OLD SECOND BANCORP INC
Form 10-Q
May 10, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended March 31, 2010

OR

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

For transition period from to

Commission File Number 0 -10537

OLD SECOND BANCORP, INC.

(Exact name of Registrant as specified in its charter)

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

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices) (Zip Code)

(630) 892-0202

(Registrant s telephone number, including area code)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2). Yes o No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock as of the latest practicable date: As of May 6, 2010, the Registrant had outstanding 13,939,833 shares of common stock, $1.00 par value per share.

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OLD SECOND BANCORP, INC.

Form 10-Q Quarterly Report

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PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

		(Unaudited) March 31, 2010		December 31, 2009
Assets				
Cash and due from banks	$	32,626	$	36,842
Interest bearing deposits with financial institutions		63,977		24,500
Federal funds sold		1,077		1,543
Short-term securities available-for-sale				16,911
Cash and cash equivalents		97,680		79,796
Securities available-for-sale		210,542		229,330
Federal Home Loan Bank and Federal Reserve Bank stock		13,044		13,044
Loans held-for-sale		8,958		11,586
Loans		1,958,101		2,062,826
Less: allowance for loan losses		66,813		64,540
Net loans		1,891,288		1,998,286
Premises and equipment, net		57,294		58,406
Other real estate owned		49,855		40,200
Mortgage servicing rights, net		2,821		2,450
Goodwill				
Core deposit and other intangible assets, net		6,372		6,654
Bank-owned life insurance (BOLI)		50,614		50,185
Accrued interest and other assets		109,217		106,720
Total assets	$	2,497,685	$	2,596,657
Liabilities				
Deposits:				
Non-interest bearing demand	$	316,240	$	308,304
Interest bearing:				
Savings, NOW, and money market		981,225		993,551
Time		866,997		904,422
Total deposits		2,164,462		2,206,277
Securities sold under repurchase agreements		21,319		18,374
Federal funds purchased				
Other short-term borrowings		4,390		54,998
Junior subordinated debentures		58,378		58,378
Subordinated debt		45,000		45,000
Notes payable and other borrowings		500		500
Accrued interest and other liabilities		15,896		15,922
Total liabilities		2,309,945		2,399,449

Stockholders Equity				
Preferred stock, ($1.00 par value; authorized 300,000 shares at March 31, 2010; series B, 5% cumulative perpetual, 73,000 shares issued and outstanding at March 31, 2010 and December 31,2009, $1,000.00 liquidation value)		69,254		69,039
Common stock, $1.00 par value; authorized 20,000,000 shares(1); issued 18,494,896 at March 31, 2010 and 18,373,296 at December 31, 2009; outstanding 13,939,833 at March 31, 2010 and 13,823,917 at December 31, 2009		18,495		18,373
Additional paid-in capital		64,315		64,431
Retained earnings		132,436		141,774
Accumulated other comprehensive (loss)		(1,916)		(1,605)
Treasury stock, at cost, 4,555,063 shares at March 31, 2010 and 4,549,379 at December 31, 2009		(94,844)		(94,804)
Total stockholders equity		187,740		197,208
Total liabilities and stockholders equity	$	2,497,685	$	2,596,657

(1) As disclosed in the Company s 8-K filing of April 23, 2010 and in Item 2, in the Management s Discussion and

Analysis of Financial Condition and Results of Operations section of this document, the Company s certificate of incorporation was amended to increase the number of authorized shares from 20.0 million to 40.0 million on April 20, 2010.

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Operations

(In thousands, except share data)

	(Unaudited) Three Months Ended March 31, 2010	2009
Interest and dividend income		
Loans, including fees	$ 26,632	$ 30,114
Loans held-for-sale	72	312
Securities:		
Taxable	1,238	3,796
Tax-exempt	745	1,431
Dividends from Federal Reserve Bank and Federal Home Loan Bank stock	56	56
Federal funds sold		2
Interest bearing deposits with financial institutions	16	2
Total interest and dividend income	28,759	35,713
Interest expense		
Savings, NOW, and money market deposits	1,385	1,846
Time deposits	5,097	9,701
Securities sold under repurchase agreements	10	98
Federal funds purchased		42
Other short-term borrowings	18	147
Junior subordinated debentures	1,072	1,072
Subordinated debt	195	490
Notes payable and other borrowings	1	111
Total interest expense	7,778	13,507
Net interest and dividend income	20,981	22,206
Provision for loan losses	19,220	9,425
Net interest and dividend income after provision for loan losses	1,761	12,781
Noninterest income		
Trust income	1,657	1,889
Service charges on deposits	2,018	2,112
Secondary mortgage fees	223	409
Mortgage servicing income	163	137
Net gain on sales of mortgage loans	1,157	2,486
Securities losses, net	(2)	(77)
Increase in cash surrender value of bank-owned life insurance	429	127
Debit card interchange income	663	576
Net interest rate swap gains and fees	190	390
Lease revenue from other real estate owned	518	9
Net gain (loss) on sale of other real estate owned	151	(52)
Other income	1,100	1,158
Total non-interest income	8,267	9,164
Noninterest expense		
Salaries and employee benefits	9,025	10,885
Occupancy expense, net	1,525	1,515
Furniture and equipment expense	1,639	1,740
FDIC insurance	1,428	817
Amortization of core deposit and other intangible assets	282	292
Advertising expense	256	432

Legal fees		559		347
Other real estate expense		6,428		844
Other expense		3,607		4,405
Total non-interest expense		24,749		21,277
(Loss) income before income taxes		(14,721)		668
Benefit for income taxes		(6,167)		(316)
Net (loss) income		(8,554)		984
Preferred stock dividends		1,128		801
Net (loss) income available to common shareholders	$	(9,682)	$	183
Share and per share information:				
Ending number of shares		13,939,833		13,824,561
Average number of shares		13,916,650		13,791,789
Diluted average number of shares		14,197,223		13,857,941
Basic (loss) earnings per share	$	(0.69)	$	0.01
Diluted (loss) earnings per share		(0.69)		0.01
Dividends paid per share		0.01		0.04

