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(Registrant's telephone number, including Area Code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of each exchange on which registered
Common Stock, \$1.00 par value	The Nasdaq Stock Market
Preferred Securities of Old Second Capital Trust I	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Act:

Preferred Share Purchase Rights

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes  No

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by Reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer	Accelerated filer	
Non-accelerated filer	Smaller reporting company	Emerging growth company

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

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, on June 29, 2018, the last business day of the registrant’s most recently completed second fiscal quarter, was approximately \$422.4 million. The number of shares outstanding of the registrant's common stock, par value \$1.00 per share, was 29,889,985 at March 4, 2019.

**DOCUMENTS INCORPORATED BY REFERENCE:**

Certain information required by Part III of this Annual Report on Form 10-K is incorporated by reference from the registrant's definitive proxy statement relating to the 2019 Annual Meeting of Stockholders, which will be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Annual Report on Form 10-K relates.



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OLD SECOND BANCORP, INC.

Form 10-K

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CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

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

- negative economic conditions that adversely affect the economy, real estate values, the job market and other factors nationally and in our market area, in each case that may affect our liquidity and the performance of our loan portfolio;
- our ability to achieve anticipated results from our acquisition of Greater Chicago Financial Corp. depends on the state of the economic and financial markets going forward. Specifically, we may incur more credit losses than expected, cost savings may be less than expected, anticipated strategic gains may be significantly harder or take longer to achieve than expected or may not be achieved in their entirety, and customer attrition may be greater than expected;
- the financial success and viability of the borrowers of our commercial loans;
- changes in U.S. monetary policy, the level and volatility of interest rates, the capital markets and other market conditions that may affect, among other things, our liquidity and the value of our assets and liabilities;
- competitive pressures from other financial service businesses and from nontraditional financial technology ("FinTech") companies;
- any negative perception of our reputation or financial strength;
- ability to raise additional capital on acceptable terms when needed;
- ability to use technology to provide products and services that will satisfy customer demands and create efficiencies in operations;
- adverse effects on our information technology systems resulting from failures, human error or cyberattacks;
- adverse effects of failures by our vendors to provide agreed upon services in the manner and at the cost agreed, particularly our information technology vendors;
- the impact of any claims or legal actions, including any effect on our reputation;
- losses incurred in connection with repurchases and indemnification payments related to mortgages;
  - the soundness of other financial institutions and other counter-party risk;
- changes in accounting standards, rules and interpretations and the impact on our financial statements;
- our ability to receive dividends from our subsidiaries;
- a decrease in our regulatory capital ratios;
- adverse federal or state tax assessments;
- litigation or government enforcement actions;
  - legislative or regulatory changes, particularly changes in regulation of financial services companies;

- increased costs of compliance, heightened regulatory capital requirements and other risks associated with changes in regulation and the current regulatory environment, including the Dodd-Frank Act; and
- each of the factors and risks under the heading “Risk Factors.”

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

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PART I

Item 1. Business

General

Old Second Bancorp, Inc. is a corporation organized under the laws of the State of Delaware in 1981 that serves as the bank holding company for its wholly-owned subsidiary bank, Old Second National Bank. Old Second National Bank (the “Bank”) is a national banking association headquartered in Aurora, Illinois, that operates through 29 banking centers located in Cook, DeKalb, DuPage, Kane, Kendall, LaSalle and Will counties in Illinois.

In this report, unless the context suggests otherwise, references to the “Company” refer to Old Second Bancorp, Inc. and references to “we,” “us,” and “our” mean the combined business of the Company, the Bank and its wholly-owned subsidiaries.

We conduct a full service community banking and trust business through the Bank and its wholly-owned subsidiaries:

- Old Second Affordable Housing Fund, L.L.C., which was formed for the purpose of providing down payment assistance for home ownership to qualified individuals;
- Station I, LLC, which is wholly-owned by the Bank to hold property acquired by the Bank through foreclosure or in the ordinary course of collecting a debt previously contracted with borrowers; and
- River Street Advisors, LLC, a wholly-owned subsidiary of the Bank, which was formed in May 2010 to provide investment advisory/management services.

Intercompany transactions and balances are eliminated in consolidation.

We are a full-service banking business offering a broad range of deposit products, trust and wealth management services, and lending services, including demand, NOW, money market, savings, time deposit and individual retirement accounts; commercial, industrial, consumer and real estate lending, including installment loans, agricultural loans, lines of credit and overdraft checking; safe deposit operations, and an extensive variety of additional services tailored to the needs of individual customers, such as the acquisition of U.S. Treasury notes and bonds, money orders, cashiers’ checks and foreign currency, direct deposit, discount brokerage, debit cards, credit cards, and other special services. Our lending activities include making commercial and consumer loans, primarily on a secured basis. Commercial lending focuses on business, capital, construction, inventory and real estate lending. Installment

lending includes direct and indirect loans to consumers and commercial customers.

We also offer a full complement of electronic banking services such as online and mobile banking and corporate cash management products including remote deposit capture, mobile deposit capture, investment sweep accounts, zero balance accounts, automated tax payments, ATM access, telephone banking, lockbox accounts, automated clearing house transactions, account reconciliation, controlled disbursement, detail and general information reporting, foreign and domestic wire transfers, vault services for currency and coin, and checking accounts. Additionally, we provide a wide range of wealth management, investment, agency, and custodial services for individual, corporate, and not-for-profit clients. These services include the administration of estates and personal trusts, as well as the management of investment accounts for individuals, employee benefit plans, and charitable foundations. We also originate residential mortgages, offering a wide range of mortgage products including conventional, government, and jumbo loans. We also handle secondary marketing of those mortgages.

We evaluate our operations as one operating segment, which is community banking. Financial information concerning our operations can be found in the financial statements in this annual report.

#### Completed Merger with Greater Chicago Financial Corp.

On April 20, 2018, we completed our acquisition of Greater Chicago Financial Corp., and its wholly-owned bank subsidiary, ABC Bank. In connection with the merger, Greater Chicago Financial Corp. merged with and into the Company, with the Company as the surviving company in the merger. Immediately following the merger, ABC Bank, an Illinois state-chartered bank and wholly-owned subsidiary of Greater Chicago Financial Corp., merged with and into the Bank, with the Bank as the surviving bank. With the acquisition of ABC Bank, we acquired four branches in the Chicago, Illinois, metropolitan area. ABC Bank had total assets with a fair value of \$336.9 million as of April 20, 2018, including \$227.6 million of loans, net of purchase accounting adjustments.

