

OLD SECOND BANCORP INC

Form 10-Q/A

November 15, 2016

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

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

For the quarterly period ended September 30, 2016

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  
(State or other jurisdiction)

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

of incorporation or organization)

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices) (Zip Code)

(630) 892-0202

(Registrant's telephone number, including area code)

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

Yes      No

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

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

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

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

Yes      No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: As of November 4, 2016, the Registrant had outstanding 29,554,716 shares of common stock, \$1.00 par value per share.



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EXPLANATORY NOTE

This Amendment to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2016 is being filed for the sole purpose of filing the corrected Exhibits 32.1 and 32.2.

This Amendment contains the complete text of the original report in addition to the corrected Exhibits listed above. This Amendment does not reflect any events occurring subsequent to the November 8, 2016 filing date of the original Form 10-Q for the quarter ended September 30, 2016, or in any way modify or update disclosures in the original Form 10-Q.

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) September 30, 2016	December 31, 2015
Assets		
Cash and due from banks	\$ 29,203	\$ 26,975
Interest bearing deposits with financial institutions	160,744	13,363
Cash and cash equivalents	189,947	40,338
Securities available-for-sale, at fair value	531,057	456,066
Securities held-to-maturity, at amortized cost	-	247,746
Federal Home Loan Bank and Federal Reserve Bank stock	7,918	8,518
Loans held-for-sale	3,750	2,849
Loans	1,202,852	1,133,715
Less: allowance for loan losses	14,983	16,223
Net loans	1,187,869	1,117,492
Premises and equipment, net	39,092	39,612
Other real estate owned	14,144	19,141
Mortgage servicing rights, net	5,075	5,847
Bank-owned life insurance (BOLI)	60,036	59,049
Deferred tax assets, net	55,536	64,552
Other assets	18,327	15,818
Total assets	\$ 2,112,751	\$ 2,077,028
Liabilities		
Deposits:		
Noninterest bearing demand	\$ 473,477	\$ 442,639
Interest bearing:		
Savings, NOW, and money market	904,137	908,598
Time	399,768	407,849
Total deposits	1,777,382	1,759,086
Securities sold under repurchase agreements	46,606	34,070
Other short-term borrowings	-	15,000
Junior subordinated debentures	57,579	57,543
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	500
Other liabilities	14,057	9,900
Total liabilities	1,941,124	1,921,099

Stockholders' Equity		
Common stock	34,533	34,427
Additional paid-in capital	116,468	115,918
Retained earnings	124,283	114,209
Accumulated other comprehensive loss	(7,437)	(12,659)
Treasury stock	(96,220)	(95,966)
Total stockholders' equity	171,627	155,929
Total liabilities and stockholders' equity	\$ 2,112,751	\$ 2,077,028

	September 30, 2016		December 31, 2015	
	Preferred Stock \$ 1	Common Stock \$ 1	Preferred Stock \$ 1	Common Stock \$ 1
Par value	\$ 1	\$ 1	\$ 1	\$ 1
Liquidation value	-	N/A	-	N/A
Shares authorized	300,000	60,000,000	300,000	60,000,000
Shares issued	-	34,532,734	-	34,427,234
Shares outstanding	-	29,554,716	-	29,483,429
Treasury shares	-	4,978,018	-	4,943,805