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In thousands)

	(Unaudited) Three Months Ended March 31, 2010	2009
Cash flows from operating activities		
Net (loss) income	$ (8,554)	$ 984
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	1,177	1,229
Amortization of leasehold improvement	127	33
Amortization and recovery of mortgage servicing rights, net		241
Provision for loan losses	19,220	9,425
Provision for deferred tax expense	(2,232)	1,461
Originations of loans held-for-sale	(58,731)	(133,095)
Proceeds from sales of loans held-for-sale	62,235	143,097
Net gain on sales of mortgage loans	(1,157)	(2,486)
Change in current income taxes payable	(249)	(1,781)
Increase in cash surrender value of bank-owned life insurance	(429)	(127)
Change in accrued interest receivable and other assets	(77)	(19,874)
Change in accrued interest payable and other liabilities	619	(12,265)
Net premium amortization on securities	141	233
Securities losses, net	2	77
Amortization of core deposit and other intangible assets	282	292
Stock based compensation	6	249
Net (gain) loss on sale of other real estate owned	(151)	52
Write-down of other real estate owned	3,908	290
Net cash provided by (used in) operating activities	16,137	(11,965)
Cash flows from investing activities		
Proceeds from maturities and pre-refunds including pay down of securities available-for-sale	21,143	75,815
Proceeds from sales of securities available-for-sale	2,000	108,345
Purchases of securities available-for-sale	(5,000)	(140,633)
Net change in loans	68,940	10,403
Investment in other real estate owned	(10)	(1,173)
Proceeds from sales of other real estate owned	5,436	765
Net purchases of premises and equipment	(192)	(199)
Net cash provided by investing activities	92,317	53,323
Cash flows from financing activities		
Net change in deposits	(41,815)	51,362
Net change in securities sold under repurchase agreements	2,945	(11,531)
Net change in federal funds purchased		(800)
Net change in other short-term borrowings	(50,608)	(163,544)
Proceeds from the issuance of preferred stock		68,245
Proceeds from the issuance of common stock warrants		4,755
Proceeds from notes payable and other borrowings		2,240
Repayment of note payable		(19,790)
Proceeds from exercise of stock options		55
Tax benefit from dividend equivalent payment		4

Dividends paid		(1,052)		(2,495)
Purchase of treasury stock		(40)		
Net cash used in financing activities		(90,570)		(71,499)
Net change in cash and cash equivalents		17,884		(30,141)
Cash and cash equivalents at beginning of period		79,796		73,214
Cash and cash equivalents at end of period	$	97,680	$	43,073

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

	(Unaudited) Three Months Ended March 31, 2010	2009
Supplemental cash flow information		
Income taxes received	$ (3,460)	$
Interest paid for deposits	6,838	11,491
Interest paid for borrowings	1,319	2,003
Non-cash transfer of loans to other real estate	18,838	3,673
Non-cash transfer of notes payable to other short-term borrowings		5,134
Change in dividends declared not paid	(454)	(1,341)
Non-cash transfer related to deferred taxes on goodwill		1,461

See accompanying notes to consolidated financial statements.

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Changes in

Stockholders Equity

(In thousands, except share data)

	Common Stock	Preferred Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders Equity
Balance, December 31, 2008	$ 18,304	$	$ 58,683	$ 213,031	$ (2,123)	$ (94,799)	$ 193,096
Comprehensive income (loss):							
Net income				984			984
Change in net unrealized loss on securities available-for-sale, net of $862 tax effect					(1,193)		(1,193)
Total comprehensive loss							(209)
Dividends Declared, $.04 per share				(556)			(556)
Change in restricted stock	63		(63)				
Stock options exercised	6		49				55
Tax effect of dividend equivalent payments			4				4
Stock based compensation			249				249
Preferred dividends declared (5% per preferred share)		203		(801)			(598)
Issuance of preferred stock		68,245					68,245

Issuance of stock warrants			4,755				4,755
Balance, March 31, 2009	$ 18,373	$ 68,448.00	$ 63,677	$ 212,658	$ (3,316)	$ (94,799)	$ 265,041
Balance, December 31, 2009	$ 18,373	$ 69,039.00	$ 64,431	$ 141,774	$ (1,605)	$ (94,804)	$ 197,208
Comprehensive loss:							
Net loss				(8,554)			(8,554)
Change in net unrealized loss on securities available-for-sale, net of $191 tax effect					(311)		(311)
Total comprehensive loss							(8,865)
Dividends Declared, $.01 per share				(141)			(141)
Change in restricted stock	122		(122)				
Tax effect from vesting of restricted stock			(225)				(225)
Stock based compensation			231				231
Purchase of treasury stock						(40)	(40)
Preferred dividends declared (5% per preferred share)		215		(672)			(457)
Adoption of mark to market of mortgage servicing rights				29			29
Balance, March 31, 2010	$ 18,495	$ 69,254	$ 64,315	$ 132,436	$ (1,916)	$ (94,844)	$ 187,740

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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

Note 1 Summary of Significant Accounting Policies

The accounting policies followed in the preparation of the interim financial statements are consistent with those used in the preparation of the annual financial information. The interim financial statements reflect all normal and recurring adjustments, which are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended March 31, 2010 are not necessarily indicative of the results that may be expected for the year ending December 31, 2010. These interim financial statements should be read in conjunction with the audited financial statements and notes included in Old Second Bancorp, Inc. s (the Company) annual report on Form 10-K for the year ended December 31, 2009. Unless otherwise indicated, amounts in the tables contained in the notes are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

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

All significant accounting policies are presented in Note 1 to the consolidated financial statements included in the Company s annual report on Form 10-K for the year ended December 31, 2009. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined.