#### Market Area

Our main office is located at 37 South River Street, Aurora, Illinois 60507. The city of Aurora is located in northeastern Illinois, approximately 40 miles west of Chicago. The Bank operates primarily in Cook, DeKalb, DuPage, Kane, Kendall, LaSalle, and Will counties in Illinois, and it has developed a strong presence in these counties. The Bank offers its services to retail, commercial,



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industrial, and public entity customers in the Aurora, North Aurora, Batavia, St. Charles, Burlington, Elburn, Elgin, Kaneville, Sugar Grove, Lisle, Joliet, Yorkville, Plano, Wasco, Ottawa, Oswego, Sycamore, Frankfort, Chicago, Bensenville, and Chicago Heights communities and surrounding areas through its 29 banking locations that are located primarily west and south of the Chicago metropolitan area.

## Lending Activities

We provide a broad range of commercial and retail lending services to corporations, partnerships, individuals and government agencies. We actively market our services to qualified borrowers, and our lending officers actively solicit the business of new borrowers entering our market areas as well as long-standing members of the local business community. We have established lending policies that include a number of underwriting factors to be considered in making a loan, including location, amortization, loan to value ratio, cash flow, pricing, documentation and the credit history of the borrower. In 2018, we originated approximately \$658.7 million in loans. Our total loan portfolio grew \$279.4 million in 2018 due to our acquisition of ABC Bank, organic originations and select portfolio purchases of leases and home equity loans from third parties. In addition, we originated approximately \$173.1 million of residential mortgage loans in 2018, which includes originations of loans held for sale of \$133.9 million. Proceeds from the sales of residential mortgage loans to third parties were \$137.6 million in 2018.

Our loan portfolio is comprised primarily of loans in the areas of commercial real estate, residential real estate, general commercial, construction real estate, leases, and consumer lending. As of December 31, 2018, commercial real estate loans represented approximately 43.5% (46.4% at year-end 2017) of our loan portfolio, residential mortgages represented approximately 21.6% (19.4% at year-end 2017), general commercial loans represented approximately 16.7% (16.9% at year-end 2017), home equity lines of credit represented 7.4% (7.0% at year-end 2017), construction lending represented approximately 5.7% (5.3% at year-end 2017), leases represented approximately 4.2% (4.2% at year-end 2017), and consumer and other lending represented less than 1.0% (less than 1.0% at year-end 2017). It is our policy to comply at all times with the various consumer protection laws and regulations including, but not limited to, the Equal Credit Opportunity Act, the Fair Housing Act, the Community Reinvestment Act, the Truth in Lending Act, and the Home Mortgage Disclosure Act.

**Commercial Loans.** We continue to focus on identifying commercial and industrial prospects in our new business pipeline with favorable results in 2018. As noted above, we are an active commercial lender in the Chicago metropolitan area, with primary markets in the city of Chicago, as well as west and south of Chicago. Commercial lending reflects revolving lines of credit for working capital, lending for capital expenditures on manufacturing equipment and lending to small business manufacturers, service companies, medical and dental entities as well as specialty contractors. We also have commercial and industrial loans to customers in food product manufacturing, food process and packing, machinery tooling manufacturing as well as service and technology companies. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. In addition, we often secure personal guarantees to help assure repayment. Loans may be made on an unsecured basis if warranted by the overall financial condition of the borrower. Commercial term loans range principally from one to seven years with the majority falling in the one to five year range. Interest rates on commercial loans are a mixture of fixed and variable rates, with these rates often tied to the prime rate, a spread over the FHLB Chicago index rate, or LIBOR.

Repayment of commercial loans is largely dependent upon the cash flows generated by the operations of the commercial borrower. Our underwriting procedures identify the sources of those cash flows and seek to match the repayment terms of the commercial loans to the sources. Secondary repayment sources are typically found in collateralization and guarantor support.

**Lease Financing Receivables.** We continued growth of our lease portfolio in 2018 primarily with organic lease originations. The collateral for lease financing receivables primarily includes manufacturing and transportation equipment, and lease terms typically range from one to seven years, with the majority falling in the one to five year range. Growth in this portfolio reflects management's efforts to diversify lending product offerings, and improve loan concentration metrics.

**Commercial Real Estate Loans.** While management has been actively working to reduce our concentration in real estate loans, a large portion of the loan portfolio continues to be comprised of commercial real estate loans. As of December 31, 2018, approximately \$358.1 million, or 43.6% (42.2%, at year-end 2017) of the total commercial real estate loan portfolio of \$820.9 million consisted of loans to borrowers secured by owner occupied property. A primary repayment risk for a commercial real estate loan is interruption or discontinuance of cash flows from operations, which are usually derived from rent in the case of non-owner occupied commercial properties. Repayment could also be influenced by economic events, which may or may not be under the control of the borrower, or changes in regulations that negatively impact the future cash flow and market values of the affected properties. Repayment risk can also arise from general downward shifts in the valuations of classes of properties over a given geographic area such as the significant price adjustments that were observed by the Bank in 2008 through 2011. Property valuations could continue to be affected by changes in demand and other economic factors, which could further influence cash flows associated with the borrower and/or the property. We seek to mitigate these risks by staying apprised of market conditions and by maintaining underwriting practices that provide for adequate cash flow margins and multiple repayment sources as well as remaining in regular contact with our borrowers. In most cases, we have collateralized these loans and/or have taken personal guarantees to help assure repayment. Commercial real estate loans are primarily made based on the identified cash flow of the borrower and/or the property at origination and secondarily on the underlying

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real estate acting as collateral. Additional credit support is provided by the borrower for most of these loans and the probability of repayment is based on the liquidation value of the real estate and enforceability of personal and corporate guarantees if any exist.

**Construction Loans.** Our construction and development portfolio increased from \$85.2 million at December 31, 2017, to \$108.4 million at December 31, 2018, due to the ABC Bank acquisition as well as organic loan originations in strengthening markets. We use underwriting and construction loan guidelines to determine whether to issue loans on build-to-suit or build out arrangements of existing borrower properties.

Construction loans are structured most often to be converted to permanent loans at the end of the construction phase or, infrequently, to be paid off upon receiving financing from another financial institution. Construction loans are generally limited to our local market area. Lending decisions have been based on the “as-is” and “prospective” appraised value of the property as determined by an independent appraiser, an analysis of the potential marketability and profitability of the project and identification of a cash flow source to service the permanent loan or verification of a refinancing source. Construction loans generally have terms of 12 to 18 months, with extensions as needed. The Bank disburses loan proceeds in increments as construction progresses and as inspections warrant.