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,		(unaudited) Nine Months Ended September 30,	
	2016	2015	2016	2015
Interest and dividend income				
Loans, including fees	\$ 13,496	\$ 13,353	\$ 39,593	\$ 40,038
Loans held-for-sale	48	38	115	153
Securities:				
Taxable	3,954	3,471	12,547	10,218
Tax exempt	180	122	579	426
Dividends from Federal Reserve Bank and Federal Home Loan Bank stock	83	76	251	230
Interest bearing deposits with financial institutions	64	12	98	43
Total interest and dividend income	17,825	17,072	53,183	51,108
Interest expense				
Savings, NOW, and money market deposits	193	185	577	547
Time deposits	931	799	2,622	2,377
Other short-term borrowings	23	6	69	22
Junior subordinated debentures	1,084	1,072	3,251	3,215
Subordinated debt	245	205	727	604
Notes payable and other borrowings	2	1	6	5
Total interest expense	2,478	2,268	7,252	6,770
Net interest and dividend income	15,347	14,804	45,931	44,338
Loan loss reserve release	-	(2,100)	-	(4,400)
Net interest and dividend income after release for loan losses	15,347	16,904	45,931	48,738
Noninterest income				
Trust income	1,403	1,444	4,274	4,526
Service charges on deposits	1,756	1,766	4,961	5,086
Secondary mortgage fees	322	190	795	715
Mortgage servicing gain / (loss), net of changes in fair value	290	(274)	(641)	18
Net gain on sales of mortgage loans	2,177	1,359	5,031	4,677
Securities loss, net	(1,959)	(57)	(2,020)	(178)
Increase in cash surrender value of bank-owned life insurance	383	236	987	1,015
Debit card interchange income	1,013	1,004	3,009	3,013
Loss on disposal and transfer of fixed assets, net	-	(1,143)	(1)	(1,143)
Other income	1,209	1,123	3,751	4,156
Total noninterest income	6,594	5,648	20,146	21,885
Noninterest expense				
Salaries and employee benefits	9,014	8,260	26,854	26,664
Occupancy expense, net	1,120	1,156	3,358	3,521



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Furniture and equipment expense	1,144	1,110	3,180	3,176
FDIC insurance	228	373	793	1,023
General bank insurance	269	308	839	975
Advertising expense	430	434	1,212	992
Debit card interchange expense	363	379	1,186	1,131
Legal fees	242	279	594	922
Other real estate expense, net	426	977	2,043	4,717
Other expense	3,346	2,968	9,487	9,203
Total noninterest expense	16,582	16,244	49,546	52,324
Income before income taxes	5,359	6,308	16,531	18,299
Provision for income taxes	1,860	2,384	5,865	6,747
Net income	\$ 3,499	\$ 3,924	\$ 10,666	\$ 11,552
Preferred stock dividends and accretion of discount	-	339	-	1,873
Net income available to common stockholders	\$ 3,499	\$ 3,585	\$ 10,666	\$ 9,679
Basic earnings per share	\$ 0.12	\$ 0.12	\$ 0.36	\$ 0.33
Diluted earnings per share	0.12	0.12	0.36	0.33

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,	
	2016	2015	2016	2015
Net Income	\$ 3,499	\$ 3,924	\$ 10,666	\$ 11,552
Unrealized holding (losses) gains on available-for-sale securities arising during the period	(616)	(5,191)	5,151	(4,845)
Related tax benefit (expense)	237	2,079	(2,071)	1,869
Holding (losses) gains after tax on available-for-sale securities	(379)	(3,112)	3,080	(2,976)
Less: Reclassification adjustment for the net losses realized during the period				
Net realized losses	(1,959)	(57)	(2,020)	(178)
Income tax benefit on net realized losses	782	23	807	71
Net realized losses after tax	(1,177)	(34)	(1,213)	(107)
Other comprehensive income (loss) on available-for-sale securities	798	(3,078)	4,293	(2,869)
Accretion and reversal of net unrealized holding gains on held-to-maturity securities	-	242	5,939	739
Related tax expense	-	(100)	(2,446)	(304)
Other comprehensive income on held-to-maturity securities	-	142	3,493	435
Changes in fair value of derivatives used for cashflow hedges	(254)	(816)	(4,278)	(816)
Related tax benefit	102	-	1,714	-
Other comprehensive loss on cashflow hedges	(152)	(816)	(2,564)	(816)
Total other comprehensive income (loss)	646	(3,752)	5,222	(3,250)
Total comprehensive income	\$ 4,145	\$ 172	\$ 15,888	\$ 8,302