As disclosed in Note 8 of the Company s annual report, the Company elected ASC 860-35 on January 1, 2010 to subsequently measure each class of mortgage servicing rights using the fair value measurement method. The initial impact of adoption of that election was an increase to beginning retained earnings of $29,000. Management believed that the fair value method of accounting would better allow management to mitigate interest rate risk. Servicing rights are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in net gain on sales of loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income.

Under the fair value measurement method, the Company measures servicing rights at fair value at each reporting date and reports changes in fair value of servicing assets in earnings in the period in which the changes occur, and are included with net gain on sales of mortgage loans on the income statement. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses. Additional disclosure related to fair value of mortgage servicing rights is found in Note 8. Prior to the January 1, 2010 change in method, residential mortgage loan servicing assets were initially measured at fair value, but were subsequently measured using the amortization method and were also evaluated for impairment. That amortization method required servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

In December 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-16 (formerly Statement No. 166), Transfers and Servicing (Topic 860) Accounting for Transfers of Financial Assets . ASU 2009-16 amends the derecognition

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accounting and disclosure guidance. ASU 2009-16 eliminates the exemption from consolidation for qualified special purpose entities (QSPEs) and also requires a transferor to evaluate all existing QSPEs to determine whether they must be consolidated. ASU 2009-16 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009. ASU 2009-16 did not have a material effect on the Company s 2010 results of operations, financial position, or disclosures.

In December 2009, the FASB issued ASU No. 2009-17 (formerly Statement No. 167), Consolidations (Topic 810) Improvements to Financial Reporting for Enterprises involved with Variable Interest Entities . ASU 2009-17 amends the consolidation guidance applicable to variable interest entities. The amendments to the consolidation guidance affect all entities, as well as qualifying special-purpose entities (QSPEs) that are currently excluded from previous consolidation guidance. ASU 2009-17 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009. ASU 2009-16 did not have a material effect on the Company s 2010 results of operations, financial position, or disclosures.

In February 2010, the FASB issued ASU No. 2010-09 Subsequent Events (Topic 855) Amendments to Certain Recognition and Disclosure Requirements. ASU 2010-09 amends the subsequent events disclosure guidance. The amendments include a definition of an SEC filer, requires an SEC filer or conduit bond obligor to evaluate subsequent events through the date the financial statements are issued, and removes the requirement for an SEC filer to disclose the date through which subsequent events have been evaluated. ASU 2010-09 was effective upon issuance except for the use of the issued date for conduit debt obligors. The effect of ASU 2010-09 including the Company s related disclosure is found in Note 20 - Subsequent Events.

In January 2010, the FASB issued ASU No. 2010-06 Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements. ASU 2010-06 amends the fair value disclosure guidance. The amendments include new disclosures and changes to clarify existing disclosure requirements. ASU 2010-06 was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements of Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The impact of ASU 2010-06 on the Company s disclosures is reflected in Note 16 - Fair Value Measurements.

Note 2 Business Combination

Old Second Acquisition, Inc., was formed as part of the November 5, 2007 Agreement and Plan of Merger between the Company, Old Second Acquisition, Inc., a wholly-owned subsidiary of the Company, and HeritageBanc, Inc. (Heritage), located in Chicago Heights. The parties consummated the merger on February 8, 2008, at which time Old Second Acquisition, Inc. was merged with and into Heritage with Heritage as the surviving corporation as a wholly-owned subsidiary of the Company. Additionally, the parties merged Heritage Bank, a wholly-owned subsidiary of Heritage, with and into Old Second National Bank, as the surviving bank (the Bank), and Heritage was subsequently dissolved, and is no longer an existing subsidiary. The purchase price was paid through a combination of $43.0 million in cash and approximately 1.6 million shares of the Company s common stock totaling $86.0 million, excluding transaction costs. The final accounting for the transaction generated $55.4 million in goodwill and $8.9 million in intangible assets subject to amortization.

The business combination was accounted for under the purchase method of accounting and the purchase price was allocated to the respective assets acquired and liabilities assumed based on their estimated fair values, net of applicable income tax effects. The excess cost over fair value of net assets acquired was recorded as goodwill. The Company decreased the goodwill attributable to the Heritage transaction by $1.4 million in the first quarter of 2009 along with an offsetting decrease to deferred tax liabilities. The Company subsequently recorded a goodwill impairment charge of $57.6 million in the

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second quarter of 2009, which primarily resulted from the goodwill that was attributable to Heritage. See Note 7 for additional information on the goodwill impairment charge.

Note 3 Securities

Securities available-for-sale are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2010:				
U.S. Treasury	$ 1,499	$ 11	$	$ 1,510
U.S. government agencies	62,014	238	(35)	62,217
U.S. government agency mortgage-backed	37,139	1,831	(34)	38,936
States and political subdivisions	77,773	1,727	(349)	79,151
Collateralized mortgage obligations	17,334	820	(4)	18,150
Collateralized debt obligations	17,864		(7,377)	10,487
Equity securities	99	2	(10)	91
	$ 213,722	$ 4,629	$ (7,809)	$ 210,542
December 31, 2009:				
U.S. Treasury	$ 1,499	$ 24	$	$ 1,523
U.S. government agencies	84,265	263	(76)	84,452
U.S. government agency mortgage-backed	41,175	1,669	(44)	42,800
States and political subdivisions	81,801	1,864	(327)	83,338
Collateralized mortgage obligations	22,246	910	(5)	23,151
Collateralized debt obligations	17,834		(6,951)	10,883
Equity securities	99	1	(6)	94
	$ 248,919	$ 4,731	$ (7,409)	$ 246,241