Development lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of the borrower or guarantor to repay principal and interest. Therefore, development lending generally involves more risk than other lending because it is based on future estimates of value and economic circumstances. While appraisals are required prior to funding, loan advances are limited to the “prospective” value determined by the appraisal, therefore there is the possibility of an unforeseen event affecting the value and/or costs of the project. Development loans are primarily used for multi-family developments, where the leasing of units is tied to local demand and rental rates, and commercial developments, where the success of the project is tied to the demand for commercial space, cap rates and leasing rates. If the borrower defaults prior to completion of the project, we may be required to fund additional amounts so that another developer can complete the project. We are located in an area where a large amount of development activity has occurred as rural and semi-rural areas are being suburbanized. This type of growth presents some economic risks should local demand for commercial buildings and multi-family housing shift. We address these risks by closely monitoring local real estate activity, adhering to proper underwriting procedures, closely monitoring construction projects, and limiting the amount of construction development lending.

**Residential Real Estate Loans.** Residential first mortgage loans and second mortgages are included in this category. First mortgage loans may include fixed rate loans that are generally sold to investors. We are a direct seller to the Federal National Mortgage Association (“FNMA”), Federal Home Loan Mortgage Corporation (“FHLMC”) and to several large financial institutions. We retain servicing rights for mortgages sold to FNMA and FHLMC. The retention of such servicing rights is a source of noninterest income and also allows us an opportunity to have regular contact with mortgage customers and can help to solidify our community involvement. Other loans that are not sold include adjustable rate mortgages, lot loans, and construction loans that are held in our portfolio. Loans sold to other investors, such as Federal Housing Administration (“FHA”), and the Veterans Administration (“VA”), are sold with servicing released. We had a moderate level of residential mortgage purchase activity in 2018; however, with interest

rates rising in 2018 in our market area, our residential mortgage lending portfolio reflected a reduction in volume and mixture of both refinance and purchase financing opportunities.

**Home Equity Lines of Credit.** Our home equity lines of credit, or HELOCs, consist of originated as well as purchased HELOCs. We had growth in our home equity lending in 2018, due to two portfolio purchases in March 2018 and November 2018 from a third party of \$20.9 million and \$20.7 million, respectively. We purchased these HELOCs at a 4.25% premium, and the average annualized yield on the total purchased HELOC portfolio in 2018 was 5.09%, net of the premium accretion.

**Consumer Loans.** We also provide many types of consumer loans including primarily motor vehicle, home improvement and signature loans. Consumer loans typically have shorter terms and lower balances with higher yields as compared to other loans but generally carry higher risks of default. Consumer loan collections are dependent on the borrower's continuing financial stability and thus are more likely to be affected by adverse personal circumstances.

## Competition

Our market area is highly competitive and our business activities require us to compete with many other financial institutions. A number of these financial institutions are affiliated with large bank holding companies headquartered outside of our principal market area as well as other institutions that are based in Aurora's surrounding communities and in Chicago, Illinois. All of these financial institutions operate banking offices in the greater Chicago area or actively compete for customers within our market area. We also face competition from finance companies, insurance companies, credit unions, mortgage companies, securities brokerage firms, money market funds, loan production offices and other providers of financial services, including nontraditional financial technology companies or FinTech companies. Many of our nonbank competitors which are not subject to the same extensive federal regulations that govern bank holding companies and banks, such as the Company and the Bank, may have certain competitive advantages.

We compete for loans principally through the quality of our client service and our responsiveness to client needs in addition to competing on interest rates and loan fees. Management believes that our long-standing presence in the community and personal one-on-one service philosophy enhances our ability to compete favorably in attracting and retaining individual and business customers. We

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actively solicit deposit-related clients and compete for deposits by offering personal attention, competitive interest rates, and professional services made available through experienced bankers and multiple delivery channels that fit the needs of our market. In wealth management and trust services, we compete with a variety of custodial banks as well as a diverse group of investment managers.

We believe the financial services industry will likely continue to become more competitive as further technological advances enable more financial institutions to provide expanded financial services without having a physical presence in our market.

## Employees

At December 31, 2018, the Company employed 518 full-time equivalent employees.

## Available Information

We maintain a corporate website at <http://www.oldsecond.com>. We make available free of charge on or through our website the Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission (the "SEC"). Many of our policies, committee charters and other investor information including our Code of Business Conduct and Ethics are available on our website. No information contained on our website is intended to be included as part of, or incorporated by reference into, this Annual Report on Form 10-K. The Company's reports, proxy and informational statements and other information regarding the Company are also available free of charge on the SEC's website (<http://www.sec.gov>). We will also provide copies of our filings free of charge upon written request to: Investor Relations, Old Second Bancorp, Inc., 37 South River Street, Aurora, Illinois 60507.

## SUPERVISION AND REGULATION

### General

FDIC-insured institutions, their holding companies and their affiliates, are extensively regulated under federal and state law. As a result, our growth and earnings performance may be affected not only by management decisions and general economic conditions, but also by the requirements of federal and state statutes and by the regulations and policies of various bank regulatory agencies, including the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Consumer Financial Protection Bureau (the "CFPB"). Furthermore, taxation laws administered by

the Internal Revenue Service and state taxing authorities, accounting rules developed by the Financial Accounting Standards Board, securities laws administered by the Securities and Exchange Commission (the “SEC”) and state securities authorities, and anti-money laundering laws enforced by the U.S. Department of the Treasury (“Treasury”) have an impact on our business. The effect of these statutes, regulations, regulatory policies and accounting rules are significant to our operations and results.

Federal and state banking laws impose a comprehensive system of supervision, regulation and enforcement on the operations of FDIC-insured institutions, their holding companies and affiliates that is intended primarily for the protection of the FDIC-insured deposits and depositors of banks, rather than stockholders. These laws, and the regulations of the bank regulatory agencies issued under them, affect, among other things, the scope of our business, the kinds and amounts of investments we may make, reserve requirements, required capital levels relative to assets, the nature and amount of collateral for loans, the establishment of branches, our ability to merge, consolidate and acquire, dealings with our insiders and affiliates and the Company’s payment of dividends. In the last several years, we have experienced heightened regulatory requirements and scrutiny following the global financial crisis approximately 8 years ago, and as a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). Although the reforms primarily targeted systemically important financial service providers, their influence filtered down in varying degrees to community banks over time, and the reforms have caused our compliance and risk management processes, and the costs thereof, to increase.

