OLD SECOND BANCORP INC
Form 10-Q
May 08, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2018

OR

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

For transition period from to

Commission File Number 0 -10537

(Exact name of Registrant as specified in its charter)

Delaware	36-3143493
(State or other jurisdiction	(I.R.S. Employer Identification Number)

of incorporation or organization)

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices) (Zip Code)

(630) 892-0202

(Registrant's telephone number, including area code)

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

Yes No

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, smaller reporting company, or an emerging growth company. See the definitions of ''large accelerated filer,'' ''accelerated filer,'' ''smaller reporting company,'' and ''emerging growth company'' in Rule 12b–2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company Emerging growth company

(Do not check if a smaller reporting company)

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

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

Yes No

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

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OLD SECOND BANCORP, INC.

Form 10-Q Quarterly Report

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

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

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

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

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

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

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

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

See accompanying notes to consolidated financial statements.

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Income

(In thousands, except per share data)

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

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

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(In thousands)

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

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In thousands)

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

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

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

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

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Changes in

Stockholders' Equity

(In thousands)

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

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

Note 1 – Summary of Significant Accounting Policies

The accounting policies followed in the preparation of the interim consolidated financial statements are consistent with those used in the preparation of the annual financial information. The interim consolidated financial statements reflect all normal and recurring adjustments that are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended March 31, 2018, are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. These interim consolidated financial statements are unaudited and should be read in conjunction with the audited financial statements and notes included in Old Second Bancorp, Inc.'s (the "Company") annual report on Form 10-K for the year ended December 31, 2017. Unless otherwise indicated, amounts in the tables contained in the notes to the consolidated financial statements are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

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

All significant accounting policies are presented in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the consolidated financial statements and how those values are determined.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09 "Revenue from Contracts with Customers (Topic 606)." The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. In August 2015, the FASB issued ASU 2015-14 “Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date.” This accounting standard update deferred the effective date of ASU 2014-09 for an additional year. ASU 2015-14 was effective for annual reporting periods beginning after December 15, 2017. The amendments could be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. Early application was not permitted. In March 2016, the FASB issued ASU 2016-08 “Revenue from Contracts with Customers (TOPIC 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)” and in April 2016, the FASB issued ASU 2016-10 “Revenue from Contracts with Customers (TOPIC 606): Identifying Performance Obligations and Licensing.” ASU 2016-08 requires the entity to determine if it is acting as a principal with control over the goods or services it is contractually obligated to provide, or an agent with no control over specified goods or services provided by another party to a customer. ASU 2016-10 was issued to further clarify ASU 2014-09 implementation regarding identifying performance obligation materiality, identification of key contract components, and scope.

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

In January 2016, the FASB issued ASU No. 2016-01 “Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.” The objective of the issuance is to provide users of financial statements with more decision–useful information, by making targeted improvements to GAAP. These targeted improvements included revisions to the methodology of accounting for equity investments, eliminating certain disclosures on fair value assumptions for financial instruments measured at amortized cost, and requiring public business entities to use the exit price notion, as defined in ASC 820, for the measurement of the fair value of financial instruments. This standard was effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted this standard as of January 1, 2018. Adoption of this standard resulted in the Company's use of an exit price rather than an entrance price to determine the fair value of loans and deposits not already measured at fair value on a non-recurring basis in the consolidated balance sheet disclosures; see Note 14–Fair Value of Financial Instruments for further information regarding the valuation processes.

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

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

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

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

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

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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

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

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

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

Subsequent Events

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

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

Note 2 – Acquisitions

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

Note 3 – Securities

Investment Portfolio Management

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

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

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

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

March 31, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale				
U.S. Treasuries	$ 4,003	$ -	$ (108)	$ 3,895
U.S. government agencies	12,788	-	(58)	12,730
U.S. government agencies mortgage-backed	14,331	-	(487)	13,844
States and political subdivisions	287,825	2,046	(4,331)	285,540
Corporate bonds	685	23	(5)	703
Collateralized mortgage obligations	65,561	71	(1,888)	63,744
Asset-backed securities	111,493	1,264	(1,887)	110,870
Collateralized loan obligations	59,305	334	(23)	59,616
Total securities available-for-sale	$ 555,991	$ 3,738	$ (8,787)	$ 550,942

December 31, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale				
U.S. Treasury	$ 4,002	$ -	$ (55)	$ 3,947
U.S. government agencies	13,062	8	(9)	13,061
U.S. government agencies mortgage-backed	12,372	7	(165)	12,214
States and political subdivisions	272,240	7,116	(1,264)	278,092
Corporate bonds	823	21	(11)	833
Collateralized mortgage obligations	66,892	202	(1,155)	65,939
Asset-backed securities	113,983	862	(1,913)	112,932
Collateralized loan obligations	54,271	251	(101)	54,421
Total securities available-for-sale	$ 537,645	$ 8,467	$ (4,673)	$ 541,439