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,	
	2016	2015
Cash flows from operating activities		
Net income	\$ 10,666	\$ 11,552
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of leasehold improvement	1,682	1,816
Change in fair value of mortgage servicing rights	1,920	1,201
Loan loss reserve release	-	(4,400)
Provision for deferred tax expense	5,476	6,485
Originations of loans held-for-sale	(147,186)	(153,990)
Proceeds from sales of loans held-for-sale	150,247	158,621
Net gain on sales of mortgage loans	(5,031)	(4,677)
Change in current income taxes receivable	300	11
Increase in cash surrender value of bank-owned life insurance	(987)	(624)
Change in accrued interest receivable and other assets	(2,659)	(2,413)
Change in accrued interest payable and other liabilities	(246)	(3,385)
Net discount (accretion)/premium amortization on securities	(517)	226
Securities losses, net	2,020	178
Amortization of junior subordinated debentures issuance costs	36	35
Stock based compensation	482	466
Net gain on sale of other real estate owned	(316)	(769)
Provision for other real estate owned losses	1,305	3,825
Net loss on disposal of fixed assets	1	4
Loss on transfer of premises to other real estate owned	-	1,139
Net cash provided by operating activities	17,193	15,301
Cash flows from investing activities		
Proceeds from maturities and calls including pay down of securities available-for-sale	62,868	33,035
Proceeds from sales of securities available-for-sale	271,374	70,176
Purchases of securities available-for-sale	(153,252)	(131,956)
Proceeds from maturities and calls including pay down of securities held-to-maturity	3,372	10,689
Proceeds from sales of Federal Home Loan Bank stock	600	787
Net change in loans	(71,600)	18,403
Improvements in other real estate owned	(16)	-
Proceeds from sales of other real estate owned	5,247	12,336
Net purchases of premises and equipment	(1,163)	(793)
Net cash provided by investing activities	117,430	12,677
Cash flows from financing activities		
Net change in deposits	18,296	35,424

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Net change in securities sold under repurchase agreements	12,536	6,038
Net change in other short-term borrowings	(15,000)	(10,000)
Redemption of preferred stock	-	(47,331)
Dividends paid on preferred stock	-	(2,417)
Dividends paid on common stock	(592)	-
Purchase of treasury stock	(254)	(117)
Net cash provided by (used in) financing activities	14,986	(18,403)
Net change in cash and cash equivalents	149,609	9,575
Cash and cash equivalents at beginning of period	40,338	44,197
Cash and cash equivalents at end of period	\$ 189,947	\$ 53,772

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

	(Unaudited)	
	Nine Months Ended	
	September 30,	
Supplemental cash flow information	2016	2015
Income taxes paid, net	\$ 160	\$ 250
Interest paid for deposits	3,142	2,964
Interest paid for borrowings	4,021	3,848
Non-cash transfer of loans to other real estate owned	1,223	7,393
Non-cash transfer of premises to other real estate owned	-	468
Non-cash transfer of securities held-to-maturity to securities available-for-sale	244,823	-
Change in dividends accrued and declared but not paid	-	(544)

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	Preferred Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2014	\$ 34,365	\$ 47,331	\$ 115,332	\$ 100,697	\$ (7,713)	\$ (95,849)	\$ 194,163
Net income				11,552			11,552
Other comprehensive loss, net of tax					(3,250)		(3,250)
Change in restricted stock	58		(58)				-
Tax effect from vesting of restricted stock			33				33
Stock based compensation			466				466
Purchase of treasury stock						(117)	(117)
Redemption of preferred stock		(47,331)					(47,331)
Preferred stock accretion and declared dividends				(1,873)			(1,873)
Balance, September 30, 2015	\$ 34,423	\$ -	\$ 115,773	\$ 110,376	\$ (10,963)	\$ (95,966)	\$ 153,643
Balance, December 31, 2015	\$ 34,427	\$ -	\$ 115,918	\$ 114,209	\$ (12,659)	\$ (95,966)	\$ 155,929
Net income				10,666			10,666
Other comprehensive gain, net of tax					5,222		5,222
Dividends declared and paid				(592)			(592)
Change in restricted stock	106		(106)				-
			174				174

Tax effect from vesting of restricted stock							
Stock based compensation			482				482
Purchase of treasury stock						(254)	(254)
Balance, September 30, 2016	\$ 34,533	\$ -	\$ 116,468	\$ 124,283	\$ (7,437)	\$ (96,220)	\$ 171,627

See accompanying notes to consolidated financial statements.