Recognition of other-than-temporary impairment was not necessary in the quarter ended March 31, 2010 or the year ended December 31, 2009. The changes in fair values related to interest rate fluctuations and other market factors and were generally not related to credit quality deterioration although the amount of deferrals and defaults in the pooled collateralized debt obligation increased from December 31, 2009. An increase in rates will generally cause a decrease in the fair value of individual securities while a decrease in rates typically results in an increase in fair value. In addition to the impact of rate changes upon pricing, uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for certain investments, particularly the collateralized debt obligations (CDO), which also impacted market pricing for the periods presented. In the case of the CDO fair value measurement, management included a risk premium adjustment as of March 31, 2010, to reflect an estimated amount that a market participant would demand because of uncertainty in cash flows. Management made that adjustment because the level of market activity for the CDO securities has continued to decrease and information on orderly transaction sales were not generally available. Accordingly, management designated this security as a level 3 security at June 30, 2009 as described in Note 16 of this quarterly report and continues with that designation as of March 31, 2010. Management does not have the intent to sell the above securities and it is more likely than not the Company will not have to sell the securities before recovery of its cost basis.

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

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	Amortized Cost	Fair Value	Gross Unrealized Loss	S&P Credit Rating (1)	Number of Banks in Issuance	Issuance Deferrals & Defaults Amount	Issuance Deferrals & Defaults Collateral %	Issuance Excess Subordination Amount	Issuance Excess Subordination Collateral %
March 31, 2010									
Class A1	$ 9,329	$ 5,401	$ (3,928)	BB+	63	$ 242,750	32.4%	$ 142,998	19.1%
Class A2A	8,535	5,086	(3,449)	BB-	63	242,750	32.4%	45,998	6.1%
	$ 17,864	$ 10,487	$ (7,377)						
December 31, 2009									
Class A1	$ 9,334	$ 5,473	$ (3,861)	BB+	63	$ 195,750	26.1%	$ 189,641	25.3%
Class A2A	8,500	5,410	(3,090)	BB-	63	195,750	26.1%	92,641	12.4%
	$ 17,834	$ 10,883	$ (6,951)						

(1) Moody s credit rating for class A1 and A2A were Baa2 and Ba2, respectively, as of March 31, 2010 and December 31, 2009. The Fitch ratings for class A1 and A2A were A and BB, respectively, as of March 31, 2010 and December 31, 2009

The model assumptions used to estimate fair value in the table above included estimated collateral default rates of 3.7%, 1.5%, and 0.6% in years 1, 2, and 3, respectively. Additionally, the estimated discount rates were Libor + 6.25% for the A1 tranche and Libor + 7.25% for the A2A tranche.

In addition to other equity securities, which are recorded at estimated fair value, the Bank owns the stock of the Federal Reserve Bank of Chicago (FRB) and the Federal Home Loan Bank of Chicago (FHLBC). Both of these entities require the Bank to invest in their non-marketable stock as a condition of membership. The value of the stock in each of those entities was recorded at cost in the amounts of $3.7 million and $9.3 million, respectively, at March 31, 2010, and at December 31, 2009. The FHLBC is a governmental sponsored entity that has been under a regulatory order for a prolonged period that generally requires approval prior to redeeming or paying dividends on their common stock. The Bank continues to utilize the various products and services of the FHLBC and management considers this stock to be a long-term investment. FHLBC members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLBC stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value.

Note 4 Loans

Major classifications of loans were as follows:

	March 31, 2010	December 31, 2009
Commercial and industrial	$ 197,420	$ 207,170
Real estate - commercial	903,289	925,013
Real estate - construction	219,364	273,719
Real estate - residential	627,936	643,936
Installment	6,980	9,834
Overdraft	602	830

Lease financing receivables		3,631		3,703
		1,959,222		2,064,205
Net deferred loan fees and costs		(1,121)		(1,379)
	$	1,958,101	$	2,062,826

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It is the policy of the Company to review each prospective credit in order to determine an adequate level of security or collateral to obtain prior to making a loan. 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 state lending laws and the Company s lending standards and credit monitoring procedures. The Bank generally makes loans 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 89.4% and 89.3% of the portfolio at March 31, 2010 and December 31, 2009, respectively. The Company is committed to overseeing and managing its loan portfolio to avoid unnecessarily high credit concentrations in accordance with interagency regulatory guidance on risk management. Consistent with that commitment, management is updating its asset diversification plan and policy and anticipates that the percentage of real estate lending to the overall portfolio will decrease in the future as result of that process.

Note 5 Allowance for Loan Losses

Changes in the allowance for loan losses for the three months ending March 31 are summarized as follows:

	2010	2009
Allowance at beginning of year	64,540	41,271
Charge-offs:		
Commercial and industrial	1,231	46
Real estate - commercial	3,536	359
Real estate - construction	11,534	3,727
Real estate - residential	2,268	293
Installment and other loans	97	102
Total charge-offs	18,666	4,527
Recoveries:		
Commercial and industrial	164	2
Real estate - commercial		
Real estate - construction	1,387	22
Real estate - residential	79	11
Installment and other loans	89	84
Total recoveries	1,719	119
Net charge-offs	16,947	4,408
Provision for loan losses	19,220	9,425
Allowance at end of quarter	$ 66,813	$ 46,288
Net charge-offs to average loans	0.84%	0.20%
Allowance at quarter end to average loans	3.30%	2.05%

Note 6: Other Real Estate Owned

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

	Three Months Ended March 31, 2010		2009
Other real estate owned			
Balance at beginning of period	$ 40,200	$	15,212
Property additions	18,838		3,673
Development improvements	10		1,173
Less:			
Property Disposals	5,285		817
Period valuation adjustments	3,908		290
Balance at end of period	$ 49,855	$	18,951

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Activity in the valuation allowance was as follows:

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
Balance at beginning of period	$ 5,668	$
Addition charged to expense	5,091	270
Write-downs taken on sales	(1,183)	
Other adjustments		20
Balance at end of period	$ 9,576	$ 290