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

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

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

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

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

Securities with unrealized losses at March 31, 2018, and December 31, 2017, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands except for number of securities):

rch 31, 2018	Less than 12 months in an unrealized loss position			12 months or more in an unrealized loss position			Total		
	Number of	Unrealized	Fair	Number of	Unrealized	Fair	Number of	Unrealized	Fair
curities ilable-for-sale	Securities	Losses	Value	Securities	Losses	Value	Securities	Losses	Value
S. Treasuries	1	$ 108	$ 3,895	-	$ -	$ -	1	$ 108	$ 3,895
S. government encies	4	58	12,730	-	-	-	4	58	12,73
S. government encies rtgage-backed	7	254	9,130	5	233	4,714	12	487	13,84
tes and itical divisions	42	3,068	140,012	2	1,263	3,742	44	4,331	143,7
rporate bonds	-	-	-	1	5	200	1	5	200
llateralized rtgage igations	4	110	21,191	8	1,778	38,589	12	1,888	59,78
	1	46	1,603	6	1,841	56,385	7	1,887	57,98

set-backed urities									
llateralized n obligations	2	23	12,991	-	-	-	2	23	12,99
tal securities ilable-for-sale	61	$ 3,667	$ 201,552	22	$ 5,120	$ 103,630	83	$ 8,787	$ 305,1

ember 31, 2017	Less than 12 months in an unrealized loss position			12 months or more in an unrealized loss position			Total		
urities lable-for-sale	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Valu
Treasuries	1	$ 55	$ 3,947	-	$ -	$ -	1	$ 55	$ 3,94
government cies	2	9	6,550	-	-	-	2	9	6,55
government cies tgage-backed	4	24	5,501	5	141	4,843	9	165	10,3
es and political divisions	13	1,237	45,985	1	27	1,512	14	1,264	47,4
porate bonds	-	-	-	1	11	332	1	11	332
ateralized tgage gations	3	31	11,534	8	1,124	40,219	11	1,155	51,7
et-backed rities	-	-	-	7	1,913	61,745	7	1,913	61,7
ateralized loan gations	3	101	29,313	-	-	-	3	101	29,3
l securities lable-for-sale	26	$ 1,457	$ 102,830	22	$ 3,216	$ 108,651	48	$ 4,673	$ 211,

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

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

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

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

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

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

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Note 4 – Loans

Major classifications of loans were as follows:

	March 31, 2018	December 31, 2017
Commercial	$ 281,134	$ 272,851
Leases	66,344	68,325
Real estate - commercial	713,422	750,991
Real estate - construction	91,479	85,162
Real estate - residential	438,610	426,230
Consumer	2,120	2,774
Other1	7,725	10,609
	1,600,834	1,616,942
Net deferred loan costs	978	680
Total loans	$ 1,601,812	$ 1,617,622

1 The "Other" class includes overdrafts.

It is the policy of the Company to review each prospective credit prior to making a loan in order to determine if an adequate level of security or collateral has been obtained. The type of collateral, when required, will vary from liquid assets to real estate. The Company's access to collateral, in the event of borrower default, is assured through adherence to lending laws, the Company's lending standards and credit monitoring procedures. With selected exceptions, the Bank makes loans solely within its market area. There are no significant concentrations of loans where the customers' ability to honor loan terms is dependent upon a single economic sector, although the real estate related categories listed above represent 77.6% and 78.0% of the portfolio at March 31, 2018, and December 31, 2017, respectively.

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

Recorded
Investment

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

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December 31, 2017	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	$ 995	$ 275	$ -	$ 1,270	$ 271,581	$ -	$ 272,851	$ -
Leases	-	-	-	-	68,147	178	68,325	-
Real estate - commercial								
Owner occupied general purpose	1,136	-	-	1,136	144,267	455	145,858	-
Owner occupied special purpose	226	-	-	226	170,546	342	171,114	-
Non-owner occupied general purpose	-	593	-	593	273,203	1,163	274,959	-
Non-owner occupied special purpose	-	-	248	248	92,923	-	93,171	254
Retail properties	-	-	-	-	49,538	1,081	50,619	-
Farm	-	-	-	-	15,270	-	15,270	-
Real estate - construction								
Homebuilder	129	-	-	129	2,221	-	2,350	-
Land	1,124	-	-	1,124	1,319	-	2,443	-
Commercial speculative	-	-	-	-	32,028	-	32,028	-
All other	-	-	-	-	48,140	201	48,341	-
Real estate - residential								
Investor	-	-	-	-	55,248	372	55,620	-
Multifamily	-	-	-	-	125,049	4,723	129,772	-
Owner occupied	74	-	-	74	123,838	4,674	128,586	-
Revolving and junior liens	491	278	-	769	110,291	1,192	112,252	-
Consumer	-	-	-	-	2,767	7	2,774	-
Other1	37	-	-	37	11,252	-	11,289	-