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Old Second Bancorp, Inc. and Subsidiaries

Notes to Consolidated Financial Statements

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

Note 1 – Summary of Significant Accounting Policies

The accounting policies followed in the preparation of the interim 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, 2016, are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. 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, 2015. Unless otherwise indicated, amounts in the tables contained in the notes to the consolidated financial statements are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

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

All significant accounting policies are presented in Note 1 to the consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the consolidated financial statements and how those values are determined.

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU No. 2014-09 "Revenue from Contracts with Customers (Topic 606)." The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. In August 2015, the FASB issued ASU 2015-14 "Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date." This accounting standards update defers the effective date of ASU 2014-09 for an additional year. ASU 2015-14 will be effective for annual reporting periods beginning after December 15, 2017. The amendments can 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 is not permitted. In March 2016, the FASB issued ASU 2016-08 "Revenue from Contracts with Customers (TOPIC 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)" and in April 2016, the FASB issued ASU 2016-10 "Revenue from Contracts with Customers (TOPIC 606): Identifying Performance Obligations and Licensing." ASU 2016-08 requires the entity to determine if it is acting as a principal with control over the goods or services it is contractually obligated to provide, or an agent with no control over specified goods or services provided by another party to a customer. ASU 2016-10 was issued to further clarify ASU 2014-09 implementation regarding identifying performance obligation materiality, identification of key contract components, and scope. The Company is assessing the impact of ASU 2014-09 and other related ASUs as noted above on its accounting and disclosures.

In April 2015, the FASB issued ASU No. 2015-03 "Simplifying the Presentation of Debt Issuance Costs." ASU 2015-03 amended prior guidance to simplify the presentation of debt issuance costs. The amendments in this ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The adoption of this standard did not have a material effect to the Company's operating results or financial condition. This standard was adopted by the Company effective January 2016.

In March 2016, the FASB issued ASU No. 2016-09 "Improvements to Employee Share-Based Payment Accounting." FASB issued this ASU as part of the Simplification Initiative. This ASU involves several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liability, and classification on the statement of cash flows. ASU 2016-09 is effective for financial statements issued for fiscal years beginning after December 15, 2016. The Company is assessing the impact of ASU 2016-09 on its accounting and disclosures.

In June 2016, the FASB issued ASU No. 2016-13 "Measurement of Credit Losses on Financial Instruments." ASU 2016-13 was issued to provide financial statement users with more useful information about the expected credit losses on financial instruments

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and other commitments to extend credit held by a reporting entity at each reporting date to enhance the decision making process. 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.

## Subsequent Events

On October 18, 2016, the Company's Board of Directors declared a cash dividend of 1 cent per share payable on November 7, 2016, to stockholders of record as of October 28, 2016.

On October 28, 2016, the bank completed its previously announced acquisition of the Chicago branch of Talmer Bank and Trust, the banking subsidiary of Talmer Bancorp, Inc. ("Talmer"). As a result of the transaction, the Bank acquired approximately \$48.9 million of deposits and \$223.4 million of loans.

## Note 2 – 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.

In the second quarter of 2016, the securities held-to-maturity portfolio was reclassified to available-for-sale to allow for portfolio restructuring and to fund loan growth. This transfer of \$244.8 million at net book value was approved by the Board of Directors, and will preclude any holdings of securities held-to-maturity for a two year period.

In the third quarter of 2016, approximately \$233.5 million of securities available-for-sale were sold to satisfy anticipated funding requirements for the acquisition of the Talmer branch. Securities losses of \$2.0 million pretax were realized upon these sales.