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

	Three Months Ended March 31, 2010	Three Months Ended March 31, 2009
(Gain) loss on sales, net	$ (151)	$ 52
Provision for unrealized losses	5,091	270
Operating expenses	1,337	574
Less:		
Lease revenue	518	9
	$ 5,759	$ 887

Note 7 Goodwill and Intangibles

Goodwill and other intangible assets are reviewed for potential impairment on an annual basis or more often if events or circumstances indicate that they may be impaired. As such, goodwill was tested for impairment at the reporting unit level as of June 30, 2009 and a total impairment loss was recorded as a result of management s determination that the carrying amount of goodwill exceeded its implied fair value. The Company s market price per share had continued to be less than its stockholders common equity as the Company s stock continued to trade at a price below its book value. At the same time, earnings decreased as nonperforming assets, particularly loans and related charge-offs increased. Consistent with prior quarters, the Company considered these and other factors, including the items outlined in the process described below. The Company employed general industry practices in evaluating the impairment of its goodwill using a two-step process that begins with an estimation of the fair value of the reporting unit. The first step included a screen for potential impairment and the second step measured the amount of impairment. Significant management judgment was applied to the process including the development of cash flow projections, selection of appropriate discount rates, identification of relevant market comparables, the incorporation of general economic and market conditions as well as the selection of an appropriate control premium.

The first step of the June 30, 2009 analysis was to determine if there was a potential impairment. The Company used both an income and market approach as part of that analysis. The income approach was based on discounted cash flows, which were derived from internal forecasts and economic expectations for the Bank reporting unit. The key assumptions used to determine fair value under the income approach included the cash flow period, terminal values based on a terminal growth rate and the discount rate. The discount rates used in the income approach evaluated at June 30, 2009 ranged from 17.5% to 22.5% to attempt to incorporate discount rates a market participant might employ in its valuation of the Bank. The market approach calculated the change of control price a market participant could have been reasonably expected to pay for the Bank by adding a change of control premium. The results of the first step of the analysis indicated that the Bank s carrying value exceeded its fair value,

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which indicated that an impairment existed and required that the Company perform the second step of the analysis to determine the amount of the impairment. The second step of the analysis involved a valuation of all of the assets of the Bank as if it had just been acquired and comparing the resultant goodwill with the actual carrying amount of goodwill. The results of the second step of the analysis determined that goodwill was fully impaired, which resulted in the pre-tax impairment charge of $57.6 million. This was a total impairment and no goodwill remained as a result of that impairment charge. The portion of the goodwill intangible asset charge that was attributable to Heritage was tax deductible and had an associated $22.0 million deferred tax asset, and although not anticipated, there can be no guarantee that a valuation allowance against this deferred tax asset will not be necessary in future periods.

Management also performed a periodic review of the core deposit and other intangible assets. Based upon these reviews, management determined there was no impairment of the core deposit and other intangible assets as of March 31, 2010. No assurance can be given that future impairment tests will not result in a charge to earnings.

The following table presents the changes in the carrying amount of goodwill and other intangibles during the first three months ended March 31, 2010, and the year ended December 31, 2009. (in thousands):

	March 31, 2010		December 31, 2009	
	Goodwill	**Core Deposit and Other Intangibles**	**Goodwill**	**Core Deposit and Other Intangibles**
Balance at beginning of period	$	$ 6,654	$ 59,040	$ 7,821
Amortization/ adjustments(1)		(282)	(1,461)	(1,167)
Impairment			(57,579)	
Balance at end of period	$	$ 6,372	$	$ 6,654

(1) The $1.46 million adjustment to goodwill was recorded in the first quarter of 2009.

The following table presents the estimated future amortization expense for core deposit and other intangibles as of March 31, 2010 (in thousands):

	Amount
2010	$ 848
2011	847
2012	779
2013	732
2014	679
Thereafter	2,487
Total	$ 6,372

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Note 8 Mortgage Servicing Rights

Changes in capitalized mortgage servicing rights as of March 31, summarized as follows:

	2010	2009
Balance at beginning of period	$ 2,470	$ 1,973
Fair value adjustment	9	
Additions	342	192
Amortization		(250)
Balance at end of period	2,821	1,915
Changes in the valuation allowance for servicing assets were as follows:		
Balance at beginning of period	(20)	(599)
Fair value adjustment	20	(254)
Provisions for impairment		
Recovery credited to expense		263
Balance at end of period		(590)
Net balance	$ 2,821	$ 1,325

As discussed in Note 1, the Company adopted ASC 860-50-35 using the fair value measurement method for all servicing rights as of January 1, 2010, and the initial impact of adoption was an increase to beginning retained earnings of $29,000. Management believed that the fair value method of accounting would better allow management to mitigate interest rate risk. Servicing rights are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in net gain on sales of loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. Additional disclosure related to fair value of mortgage servicing rights is found in Note 16.

Under the fair value measurement method, the Company measures servicing rights at fair value at each reporting date and reports changes in fair value of servicing assets in earnings in the period in which the changes occur, and are included with net gain on sales of mortgage loans on the income statement. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses

Note 9 Deposits

Major classifications of deposits as of March 31, 2010 and December 31, 2009, were as follows:

	2010	2009
Non-interest bearing demand	$ 316,240	$ 308,304
Savings	190,599	178,257
NOW accounts	398,011	422,778

Money market accounts	392,615	392,516
Certificates of deposit of less than $100,000	529,117	551,106
Certificates of deposit of $100,000 or more	337,880	353,316
	$ 2,164,462	$ 2,206,277

Note 10 Borrowings

The following table is a summary of borrowings as of March 31, 2010 and December 31, 2009:

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		2010		2009
Securities sold under repurchase agreements	$	21,319	$	18,374
FHLB advances				50,019
Treasury tax and loan		4,390		4,979
Junior subordinated debentures		58,378		58,378
Subordinated debt		45,000		45,000
Notes payable and other borrowings		500		500
	$	129,587	$	177,250

The Company enters into sales of securities under agreements to repurchase (repurchase agreements) which generally mature within 1 to 90 days from the transaction date. These repurchase agreements are treated as financings and they are secured by mortgage-backed securities with a carrying amount of $23.9 and $25.1 million at March 31, 2010 and December 31, 2009, respectively. The securities sold under agreements to repurchase consisted of U.S. government agencies during the two-year reporting period.