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

1 The “Other” class includes overdrafts and net deferred costs.

Credit Quality Indicators

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

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

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

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

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

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Credit Quality Indicators by class of loans were as follows:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TDRs that were modified during the period are as follows:

	TDR Modifications Three Months Ended March 31, 2018		
	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
Troubled debt restructurings			
Real estate - residential			
Investor			
Deferral1	1	$ 165	$ 74
Revolving and junior liens			
Rate2	1	24	24
Other3	4	218	217
Total	6	$ 407	$ 315

TDR Modifications
Three Months Ended March 31, 2017

	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
Troubled debt restructurings			
Revolving and junior liens			
HAMP4	1	$ 56	$ 56
Other3	3	188	187
Total	4	$ 244	$ 243

1 Deferral: Refers to the deferral of principal.

2 Rate: Refers to interest rate reduction.

3 Other: Change of terms from bankruptcy court.

4 HAMP: Home Affordable Modification Program.

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

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Note 5 – Allowance for Loan and Lease Losses

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

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

evaluated for impairment

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

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

Note 6 – Other Real Estate Owned

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

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

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Activity in the valuation allowance was as follows:

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

Expenses related to OREO, net of lease revenue includes:

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

Note 7 – Deposits

Major classifications of deposits were as follows:

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

Note 8 – Borrowings

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

	March 31, 2018	December 31, 2017
Securities sold under repurchase agreements	$ 41,366	$ 29,918
FHLBC advances1	45,000	115,000
Junior subordinated debentures	57,650	57,639
Senior notes	44,083	44,058
Total borrowings	$ 188,099	$ 246,615

1 Included in other short-term borrowings on the balance sheet.

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

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

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

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

Note 9 – Junior Subordinated Debentures

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

The Company issued an additional $25.0 million of cumulative trust preferred securities through a private placement completed by an additional, unconsolidated subsidiary, Old Second Capital Trust II, in April 2007. These trust preferred securities also mature in 30 years, but subject to the aforementioned regulatory approval, can be called in whole or in part on a quarterly basis commencing June 15, 2017. The quarterly cash distributions on the securities were fixed at 6.77% through June 15, 2017, and float at 150 basis points over three-month LIBOR thereafter. The Trust II issuance converted from fixed to floating rate at three month LIBOR plus 150 basis points on June 15, 2017. Upon conversion to a floating rate, a cash flow hedge was initiated which resulted in the total interest rate paid on the debt of 4.41% as of March 31, 2018, compared to the rate paid prior to June 15, 2017 of 6.77%. The Company issued a new $25.8 million subordinated debenture to Old Second Capital Trust II in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities. Both of the debentures issued by the Company are disclosed on the Consolidated Balance Sheet as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Income. As of March 31, 2018, and December 31, 2017, unamortized debt issuance costs related to the junior subordinated debentures were $727,000 and $739,000 respectively, and are included as a reduction to the balance of the junior subordinated debentures on the Consolidated Balance Sheet.

Note 10 – Equity Compensation Plans

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

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

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

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

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

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

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

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

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

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

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

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Note 11 – Earnings Per Share

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

	Quarters Ended March 31,	
	2018	2017
Basic earnings per share:		
Weighted-average common shares outstanding	29,659,454	29,560,521
Net income	$ 9,489	$ 4,427
Basic earnings per share	$ 0.32	$ 0.15
Diluted earnings per share:		
Weighted-average common shares outstanding	29,659,454	29,560,521
Dilutive effect of unvested restricted awards1	472,936	378,112
Dilutive effect of stock options and warrants	36,358	2,317
Diluted average common shares outstanding	30,168,748	29,940,950
Net Income	$ 9,489	$ 4,427
Diluted earnings per share	$ 0.31	$ 0.15
Number of antidilutive options and warrants excluded from the diluted earnings per share calculation	-	900,839

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

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

Note 12 – Regulatory & Capital Matters

The Bank is subject to the risk-based capital regulatory guidelines, which include the methodology for calculating the risk-weighted Bank assets, developed by the Office of the Comptroller of the Currency (the “OCC”) and the other bank regulatory agencies. In connection with the current economic environment, the Bank's current level of nonperforming assets and the risk-based capital guidelines, the Bank's Board of Directors has determined that the Bank should maintain a Tier 1 leverage capital ratio at or above eight percent (8%) and a total risk-based capital ratio at or above twelve percent (12%). At March 31, 2018, the Bank exceeded those thresholds.