Nonmarketable equity investments include Federal Home Loan Bank of Chicago (“FHLBC”) stock and Federal Reserve Bank of Chicago (“Reserve Bank”) stock. FHLBC stock was recorded at \$3.2 million at September 30, 2016, and \$3.7 million at December 31, 2015. Reserve Bank stock was recorded at \$4.8 million at September 30, 2016, and December 31, 2015. Our FHLBC stock is necessary to maintain access to FHLBC advances.

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The following table summarizes the amortized cost and fair value of the securities portfolio at September 30, 2016, and December 31, 2015, and the corresponding amounts of gross unrealized gains and losses (in thousands):

September 30, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale				
U.S. government agencies	\$ 1,661	\$ -	\$ (158)	\$ 1,503
U.S. government agencies mortgage-backed	42,899	824	-	43,723
States and political subdivisions	21,489	765	-	22,254
Corporate bonds	10,958	-	(228)	10,730
Collateralized mortgage obligations	202,670	2,478	(758)	204,390
Asset-backed securities	149,394	431	(9,652)	140,173
Collateralized loan obligations	109,468	-	(1,184)	108,284
Total securities available-for-sale	\$ 538,539	\$ 4,498	\$ (11,980)	\$ 531,057

December 31, 2015	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available-for-sale				
U.S. Treasury	\$ 1,509	\$ -	\$ -	\$ 1,509
U.S. government agencies	1,683	-	(127)	1,556
U.S. government agencies mortgage-backed	2,040	-	(44)	1,996
States and political subdivisions	30,341	285	(100)	30,526
Corporate bonds	30,157	-	(757)	29,400
Collateralized mortgage obligations	68,743	24	(1,847)	66,920
Asset-backed securities	241,872	74	(10,038)	231,908
Collateralized loan obligations	94,374	-	(2,123)	92,251
Total securities available-for-sale	\$ 470,719	\$ 383	\$ (15,036)	\$ 456,066
Securities held-to-maturity				
U.S. government agency mortgage-backed	\$ 36,505	\$ 1,592	\$ -	\$ 38,097
Collateralized mortgage obligations	211,241	3,302	(965)	213,578
Total securities held-to-maturity	\$ 247,746	\$ 4,894	\$ (965)	\$ 251,675

The fair value, amortized cost and weighted average yield of debt securities at September 30, 2016, by contractual maturity, were as follows in the table below. Securities not due at a single maturity date are shown separately.

	Amortized Cost	Weighted Average Yield		Fair Value
Securities available-for-sale				
Due in one year or less	\$ 410	4.60	%	\$ 420
Due after one year through five years	11,575	2.31		11,734
Due after five years through ten years	18,573	2.43		18,538
Due after ten years	3,550	2.77		3,795
	34,108	2.45		34,487
Mortgage-backed and collateralized mortgage obligations	245,569	2.43		248,113
Asset-backed securities	149,394	1.95		140,173
Collateralized loan obligations	109,468	3.66		108,284
Total securities available-for-sale	\$ 538,539	2.55	%	\$ 531,057

At September 30, 2016, the Company's investments include \$118.9 million of asset-backed securities that are backed by student loans originated under the Federal Family Education Loan program ("FFEL"). Under the FFEL, private lenders made federally guaranteed student loans to parents and students and packaged and sold them as asset-backed securities. While the program was modified several times before elimination in 2010, not less than 97% of the outstanding principal amount of the loans made under FFEL are guaranteed by the U.S. Department of Education. In addition to the U.S. Department of Education guarantee, total added credit enhancement in the form of overcollateralization and/or subordination amounted to \$12.8 million, or 9.62%, of outstanding principal.

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Securities with unrealized losses at September 30, 2016, and December 31, 2015, 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):

September 30, 2016	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			
Securities									
Available-for-sale	Securities	Losses	Value	Securities	Losses	Value	Securities	Losses	Value
U.S. government									
Securities	-	\$ -	\$ -	1	\$ 158	\$ 1,503	1	\$ 158	\$ 1,503
Corporate bonds	2	52	5,423	2	176	5,307	4	228	10,730
Securities collateralized									
Mortgage									
Investments	10	415	50,958	6	343	17,020	16	758	67,978
Asset-backed									
Securities	6	694	23,817	10	8,958	99,432	16	9,652	123,247
Securities collateralized loan									
Investments	2	48	11,947	12	1,136	81,337	14	1,184	93,284
Other securities									
Available-for-sale	20	\$ 1,209	\$ 92,145	31	\$ 10,771	\$ 204,599	51	\$ 11,980	\$ 296,723
December 31, 2015									
Securities									
Available-for-sale	Securities	Losses	Value	Securities	Losses	Value	Securities	Losses	Value
U.S. government									
Securities	-	\$ -	\$ -	1	\$ 127	\$ 1,556	1	\$ 127	\$ 1,556
U.S. government									
Securities									
Mortgage-backed	1	44	1,996	-	-	-	1	44	1,996
Securities and political									
Divisions	2	19	1,541	1	81	1,713	3	100	3,250
Corporate bonds	5	292	14,866	3	465	14,534	8	757	29,400
Securities collateralized									
Mortgage									
Investments	4	334	16,218	7	1,513	43,618	11	1,847	59,836
Asset-backed									
Securities	9	2,080	78,301	8	7,958	121,217	17	10,038	199,518
Securities collateralized loan									
Investments	5	446	29,480	9	1,677	62,771	14	2,123	92,251

al securities									
available-for-sale	26	\$ 3,215	\$ 142,402	29	\$ 11,821	\$ 245,409	55	\$ 15,036	\$ 387,100
securities									
held-to-maturity									
collateralized									
mortgage									
investments	8	\$ 505	\$ 40,307	2	\$ 460	\$ 33,842	10	\$ 965	\$ 74,100
al securities									
held-to-maturity	8	\$ 505	\$ 40,307	2	\$ 460	\$ 33,842	10	\$ 965	\$ 74,100

Recognition of other-than-temporary impairment was not necessary in the three and nine months ending September 30, 2016, or the year ended December 31, 2015. 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.

### Note 3 – Loans

Major classifications of loans were as follows:

	September 30, 2016	December 31, 2015
Commercial	\$ 169,824	\$ 130,362
Real estate - commercial	617,280	605,721
Real estate - construction	28,786	19,806
Real estate - residential	357,846	351,007
Consumer	3,325	4,216
Overdraft	403	483
Lease financing receivables	14,210	10,953
Other	10,114	10,130
	1,201,788	1,132,678
Net deferred loan costs	1,064	1,037
Total loans	\$ 1,202,852	\$ 1,133,715

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 83.5% and 86.1% of the portfolio at September 30, 2016, and December 31, 2015, respectively.





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

September 30, 2016	90 Days or Greater Past				Current	Nonaccrual	Total Loans	Recorded Investment 90 days or Greater Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due				
Commercial	\$ 182	\$ -	\$ -	\$ 182	\$ 183,269	\$ 583	\$ 184,034	\$ -
Real estate - commercial								
Owner occupied general purpose	96	-	-	96	125,733	1,492	127,321	-
Owner occupied special purpose	-	-	-	-	167,664	397	168,061	-
Non-owner occupied general purpose	789	-	-	789	159,923	2,463	163,175	-
Non-owner occupied special purpose	-	-	-	-	103,990	1,013	105,003	-
Retail properties	-	-	-	-	37,685	1,980	39,665	-
Farm	22	1,350	-	1,372	12,683	-	14,055	-
Real estate - construction								
Homebuilder	-	-	-	-	612	-	612	-
Land	-	-	-	-	1,237	-	1,237	-
Commercial speculative	-	-	-	-	8,901	76	8,977	-
All other	102	-	-	102	17,858	-	17,960	-
Real estate - residential								
Investor	419	132	454	1,005	129,302	910	131,217	454
Owner occupied	-	70	-	70	119,854	5,654	125,578	-
Revolving and junior liens	112	102	29	243	98,640	2,168	101,051	29
Consumer	10	-	-	10	3,315	-	3,325	-
Other <sup>2</sup>	-	-	-	-	11,581	-	11,581	-
Total	\$ 1,732	\$ 1,654	\$ 483	\$ 3,869	\$ 1,182,247	\$ 16,736	\$ 1,202,852	\$ 483

Recorded

December 31, 2015	90 Days or Greater Past				Current	Nonaccrual	Total Loans	Investment 90 days or Greater Past Due and Accruing
	30-59 Days Past Due	60-89 Days Past Due	Greater Past Due	Total Past Due				
Commercial <sup>1</sup>	\$ 394	\$ -	\$ -	\$ 394	\$ 140,848	\$ 73	\$ 141,315	\$ -
Real estate - commercial								
Owner occupied general purpose	652	119	-	771	123,479	1,254	125,504	-
Owner occupied special purpose	358	-	-	358	170,827	763	171,948	-
Non-owner occupied general purpose	-	-	-	-	166,668	975	167,643	-
Non-owner occupied special purpose	-	-	-	-	92,387	-	92,387	-
Retail properties	-	-	-	-	34,352	-	34,352	-
Farm	-	-	-	-	12,615	1,272	13,887	-
Real estate - construction								
Homebuilder	-	-	-	-	2,604	-	2,604	-
Land	-	-	-	-	1,137	-	1,137	-
Commercial speculative	-	-	-	-	2,117	83	2,200	-
All other	6	77	65	148	13,717	-	13,865	65
Real estate - residential								
Investor	101	-	-	101	125,611	972	126,684	-
Owner occupied	1,083	446	-	1,529	110,885	6,378	118,792	-
Revolving and junior liens	344	68	-	412	102,500	2,619	105,531	-
Consumer	4	-	-	4	4,212	-	4,216	-
Other <sup>2</sup>	-	-	-	-	11,650	-	11,650	-
Total	\$ 2,942	\$ 710	\$ 65	\$ 3,717	\$ 1,115,609	\$ 14,389	\$ 1,133,715	\$ 65

1 The "Commercial" class includes lease financing receivables.

2 The "Other" class includes overdrafts and net deferred costs.

#### Credit Quality Indicators

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

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

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

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

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

Credit Quality Indicators by class of loans were as follows:

September 30, 2016	Pass	Special Mention	Substandard 1	Doubtful	Total
Commercial	\$ 177,082	\$ 4,650	\$ 2,302	\$ -	\$ 184,034
Real estate - commercial					
Owner occupied general purpose	124,359	645	2,317	-	127,321
Owner occupied special purpose	165,333	2,330	398	-	168,061
Non-owner occupied general purpose	160,463	249	2,463	-	163,175
Non-owner occupied special purpose	100,191	-	4,812	-	105,003
Retail Properties	36,435	-	3,230	-	39,665
Farm	11,014	1,240	1,801	-	14,055
Real estate - construction					
Homebuilder	612	-	-	-	612
Land	1,237	-	-	-	1,237
Commercial speculative	8,901	-	76	-	8,977
All other	17,782	-	178	-	17,960
Real estate - residential					
Investor	130,046	-	1,171	-	131,217
Owner occupied	119,146	-	6,432	-	125,578
Revolving and junior liens	97,973	-	3,078	-	101,051
Consumer	3,324	-	1	-	3,325
Other	11,554	27	-	-	11,581
Total	\$ 1,165,452	\$ 9,141	\$ 28,259	\$ -	\$ 1,202,852

