645	3,971	5,722	(326)	(2,077)
Real estate-commercial, nonfarm	27,633	37,297	61,442	(9,664)	(33,809)
Real estate-commercial, farm	-	-	2,417	-	(2,417)
Commercial	455	481	747	(26)	(292)
Other	-	1	1	(1)	(1)
	$ 52,684	$ 62,223	$ 102,361	$ (9,539)	$ (49,677)

Classified loans include nonaccrual, performing troubled debt restructurings and all other loans considered substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor, or by the collateral pledged to secure the loan, if any. These loans have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt and carry the distinct possibility that the Company will sustain some loss if deficiencies remain uncorrected.

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Classified assets include both classified loans and OREO. Management monitors a ratio of classified assets to the sum of Bank Tier 1 capital and the allowance for loan and lease loss reserve as another measure of overall change in loan related asset quality. With the decline in both classified loans and OREO in the first quarter, this ratio improved to 38.44% at March 31, 2014, down from 43.44% at December 31, 2013.

Allowance for Loan and Lease Losses

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

	Three Months Ending		
	March 31, 2014	December 31, 2013	March 31, 2013
Allowance at beginning of quarter	$ 27,281	$ 29,547	$ 38,597
Charge-offs:			
Commercial	4	8	254
Real estate - commercial	329	608	508
Real estate - construction	68	63	4
Real estate - residential	849	1,100	585
Consumer and other loans	110	123	172
Total charge-offs	1,360	1,902	1,523
Recoveries:			
Commercial	15	15	19
Real estate - commercial	141	1,573	2,724
Real estate - construction	37	1	770
Real estate - residential	250	429	404
Consumer and other loans	112	118	143
Total recoveries	555	2,136	4,060
Net charge-offs (recoveries)	805	(234)	(2,537)
Loan loss reserve release	(1,000)	(2,500)	(2,500)
Allowance at end of period	$ 25,476	$ 27,281	$ 38,634
Average total loans (exclusive of loans held-for-sale)	$ 1,104,065	$ 1,072,320	$ 1,138,579
Net charge-offs to average loans	0.07%	-0.02%	-0.22%
Allowance at period end to average loans	2.31%	2.54%	3.39%
Ending balance: Individually evaluated for impairment	$ 1,247	$ 2,395	$ 5,038
Ending balance: Collectively evaluated for impairment	$ 24,229	$ 24,886	$ 33,596

The coverage ratio of the allowance for loan losses to nonperforming loans was 66.0% as of March 31, 2014, which reflects a slight decrease from 68.6% as of December 31, 2013. Management updated the estimated specific allocations in the first quarter after receiving more recent appraisals for detailed collateral valuations or information on cash flow trends related to the impaired credits. This update resulted in a lower amount required in the reserve for estimable losses on these credits at the end of the first quarter 2014 compared to year end 2013. The estimated general allocation was essentially unchanged from December 31, 2013, as the overall credit condition of our loan portfolio adjusted for environmental factors remained relatively stable during the quarter. The third component of the Company s loan loss reserve analysis showed lower required reserves, most notably in the pooled commercial real estate category. Management determined that the dollar amount of loans in this component was markedly lower at period end first quarter 2014 compared to year end 2013. In summary, after careful and detailed review, management determined an appropriate amount to release from the allowance for loan losses. Factors considered include loan growth or contraction, the quality and composition of the loan portfolio and loan loss experience.

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. Management also reviewed and evaluated several environmental factors. These

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factors are evaluated on an ongoing basis and are included in the assessment of the adequacy of the allowance for loan losses.

After a review of the adequacy of the loan loss reserve at March 31, 2014, management concluded that a $1.0 million reserve release was justified. When measured as a percentage of loans outstanding, the total allowance for loan losses decreased slightly from 2.5% of total loans as of December 31, 2013 to 2.3% of total loans at March 31, 2014. In management s judgment, an adequate, measured and entirely appropriate allowance for estimated losses has been established for inherent losses at March 31, 2014; however, there can be no assurance that actual losses will not exceed the estimated amounts in the future.

Other Real Estate Owned

OREO decreased modestly by $1.3 million from $41.5 million at December 31, 2013, to $40.2 million at March 31, 2014. Disposition activity and valuation writedowns in the first quarter exceeded additions to OREO as shown below. As a result, holdings in lots suitable for development and commercial property decreased in the quarter. The dollar value of vacant land was unchanged at end of the first quarter. Overall, a net gain on sale of $386,000 was realized in the first quarter. Lower total OREO (down from $65.7 million at March 31, 2013) has resulted in reduced expenses to carry and operate remaining properties.

		Three Months Ended	
(in thousands)	**March 31, 2014**	**December 31, 2013**	**March 31, 2013**
Beginning balance	$ 41,537	$ 49,066	$ 72,423
Property additions	4,688	4,998	6,985
Development improvements	-	13	50
Less:			
Property disposals	5,569	10,784	11,661
Period valuation adjustments	436	1,756	2,134
Other real estate owned	$		