The Company s borrowings at the Federal Home Loan Bank of Chicago (FHLBC) requires the Bank to be a member and invest in the stock of the FHLBC and are generally limited to the lesser of 35% of total assets or 60% of the book value of certain mortgage loans. In addition, these notes were collateralized by FHLBC stock of $9.3 million and loans totaling $195.4 million at March 31, 2010. FHLBC stock of $9.3 million and loans totaling $203.7 million were pledged as of December 31, 2009. The Company has also established borrowing capacity at the FRB that was not used at either December 31, 2009 or March 31, 2010. The Company currently has $63.4 million of borrowing capacity available at the FRB.

The Bank is a Treasury Tax & Loan (TT&L) depository for the FRB, and as such, we accept TT&L deposits. The Company is allowed to hold these deposits for the FRB until they are called. The interest rate is the federal funds rate less 25 basis points. Securities with a face value greater than or equal to the amount borrowed are pledged as a condition of borrowing TT&L deposits. As of March 31, 2010 and December 31, 2009, the TT&L deposits were $4.4 million and $5.0 million, respectively.

One of the Company s most significant borrowing relationships continued to be the $45.5 million credit facility with LaSalle Bank National Association (now Bank of America and, the Lender). That credit facility began in January 2008 and was originally comprised of a $30.5 million senior debt facility, which included a $30.0 million revolving line that matured on March 31, 2010, and $500,000 in term debt as well as $45.0 million of subordinated debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly, and is based on, at the Company s option, either the Lender s prime rate or three-month LIBOR plus 90 basis points. The interest rate on the subordinated debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The proceeds of the $45.0 million of subordinated debt were used to finance the 2008 acquisition of Heritage, including transaction costs. The Company had no principal outstanding balance on the Bank of America senior line of credit when it matured, but did have $500,000 in principal outstanding in term debt and $45.0 million in principal outstanding in subordinated debt at both December 31, 2009 and March 31, 2010. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the agreement, as described therein. The agreement also contains certain customary representations and warranties and financial and negative covenants. At March 31, 2010, the Company continued to be out of compliance with two of the financial covenants contained within the credit agreement. The agreement provides that upon an event of default as the result of the Company s failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the

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revolving line of the term debt (together the Senior Debt) by 200 basis points, (iii) declare the Senior Debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal amount of the Senior Debt is the $500,000 in term debt. Because the Subordinated Debt is treated as Tier 2 capital for regulatory capital purposes, the Agreement does not provide the lender with any rights of acceleration or other remedies with regard to the Subordinated Debt upon an event of default caused by the Company s failure to comply with a financial covenant. In November 2009, the lender provided notice to the Company that it was invoking the default rate, thereby increasing the rate on the term debt by 200 basis points retroactive to July 30, 2009. This action by the lender resulted in nominal additional interest expense as it only applies to the $500,000 of outstanding term debt. The Company and the Lender have periodically engaged in discussions regarding the potential resolution of the issues, which could include a range of results including, but not limited to, a renegotiation of the credit facility and/or a change in the covenants or other terms. The parties have not agreed to a mutually satisfactory resolution.

Note 11 Junior Subordinated Debentures

The Company completed the sale of $27.5 million of cumulative trust preferred securities by its unconsolidated subsidiary, Old Second Capital Trust I in June 2003. An additional $4.1 million of cumulative trust preferred securities was sold in July 2003. The costs associated with the issuance of the cumulative trust preferred securities are being amortized over 30 years. The trust-preferred securities can remain outstanding for a 30-year term but, subject to regulatory approval, can be called in whole or in part by the Company. The stated call period commenced on June 30, 2008 and can be exercised by the Company from time to time hereafter. Cash distributions on the securities are payable quarterly at an annual rate of 7.80%. The Company issued a new $32.6 million subordinated debenture to the trust in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

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

Both of the debentures issued by Old Second Bancorp, Inc. are recorded on the Consolidated Balance Sheets as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Operations.

Note 12 Long-Term Incentive Plan

The Long-Term Incentive Plan (the Incentive Plan) authorizes the issuance of up to 1,908,332 shares of the Company s common stock, including the granting of qualified stock options (Incentive Stock Options), nonqualified stock options, restricted share rights (restricted stock and restricted stock units), and stock appreciation rights. Total shares issuable under the plan were 215,672 at March 31, 2010 and 426,872 at December 31, 2009. Stock based awards may be granted to selected directors and officers or employees at the discretion of the board of directors. All stock options were granted for a term of ten years. Restricted share rights vest three years from the grant date. Awards under the Incentive Plan become fully vested upon a merger or change in control of the Company. Compensation expense is recognized over the vesting period of the options based on the fair value of the options at the grant date.

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Total compensation cost that has been charged for those plans was $231,000 in the first quarter of 2010 and $249,000 in the first quarter of 2009. The total income tax benefit was $81,000 in the first quarter of 2010 and $87,000 in the first quarter of 2009.

There were no stock options exercised during the first quarter of 2010 and the Company did not grant any options of the Company s common stock. There were 5,334 stock options exercised during the first quarter of 2009 and the Company granted options to purchase 16,500 shares of the Company s common stock. Total unrecognized compensation cost related to nonvested stock options granted under the Incentive Plan is $140,000 as of March 31, 2010, and is expected to be recognized over a weighted-average period of 0.67 years. Total unrecognized compensation cost related to nonvested stock options granted under the Incentive Plan is $467,000 as of March 31, 2009, and is expected to be recognized over a weighted-average period of 1.36 years.

A summary of stock option activity in the Incentive Plan as of each quarter is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
March 31, 2010:				
Beginning outstanding	683,666	$ 24.29		
Granted				
Exercised				
Canceled				
Expired				
Ending outstanding	683,666	$ 24.29	4.49	$
Exercisable at end of quarter	644,668	$ 24.37	4.28	$
March 31, 2009:				
Beginning outstanding	722,132	$ 24.03		
Granted	16,500	7.49		
Exercised	(5,334)	10.13		
Canceled	(13,000)	29.12		
Expired				
Ending outstanding	720,298	$ 23.66	5.30	$
Exercisable at end of quarter	617,136	$ 23.46	4.70	$

A summary of changes in the Company s nonvested options in the Incentive Plan is as follows:

	March 31, 2010	
	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2010	43,498	$ 4.83
Granted		
Forfeited		
Vested	(4,500)	2.01
Nonvested at March 31, 2010	38,998	$ 5.16

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A summary of stock option activity as of March 31 is as follows:

	Three Months Ended March 31, 2010		2009
Intrinsic value of options exercised	$	$	673
Cash received from option exercises			54,033
Tax benefit realized from option exercises			268
Weighted average fair value of options granted	$	$	2.01

Restricted stock was granted beginning in 2005 under the Incentive Plan. Restricted stock units were granted beginning in 2009 under the Incentive Plan. There were 121,600 restricted stock shares and 89,600 restricted stock units issued during the first quarter of 2010 whereas there were 66,041 restricted stock shares and 67,683 restricted stock units issued during the first quarter of 2009. These share rights are subject to forfeiture until certain restrictions have lapsed, including employment for a specific period. These share rights vest after a three-year period. Compensation expense is recognized over the vesting period of the shares based on the market value of the shares at issue date. Awards under the Incentive Plan become fully vested upon a merger or change in control of the Company.

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

	March 31, 2010		March 31, 2009	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1	179,178	$ 12.95	53,311	$ 28.49
Granted	211,200	7.00	133,724	7.49
Vested	(21,663)	29.20		
Forfeited			(2,698)	29.29
Nonvested at March 31	368,715	$ 8.59	184,337	$ 13.24

Total unrecognized compensation cost of restricted share rights is $2.2 million as of March 31, 2010, which is expected to be recognized over a weighted-average period of 3.16 years. Total unrecognized compensation cost of restricted share rights was $1.5 million as of March 31, 2009, which was expected to be recognized over a weighted-average period of 2.90 years. There were 21,663 restricted share rights vested during the first quarter ending March 31, 2010. There were no restricted share rights vested at March 31, 2009.

Note 13 (Loss) Earnings Per Share

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

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	Three Months Ended March 31,			
		2010		2009
Basic (loss) earnings per share:				
Weighted-average common shares outstanding		13,916,650		13,791,789
Weighted-average common shares less stock based awards		13,707,907		13,707,255
Weighted-average common shares stock based awards		366,368		116,872
Net (loss) income	$	(8,554)	$	984
Dividends on preferred shares		1,128		801
Net loss income available to common shareholders		(9,682)		183
Common stock dividends		(137)		(548)
Un-vested share-based payment awards		(4)		(7)
Undistributed (loss) earnings		(9,823)		(372)
Basic (loss) earnings per share common undistributed earnings		(0.70)		(0.03)
Basic (loss) earnings per share common distributed earnings		0.01		0.04
Basic (loss) earnings per share	$	(0.69)	$	0.01
Diluted (loss) earnings per share:				
Weighted-average common shares outstanding		13,916,650		13,791,789
Dilutive effect of restricted shares(1)		280,573		66,152
Dilutive effect of stock options				
Diluted average common shares outstanding		14,197,223		13,857,941
Net (loss) income available to common stockholders	$	(9,682)	$	183
Diluted (loss) earnings per share	$	(0.69)	$	0.01
Number of antidilutive options excluded from the diluted (loss) earnings per share calculation		1,577,000		1,577,000

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

The above (loss) earnings per share calculation did not include 815,339 common stock warrants that were outstanding as of March 31, 2010.

Note 14 Other Comprehensive Loss

The following table summarizes the related income tax effect for the components of Other Comprehensive Loss as of March 31:

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	Three Months Ended March 30, 2010	2009
Net (loss) income available to common stockholders	$ (9,682)	$ 183
Unrealized holding (losses) gains on available-for-sale securities arising during the period		
U.S. Treasury	$ (13)	$ (14)
U.S. government agencies	14	(30)
U.S. government agency mortgage-backed	172	1,138
States and political subdivisions	(159)	590
Collateralized mortgage obligations	(89)	694
Collateralized debt obligations	(426)	(4,601)
Equity securities	(3)	(4)
	$ (504)	$ (2,227)
Related tax benefit	192	893
Holding losses after tax	(312)	(1,334)
Less: Reclassification adjustment for the net gains and losses realized during the period		
Realized gains (losses) by security type:		
U.S. government agencies	$ (2)	$ (57)
States and political subdivisions		(24)
Collateralized mortgage obligations		4
Net realized losses	(2)	(77)
Income tax benefit on net realized losses	1	31
Net realized losses after tax	(1)	(46)
Other comprehensive loss on available-for-sale	(311)	(1,288)
Changes in fair value of derivatives used for cashflow hedges arising during the period	$	$ 158
Related tax expense		(63)
Other comprehensive income on cashflow hedges		95
Total other comprehensive loss	$ (311)	$ (1,193)

Note 15 Retirement Plans

The Company maintains tax-qualified contributory and non-contributory profit sharing plans covering substantially all full-time and regular part-time employees. The expense of these plans was $228,000 and $529,000 in the first three months of 2010 and 2009, respectively, as the Company eliminated the profit sharing contribution and lowered the amount of the 401K match in second quarter of 2009.

Note 16 Fair Value Option and Fair Value Measurements

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements (now ASC 820-10). This statement defines fair value, establishes a framework for measuring fair value, and expands disclosures about Fair Value Measurements. The guidance establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. Fair Value Measurements defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Fair Value Option for Financial Assets and Financial Liabilities requirement generally permits the measurement of selected eligible financial instruments at fair value at specified election dates, subject to the conditions set for the in the standard.

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The Company elected to adopt the   Fair Value Option for Financial Assets and Financial Liabilities   as required on January 1, 2008 and the impact of adoption was not material. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. As of April 1, 2009, the Company elected the fair value option for loans held-for-sale. As of January 1, 2010, the Company elected the fair value measurement method option available under ASC 820-35 for mortgage servicing rights as discussed Notes 1 and 8. The Company did not elect the fair value option for any other financial assets or financial liabilities as of March 31, 2010.

Fair Value Measurement

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

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

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

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

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

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

- U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

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

- Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMOs are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.

- Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.

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

- Collateralized debt obligations are collateralized by trust preferred security issuances of other financial institutions. Uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for these investment securities, which continued to affect market pricing in the period presented. To reflect an appropriate fair value measurement, management included a risk premium adjustment to provide an estimate of the amount that a market participant would demand because of uncertainty in cash flows in the discounted cash flow analysis. Management made that adjustment to Level 3 valuation at June 30, 2009 because the level of market activity

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for the CDO security has continued to decrease and information on orderly sale transactions was not generally available.

- Marketable equity securities are priced using available market information.

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

- Lending related commitments to fund certain residential mortgage loans (interest rate locks) to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors as well as forward commitments for future delivery of mortgage-backed securities are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices from the date of the commitment and do not typically involve significant judgments by management.

- The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.

- Interest rate swap positions, both assets and liabilities, are based on a valuation pricing models using an income approach based upon readily observable market parameters such as interest rate yield curves.

- The credit valuation reserve on customer interest rate swap positions was determined based upon management s estimate of the amount of credit risk exposure, including available collateral protection and/or by utilizing an estimate related to a probability of default as indicated in the Bank credit policy. Such adjustments would result in a Level 3 classification.

- The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

- OREO: Nonrecurring adjustments to certain commercial and residential real estate properties classified as OREO are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the estimated fair value, less costs to sell, an impairment loss is recognized.

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

The tables below present the balance of assets and liabilities at March 31, 2010 and December 31, 2009, respectively, which are measured by the Company at fair value on a recurring basis:

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	March 31, 2010			
	Level 1	Level 2	Level 3	Total
Assets:				
Investment securities available-for-sale				
U.S. Treasury	$ 1,510	$	$	$ 1,510
U.S. government agencies		62,217		62,217
U.S. government agency mortgage-backed		38,936		38,936
States and political subdivisions		79,151		79,151
Collateralized mortgage obligations		18,150		18,150
Collateralized debt obligations			10,487	10,487
Equity securities	37		54	91
Loans held-for-sale		8,958		8,958
Mortgage servicing rights(1)			2,821	2,821
Other assets (Interest rate swap agreements net of swap credit valuation)		4,766	(119)	4,647
Other assets (Forward loan commitments to investors)		39		39
Total	$ 1,547	$ 212,217	$ 13,243	$ 227,007
Liabilities:				
Other liabilities (Interest rate swap agreements)	$	$ 4,766	$	$ 4,766
Other liabilities (Interest rate lock commitments to borrowers)		187		187
Other liabilities (Risk Participation Agreement)			32	32
Total	$	$ 4,953	$ 32	$ 4,985

	December 31, 2009			
	Level 1	Level 2	Level 3	Total
Assets:				
Investment securities available-for-sale				
U.S. Treasury	$ 1,523	$	$	$ 1,523
U.S. government agencies	5,000	79,452		84,452
U.S. government agency mortgage-backed		42,800		42,800
States and political subdivisions		83,338		83,338
Collateralized mortgage obligations		23,151		23,151
Collateralized debt obligations			10,883	10,883
Equity securities	41		53	94
Loans held-for-sale		11,586		11,586
Other assets (Interest rate swap agreements net of swap credit valuation)		3,742	(285)	3,457
Other assets (Forward loan commitments to investors)		146		146
Total	$ 6,564	$ 244,215	$ 10,651	$ 261,430
Liabilities:				
Other liabilities (Interest rate swap agreements)	$	$ 3,742	$	$ 3,742
Other liabilities (Interest rate lock commitments to borrowers)		(70)		(70)
Other liabilities (Risk Participation Agreement)			31	31
Total	$	$ 3,672	$ 31	$ 3,703

(1) As of January 1, 2010, the Company elected the fair value measurement method of accounting for mortgage servicing rights available under ASC 820-35 as discussed in more detail in Notes 1 and 8.

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

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	March 31, 2010				
	Securities available-for-sale				
	Equity Securities	Collateralized Debt Obligations	Mortgage Servicing Rights	Interest Rate Swap Valuation	Risk Participation Agreement
Beginning balance January 1, 2010	$ 53	$ 10,883	$	$ (285)	$ (31)
Transfers into Level 3			2,821		
Transfers out of Level 3					
Total gains or losses					
Included in earnings (or changes in net assets)		39			(1)
Included in other comprehensive income	1	(426)			
Purchases, issuances, sales, and settlements					
Purchases				166	
Issuances					
Settlements		(9)			
Expirations					
Ending balance March 31, 2010	$ 54	$ 10,487	$ 2,821	$	