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December 31, 2015	Pass	Special Mention	Substandard 1	Doubtful	Total
Commercial	\$ 136,078	\$ 3,208	\$ 2,029	\$ -	\$ 141,315
Real estate - commercial					
Owner occupied general purpose	123,827	-	1,677	-	125,504
Owner occupied special purpose	171,185	-	763	-	171,948
Non-owner occupied general purpose	163,956	1,908	1,779	-	167,643
Non-owner occupied special purpose	88,468	-	3,919	-	92,387
Retail Properties	30,432	1,490	2,430	-	34,352
Farm	12,615	-	1,272	-	13,887
Real estate - construction					
Homebuilder	2,604	-	-	-	2,604
Land	1,137	-	-	-	1,137
Commercial speculative	2,117	-	83	-	2,200
All other	13,865	-	-	-	13,865
Real estate - residential					
Investor	125,548	-	1,136	-	126,684
Owner occupied	111,713	-	7,079	-	118,792
Revolving and junior liens	102,476	-	3,055	-	105,531
Consumer	4,215	-	1	-	4,216
Other	11,650	-	-	-	11,650
Total	\$ 1,101,886	\$ 6,606	\$ 25,223	\$ -	\$ 1,133,715

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

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The Company had \$2.2 million and \$3.9 million residential assets in the process of foreclosure as of September 30, 2016, and December 31, 2015, respectively.

Impaired loans, which include nonaccrual loans and troubled debt restructurings, by class of loans for the September 2016 periods listed were as follows:

	As of September 30, 2016			Nine Months Ended September 30, 2016	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded					
Commercial	\$ 382	\$ 464	\$ -	\$ 226	\$ -
Commercial real estate					
Owner occupied general purpose	2,509	2,807	-	2,412	66
Owner occupied special purpose	397	525	-	580	-
Non-owner occupied general purpose	2,263	2,458	-	1,655	2
Non-owner occupied special purpose	1,013	1,649	-	506	-
Retail properties	1,980	2,364	-	990	-
Farm	-	-	-	636	-
Construction					
Homebuilder	-	-	-	-	-
Land	-	-	-	-	-
Commercial speculative	76	83	-	80	-
All other	-	-	-	-	-
Residential					
Investor	1,822	2,156	-	1,864	35
Owner occupied	9,294	10,720	-	9,916	120
Revolving and junior liens	2,322	3,336	-	2,527	9
Consumer	201	268	-	100	-
Total impaired loans with no recorded allowance	22,259	26,830	-	21,492	232
With an allowance recorded					
Commercial	-	-	-	2	-
Commercial real estate					
Owner occupied general purpose	-	-	-	-	-
Owner occupied special purpose	-	-	-	-	-
Non-owner occupied general purpose	264	603	264	132	31
Non-owner occupied special purpose	-	-	-	-	-
Retail properties	-	-	-	-	-
Farm	-	-	-	-	-

Construction					
Homebuilder	-	-	-	-	-
Land	-	-	-	-	-
Commercial speculative	-	-	-	-	-
All other	-	-	-	-	-
Residential					
Investor	-	-	-	-	-
Owner occupied	600	639	250	356	-
Revolving and junior liens	-	-	-	23	-
Consumer	-	-	-	-	-
Total impaired loans with a recorded allowance	864	1,242	514	513	31
Total impaired loans	\$ 23,123	\$ 28,072	\$ 514	\$ 22,005	\$ 263

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Impaired loans by class of loans as of December 31, 2015 and for the nine months ended September 30, 2015 were as follows:

	As of December 31, 2015			Nine Months Ended September 30, 2015	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded					
Commercial	\$ 70	\$ 149	\$ -	\$ 1,014	\$ -
Commercial real estate					
Owner occupied general purpose	2,314	3,004	-	4,857	62
Owner occupied special purpose	763	871	-	1,288	-
Non-owner occupied general purpose	1,047	1,065	-	2,583	-
Non-owner occupied special purpose	-	-	-	712	-
Retail properties	-	-	-	-	-
Farm	1,272	1,338	-	636	-
Construction					
Homebuilder	-	-	-	896	-
Land	-	-	-	-	-