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

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

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

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

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

	Actual		Minimum Capital Adequacy with Capital Conservation Buffer if applicable1		To Be Well Capitalized Under Prompt Corrective Action Provisions2	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
March 31, 2018						
Common equity tier 1 capital to risk weighted assets						
Consolidated	$ 189,150	9.82 %	$ 122,793	6.375 %	N/A	N/A
Old Second Bank	260,159	13.56	122,309	6.375	$ 124,707	6.50 %
Total capital to risk weighted assets						
Consolidated	261,536	13.58	190,182	9.875	N/A	N/A
Old Second Bank	278,342	14.51	189,430	9.875	191,828	10.00
Tier 1 capital to risk weighted assets						
Consolidated	243,353	12.63	151,734	7.875	N/A	N/A
Old Second Bank	260,159	13.56	151,088	7.875	153,486	8.00
Tier 1 capital to average assets						
Consolidated	243,353	10.44	93,239	4.00	N/A	N/A
Old Second Bank	260,159	11.19	92,997	4.00	116,246	5.00
December 31, 2017						
Common equity tier 1 capital to risk weighted assets						
Consolidated	$ 179,853	9.25 %	$ 111,801	5.750 %	N/A	N/A
Old Second Bank	249,417	12.88	111,347	5.750	$ 125,870	6.50 %
Total capital to risk weighted assets						
Consolidated	251,383	12.93	179,837	9.250	N/A	N/A
Old Second Bank	266,873	13.78	179,142	9.250	193,667	10.00
Tier 1 capital to risk weighted assets						
Consolidated	233,927	12.03	140,978	7.250	N/A	N/A
Old Second Bank	249,417	12.88	140,394	7.250	154,917	8.00
Tier 1 capital to average assets						
Consolidated	233,927	10.08	92,828	4.00	N/A	N/A

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

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

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

Dividend Restrictions

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

Note 13 – Fair Value Measurements

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

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

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

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

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

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

Residential mortgage loans available for sale in the secondary market are carried at fair market value. The fair value of loans held-for-sale is determined using quoted secondary market prices.

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

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

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

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

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

U.S. government agencies mortgage-backed	-	12,214	-	12,214
States and political subdivisions	-	263,831	14,261	278,092
Corporate bonds	-	833	-	833
Collateralized mortgage obligations	-	63,671	2,268	65,939
Asset-backed securities	-	112,932	-	112,932
Collateralized loan obligations	-	54,421	-	54,421
Loans held-for-sale	-	4,067	-	4,067
Mortgage servicing rights	-	-	6,944	6,944
Interest rate swap agreements	-	727	-	727
Mortgage banking derivatives	-	238	-	238
Total	$ 3,947	$ 525,995	$ 23,473	$ 553,415
Liabilities:				
Interest rate swap agreements, including risk participation agreements	$ -	$ 2,014	$ -	$ 2,014
Total	$ -	$ 2,014	$ -	$ 2,014

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

	Three Months Ended March 31, 2018		
	Securities available-for-sale		
	Collateralized Mortgage Obligation	States and Political Subdivisions	Mortgage Servicing Rights
Beginning balance January 1, 2018	$ 2,268	$ 14,261	$ 6,944
Total gains or losses			
Included in earnings (or changes in net assets)	13	-	417
Included in other comprehensive income	28	(699)	-
Purchases, issuances, sales, and settlements			
Purchases	-	13,085	-
Issuances	-	-	291
Settlements	(213)	(120)	(111)
Ending balance March 31, 2018	$ 2,096	$ 26,527	$ 7,541

	Three Months Ended March 31, 2017		
	Securities available-for-sale		
	Collateralized Mortgage Obligation	States and Political Subdivisions	Mortgage Servicing Rights
Beginning balance January 1, 2017	$ 3,119	$ 22,226	$ 6,489
Total gains or losses			
Included in earnings (or changes in net assets)	13	-	(33)
Included in other comprehensive income	16	(8)	-
Purchases, issuances, sales, and settlements			
Purchases	-	9,561	-
Issuances	-	-	252
Settlements	(304)	(114)	(100)

Ending balance March 31, 2017	$ 2,844	$ 31,665	$ 6,608

The following table and commentary presents quantitative and qualitative information about Level 3 fair value measurements as of March 31, 2018:

Measured at fair value on a recurring basis:	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Input	Weighted Average of Inputs
Mortgage servicing rights	$ 7,541	Discounted Cash Flow	Discount Rate	10.0 - 106.3%	10.2 %
			Prepayment Speed	7.0 - 68.4%	8.5 %

The following table and commentary presents quantitative and qualitative information about Level 3 fair value measurements as of December 31, 2017: