OLD SECOND BANCORP INC
Form 10-Q
November 07, 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 September 30, 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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) 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

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 November 2, 2018, the Registrant had 29,758,578 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 included conversion of Greater Chicago Financial Corp.'s operating systems and procedures, may have unanticipated adverse results relating to 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;
- risks related to potential mergers and acquisitions including potential deposit attrition, higher than expected costs, customer loss and business disruption, including, without limitation, potential difficulties in maintaining relationships with key personnel and other integration related-matters, and the potential inability to identify and successfully negotiate and complete additional successful combinations with potential merger or acquisition partners;
- 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) September 30, 2018	December 31, 2017
Assets		
Cash and due from banks	$ 34,366	$ 37,444
Interest bearing deposits with financial institutions	15,956	18,389
Cash and cash equivalents	50,322	55,833
Securities available-for-sale, at fair value	542,338	541,439
Federal Home Loan Bank Chicago ("FHLBC") and Federal Reserve Bank Chicago ("FRBC") stock	10,511	10,168
Loans held-for-sale	2,911	4,067
Loans	1,834,949	1,617,622
Less: allowance for loan and lease losses	19,328	17,461
Net loans	1,815,621	1,600,161
Premises and equipment, net	42,752	37,628
Other real estate owned	6,964	8,371
Mortgage servicing rights, net	8,131	6,944
Goodwill and core deposit intangible	21,947	8,922
Bank-owned life insurance ("BOLI")	61,506	61,764
Deferred tax assets, net	25,116	25,356
Other assets	24,354	22,776
Total assets	$ 2,612,473	$ 2,383,429
Liabilities		
Deposits:		
Noninterest bearing demand	$ 621,580	$ 572,404
Interest bearing:		
Savings, NOW, and money market	1,045,886	967,750
Time	464,904	382,771
Total deposits	2,132,370	1,922,925
Securities sold under repurchase agreements	44,333	29,918
Other short-term borrowings	81,875	115,000
Junior subordinated debentures	57,674	57,639
Senior notes	44,133	44,058
Notes payable and other borrowings	18,050	-
Other liabilities	15,908	13,539

Total liabilities	2,394,343	2,183,079
Stockholders’ Equity		
Common stock	34,717	34,626
Additional paid-in capital	118,625	117,742
Retained earnings	167,140	142,959
Accumulated other comprehensive (loss) income	(6,058)	1,479
Treasury stock	(96,294)	(96,456)
Total stockholders’ equity	218,130	200,350
Total liabilities and stockholders’ equity	$ 2,612,473	$ 2,383,429

	September 30, 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.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Income

(In thousands, except per share data)

	(unaudited) Three Months Ended September 30, 2018	2017	(unaudited) Nine Months Ended September 30, 2018	2017
Interest and dividend income				
Loans, including fees	$ 23,377	$ 18,208	$ 64,625	$ 52,202
Loans held-for-sale	39	34	94	95
Securities:				
Taxable	2,491	2,424	7,053	7,994
Tax exempt	2,064	1,628	6,239	4,188
Dividends from FHLBC and FRBC stock	121	94	338	271
Interest bearing deposits with financial institutions	84	37	230	91
Total interest and dividend income	28,176	22,425	78,579	64,841
Interest expense				
Savings, NOW, and money market deposits	642	239	1,487	695
Time deposits	1,568	1,077	4,187	3,081
Securities sold under repurchase agreements	140	4	323	10
Other short-term borrowings	311	220	916	472
Junior subordinated debentures	930	930	2,784	3,073
Senior notes	672	672	2,016	2,017
Notes payable and other borrowings	173	-	268	-
Total interest expense	4,436	3,142	11,981	9,348
Net interest and dividend income	23,740	19,283	66,598	55,493
Provision for loan and lease losses	-	300	728	1,050
Net interest and dividend income after provision for loan and lease losses	23,740	18,983	65,870	54,443
Noninterest income				
Trust income	1,644	1,468	4,784	4,564
Service charges on deposits	1,923	1,722	5,284	4,955
Secondary mortgage fees	199	195	556	594
Mortgage servicing rights mark to market (loss) gain	(11)	(194)	189	(756)
Mortgage servicing income	471	451	1,550	1,330
Net gain on sales of mortgage loans	965	1,095	3,122	3,715
Securities gains (losses), net	13	102	360	(165)
Increase in cash surrender value of BOLI	347	362	946	1,071
Death benefit realized on bank-owned life insurance	-	-	1,026	-
Debit card interchange income	1,135	1,075	3,279	3,131
Gain on disposal and transfer of fixed assets, net	-	-	-	10
Other income	1,128	1,567	3,755	3,739
Total noninterest income	7,814	7,843	24,851	22,188

Noninterest expense				
Salaries and employee benefits	11,165	10,049	33,727	31,167
Occupancy, furniture and equipment	1,782	1,482	4,992	4,510
Computer and data processing	1,247	1,081	5,332	3,283
FDIC insurance	162	199	483	512
General bank insurance	230	246	780	780
Amortization of core deposit intangible	136	24	254	74
Advertising expense	492	255	1,325	1,093
Debit card interchange expense	320	285	902	1,033
Legal fees	243	162	688	450
Other real estate expense, net	(370)	680	232	1,928
Other expense	3,304	2,455	9,636	8,128
Total noninterest expense	18,711	16,918	58,351	52,958
Income before income taxes	12,843	9,908	32,370	23,673
Provision for income taxes	3,201	1,831	6,978	6,023
Net income available to common stockholders	$ 9,642	$ 8,077	$ 25,392	$ 17,650
Basic earnings per share	$ 0.32	$ 0.27	$ 0.85	$ 0.60
Diluted earnings per share	0.32	0.27	0.84	0.59
Dividends declared per share	0.01	0.01	0.03	0.03

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 September 30,		(unaudited) Nine Months Ended September 30,	
	2018	2017	2018	2017
Net Income	$ 9,642	$ 8,077	$ 25,392	$ 17,650
Unrealized holding (losses) gains on available-for-sale securities arising during the period	(2,801)	2,971	(12,999)	13,798
Related tax benefit (expense)	788	(1,191)	3,664	(5,556)
Holding (losses) gains after tax on available-for-sale securities	(2,013)	1,780	(9,335)	8,242
Less: Reclassification adjustment for the net gains (losses) realized during the period				
Net realized gains (losses)	12	102	360	(165)
Related tax (expense) benefit	(2)	(42)	(100)	24
Net realized gains (losses) after tax	10	60	260	(141)
Other comprehensive (loss) income on available-for-sale securities	(2,023)	1,720	(9,595)	8,383
Changes in fair value of derivatives used for cash flow hedges	628	19	2,422	(445)
Related tax (expense) benefit	(176)	8	(683)	192
Other comprehensive income on cash flow hedges	452	27	1,739	(253)
Total other comprehensive (loss) income	(1,571)	1,747	(7,856)	8,130
Total comprehensive income	$ 8,071	$ 9,824	$ 17,536	$ 25,780

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In thousands)

	(Unaudited) Nine Months Ended September 30, 2018	2017
Cash flows from operating activities		
Net income	$ 25,392	$ 17,650
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation of fixed assets and amortization of leasehold improvements	1,778	1,760
Change in fair value of mortgage servicing rights	(189)	756
Provision for loan and lease losses	728	1,050
Provision for deferred tax expense	6,777	5,682
Originations of loans held-for-sale	(107,947)	(113,077)
Proceeds from sales of loans held-for-sale	111,169	119,059
Net gains on sales of mortgage loans	(3,122)	(3,715)
Net discount (accretion)/premium amortization of purchase accounting adjustment on loans	(776)	(1,115)
Change in current income taxes receivable	671	111
Increase in cash surrender value of BOLI	(946)	(1,071)
Change in accrued interest receivable and other assets	533	(6,849)
Change in accrued interest payable and other liabilities	2,432	4,571
Net premium amortization/discount (accretion) on securities	2,128	1,320
Securities (gains) losses, net	(360)	165
Amortization of core deposit intangible	254	74
Amortization of junior subordinated debentures issuance costs	35	36
Amortization of senior notes issuance costs	75	77
Stock based compensation	1,641	897
Net gains on sale of other real estate owned	(716)	(454)
Provision for other real estate owned valuation losses	485	1,630
Net losses on disposal and transfer of fixed assets	-	(10)
Net cash provided by operating activities	40,042	28,547
Cash flows from investing activities		
Proceeds from maturities and calls including pay down of securities available-for-sale	32,890	105,327
Proceeds from sales of securities available-for-sale	94,663	152,476
Purchases of securities available-for-sale	(71,488)	(246,971)
Net disbursements/proceeds from sales (purchases) of FHLBC stock	2,627	(2,475)
Net disbursements/proceeds from (purchases) sales of FRB stock	(1,421)	-
Net change in loans	9,988	(118,711)
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	4,292	5,512
Proceeds from disposition of premises and equipment	-	13
Net purchases of premises and equipment	(1,563)	(852)
Cash paid for acquisition, net of cash and cash equivalents retained	(35,711)	-
Net cash provided by (used in) investing activities	35,422	(105,681)
Cash flows from financing activities		
Net change in deposits	(39,053)	22,330
Net change in securities sold under repurchase agreements	8,792	1,138
Net change in other short-term borrowings	(44,000)	55,000
Payment of senior note issuance costs	-	(42)
Net change in notes payable and other borrowings	(5,317)	-
Dividends paid on common stock	(892)	(888)
Purchase of treasury stock	(505)	(236)
Net cash (used in) provided by financing activities	(80,975)	77,302
Net change in cash and cash equivalents	(5,511)	168
Cash and cash equivalents at beginning of period	55,833	47,334
Cash and cash equivalents at end of period	$ 50,322	$ 47,502

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

	Nine Months Ended September 30,	
Supplemental cash flow information	2018	2017
Income taxes paid, net	$ -	$ 230
Interest paid for deposits	5,381	3,802
Interest paid for borrowings	5,482	4,890
Non-cash transfer of loans to other real estate owned	2,194	3,701
Non-cash transfer of premises to other real estate owned	-	95

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			17,650			17,650
Other comprehensive income, net of tax				8,130		8,130
Dividends declared and paid, ($0.03 per share)			(888)			(888)
Vesting of restricted stock	92	(92)				-
Stock based compensation		897				897
Purchase of treasury stock					(236)	(236)
Balance, September 30, 2017	$ 34,626	$ 117,458	$ 145,767	$ (632)	$ (96,456)	$ 200,763
Balance, December 31, 2017	$ 34,626	$ 117,742	$ 142,959	$ 1,479	$ (96,456)	$ 200,350
Net income			25,392			25,392
Other comprehensive loss, net of tax				(7,856)		(7,856)
Dividends declared and paid, ($0.03 per share)			(892)			(892)
Vesting of restricted stock	91	(758)			667	-
Reclassification of stranded tax effects			(319)	319		-
Stock based compensation		1,641				1,641
Purchase of treasury stock					(505)	(505)
Balance, September 30, 2018	$ 34,717	$ 118,625	$ 167,140	$ (6,058)	$ (96,294)	$ 218,130

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 September 30, 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.

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.

In addition to the significant accounting policies presented in our Form 10-K, as noted above, as a result of our acquisition of Greater Chicago Financial Corp. ("GCFC"), and its wholly-owned subsidiary, ABC Bank, that closed in the second quarter of 2018, the Company has implemented accounting policies regarding purchased loans. Loans purchased as a result of a business combination are recorded at estimated fair value on the acquisition date, with no carryover of the related allowance for loan and lease losses recorded by the acquiree at the time of purchase. These loans are segregated into two classifications upon purchase:

1) purchased non-credit impaired ("non-PCI") loans, accounted for in accordance with FASB ASC Subtopic 310-20 "Nonrefundable Fees and Costs" ("ASC 310-20"), which have a discount attributable in part to credit quality. Premiums and discounts created when ASC 310-20 loans are recorded at their fair values at acquisition are amortized over the remaining terms of the loans as an adjustment to the related loan's yield; and
2) purchased credit impaired ("PCI") loans, accounted for under FASB ASC Subtopic 310-30, "Loans and Debt Securities Acquired with Deteriorated Credit Quality" ("ASC 310-30") as they display signs of credit deterioration. Interest income, through accretion of the difference between the carrying value of the loans and the expected cash flows, is recognized on the acquired loans accounted for under ASC 310-30.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("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," which 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.

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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

The 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 to create a new model to follow for sale-leaseback transactions. The impact of this pronouncement will primarily affect lessees, 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. In July 2018, the FASB issued ASU No. 2018-11, "Leases (Topic 842): Targeted Improvements" which provided additional guidance on the transition method, including application as a cumulative-effect adjustment to equity and practical expedients to use when accounting for lease components. The Company is in the process of identifying the population of all lease arrangements and an implementation team is currently assessing the impact of the ASU on the Company's processes, accounting, internal controls over financial reporting, and regulatory capital.

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 has determined that a loss rate model will be used for calculation of future risk assessments upon the ASU's adoption in 2020. The Company has accumulated historical data by loan pools and collateral classifications, and anticipates calculation of estimates for at least two quarters in 2019 on a test basis to confirm model processes and to determine financial statement impact prior to adoption in 2020.

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.

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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 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 adoption of the accounting standard.

Subsequent Events

On October 16, 2018, the Company's Board of Directors declared a cash dividend of $0.01 per share payable on November 5, 2018, to stockholders of record as of October 26, 2018; dividends of $298,000 were paid to stockholders on November 5, 2018.

Note 2 – Acquisitions

On April 20, 2018, the Company acquired GCFC and its wholly owned subsidiary, ABC Bank, which operated four branches in the Chicago metro area. In addition to the acquisition price of $41.1 million, the Company retired the convertible and nonconvertible debentures held by GCFC upon acquisition, which totaled $6.6 million, including interest due. The purchase and the retirement of the debentures was funded with the Company's cash on hand, and all GCFC common stock was retired and cancelled simultaneous with the close of the transaction. The Company acquired $227.6 million of loans, net of purchase accounting adjustments, and $248.5 million of deposits, net of purchase accounting adjustments for time deposits. Purchase accounting adjustments recorded in the second quarter of 2018 include a loan valuation mark of $11.2 million, a core deposit intangible of $3.1 million, a fixed asset valuation adjustment of $1.5 million, and goodwill of $9.9 million. In addition, a deferred tax asset of $3.5 million was recorded as of the date of acquisition based on analysis of the fair value of assets acquired, less liabilities assumed. None of the $9.9 million recorded as goodwill is expected to be deductible for tax purposes. Acquisition related costs incurred by the Company for the nine months ended

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September 30, 2018, totaled $3.3 million, pre-tax, and included $1.0 million of salaries and employee benefits related expenses, and $1.8 million of data processing, computer and ATM related conversion costs.

The assets and liabilities associated with the acquisition of GCFC were recorded in the Consolidated Balance Sheets at their estimated fair values as of the acquisition date. In many cases the determination of these fair values required management to make estimates about discount rates, future expected cash flows, market conditions and other future events that are highly subjective in nature and subject to change, as noted below. The following table shows the estimated fair value of the assets acquired and liabilities assumed as of April 20, 2018. These fair value estimates are preliminary and subject to refinement for up to one year after the closing date of the acquisition or the date we receive the information about the facts and circumstances that existed at the acquisition date. Subsequent adjustments are, and if necessary, will be prospectively reflected in future filings, and may impact loans, other assets, deferred tax assets, net, and goodwill.

The below table summarizes the assets acquired, less the liabilities assumed, related to the GCFC/ABC Bank acquisition. All amounts are listed at their estimated fair values as of date of acquisition, and have been accounted for under the acquisition method of accounting.

GCFC/ABC Bank Acquisition Summary
As of Date of Acquisition

		April 20, 2018
Assets		
Cash and due from banks	$	6,669
Interest bearing deposits with financial institutions		500
Securities available-for-sale, at fair value		72,091
Federal funds sold		4,300
FHLBC stock		1,549
Loans		227,594
Premises and equipment		5,339
Other real estate owned		401
Goodwill and core deposit intangible		12,966
Deferred tax assets, net		3,459
Other assets		1,925
Total assets	$	336,793
Liabilities		
Noninterest bearing demand	$	58,005

Savings, NOW and money market		91,494
Time		98,999
Total deposits		248,498
Securities sold under repurchase agreements		5,624
Other short-term borrowings		10,875
Notes payable and other borrowings		23,367
Other liabilities		1,249
Total liabilities		289,613
Cash consideration paid		47,180
Total Liabilities Assumed and Cash Consideration Paid for Acquisition	$	336,793

Loans acquired in the GCFC acquisition were initially recorded at fair value with no separate allowance for loan losses. The Company reviewed the loans at acquisition to determine which loans should be considered PCI loans, defining impaired loans as those that were either not accruing interest or exhibited credit risk factors consistent with nonperforming loans at the acquisition date, or non-PCI loans, as addressed in the Company's significant accounting policies.

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The following table represents the acquired loans as of date of acquisition and as of September 30, 2018:

	April 20, 2018		September 30, 2018	
ABC Bank Acquired Loans	PCI	Non-PCI	PCI	Non-PCI
Fair Value	$ 11,360	$ 216,306	$ 10,887	$ 201,289
Contractually required principal and interest payment	19,447	219,488	18,174	203,156
Best estimate of contractual cash flows not expected to be collected	6,537	2,511	6,069	1,457
Best estimate of contractual cash flows expected to be collected	12,910	216,977	12,105	201,699

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 $4.3 million at September 30, 2018, and $5.4 million at December 31, 2017. FRBC stock was recorded at $6.2 million and $4.8 million at September 30, 2018, and December 31, 2017, respectively.

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The following table summarizes the amortized cost and fair value of the securities portfolio at September 30, 2018, and December 31, 2017, and the corresponding amounts of gross unrealized gains and losses:

September 30, 2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale				
U.S. Treasuries	$ 4,005	$ -	$ (151)	$ 3,854
U.S. government agencies	11,881	-	(178)	11,703
U.S. government agencies mortgage-backed	15,474	-	(708)	14,766
States and political subdivisions	278,604	398	(6,738)	272,264
Collateralized mortgage obligations	67,762	118	(2,920)	64,960
Asset-backed securities	108,622	991	(440)	109,173
Collateralized loan obligations	65,555	162	(99)	65,618
Total securities available-for-sale	$ 551,903	$ 1,669	$ (11,234)	$ 542,338

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 September 30, 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	$ 1,500	4.78	%	$ 1,502
Due after one year through five years	4,005	1.85		3,854
Due after five years through ten years	6,688	3.03		6,626
Due after ten years	282,297	3.00		275,839
	294,490	3.00		287,821
Mortgage-backed and collateralized mortgage obligations	83,236	3.21		79,726
Asset-backed securities	108,622	3.22		109,173
Collateralized loan obligations	65,555	4.71		65,618
Total securities available-for-sale	$ 551,903	3.28	%	$ 542,338

At September 30, 2018, the Company's investments included $92.6 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 DOE guarantee, total added credit enhancement in the form of overcollateralization and/or subordination amounted to $11.7 million, or 12.44% 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:

	September 30, 2018	
Issuer	Amortized Cost	Fair Value
GCO Education Loan Funding Corp	$ 27,711	$ 27,788
Towd Point Mortgage Trust	34,390	33,181
Student Loan Marketing Association	25,798	26,134

Securities with unrealized losses at September 30, 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):

ember 30, 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
rities able-for-sale	Securities	Losses	Value	Securities	Losses	Value	Securities	Losses	Value
Treasuries	-	$ -	$ -	1	$ 151	$ 3,854	1	$ 151	$ 3,85
government cies	3	109	7,829	1	69	3,874	4	178	11,7
government cies									
gage-backed	6	287	7,357	7	421	7,409	13	708	14,7
s and political visions	55	3,843	174,924	9	2,895	28,218	64	6,738	203
teralized gage ations	4	714	25,620	8	2,206	33,342	12	2,920	58,9
-backed ities	3	79	7,526	5	361	30,240	8	440	37,7
teralized loan ations	4	85	24,502	1	14	7,986	5	99	32,4
	75	$ 5,117	$ 247,758	32	$ 6,117	$ 114,923	107	$ 11,234	$ 362

securities
able-for-sale

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 livisions	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 the three and nine months ended September 30, 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 three and nine months ended September 30, 2018 and 2017.

	Three Months Ended September 30,		Nine Months Ended September 30,	
Securities available-for-sale	2018	2017	2018	2017
Proceeds from sales of securities	$ 1,917	$ 51,620	$ 94,663	$ 152,476
Gross realized gains on securities	23	474	370	911
Gross realized losses on securities	(10)	(371)	(10)	(1,076)
Securities realized gains (losses), net	$ 13	$ 103	$ 360	$ (165)
Income tax (expense) benefit on net realized gains (losses)	(2)	(42)	(100)	24

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 $311.2 million as of September 30, 2018, an increase 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:

	September 30, 2018	December 31, 2017
Commercial	$ 306,407	$ 272,851
Leases	70,661	68,325
Real estate - commercial	804,184	750,991
Real estate - construction	112,873	85,162
Real estate - residential	393,598	313,397
Home equity lines of credit "HELOC"	122,022	112,833
Other 1	12,969	13,383
Total loans, excluding deferred loan costs and PCI loans	1,822,714	1,616,942
Net deferred loan costs	1,348	680
Total loans, excluding PCI loans	1,824,062	1,617,622
PCI loans, net of purchase accounting adjustments	10,887	-
Total loans	$ 1,834,949	$ 1,617,622

1 The “Other” class includes consumer and 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 78.1% and 78.0% of the portfolio at September 30, 2018, and December 31, 2017, respectively.

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

September 30, 2018	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Nonaccrual	Total Loans	Recorded Investmen 90 days or Greater Pa Due and Accruing
Commercial	$ 1,074	$ -	$ 6	$ 1,080	$ 305,327	$ -	$ 306,407	$ 6
Leases	-	-	-	-	70,661	-	70,661	-
Real estate - commercial								
Owner occupied general purpose	1,022	-	-	1,022	164,304	1,625	166,951	-
Owner occupied special purpose	891	-	-	891	188,984	410	190,285	-
Non-owner occupied general purpose	346	3,422	-	3,768	293,979	142	297,889	-
Non-owner occupied special purpose	-	-	-	-	85,171	3,099	88,270	-
Retail properties	624	-	-	624	46,252	-	46,876	-
Farm	1,241	-	-	1,241	12,672	-	13,913	-
Real estate - construction								
Homebuilder	-	-	-	-	4,556	-	4,556	-
Land	-	-	-	-	3,841	-	3,841	-
Commercial speculative	-	-	-	-	56,052	-	56,052	-
All other	38	-	-	38	48,277	109	48,424	-
Real estate - residential								
Investor	952	-	-	952	70,102	364	71,418	-
Multifamily	1,304	-	73	1,377	179,645	-	181,022	76
Owner occupied	780	136	-	916	136,678	3,564	141,158	-
HELOC	1,422	92	-	1,514	119,880	628	122,022	-
Other 1	42	1	-	43	14,234	40	14,317	-
Total, excluding PCI loans	$ 9,736	$ 3,651	$ 79	$ 13,466	$ 1,800,615	$ 9,981	$ 1,824,062	$ 82
PCI loans, net of purchase accounting adjustments	3,415	-	-	3,415	5,174	2,298	10,887	-
Total	$ 13,151	$ 3,651	$ 79	$ 16,881	$ 1,805,789	$ 12,279	$ 1,834,949	$ 82

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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	123,257	4,674	128,005	-
HELOC	491	278	-	769	110,872	1,192	112,833	-
Other 1	37	-	-	37	14,019	7	14,063	-
Total	$ 4,212	$ 1,146	$ 248	$ 5,606	$ 1,597,628	$ 14,388	$ 1,617,622	$ 254

1 The "Other" class includes consumer, 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 Bank 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:

September 30, 2018	Pass	Special Mention	Substandard 2	Doubtful	Total
Commercial	$ 303,176	$ 2,878	$ 353	$ -	$ 306,407
Leases	70,661	-	-	-	70,661
Real estate - commercial					
Owner occupied general purpose	160,999	1,489	4,463	-	166,951
Owner occupied special purpose	183,375	2,883	4,027	-	190,285
Non-owner occupied general purpose	289,438	834	7,617	-	297,889
Non-owner occupied special purpose	83,648	1,523	3,099	-	88,270
Retail Properties	45,074	-	1,802	-	46,876
Farm	11,423	1,249	1,241	-	13,913
Real estate - construction					
Homebuilder	4,556	-	-	-	4,556
Land	3,841	-	-	-	3,841
Commercial speculative	56,052	-	-	-	56,052
All other	46,152	1,990	282	-	48,424
Real estate - residential					
Investor	70,315	-	1,103	-	71,418
Multifamily	177,845	-	3,177	-	181,022
Owner occupied	135,625	511	5,022	-	141,158
HELOC	120,193	-	1,829	-	122,022
Other 1	14,262	-	55	-	14,317
Total, excluding PCI loans	$ 1,776,635	$ 13,357	$ 34,070	$ -	$ 1,824,062
PCI loans, net of purchase accounting adjustments	-	-	10,887	-	10,887
Total	$ 1,776,635	$ 13,357	$ 44,957	$ -	$ 1,834,949

December 31, 2017	Pass	Special Mention	Substandard 2	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	122,178	561	5,266	-	128,005
HELOC	110,934	-	1,899	-	112,833
Other 1	14,043	-	20	-	14,063
Total	$ 1,583,352	$ 10,965	$ 23,305	$ -	$ 1,617,622

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

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

The Company had $1.0 million and $1.3 million in residential real estate loans in the process of foreclosure as of September 30, 2018, and December 31, 2017, respectively.

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The following tables set forth the recorded investments, unpaid principal balance and related allowance, excluding purchased credit-impaired loans, by class of loans for the three and nine months ended September 30, 2018:

	As of September 30, 2018			Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded							
Commercial	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Leases	-	-	-	-	-	-	-
Commercial real estate							
Owner occupied general purpose	1,614	1,699	-	1,263	2	1,035	5
Owner occupied special purpose	409	538	-	417	-	375	-
Non-owner occupied general purpose	142	158	-	91	-	653	-
Non-owner occupied special purpose	-	-	-	-	-	-	-
Retail properties	-	-	-	-	-	-	-
Farm	-	-	-	-	-	-	-
Construction							
Homebuilder	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-
Commercial speculative	-	-	-	-	-	-	-
All other	50	74	-	121	-	125	-
Residential							
Investor	365	466	-	368	-	369	-
Multifamily	-	-	-	-	-	2,361	-
Owner occupied	3,855	5,326	-	4,050	11	4,532	29
HELOC	634	739	-	687	-	880	1
Other 1	14	15	-	15	-	10	-
Total impaired loans with no recorded allowance	7,083	9,015	-	7,012	13	10,340	35
With an allowance recorded							
Commercial	-	-	-	-	-	-	-

Leases	-	-	-	-	-	-	-
Commercial real estate							
Owner occupied general purpose	518	518	46	259	22	259	22
Owner occupied special purpose	-	-	-	-	-	-	-
Non-owner occupied general purpose	-	-	-	-	-	-	-
Non-owner occupied special purpose	3,099	3,575	139	3,099	-	1,550	-
Retail properties	-	-	-	-	-	-	-
Farm	-	-	-	-	-	-	-
Construction							
Homebuilder	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-
Commercial speculative	-	-	-	-	-	-	-
All other	59	59	42	30	-	29	-
Residential							
Investor	810	810	10	812	11	820	33
Multifamily	-	-	-	-	-	-	-
Owner occupied	3,710	3,710	49	3,678	35	3,576	108
HELOC	1,420	1,420	61	1,371	17	1,203	41
Other 1	26	26	26	14	-	13	-
Total impaired loans with a recorded allowance	9,642	10,118	373	9,263	85	7,450	204
Total impaired loans	$ 16,725	$ 19,133	$ 373	$ 16,275	$ 98	$ 17,790	$ 239

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

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Impaired loans by class of loans as of December 31, 2017, and for the three and nine months ended September 30, 2017, were as follows:

	As of December 31, 2017			Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded							
Commercial	$ -	$ -	$ -	$ 212	$ -	$ 123	$ -
Leases	178	213	-	208	-	281	-
Commercial real estate							
Owner occupied general purpose	455	495	-	458	-	1,169	-
Owner occupied special purpose	342	498	-	363	-	372	-
Non-owner occupied general purpose	1,163	1,538	-	1,180	1	1,481	2
Non-owner occupied special purpose	-	-	-	-	-	507	-
Retail properties	1,081	1,177	-	1,129	-	1,146	-
Farm	-	-	-	-	-	-	-
Construction							
Homebuilder	-	-	-	-	-	-	-
Land	-	-	-	-	-	-	-
Commercial speculative	-	-	-	34	-	37	-
All other	201	229	-	178	-	206	-
Residential							
Investor	372	676	-	1,475	16	1,607	36
Multifamily	4,723	4,965	-	4,791	-	2,379	-
Owner occupied	5,208	6,680	-	8,179	54	8,987	119
HELOC	1,125	1,313	-	1,981	12	2,237	27
Other 1	7	8	-	9	-	104	-
Total impaired loans with no recorded allowance	14,855	17,792	-	20,197	83	20,636	184

With an allowance recorded							
Commercial	-	-	-	-	-	-	-
Leases	-	-	-	120	-	-	-
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	-	-	402	-
HELOC	985	985	91	25	2	26	2
Other 1	-	-	-	-	-	-	-
Total impaired loans with a recorded allowance	5,257	5,257	144	145	2	551	2
Total impaired loans	$ 20,112	$ 23,049	$ 144	$ 20,342	$ 85	$ 21,187	$ 186

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

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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 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 September 30, 2018			TDR Modifications Nine Months Ended September 30, 2018		
	# of contracts	Pre-modification recorded investment	Post-modification recorded investment	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
Troubled debt restructurings						
Real estate - commercial						
Owner occupied general purpose						
Other1	1	$ 427	$ 424	1	$ 427	$ 424
Owner occupied special purpose						

Other1	-	-	-	1	110	52
Real estate - residential						
Owner occupied						
HAMP2	1	211	211	3	383	331
Other1	1	34	29	1	34	29
HELOC						
HAMP2	1	26	26	1	26	26
Rate3				1	24	24
Other1	2	93	92	9	596	587
Total	6	$ 791	$ 782	17	$ 1,600	$ 1,473

	TDR Modifications Three Months Ended September 30, 2017			TDR Modifications Nine Months Ended September 30, 2017		
	# of contracts	Pre-modification recorded investment	Post-modification recorded investment	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
Troubled debt restructurings						
HELOC						
Other1	2	$ 155	$ 147	6	$ 399	$ 388
Total	2	$ 155	$ 147	6	$ 399	$ 388

1 Other: Change of terms from bankruptcy court.

2 HAMP: Home Affordable Modification Program.

3 Rate: Refers to interest rate reduction.

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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 periods ended September 30, 2018 and September 30, 2017, for loans that were restructured within the 12 month period prior to default.

The following table details the accretable discount on all of the Company's purchased loans, both non-PCI loans and PCI loans as of September 30, 2018.

	Accretable Discount - Non-PCI Loans	Accretable Discount - PCI Loans	Non-Accretable Discount - PCI Loans	Total
Beginning balance, July 1, 2018	$ 2,995	$ 1,373	$ 6,403	$ 10,771
Purchases	-	-	-	-
Accretion	(312)	(129)	(334)	(775)
Transfer1	(373)	(26)	-	(399)
Ending balance, September 30, 2018	$ 2,310	$ 1,218	$ 6,069	$ 9,597

1 Transfer was due to loans moved to OREO.

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 the three and nine months ended September 30, 2018, were as follows:

Allowance for loan and lease losses:	Commercial	Leases	Real Estate Commercial	Real Estate Construction	Real Estate Residential	HELOC	Other1	Total
Three months ended September 30, 2018								
Beginning balance	$ 2,676	$ 634	$ 10,537	$ 1,398	$ 1,818	$ 1,390	$ 868	$ 19,321

Charge-offs	7	-	201	-	-	49	115	372
Recoveries	32	-	37	32	83	139	56	379
Provision (Release)	96	31	(144)	(374)	67	(372)	696	-
Ending balance	$ 2,797	$ 665	$ 10,229	$ 1,056	$ 1,968	$ 1,108	$ 1,505	$ 19,328
Nine months ended September 30, 2018								
Beginning balance	$ 2,453	$ 692	$ 9,522	$ 923	$ 1,846	$ 1,446	$ 579	$ 17,461
Charge-offs	38	13	609	(16)	(55)	141	316	1,046
Recoveries	141	-	425	35	1,099	277	208	2,185
Provision (Release)	241	(14)	891	82	(1,032)	(474)	1,034	728
Ending balance	$ 2,797	$ 665	$ 10,229	$ 1,056	$ 1,968	$ 1,108	$ 1,505	$ 19,328
Ending balance: Individually evaluated for impairment	$ -	$ -	$ 185	$ 42	$ 59	$ 61	$ 26	$ 373
Ending balance: Collectively evaluated for impairment	2,797	665	10,044	1,014	1,909	1,047	1,479	18,955
Ending balance: Acquired and accounted for ASC 310-30	-	-	-	-	-	-	-	-
Total ending allowance balance	$ 2,797	$ 665	$ 10,229	$ 1,056	$ 1,968	$ 1,108	$ 1,505	$ 19,328
Loans:								
Ending balance: Individually evaluated for Impairment	$ -	$ -	$ 5,782	$ 109	$ 8,740	$ 2,054	$ 40	$ 16,725
Ending balance: Collectively evaluated for impairment	306,407	70,661	798,402	112,764	384,858	119,968	14,277	1,807,337
Ending balance: Acquired and accounted for ASC 310-30	-	-	4,126	778	5,983	-	-	10,887
Total ending loans balance	$ 306,407	$ 70,661	$ 808,310	$ 113,651	$ 399,581	$ 122,022	$ 14,317	$ 1,834,949

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

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Changes in the allowance for loan and lease losses by segment of loans based on method of impairment for the three and nine months ended September 30, 2017, were as follows:

Allowance for loan and lease losses:	Commercial	Leases	Commercial	Construction	Residential	HELOC	Other1	Total
Three months ended September 30, 2017								
Beginning balance	$ 2,150	$ 791	$ 8,107	$ 857	$ 1,872	$ 1,513	$ 546	$ 15,836
Charge-offs	13	98	22	19	5	2	82	241
Recoveries	6	-	43	11	90	369	51	570
(Release) Provision	(104)	77	505	165	(187)	(455)	299	300
Ending balance	$ 2,039	$ 770	$ 8,633	$ 1,014	$ 1,770	$ 1,425	$ 814	$ 16,465
Nine months ended September 30, 2017								
Beginning balance	$ 1,629	$ 633	$ 9,547	$ 389	$ 2,178	$ 1,331	$ 451	$ 16,158
Charge-offs	20	215	300	23	982	196	262	1,998
Recoveries	13	-	124	89	243	607	179	1,255
Provision (Release)	417	352	(738)	559	331	(317)	446	1,050
Ending balance	$ 2,039	$ 770	$ 8,633	$ 1,014	$ 1,770	$ 1,425	$ 814	$ 16,465
Ending balance: Individually evaluated for impairment	$ -	$ -	$ -	$ -	$ 6	$ -	$ -	$ 6
Ending balance: Collectively evaluated for impairment	2,039	770	8,633	1,014	1,764	1,425	814	16,459
Total ending allowance balance	$ 2,039	$ 770	$ 8,633	$ 1,014	$ 1,770	$ 1,425	$ 814	$ 16,465
Loans:								
Ending balance: Individually evaluated for impairment	$ 207	$ 196	$ 3,147	$ 205	$ 14,281	$ 2,042	$ 8	$ 20,086
Ending balance: Collectively evaluated for	257,149	69,109	735,989	94,663	288,799	114,461	13,935	1,574,105

impairment								
Total ending loan balance	$ 257,356	$ 69,305	$ 739,136	$ 94,868	$ 303,080	$ 116,503	$ 13,943	$ 1,594,191

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

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 September 30,		Nine Months Ended September 30,	
Other real estate owned	2018	2017	2018	2017
Balance at beginning of period	$ 8,912	$ 11,724	$ 8,371	$ 11,916
Property additions, net of acquisition adjustments	(217)	176	2,595	3,796
Property improvements	-	-	59	-
Less:				
Proceeds from property disposals, net of participation purchase and of gains/losses	1,612	1,956	3,576	5,058
Period valuation adjustments	119	920	485	1,630
Balance at end of period	$ 6,964	$ 9,024	$ 6,964	$ 9,024

Activity in the valuation allowance was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Balance at beginning of period	$ 8,348	$ 8,304	$ 8,208	$ 9,982
Provision for unrealized losses	119	920	485	1,630
Reductions taken on sales	(456)	(421)	(682)	(2,809)
Other adjustments	-	-	-	-
Balance at end of period	$ 8,011	$ 8,803	$ 8,011	$ 8,803

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Expenses related to OREO, net of lease revenue includes:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Gain on sales, net	$ (612)	$ (276)	$ (716)	$ (454)
Provision for unrealized losses	119	920	485	1,630
Operating expenses	133	221	502	1,037
Less:				
Lease revenue	10	185	39	285
Net OREO expense	$ (370)	$ 680	$ 232	$ 1,928

Note 7 – Deposits

Major classifications of deposits were as follows:

	September 30, 2018	December 31, 2017
Noninterest bearing demand	$ 621,580	$ 572,404
Savings	298,073	262,220
NOW accounts	437,361	429,448
Money market accounts	310,452	276,082
Certificates of deposit of less than $100,000	235,272	216,493
Certificates of deposit of $100,000 through $250,000	163,716	122,489
Certificates of deposit of more than $250,000	65,916	43,789
Total deposits	$ 2,132,370	$ 1,922,925

Note 8 – Borrowings

The following table is a summary of borrowings as of September 30, 2018, and December 31, 2017. Junior subordinated debentures are discussed in detail in Note 9:

	September 30, 2018	December 31, 2017
Securities sold under repurchase agreements	$ 44,333	$ 29,918
Other short-term borrowings 1	81,875	115,000
Junior subordinated debentures	57,674	57,639
Senior notes	44,133	44,058
Notes payable and other borrowings	18,050	-
Total borrowings	$ 246,065	$ 246,615

1 Includes short-term FHLBC advances and the outstanding portion of an operating line of credit.

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 $44.3 million at September 30, 2018, and $29.9 million at December 31, 2017. The fair value of the pledged collateral was $72.6 million at September 30, 2018 and $40.0 million at December 31, 2017. At September 30, 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 September 30, 2018, the Bank had $77.9 million in short-term advances outstanding under the FHLBC compared to $115.0 million outstanding as of December 31, 2017; $65.0 million of the September 30, 2018, balance was issued at 2.22%, and $5.0 million was issued at 2.24%. The additional $4.0 million in other short-term borrowings as of September 30, 2018, was the outstanding portion of a $20.0 million line of credit the Company has with a correspondent bank for short-term funding needs, paying 3.85% as of the current quarter end; advances under the line can be outstanding up to 360 days from date of issuance. The Bank also assumed $23.5 million of long-term FHLBC advances with the ABC Bank acquisition. At September 30, 2018, these advances have a total outstanding balance

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of $18.1 million and are scheduled to mature over the next 7.5 years with interest rates ranging between 1.40% to 2.83 %. FHLBC stock held was valued at $4.3 million, and any potential FHLBC advances were collateralized by securities with a fair value of $77.3 million and loans with a principal balance of $304.2 million, which carried a FHLBC calculated combined collateral value of $303.3 million. The Company had excess collateral of $133.0 million available to secure borrowings at September 30, 2018.

The Company also has $44.1 million of senior notes outstanding, net of deferred issuance costs, as of September 30, 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 September 30, 2018 and December 31, 2017, unamortized debt issuance costs related to the senior notes were $867,000 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. Upon conversion to a floating rate, a cash flow hedge was initiated which resulted in the total interest rate paid on the debt of 4.34% as of September 30, 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 September 30, 2018, and December 31, 2017, unamortized debt issuance costs related to the junior subordinated debentures were $704,000 and $739,000 respectively, and are included as a reduction to the balance of the junior subordinated debentures on the Consolidated Balance Sheet. These deferred issuance costs will be amortized to interest expense over the 30-year term of the notes and are included in the Consolidated Statements of Income.

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, as amended (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 September 30, 2018, 169,791 shares remained available for issuance under the 2014 Plan.

There were no stock options granted or exercised in the nine months ended September 30, 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.

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A summary of stock option activity in the Plans for the nine months ended September 30, 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	0.4	$ 72
Exercisable at end of period	9,000	$ 7.49	0.4	$ 72

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. Awards of restricted stock 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. Awards of 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 254,281 restricted stock units issued under the 2014 Plan during the nine months ended September 30, 2018, which included 140,000 units granted under a new performance restricted stock unit agreement for select officers and all directors. The performance period covers January 1, 2018 through December 31, 2020, and vesting will be based upon the achievement of certain key Company performance metrics, such as total shareholder returns, earnings, and corporate efficiencies. There were 161,500 restricted stock units issued during the nine months ended September 30, 2017. Compensation expense is recognized over the vesting period of the restricted stock unit based on the market value of the award on the issue date. Total compensation cost that has been recorded for the 2014 Plan was $1.7 million and $925,000 in the first nine months of 2018 and 2017, respectively.

A summary of changes in the Company's unvested restricted awards for the nine months ended September 30, 2018, is as follows:

	September 30, 2018	
	Restricted Stock Shares and Units	Weighted Average Grant Date Fair Value
Unvested at January 1	465,000	$ 7.79
Granted	254,281	13.98
Vested	(155,500)	5.14
Forfeited	-	-
Unvested at September 30	563,781	$ 11.31

Total unrecognized compensation cost of restricted awards was $3.6 million as of September 30, 2018, which is expected to be recognized over a weighted-average period of 2.01 years.

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Note 11 – Earnings Per Share

The earnings per share – both basic and diluted – are included below as of September 30 (in thousands except for share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Basic earnings per share:				
Weighted-average common shares outstanding	29,747,078	29,627,086	29,718,191	29,591,811
Net income	$ 9,642	$ 8,077	$ 25,392	$ 17,650
Basic earnings per share	$ 0.32	$ 0.27	$ 0.85	$ 0.60
Diluted earnings per share:				
Weighted-average common shares outstanding	29,747,078	29,627,086	29,718,191	29,591,811
Dilutive effect of unvested restricted awards1	563,781	473,967	525,627	425,081
Dilutive effect of stock options and warrants	73,032	2,556	53,476	2,473
Diluted average common shares outstanding	30,383,891	30,103,609	30,297,294	30,019,365
Net Income	$ 9,642	$ 8,077	$ 25,392	$ 17,650
Diluted earnings per share	$ 0.32	$ 0.27	$ 0.84	$ 0.59
Number of antidilutive options and warrants excluded from the diluted earnings per share calculation	-	900,839	-	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 September 30, 2018, and is considered dilutive. The same warrant was not included as of September 30, 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 September 30, 2018, the Bank exceeded those thresholds.

At September 30, 2018, the Bank’s Tier 1 capital leverage ratio was 11.05%, an increase of 26 basis points from December 31, 2017, and is well above the 8.00% objective. The Bank’s total capital ratio was 14.16%, an increase of 38 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 September 30, 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 September 30, 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 Amount	Ratio	Minimum Capital Adequacy with Capital Conservation Buffer if applicable1 Amount	Ratio	To Be Well Capitalized Under Prompt Corrective Action Provisions2 Amount	Ratio
September 30, 2018						
Common equity tier 1 capital to risk weighted assets						
Consolidated	$ 196,632	9.12 %	$ 137,448	6.375 %	N/A	N/A
Old Second Bank	285,010	13.26	137,024	6.375	$ 139,711	6.50 %
Total capital to risk weighted assets						
Consolidated	270,976	12.57	212,879	9.875	N/A	N/A
Old Second Bank	304,333	14.16	212,238	9.875	214,924	10.00
Tier 1 capital to risk weighted assets						
Consolidated	251,653	11.67	169,817	7.875	N/A	N/A
Old Second Bank	285,010	13.26	169,265	7.875	171,952	8.00
Tier 1 capital to average assets						
Consolidated	251,653	9.72	103,561	4.00	N/A	N/A
Old Second Bank	285,010	11.05	103,171	4.00	128,964	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 September 30, 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 September 30, 2018, and December 31, 2017, respectively, measured by the Company at fair value on a recurring basis:

	September 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets:				
Securities available-for-sale				
U.S. Treasury	$ 3,854	$ -	$ -	$ 3,854
U.S. government agencies	-	11,703	-	11,703
U.S. government agencies mortgage-backed	-	14,766	-	14,766
States and political subdivisions	-	262,753	9,511	272,264
Collateralized mortgage obligations	-	63,396	1,564	64,960
Asset-backed securities	-	109,173	-	109,173
Collateralized loan obligations	-	65,618	-	65,618
Loans held-for-sale	-	2,911	-	2,911
Mortgage servicing rights	-	-	8,131	8,131
Interest rate swap agreements	-	2,803	-	2,803
Mortgage banking derivatives	-	151	-	151
Total	$ 3,854	$ 533,274	$ 19,206	$ 556,334
Liabilities:				
Interest rate swap agreements	$ -	$ 2,803	$ -	$ 2,803
Total	$ -	$ 2,803	$ -	$ 2,803

	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	$ -	$ 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:

	Nine Months Ended September 30, 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
Transfers into Level 3	-	-	-
Transfers out of Level 3	-	-	-
Total gains or losses			
Included in earnings (or changes in net assets)	32	-	636
Included in other comprehensive income	34	(805)	-
Purchases, issuances, sales, and settlements			
Purchases	-	20,421	-
Issuances	-	-	997
Settlements	(770)	(24,366)	(446)
Ending balance September 30, 2018	$ 1,564	$ 9,511	$ 8,131

	Nine Months Ended September 30, 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
Transfers into Level 3	-	-	-
Transfers out of Level 3	-	-	-
Total gains or losses			
Included in earnings (or changes in net assets)	32	-	(354)
Included in other comprehensive income	7	(501)	-
Purchases, issuances, sales, and settlements			

Purchases	-	10,994	-
Issuances	-	-	951
Settlements	(666)	(20,359)	(402)
Ending balance September 30, 2017	$ 2,492	$ 12,360	$ 6,684

The following table and commentary presents quantitative and qualitative information about Level 3 fair value measurements as of September 30, 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	$ 8,131	Discounted Cash Flow	Discount Rate	7.0 - 302.1%	10.2 %
			Prepayment Speed	7.0 - 68.9%	8.1 %

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

Measured at fair value on a recurring basis:	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Input	Weighted Average of Inputs
Mortgage servicing rights	$ 6,944	Discounted Cash Flow	Discount Rate	10.0 - 34.3%	10.2 %
			Prepayment Speed	7.0 - 68.4%	9.6 %

In addition to the above, Level 3 fair value measurement included $9.5 million for state and political subdivisions representing various local municipality securities and $1.6 million of collateralized mortgage obligations at September 30, 2018. Both of these were classified as securities available-for-sale, and were valued using a discount based on market spreads of similar assets, but the liquidity premium was an unobservable input. The state and political subdivisions securities balance in Level 3 fair value at September 30, 2017, was $12.4 million and collateralized mortgage obligation balance in Level 3 was $2.5 million. Both of these were classified as securities available-for-sale, and were valued using a discount based on market spreads of similar assets, but the liquidity premium was an unobservable input.

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

The Company may be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with GAAP. These assets consist of impaired loans and OREO. For assets measured at fair value on a nonrecurring basis at September 30, 2018, and December 31, 2017, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

	September 30, 2018			
	Level 1	Level 2	Level 3	Total
Impaired loans1	$ -	$ -	$ 9,269	$ 9,269

Other real estate owned, net2	-	-	6,964	6,964
Total	$ -	$ -	$ 16,233	$ 16,233

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 $9.6 million and a valuation allowance of $373,000 resulting in an increase of specific allocations within the allowance for loan and lease losses of $229,000 for the nine months ended September 30, 2018.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of $7.0 million, which is made up of the outstanding balance of $15.9 million, net of a valuation allowance of $8.0 million and participations of $937,000 at September 30, 2018.

	December 31, 2017			
	Level 1	Level 2	Level 3	Total
Impaired loans1	$ -	$ -	$ 5,113	$ 5,113
Other real estate owned, net2	-	-	8,371	8,371
Total	$ -	$ -	$ 13,484	$ 13,484

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 $5.3 million and a valuation allowance of $144,000, resulting in an increase of specific allocations within the allowance for loan and lease losses of $856,000 for the year December 31, 2017.

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

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

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Note 14 – Fair Values of Financial Instruments

The estimated fair values approximate carrying amount for all items except those described in the following table. Securities available-for-sale fair values are based upon market prices or dealer quotes, and if no such information is available, on the rate and term of the security. The carrying value of FHLBC stock approximates fair value as the stock is nonmarketable and can only be sold to the FHLBC or another member institution at par. FHLBC stock is carried at cost and considered a Level 2 fair value. For September 30, 2018, the fair values of loans and leases are estimated on an exit price basis incorporating discounts for credit, liquidity and marketability factors. This is not comparable with the fair value disclosures for December 31, 2017, which were estimated using an entrance price basis. For December 31, 2017, fair values of variable rate loans and leases with no significant change in credit risk were based on carrying values. The fair values of other loans and leases were estimated using discounted cash flow analyses which used interest rates being offered for loans and leases with similar terms to borrowers of similar credit quality. The fair value of time deposits is estimated using discounted future cash flows at current rates offered for deposits of similar remaining maturities. The fair values of borrowings were estimated based on interest rates available to the Company for debt with similar terms and remaining maturities. The fair value of off balance sheet volume is not considered material.

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

	September 30, 2018				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and due from banks	$ 34,366	$ 34,366	$ 34,366	$ -	$ -
Interest bearing deposits with financial institutions	15,956	15,956	15,956	-	-
Securities available-for-sale	542,338	542,338	3,854	527,409	11,075
FHLBC and FRBC Stock	10,511	10,511	-	10,511	-
Loans held-for-sale	2,911	2,911	-	2,911	-
Net loans	1,815,621	1,801,489	-	-	1,801,489
Interest rate swap agreements	1,135	1,135	-	1,135	
Accrued interest receivable	10,460	10,460	-	10,460	-
Financial liabilities:					

Noninterest bearing deposits	$ 621,580	$ 621,580	$ 621,580	$ -	$ -
Interest bearing deposits	1,510,790	1,583,984	-	1,583,984	-
Securities sold under repurchase agreements	44,333	44,333	-	44,333	-
Other short-term borrowings	81,875	81,875	-	81,875	-
Junior subordinated debentures	57,674	59,104	33,336	25,769	-
Senior notes	44,133	45,693	-	45,693	-
Note payable and other borrowings	18,050	18,050	-	18,050	-
Borrowing interest payable	801	801	-	801	-
Deposit interest payable	924	924	-	924	-

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

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

Risk Management Objective of Using Derivatives

The Company is exposed to certain risk arising from both its business operations and economic conditions. The Company principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Company manages economic risks, including interest rate, liquidity, and credit risk primarily by managing the amount, sources, and duration of its assets and liabilities and the use of derivative financial instruments. Specifically, the Company enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Company's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Company's known or expected cash receipts and its known or expected cash payments principally related to the Company's loan portfolio.

Cash Flow Hedges of Interest Rate Risk

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

For derivatives designated and that qualify as cash flow hedges of interest rate risk, the gain or loss on the derivative is recorded in Accumulated Other Comprehensive Income and subsequently reclassified into interest expense in the same period(s) during which the hedged transaction affects earnings. Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are received on the Company's variable-rate borrowings. During the next twelve months, the Company estimates that an additional $18,000 will be reclassified as a reduction to interest expense.

Non-designated Hedges

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

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

program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer derivatives and the offsetting derivatives are recognized directly in earnings.

The Company 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 MBS 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.

Disclosure of Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company’s derivative financial instruments as well as their classification on the Balance Sheet as of September 30, 2018 and December 31, 2017.

Fair Value of Derivative Instruments

			Asset Derivatives				Liability Derivatives			
			September 30, 2018		December 31, 2017		September 30, 2018		December 31, 2017	
	No. of Trans.	Notional Amount $	Balance Sheet Location	Fair Value $	Balance Sheet Location	Fair Value $	Balance Sheet Location	Fair Value $	Balance Sheet Location	Fair Value $
Derivatives designated as hedging instruments										
Interest rate swaps	1	25,774	Other Assets	1,135	Other Assets	-	Other Liabilities	-	Other Liabilities	1,287

Total derivatives designated as hedging instruments				1,135		-		-			1,287
Derivatives not designated as hedging instruments											
Interest rate swaps with commercial loan customers	25	168,394	Other Assets	2,803	Other Assets	727	Other Liabilities	2,803	Other Liabilities		727
Interest rate lock commitments and forward contracts	96	25,250	Other Assets	151	Other Assets	238	Other Liabilities	-	Other Liabilities		-
Other contracts	3	15,806	Other Assets	-	Other Assets	-	Other Liabilities	3	Other Liabilities		13
Total derivatives not designated as hedging instruments				2,954		965		2,806			740

Disclosure of the Effect of Fair Value and Cash Flow Hedge Accounting

The fair value and cash flow hedge accounting related to derivatives covered under ASC Subtopic 815-20 impacted Accumulated Other Comprehensive Income (“AOCI”) and the Income Statement. The gain recognized in AOCI on derivatives totaled $599,000 as of September 30, 2018, and a loss in AOCI of $80,000 as of September 30, 2017. The amount of the gain (loss) reclassified from AOCI to interest income on the income statement totaled ($29,000) and ($101,000) for the three months ended September 30, 2018, and September 30, 2017, respectively. The amount of the gain (loss) reclassified from AOCI to interest income or interest expense on the income statement totaled ($145,000) and ($119,000) for the nine months ended September 30, 2018, and September 30, 2017, respectively.

Credit-risk-related Contingent Features

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

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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

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

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

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

As of September 30, 2018, there were no derivatives in a net liability position. As of September 30, 2018, the Company has not posted any collateral related to derivatives agreements.

The Bank also issues letters of credit, which are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit are essentially the same as that involved in extending loan commitments to our customers. In addition to customer related commitments, the Company is responsible for letters of credit commitments that relate to properties held in OREO. The following table represents the Company’s contractual commitments due to letters of credit as of September 30, 2018, and December 31, 2017.

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

	September 30, 2018			December 31, 2017		
	Fixed	Variable	Total	Fixed	Variable	Total
Letters of credit:						
Borrower:						

Financial standby	$ 327	$ 7,165	$ 7,492	$ 177	$ 3,770	$ 3,947
Commercial standby	-	388	388	-	354	354
Performance standby	532	7,074	7,606	241	7,594	7,835
	859	14,627	15,486	418	11,718	12,136
Non-borrower:						
Performance standby	-	67	67	-	142	142
Total letters of credit	$ 859	$ 14,694	$ 15,553	$ 418	$ 11,860	$ 12,278

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

Overview

The following management's discussion and analysis presents information concerning our financial condition as of September 30, 2018, as compared to December 31, 2017, and our results of operations for the three and nine months ended September 30, 2018 and September 30, 2017. This discussion and analysis is best read in conjunction with our consolidated financial statements as well as the financial and statistical data appearing elsewhere in this report and our Form 10-K for the year ended December 31, 2017. The results of operations for the quarter and nine months ended September 30, 2018, are not necessarily indicative of future results.

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

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

Business Overview

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

Financial Overview

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

The following provides an overview of some of the factors impacting our financial performance for the three and nine month periods ending September 30, 2018:

- This is the second quarter of results of operations that included our recent acquisition of Greater Chicago Financial Corp., and its wholly-owned subsidiary bank, ABC Bank, which closed on April 20, 2018.

- Net income for the third quarter of 2018 was $9.6 million, or $0.32 per diluted share, compared to $8.1 million, or $0.27 per diluted share, for the third quarter of 2017. Net income for the nine months ended September 30, 2018, totaled $25.4 million, or $0.84 per diluted share, compared to $17.7 million, or $0.59 per diluted share for the nine months ended September 30, 2017.

- Net interest and dividend income was $23.7 million for the third quarter of 2018, compared to $19.3 million for the quarter ended September 30, 2017. Net interest and dividend income was $66.6 million for the nine months ended September 30, 2018, compared to $55.5 million for the like period in 2017.

- Noninterest income was $7.8 million for both the third quarter of 2018 and the third quarter of 2017. Noninterest income was $24.9 million for the nine months ended September 30, 2018, which reflected an increase of $2.7 million, or 12.0%, over the like period in 2017, due primarily to a $1.0 million BOLI death benefit recorded in the first quarter of 2018, as well as increases in interest rate driven mark to market adjustments on mortgage servicing rights.

- Noninterest expense was $18.7 million for the third quarter of 2018, which reflects an increase of $1.8 million, or 10.6%, from the third quarter of 2017. For the nine months ended September 30, 2018, noninterest expense totaled $58.4 million, an

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increase of $5.4 million, or 10.2%, over the like period in 2017. Increases noted were primarily due to acquisition-related costs recorded in 2018 stemming from our acquisition of ABC Bank.

· Asset quality remained consistent, with nonperforming loans as a percent of total loans declining to 0.6% as of September 30, 2018 from 1.0% as of September 30, 2017. We added $11.4 million of purchase credit impaired loans ("PCI loans"), net of purchase accounting adjustments, in our acquisition of ABC Bank in the second quarter of 2018. As of September 30, 2018, PCI loans, net of purchase accounting adjustments, totaled $10.9 million, and PCI loans to total loans were 0.6%. We had no PCI loans before our acquisition of ABC Bank.

· Income tax expense increased in the 2018 periods reported compared to the like 2017 periods due primarily to a $2.9 million increase in pre-tax income for the third quarter of 2018 compared to the third quarter of 2017, and a $8.7 million increase in pre-tax income for the nine months ended September 30, 2018 compared to the like 2017 period. In addition, an increase in the State of Illinois income tax became effective on July 1, 2017, and resulted in the remeasurement of our deferred tax asset and a $1.6 million tax benefit in the third quarter of 2017. These increases in income tax expense and the provision for income taxes for the quarter and nine months ended September 30, 2018, compared to the like periods in 2017, were partially offset by the enactment of the "Tax Cuts and Jobs Act," which became effective on January 1, 2018, and lowered the Federal corporate income tax rate to 21%.

Recent Developments

On April 20, 2018, we completed our previously announced acquisition of Greater Chicago Financial Corp., and its wholly-owned bank subsidiary, ABC Bank. In connection with the merger, Greater Chicago Financial Corp merged with and into the Company, with the Company as the surviving company in the merger. Immediately following the merger, ABC Bank, an Illinois state-chartered bank and wholly owned subsidiary of Greater Chicago Financial Corp., merged with and into the Bank, with the Bank as the surviving bank. With the acquisition of ABC Bank, we acquired four branches in the Chicago, Illinois, metropolitan area. We acquired $227.6 million of loans, net of purchase accounting adjustments, and $248.5 million of deposits, net of purchase accounting adjustments for time deposits, in the acquisition.

Critical Accounting Policies

The Company's consolidated financial statements are prepared based on the application of accounting policies in accordance with generally accepted accounting principles ("GAAP") and follow general practices within the banking industry. These policies require the reliance on estimates and assumptions, which may prove inaccurate or are subject to variations. 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. Changes in underlying factors, assumptions, or estimates could have a material impact on the Company's future financial condition and results of operations. The most critical of these significant accounting policies are the policies related to the allowance for loan and lease losses, fair valuation methodologies and income taxes. In addition, as a result of our acquisition of Greater Chicago Financial Corporation and its wholly-owned subsidiary, ABC Bank, that closed on

April 20, 2018, the Company has implemented accounting policies regarding loans purchased in a business combination, as discussed below and more fully described in Note 1 to our unaudited consolidated financial statements contained in this Quarterly Report on Form 10-Q.

Loans Acquired in Business Combinations

We record purchased loans at fair value at the date of acquisition based on a discounted cash flow methodology that considers various factors, including the type of loan and related collateral, classification status, whether the loan has a fixed or variable interest rate, its term and whether or not the loan was amortizing, and our assessment of risk inherent in the cash flow estimates. These cash flow evaluations are inherently subjective as they require material estimates, all of which may be susceptible to significant change. Purchased loans are segregated into two categories upon purchase: (1) loans purchased without evidence of deteriorated credit quality since origination, referred to as purchased non-credit impaired ("non-PCI") loans, and (2) loans purchased with evidence of deteriorated credit quality since origination for which it is probable that all contractually required payments will not be collected, referred to as purchased credit impaired ("PCI") loans.

We account for and evaluate PCI loans for impairment in accordance with the provisions of ASC 310-30. We estimate the cash flows expected to be collected on purchased loans based upon the expected remaining life of the loans, which includes the effects of estimated prepayments. Cash flow evaluations are inherently subjective as they require material estimates, all of which may be susceptible to significant change. We will perform re-estimations of cash flows on our PCI loan portfolio on a quarterly basis. Any decline in expected cash flows as a result of these re-estimations, due in any part to a change in credit, is deemed credit impairment, and recorded as provision for loan and lease losses during the period. Any decline in expected cash flows due only to changes in expected timing of cash flows is recognized prospectively as a decrease in yield on the loan and any improvement in expected cash flows, once any previously recorded impairment is recaptured, is recognized prospectively as an adjustment to the yield on the loan.

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Non-PCI loans outside the scope of ASC 310-30 are accounted for under ASC 310-20. For non-PCI loans, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value and the discount is accreted to interest income over the life of the loan. Subsequent to the purchase date, the method used to evaluate the sufficiency of the credit discount is similar to organic loans, and if necessary, additional reserves are recognized in the allowance for loan and lease losses.

No Other Material Changes in Significant Accounting Policies

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

Non-GAAP Financial Measures

This report contains references to financial measures that are not defined in GAAP. Such non-GAAP financial measures include the presentation of net interest income and net interest income to interest earning assets on a tax equivalent ("TE") basis, our adjusted efficiency ratio and our tangible common equity to tangible assets ratio. Management believes that the presentation of these non-GAAP financial measures (a) provides important supplemental information that contributes to a proper understanding of our operating performance, (b) enables a more complete understanding of factors and trends affecting our business, and (c) allows investors to evaluate our performance in a manner similar to management, the financial services industry, bank stock analysts, and bank regulators. Management uses non-GAAP measures as follows: in the preparation of our operating budgets, monthly financial performance reporting, and in our presentation to investors of our performance. However, we acknowledge that these non-GAAP financial measures have a number of limitations. Limitations associated with non-GAAP financial measures include the risk that persons might disagree as to the appropriateness of items comprising these measures and that different companies might calculate these measures differently. These disclosures should not be considered an alternative to our GAAP results. A reconciliation of non-GAAP financial measures to the most directly comparable GAAP financial measures is presented below or alongside the first instance where each non-GAAP financial measure is used.

Results of Operations

Three months ended September 30, 2018 and 2017

Our net income before taxes was $12.8 million in the third quarter of 2018 compared to $9.9 million in the third quarter of 2017. Net interest and dividend income increased $4.5 million, and noninterest income remained steady at $7.8 million in both the third quarter of 2018 and 2017. The increase in pre-tax income was also due to no provision for loan and lease loss expense being recorded in the third quarter of 2018, compared to $300,000 recorded in the third quarter of 2017. Partially offsetting the increase in pre-tax income was an increase of $1.8 million in noninterest expense due primarily to an increase in salaries and employee benefits and other expenses, partially offset by net gains on OREO sales in the third quarter of 2018.

The increase in net interest and dividend income was driven primarily by rising interest rates and loan growth due to the ABC Bank acquisition. Loans acquired, net of the purchase accounting adjustments, totaled $227.6 million in the second quarter of 2018. Loans and loans held for sale yielded 5.0% in the third quarter of 2018, compared to 4.6% in the third quarter of 2017.

Management has remained diligent in reviewing our loan portfolio to analyze and to determine if charge-offs are required. Due to an increasingly competitive loan origination environment, coupled with significant loan paydowns, there was no net loan growth in the third quarter of 2018, compared to the prior linked quarter. Management's review of the loan portfolio concluded that no additional provision expense was necessary, based on analysis of the allowance and loan portfolio held. The allowance for loan and lease loss analysis methodology remained consistent, with no material changes incorporated in the third quarter of 2018 from the prior quarter. Management determined an additional provision for loan and lease losses of $300,000 was appropriate for the quarter ended September 30, 2017.

Earnings for the third quarter of 2018 were $0.32 per diluted share on $9.6 million of net income, as compared to $0.27 per diluted share on net income of $8.1 million for the third quarter of 2017. Earnings in the 2018 period, compared to the like 2017 period, were positively impacted by increased loan volumes due to the ABC Bank acquisition, as well as the favorable impact of a rising interest rate environment and the federal income tax rate reduction to 21% from 35% stemming from the "Tax Cuts and Jobs Act" passed in late 2017.

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Nine months ended September 30, 2018 and 2017

Our net income before taxes was $32.4 million for the nine months ended September 30, 2018, compared to $23.7 million for the nine months ended September 30, 2017. Net interest and dividend income increased $11.1 million, and noninterest income increased $2.7 million for the nine months ended September 30, 2018, compared to the like period in 2017. The increase in pre-tax income was partially offset by a $5.4 million increase in noninterest expenses for the nine months ended September 30, 2018, compared to the like period in 2017, due primarily to acquisition-related costs incurred year to date of $3.3 million, pre-tax, partially offset by net gains on OREO sales and a decrease in OREO related operating costs due to a decline in OREO for the nine months ended September 30, 2018.

The increase in net interest and dividend income was driven primarily by rising interest rates and the ABC Bank acquisition, while the increase in noninterest income was primarily due to a $1.0 million death benefit received on a BOLI claim in the first quarter of 2018, as well as increases in interest rate driven mark to market adjustment on mortgage servicing rights.

Earnings for the nine month period ending September 30, 2018, were $0.84 per diluted share on $25.4 million of net income, as compared to $0.59 per diluted share on net income of $17.7 million for the nine month period ending September 30, 2017. Earnings in the 2018 period, compared to the like 2017 period, were positively impacted by increased loan volumes due to the ABC Bank acquisition, recoveries on a few nonperforming credits and the BOLI death benefit in the first quarter of 2018, as well as the favorable impact of a rising interest rate environment and the federal income tax rate reduction to 21% from 35% stemming from the “Tax Cuts and Jobs Act” passed in late 2017. The performance of our loan portfolio, the impact of the restructuring of our securities portfolio into higher yielding instruments and organic loan growth in the year over year period also contributed to the increase in earnings for the 2018 period.

Net Interest Income

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

Three months ended September 30, 2018 and 2017

Net interest and dividend income increased by $4.5 million from $19.3 million for the quarter ended September 30, 2017, to $23.7 million for the quarter ended September 30, 2018. Our interest and dividend income increased $915,000, or 3.4%, for the quarter ended September 30, 2018 compared to the second quarter of 2018, and reflected an increase of $5.8 million, or 25.6%, compared to the third quarter of 2017. Tax equivalent interest and dividend income increased by $5.4 million from $23.3 million for the quarter ended September 30, 2017, to $28.7 million for the quarter ended September 30, 2018. Average earning assets for the quarter ended September 30, 2018 were $2.41 billion, reflecting an increase of $19.7 million compared to the second quarter of 2018, and an increase of $289.8 million compared to the third quarter of 2017. Total average loans, including loans held-for-sale, totaled $1.84 billion in the third quarter of 2018, which reflected an increase of $33.5 million compared to the second quarter of 2018, and an increase of $289.1 million compared to the third quarter of 2017. The growth in average balances and resultant interest income was primarily due to $227.6 million of loans acquired, net of purchase accounting adjustments, in our acquisition of ABC Bank on April 20, 2018. In addition, the rising interest rate environment in the 2018 period and the repositioning on our securities portfolio over the past year has driven higher yields and growth in interest and dividend income. Total securities yields have increased by 14 basis points for the quarter ended September 30, 2018, compared to the quarter ended September 30, 2017, due to the repositioning of our portfolio into higher yielding tax exempt securities. Our average tax exempt securities portfolio increased by $53.7 million in the third quarter of 2018 compared to the third quarter of 2017.

Quarterly average interest bearing liabilities increased $12.3 million, or 0.7%, in the third quarter of 2018, compared to the second quarter of 2018, and increased $202.8 million, or 13.0%, compared to the third quarter of 2017. Growth from the prior periods was primarily due to deposits of $248.5 million, net of purchase accounting adjustments, recorded in our acquisition of ABC Bank in the second quarter of 2018. In addition, an increase of $14.1 million was reflected in the average balances of securities sold under repurchase agreements. The average of other short-term borrowed funds, which primarily consist of FHLBC advances, reflected a decrease of $16.9 million in the third quarter of 2018, compared to the third quarter of 2017. The short-term FHLBC advances were impacted by the higher interest rate environment in the third quarter of 2018, reflecting a cost of funds of 2.24% compared to 1.90% for the second quarter of 2018, and 1.19% for the third quarter of 2017. The decrease in average short-term borrowings was offset by the increase in notes payable and other borrowings, which included long-term FHLBC advances acquired with the ABC Bank purchase. The average of these long-term advances totaled $20.8 million for the third quarter of 2018, and reflected a cost of funds of 3.30%.

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The rate on our junior subordinated debentures declined in the third quarter of 2018, compared to the third quarter of 2017, due to the rate conversion on the debt from fixed to floating rate at three month LIBOR plus 150 basis points on June 15, 2017. Upon conversion to a floating rate, we initiated a cash flow hedge that resulted in a reduction in the total interest rate paid on the debt from 6.77% prior to June 15, 2017, to 4.34% at September 30, 2018.

Our net interest margin (on a tax-equivalent basis), expressed as a percentage of average earning assets, was 4.00% in the third quarter of 2018, reflecting a one basis point increase from the second quarter of 2018, and an increase of 23 basis points from the third quarter of 2017. The average tax-equivalent yield on earning assets increased to 4.73% for the third quarter of 2018, compared to 4.67% for the second quarter of 2018 and 4.32% for the third quarter of 2017. Increases in net interest margin and yield on average earning assets for the third quarter of 2018 compared to the third quarter of 2017 was attributable to growth in loan volumes and rates, as well as the restructuring of our securities portfolio into higher yielding tax exempt holdings, as discussed above. The cost of funds on interest bearing liabilities was 1.00% for the third quarter of 2018, 0.92% for the second quarter of 2018, and 0.80% for the third quarter of 2017. The increase in our cost of funds in each period was driven by the rising interest rate environment, specifically impacting the rates on newly issued time deposits and FHLBC advances.

Nine months ended September 30, 2018 and 2017

Net interest and dividend income increased by $11.1 million from $55.5 million for the nine months ended September 30, 2017, to $66.6 million for the nine months ended September 30, 2018. Our interest and dividend income increased $13.7 million, or 21.2%, for the nine months ended September 30, 2018, compared to the nine months ended September 30, 2017. Tax equivalent interest and dividend income increased by $13.1 million from $67.2 million for the nine months ended September 30, 2017, to $80.3 million for the nine months ended September 30, 2018.

Our net interest margin (on a tax equivalent basis) for the nine months ended September 30, 2018, was 3.92% compared to 3.68% for the like 2017 period, reflecting a 24 basis point increase. Average earning assets for the nine months ended September 30, 2018, were $2.33 billion, reflecting an increase of $224.1 million compared to the nine months ended September 30, 2017. The yield on average earning assets for the nine months ended September 30, 2018, was 4.61%, compared to 4.22% for the nine months ended September 30, 2017. Average interest bearing liabilities for the nine months ended September 30, 2018, increased $138.2 million, or 8.9%, compared to the nine months ended September 30, 2017. The cost of funds for the nine months ended September 30, 2018, was 94 basis points, compared to the cost of funds of 80 basis points for the like 2017 period. Growth in volumes and rates has resulted in an increase for all line items presented, excluding the junior subordinated debentures and senior notes.

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

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

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ANALYSIS OF AVERAGE BALANCES,

TAX EQUIVALENT INTEREST AND RATES

(In thousands - unaudited)

	Quarters Ended								
	September 30, 2018			June 30, 2018			September 30, 2017		
	Average Balance	Interest	Rate %	Average Balance	Interest	Rate %	Average Balance	Interest	Rate %
Assets									
Interest bearing deposits with financial institutions	$ 17,975	$ 84	1.85	$ 19,161	$ 97	2.03	$ 11,685	$ 37	1.24
Securities:									
Taxable	268,015	2,491	3.69						