This supervisory and regulatory framework subjects banks and their bank holding companies to regular examination by their respective regulatory agencies, which results in examination reports and ratings that are not publicly available and that can impact the conduct and growth of their business. These examinations consider not only compliance with applicable laws and regulations, but also capital levels, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. The regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of a regulated entity where the agencies determine, among other things, that such operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

The following is a summary of certain of the material elements of the supervisory and regulatory framework applicable to the Company and the Bank. It does not describe all of the statutes, regulations and regulatory policies that apply, nor does it restate all of the requirements of those that are described. The descriptions are qualified in their entirety by reference to the particular statutory and regulatory provision.

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Regulatory Emphasis on Capital

Regulatory capital represents the net assets of a banking organization available to absorb losses. Because of the risks attendant to their business, FDIC-insured institutions are generally required to hold more capital than other businesses, which directly affects our earnings capabilities. While capital has historically been one of the key measures of the financial health of both bank holding companies and banks, its role became fundamentally more important in the wake of the global financial crisis, as the banking regulators recognized that the amount and quality of capital held by banks prior to the crisis was insufficient to absorb losses during periods of severe stress. Certain provisions of the Dodd-Frank Act and Basel III, discussed below, establish strengthened capital standards for banks and bank holding companies that are meaningfully more stringent than those in place previously.

**Minimum Required Capital Levels.** Banks have been required to hold minimum levels of capital based on guidelines established by the bank regulatory agencies since 1983. The minimums have been expressed in terms of ratios of capital divided by total assets. As discussed below, bank capital measures have become more sophisticated over the years and have focused more on the quality of capital and the risk of assets. Bank holding companies have historically had to comply with less stringent capital standards than their bank subsidiaries and have been able to raise capital with hybrid instruments such as trust preferred securities. The Dodd-Frank Act mandated the Federal Reserve to establish minimum capital levels for holding companies on a consolidated basis as stringent as those required for FDIC-insured institutions. A result of this change is that the proceeds of hybrid instruments, such as trust preferred securities, are being excluded from capital over a phase-out period. However, if such securities were issued prior to May 19, 2010 by bank holding companies with less than \$15 billion of assets, they may be retained, subject to certain restrictions. Because the Company has assets of less than \$15 billion, the Company is able to maintain its trust preferred proceeds as capital but the Company has to comply with new capital mandates in other respects and will not be able to raise capital in the future through the issuance of trust preferred securities.

**The Basel III Rule.** In July of 2013, the U.S. federal banking agencies approved the implementation of the Basel III regulatory capital reforms in pertinent part, and, at the same time, promulgated rules effecting certain changes required by the Dodd-Frank Act (the “Basel III Rule”). In contrast to capital requirements historically, which were in the form of guidelines, Basel III was released in the form of enforceable regulations by each of the regulatory agencies. The Basel III Rule is applicable to all banking organizations that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as to bank and savings and loan holding companies, other than “small bank holding companies” generally holding companies with consolidated assets of less than \$3 billion. The Company is currently considered a “small bank holding company.” More stringent requirements are imposed on “advanced approaches” banking organizations—those organizations with \$250 billion or more in total consolidated assets, \$10 billion or more in total foreign exposures, or that have opted in to the Basel II capital regime.

The OCC’s final capital rules included new risk-based capital and leverage ratios and refined the definition of what constitutes “capital” for purposes of calculating those ratios. The minimum capital-level requirements applicable to us under the final rule are:

- a new Common Equity Tier 1 risk-based capital ratio of 4.5%;
- a Tier 1 risk-based capital ratio of 6% (increased from the former 4% requirement);
- a total risk-based capital ratio of 8% (unchanged from the former requirement); and
- a leverage ratio of 4% (also unchanged from the former requirement).

The final rules also established a “capital conservation buffer” above the new regulatory minimum capital requirements, which must consist entirely of Common Equity Tier 1 capital, which was phased in over several years. The phase-in of the capital conservation buffer began on January 1, 2016, at a level of 0.625% of risk-weighted assets for 2016, increased to 1.250% for 2017, and 1.875% for 2018. The fully phased-in capital conservation buffer of 2.500%, which became effective on January 1, 2019, resulted in the following effective minimum capital ratios beginning in 2019: (i) a Common Equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. Under the final rules, institutions are subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if their capital levels fall below the buffer amount. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions.

The Basel III Rule also changed the definition of capital by establishing more stringent criteria that instruments must meet to be considered Additional Tier 1 Capital (primarily non-cumulative perpetual preferred stock that meets certain requirements) and Tier 2 Capital (primarily other types of preferred stock and subordinated debt, subject to limitations). A number of instruments that previously qualified as Tier 1 Capital no longer qualify, or their qualifications changed. For example, noncumulative perpetual preferred stock, which used to qualify as simple Tier 1 Capital, does not qualify as Common Equity Tier 1 Capital, but qualifies as Additional Tier 1 Capital. The Basel III Rule also constrained the inclusion of minority interests, mortgage-servicing assets, and deferred tax assets in capital and requires deductions from Common Equity Tier 1 Capital in the event that such assets exceed a certain percentage of a banking institution’s Common Equity Tier 1 Capital.

**Well-Capitalized Requirements.** The ratios described above are minimum standards in order for banking organizations to be considered “adequately capitalized.” Bank regulatory agencies uniformly encourage banks to hold more capital and be “well-

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capitalized” and, to that end, federal law and regulations provide various incentives for banking organizations to maintain regulatory capital at levels in excess of minimum regulatory requirements. For example, a banking organization that is well-capitalized may: (i) qualify for exemptions from prior notice or application requirements otherwise applicable to certain types of activities; (ii) qualify for expedited processing of other required notices or applications; and (iii) accept, roll-over or renew brokered deposits. Higher capital levels could also be required if warranted by the particular circumstances or risk profiles of individual banking organizations. For example, the Federal Reserve’s capital guidelines contemplate that additional capital may be required to take adequate account of, among other things, interest rate risk, or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. Further, any banking organization experiencing or anticipating significant growth would be expected to maintain capital ratios, including tangible capital positions (i.e., Tier 1 Capital less all intangible assets), well above the minimum levels.

Under the capital regulations of the OCC, in order to be well capitalized, a banking organization must maintain:

- A Common Equity Tier 1 Capital ratio to risk-weighted assets of 6.5% or more;
- A ratio of Tier 1 Capital to total risk-weighted assets of 8%;
- A ratio of Total Capital to total risk-weighted assets of 10%; and
- A leverage ratio of Tier 1 Capital to total adjusted average quarterly assets of 5% or greater.

It is possible under the Basel III Rule to be well-capitalized while remaining out of compliance with the capital conservation buffer discussed above.

As of December 31, 2018 the Bank was well-capitalized, as defined by OCC regulations. As of December 31, 2018, the Company had regulatory capital in excess of the Federal Reserve’s requirements and met the Basel III Rule requirements to be well-capitalized.

**Prompt Corrective Action.** An FDIC-insured institution’s capital plays an important role in connection with regulatory enforcement as well. Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators’ powers depends on whether the institution in question is “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized,” in each case as defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators’ corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution’s asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to sell itself; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

## Regulation and Supervision of the Company

**General.** The Company, as the sole stockholder of the Bank, is a bank holding company. As a bank holding company, the Company is registered with, and subject to regulation, supervision and enforcement by, the Federal Reserve under the Bank Holding Company Act, as amended (the “BHCA”). The Company is legally obligated to act as a source of financial and managerial strength to the Bank and to commit resources to support the Bank in circumstances where the Company might not otherwise do so. Under the BHCA, the Company is subject to periodic examination by the Federal Reserve and is required to file with the Federal Reserve periodic reports of the Company's

operations and such additional information regarding the Company and the Bank as the Federal Reserve may require.

**Acquisitions, Activities and Change in Control.** The primary purpose of a bank holding company is to control and manage banks. The BHCA generally requires the prior approval of the Federal Reserve for any merger involving a bank holding company or any acquisition by a bank holding company of another bank or bank holding company. Subject to certain conditions (including deposit concentration limits established by the BHCA), the Federal Reserve may allow a bank holding company to acquire banks located in any state of the United States. In approving interstate acquisitions, the Federal Reserve is required to give effect to applicable state law limitations on the aggregate amount of deposits that may be held by the acquiring bank holding company and its FDIC-insured institution affiliates in the state in which the target bank is located (provided that those limits do not discriminate against out-of-state institutions or their holding companies) and state laws that require that the target bank have been in existence for a minimum period of time (not to exceed five years) before being acquired by an out-of-state bank holding company. Furthermore, in accordance with the Dodd-Frank Act, bank holding companies must be well-capitalized and examiners must rate them well-managed in order to effect interstate mergers or acquisitions. For a discussion of the capital requirements, see “Regulatory Emphasis on Capital” above.

The BHCA generally prohibits the Company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than that of banking, managing and controlling banks or furnishing services to banks and their subsidiaries. This general prohibition is subject to a number of exceptions. The principal exception allows bank holding companies to engage in, and to own shares of companies engaged in, certain businesses found by the Federal Reserve prior to November 11, 1999, to be “so closely related to banking ... as to be a proper incident thereto.” This authority would permit the Company to engage in a variety of banking-related businesses, including the ownership and operation of a savings association, or any entity engaged in consumer finance, equipment leasing, the operation of a computer service bureau (including software development) and mortgage banking and brokerage services. The BHCA does not place territorial restrictions on the domestic activities of nonbank subsidiaries of bank holding companies.

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Additionally, bank holding companies that meet certain eligibility requirements prescribed by the BHCA and elect to operate as financial holding companies may engage in, or own shares in companies engaged in, a wider range of nonbanking activities, including securities and insurance underwriting and sales, merchant banking and any other activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines by regulation or order is financial in nature or incidental to any such financial activity or that the Federal Reserve determines by order to be complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of FDIC-insured institutions or the financial system generally. The Company has not elected to operate as a financial holding company.

The BHCA prohibits a company from, directly or indirectly, acquiring 25% or more (5% if the acquirer is a bank holding company) of any class of our voting stock or obtaining the ability to control in any manner the election of a majority of our directors or otherwise directing the management or policies of the Bank without prior application to and the approval of the Federal Reserve. Moreover, under the Change in Bank Control Act, any person or group of persons acting in concert who intends to acquire 10% or more of any class of our voting stock or otherwise obtain control over us would be required to provide prior notice to and obtain the non-objection of the OCC.

**Capital Requirements.** Bank holding companies are required to maintain capital in accordance with Federal Reserve capital adequacy requirements. For a discussion of capital requirements, see “Regulatory Emphasis on Capital” above.

**Dividend Payments.** The Company’s ability to pay dividends to its stockholders may be affected by both general corporate law considerations and policies of the Federal Reserve applicable to bank holding companies. As a Delaware corporation, the Company is subject to the limitations of the Delaware General Corporation Law (the “DGCL”). The DGCL allows the Company to pay dividends only out of its surplus (as defined and computed in accordance with the provisions of the DGCL) or if the Company has no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.

As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should eliminate, defer or significantly reduce dividends to stockholders if: (i) the company's net income available to stockholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends; (ii) the prospective rate of earnings retention is inconsistent with the company's capital needs and overall current and prospective financial condition; or (iii) the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. The Federal Reserve also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies. In addition, under the Basel III Rule, financial institutions that seek to pay dividends will have to maintain 2.5% in Common Equity Tier 1 Capital attributable to the capital conservation buffer. See “Regulatory Emphasis on Capital – Capital and Related Requirements” above.

**Incentive Compensation.** There have been a number of developments in recent years focused on incentive compensation plans sponsored by bank holding companies and banks, reflecting recognition by the bank regulatory agencies and Congress that flawed incentive compensation practices in the financial industry were one of many factors contributing to the global financial crisis. Layered on top of that are the abuses in the headlines dealing with product cross-selling incentive plans. The result is interagency guidance on sound incentive compensation practices and proposed rulemaking by the agencies required under Section 956 of the Dodd-Frank Act.

The interagency guidance recognized three core principles; effective incentive plans are required to: (i) provide employees incentives that appropriately balance risk and reward; (ii) be compatible with effective controls and risk-management; and (iii) be supported by strong corporate governance, including active and effective oversight by the organization’s board of directors. Much of the guidance addresses large banking organizations and, because of the

size and complexity of their operations, the regulators expect those organizations to maintain systematic and formalized policies, procedures, and systems for ensuring that the incentive compensation arrangements for all executive and non-executive employees covered by this guidance are identified and reviewed, and appropriately balance risks and rewards. Smaller banking organizations like the Company that use incentive compensation arrangements are expected to be less extensive, formalized, and detailed than those of the larger banks.

Section 956 of the Dodd-Frank Act required the banking agencies, the National Credit Union Administration, the SEC and the Federal Housing Finance Agency to jointly prescribe regulations that prohibit types of incentive-based compensation that encourage inappropriate risk taking and to disclose certain information regarding such plans. On June 10, 2016, the agencies released an updated proposed rule for comment. Section 956 will only apply to banking organizations with assets of greater than \$1 billion. The Company has consolidated assets greater than \$1 billion and less than \$50 billion and the Company is considered a Level 3 banking organization under the proposed rules. The proposed rules contain mostly general principles and reporting requirements for Level 3 institutions so there are no specific prescriptions or limits, deferral requirements or claw-back mandates. Risk management and controls are required, as is board or committee level approval and oversight. No final rule has been issued yet.

Monetary Policy. The monetary policy of the Federal Reserve has a significant effect on the operating results of financial or bank holding companies and their subsidiaries. Among the tools available to the Federal Reserve to affect the money supply are open market transactions in U.S. government securities, changes in the discount rate on bank borrowings and changes in reserve requirements against bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid on deposits.

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**Federal Securities Regulation.** The Company's common stock is registered with the SEC under the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Consequently, the Company is subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act.

**Corporate Governance.** The Dodd-Frank Act addressed many investor protection, corporate governance and executive compensation matters that affect most U.S. publicly traded companies. The Dodd-Frank Act (i) grants stockholders of U.S. publicly traded companies an advisory vote on executive compensation and so-called "golden parachute" payments, (ii) enhances independence requirements for compensation committee members, (iii) requires the SEC to adopt rules directing national securities exchanges to establish listing standards requiring all listed companies to adopt incentive-based compensation clawback policies for executive officers, and (iv) provides the SEC with authority to adopt proxy access rules that would allow stockholders of publicly traded companies to nominate candidates for election as a director and have those nominees included in a company's proxy materials. The SEC has completed the bulk (although not all) of the rulemaking necessary to implement these provisions.

## Regulation and Supervision of the Bank

**General.** The Bank is a national bank, chartered by the OCC under the National Bank Act. The deposit accounts of the Bank are insured by the FDIC's Deposit Insurance Fund (the "DIF") to the maximum extent provided under federal law and FDIC regulations, currently \$250,000 per insured depositor category, and the Bank is a member of the Federal Reserve System. As a national bank, the Bank is subject to the examination, supervision, reporting and enforcement requirements of the OCC, the chartering authority for national banks. The FDIC, as administrator of the DIF, also has regulatory authority over the Bank.

**Deposit Insurance.** As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. Effective July 1, 2016, the FDIC changed its pricing system for banks under \$10 billion, so that minimum and maximum initial base assessment rates are based on supervisory ratings. The initial base assessment rates currently range from three basis points to 30 basis points. At least semi-annually, the FDIC updates its loss and income projections for the DIF and, if needed, increases or decreases the assessment rates, following notice and comment on proposed rulemaking.

The assessment base against which an FDIC-insured institution's deposit insurance premiums paid to the DIF are calculated based on its average consolidated total assets less its average tangible equity. This method shifts the burden of deposit insurance premiums toward those large depository institutions that rely on funding sources other than U.S. deposits.

The reserve ratio is the DIF balance divided by estimated insured deposits. The Dodd-Frank Act altered the minimum reserve ratio of the DIF, increasing the minimum from 1.15% to 1.35% of the estimated amount of total insured deposits, and eliminating the requirement that the FDIC pay dividends to FDIC-insured institutions when the reserve ratio exceeds certain thresholds. The reserve ratio reached 1.36% on September 30, 2018. Because the reserve ratio has reached 1.35%, two deposit insurance assessment changes occurred under FDIC regulations: (1) surcharges on insured depository institutions with total consolidated assets of \$10 billion or more (large institutions) will cease; and (2) banks with assets of less than \$10 billion, such as us, will receive assessment credits for the portion of their assessments that contributed to the growth in the reserve ratio from between 1.15% and 1.35%, to be applied when the reserve ratio is at or above 1.38%, with credits starting with the March 31, 2019 assessment invoiced in June 2019.

**FICO Assessments.** In addition to paying basic deposit insurance assessments, the FDIC collects Financing Corporation ("FICO") assessments to pay interest on FICO bonds. FICO bonds were issued in the late 1980's to recapitalize the (former) Federal Savings & Loan Insurance Corporation. The last of the remaining FICO bonds will mature in September 2019. The FICO assessment rate is adjusted quarterly and for the fourth quarter of 2018 was

0.35 basis points (35 cents per \$100 dollars of assessable deposits). We were informed by the FDIC that our final FICO assessments will be collected on March 31, 2019.

**Supervisory Assessments.** National banks are required to pay supervisory assessments to the OCC to fund the operations of the OCC. The amount of the assessment is calculated using a formula that takes into account the bank's size and its supervisory condition. During the year ended December 31, 2018, the Bank paid supervisory assessments to the OCC totaling \$504,000.

**Capital Requirements.** Banks are generally required to maintain capital levels in excess of other businesses. For a discussion of capital requirements, see "Regulatory Emphasis on Capital" above.

**Liquidity Requirements.** Liquidity is a measure of the ability and ease with which bank assets may be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations. To remain viable, FDIC-insured institutions must have enough liquid assets to meet their near-term obligations, such as withdrawals by depositors. Because the global financial crisis was in part a liquidity crisis, Basel III also includes a liquidity framework that requires FDIC-insured institutions to measure their liquidity against specific liquidity tests. One test, referred to as the Liquidity Coverage Ratio ("LCR"), is designed to ensure that the banking entity has an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet liquidity needs for a 30-calendar day liquidity stress scenario. The other test, known as the Net Stable Funding Ratio ("NSFR") is designed to promote more medium and long-term funding of the assets and activities of FDIC-insured institutions over a one-year horizon. These tests provide an incentive for banks and holding companies to increase their holdings in Treasury securities and other sovereign debt as a component of assets, increase the use of long-term debt as a funding source and rely on stable funding like core deposits (in lieu of brokered deposits).

In addition to liquidity guidelines already in place, the federal bank regulatory agencies implemented the Basel III LCR in 2014 and have proposed the NSFR. While the LCR only applies to the largest banking organizations in the country, as will the NSFR, certain elements are expected to filter down to all FDIC-insured institutions. The Company has adopted a modified version of the LCR as a

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part of measuring the liquidity at the Bank. The Company has no plans to adopt the NSFR and has not received regulatory guidance indicating a requirement to do so.

**Dividend Payments.** The primary source of funds for the Company is dividends from the Bank. Under the National Bank Act, a national bank may pay dividends out of its undivided profits in such amounts and at such times as the bank's board of directors deems prudent. Without prior OCC approval, however, a national bank may not pay dividends in any calendar year that, in the aggregate, exceed the bank's year-to-date net income plus the bank's retained net income for the two preceding years. The payment of dividends by any FDIC-insured institution is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and an FDIC-insured institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, the Bank exceeded its capital requirements under applicable guidelines as of December 31, 2018. Notwithstanding the availability of funds for dividends, however, the OCC may prohibit the payment of dividends by the Bank if it determines such payment would constitute an unsafe or unsound practice. In addition, under the Basel III Rule, institutions that seek the freedom to pay dividends will have to maintain 2.5% in Common Equity Tier 1 Capital attributable to the capital conservation buffer. See "Regulatory Emphasis on Capital" above.

**Insider Transactions.** The Bank is subject to certain restrictions imposed by federal law on "covered transactions" between the Bank and its "affiliates." The Company is an affiliate of the Bank for purposes of these restrictions, and covered transactions subject to the restrictions include extensions of credit to the Company, investments in the stock or other securities of the Company and the acceptance of the stock or other securities of the Company as collateral for loans made by the Bank. The Dodd-Frank Act enhanced the requirements for certain transactions with affiliates, including an expansion of the definition of "covered transactions" and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained.

Certain limitations and reporting requirements are also placed on extensions of credit by the Bank to its directors and officers, to directors and officers of the Company and its subsidiaries, to principal stockholders of the Company and to "related interests" of such directors, officers and principal stockholders. In addition, federal law and regulations may affect the terms upon which any person who is a director or officer of the Company or the Bank, or a principal stockholder of the Company, may obtain credit from banks with which the Bank maintains a correspondent relationship.

**Safety and Soundness Standards/Risk Management.** The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of FDIC-insured institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the FDIC-insured institution's primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. If an FDIC-insured institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the institution to cure the deficiency. Until the deficiency cited in the regulator's order is cured, the regulator may restrict the FDIC-insured institution's rate of growth, require the FDIC-insured institution to increase its capital, restrict the rates the institution pays on deposits or require the institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal bank regulatory agencies, including cease and desist orders and civil money penalty assessments.

During the past decade, the bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the FDIC-insured institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal and reputational risk. In particular, recent regulatory pronouncements have focused on operational risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. New products and services, third-party risk and cybersecurity are critical sources of operational risk that FDIC-insured institutions are expected to address in the current environment. The Bank is expected to have active board and senior management oversight; adequate policies, procedures, and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls.

**Branching Authority.** National banks headquartered in Illinois, such as the Bank, have the same branching rights in Illinois as banks chartered under Illinois law, subject to OCC approval. Illinois law grants Illinois-chartered banks the authority to establish branches anywhere in the State of Illinois, subject to receipt of all required regulatory approvals.

The Dodd-Frank Act permits well-capitalized and well-managed banks to establish new interstate branches or acquire individual branches of a bank in another state (rather than the acquisition of an out-of-state bank in its entirety) without impediments.

**Financial Subsidiaries.** Under federal law and OCC regulations, national banks are authorized to engage, through “financial subsidiaries,” in any activity that is permissible for a financial holding company and any activity that the Secretary of the Treasury, in consultation with the Federal Reserve, determines is financial in nature or incidental to any such financial activity, except (i) insurance underwriting, (ii) real estate development or real estate investment activities (unless otherwise permitted by law), (iii) insurance company

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portfolio investments and (iv) merchant banking. The authority of a national bank to invest in a financial subsidiary is subject to a number of conditions, including, among other things, requirements that the bank must be well-managed and well-capitalized (after deducting from capital the bank's outstanding investments in financial subsidiaries). The Bank has not applied for approval to establish any financial subsidiaries.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank of Chicago (the "FHLBC"), which serves as a central credit facility for its members. The FHLBC is funded primarily from proceeds from the sale of obligations of the FHLBC system. It makes loans to member banks in the form of FHLBC advances. All advances from the FHLBC are required to be fully collateralized as determined by the FHLBC.

Transaction Account Reserves. Federal Reserve regulations require FDIC-insured institutions to maintain reserves against their transaction accounts (primarily NOW and regular checking accounts). For 2018, the first \$16.0 million of otherwise reservable balances are exempt from reserves and have a zero percent reserve requirement; for transaction accounts aggregating more than \$16.0 million to \$122.3 million, the reserve requirement is 3% of total transaction accounts; and for net transaction accounts in excess of \$122.3 million, the reserve requirement is 3% up to \$122.3 million plus 10% of the aggregate amount of total transaction accounts in excess of \$122.3 million. These reserve requirements are subject to annual adjustment by the Federal Reserve.

Community Reinvestment Act Requirements. The Community Reinvestment Act requires the Bank to have a continuing and affirmative obligation in a safe and sound manner to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. Federal regulators regularly assess the Bank's record of meeting the credit needs of its communities. Applications for additional acquisitions would be affected by the evaluation of the Bank's effectiveness in meeting its Community Reinvestment Act requirements. The Bank received an overall "outstanding" rating on its most recent CRA performance evaluation.

Anti-Money Laundering. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "Patriot Act") is designed to deny terrorists and criminals the ability to obtain access to the U.S. financial system and has significant implications for FDIC-insured institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act mandates financial services companies to have policies and procedures with respect to measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between FDIC-insured institutions and law enforcement authorities. Bank regulators routinely examine institutions for compliance with these obligations, and this area has become a particular focus of the regulators in recent years. In addition, the regulators are required to consider compliance in connection with the regulatory review of certain applications. In recent years, regulators have expressed concern over banking institutions' compliance with anti-money laundering requirements and, in some cases, have delayed approval of their expansionary proposals. The regulators and other governmental authorities have been active in imposing "cease and desist" orders and significant money penalty sanctions against institutions found to be in violation of the anti-money laundering regulations.

Concentrations in Commercial Real Estate. Concentration risk exists when FDIC-insured institutions deploy too many assets to any one industry or segment. A concentration in commercial real estate is one example of regulatory concern. The interagency Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices guidance ("CRE Guidance") provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny: (i) non-owner occupied commercial real estate loans exceeding 300% of capital and increasing 50% or more in the preceding three years; or (ii) construction and land development loans exceeding

100% of capital. The CRE Guidance does not limit banks' levels of commercial real estate lending activities, but rather guides institutions in developing risk management practices and levels of capital that are commensurate with the level and nature of their commercial real estate concentrations. On December 18, 2015, the federal banking agencies issued a statement to reinforce prudent risk-management practices related to CRE lending, having observed substantial growth in many CRE asset and lending markets, increased competitive pressures, rising CRE concentrations in banks, and an easing of CRE underwriting standards. The federal bank agencies reminded FDIC-insured institutions to maintain underwriting discipline and exercise prudent risk-management practices to identify, measure, monitor, and manage the risks arising from CRE lending. In addition, FDIC-insured institutions must maintain capital commensurate with the level and nature of their CRE concentration risk.

Based on the Bank's loan portfolio as of December 31, 2018, concentrations in commercial real estate did not exceed the 300% guideline for non-owner occupied commercial real estate loans, or the 100% guideline for construction and development loans.

**Financial Privacy and Cybersecurity.** Under privacy protection provisions of the Gramm-Leach-Bliley Act of 1999 and related regulations, we are limited in our ability to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. Federal banking agencies have adopted guidelines for establishing information security standards and cybersecurity programs for implementing safeguards under the supervision of the board of directors. These guidelines, along with related regulatory materials, increasingly focus on risk management and processes related to information technology and the use of third parties in the provision of financial services.

**Consumer Protection Regulations.** The activities of the Bank are subject to a variety of statutes and regulations designed to protect consumers. Interest and other charges collected or contracted for by the Bank are subject to state usury laws and federal laws concerning interest rates. The loan operations of the Bank are also subject to federal laws applicable to credit transactions, such as:

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- the Truth-In-Lending Act (“TILA”) and Regulation Z, governing disclosures of credit and servicing terms to consumer borrowers and including substantial new requirements for mortgage lending and servicing, as mandated by the Dodd-Frank Act;
- the Home Mortgage Disclosure Act of 1975 and Regulation C, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the communities they serve;
- the Equal Credit Opportunity Act and Regulation B, prohibiting discrimination on the basis of race, color, religion, or other prohibited factors in extending credit;
- the Fair Credit Reporting Act of 1978, as amended by the Fair and Accurate Credit Transactions Act and Regulation V, as well as the rules and regulations of the FDIC governing the use and provision of information to credit reporting agencies, certain identity theft protections and certain credit and other disclosures;
- the Fair Debt Collection Practices Act and Regulation F, governing the manner in which consumer debts may be collected by collection agencies; and
- the Real Estate Settlement Procedures Act and Regulation X, which governs aspects of the settlement process for residential mortgage loans.

The deposit operations of the Bank are also subject to federal laws, such as:

- the FDIA, which, among other things, limits the amount of deposit insurance available per insured depositor category to \$250,000 and imposes other limits on deposit-taking;
- the Right to Financial Privacy Act, which imposes a duty to maintain the confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- the Electronic Funds Transfer Act and Regulation E, which governs automatic deposits to and withdrawals from deposit accounts and customers’ rights and liabilities arising from the use of automated teller machines and other electronic banking services; and
- the Truth in Savings Act and Regulation DD, which requires depository institutions to provide disclosures so that consumers can make meaningful comparisons about depository institutions and accounts.

The Consumer Financial Protection Bureau (the “CFPB”) is an independent regulatory authority housed within the Federal Reserve. The CFPB has broad authority to regulate the offering and provision of consumer financial products. The CFPB has the authority to supervise and examine depository institutions with more than \$10 billion in assets for compliance with federal consumer laws. The authority to supervise and examine depository institutions with \$10 billion or less in assets, such as the Bank, for compliance with federal consumer laws remains largely with those institutions’ primary regulators. However, the CFPB may participate in examinations of these smaller institutions on a “sampling basis” and may refer potential enforcement actions against such institutions to their primary regulators. As such, the CFPB may participate in examinations of the Bank.

The CFPB has issued a number of significant rules that impact nearly every aspect of the lifecycle of a residential mortgage loan. These rules implement Dodd-Frank Act amendments to the Equal Credit Opportunity Act, TILA and the Real Estate Settlement Procedures Act (“RESPA”). Among other things, the rules adopted by the CFPB require banks to: (i) develop and implement procedures to ensure compliance with a “reasonable ability-to-repay” test; (ii) implement new or revised disclosures, policies and procedures for originating and servicing mortgages, including, but not limited to, pre-loan counseling, early intervention with delinquent borrowers and specific loss mitigation procedures for loans secured by a borrower’s principal residence, and mortgage origination disclosures, which integrate

existing requirements under TILA and RESPA; (iii) comply with additional restrictions on mortgage loan originator hiring and compensation; and (iv) comply with new disclosure requirements and standards for appraisals and certain financial products.

Bank regulators take into account compliance with consumer protection laws when considering approval of any proposed expansionary proposals.

### GUIDE 3 STATISTICAL DATA REQUIREMENTS

The statistical data required by Guide 3 of the Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934 is set forth in the following pages. This data should be read in conjunction with the consolidated financial statements, related notes and "Management's Discussion and Analysis of Financial Condition and Results of Operations" as set forth in Part II Items 7 and 8. All dollars in the tables are expressed in thousands.

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## I. Distribution of Assets, Liabilities and Stockholders' Equity; Interest Rate and Interest Differential.

The following table sets forth certain information relating to our average consolidated balance sheets and reflects the yield on average interest earning assets and cost of average interest bearing liabilities for the years indicated obtained by dividing the related interest by the average balance of assets or liabilities. Average balances are derived from daily balances.

Analysis of Average Balances,  
Tax Equivalent Interest and Rates  
Years Ended December 31, 2018, 2017 and 2016

	2018 Average Balance	Interest	Rate %	2017 Average Balance	Interest	Rate %	2016 Average Balance	Interest	Rate %
Assets									
Interest earning deposits with financial institutions	\$ 17,540	\$ 334	1.90	\$ 12,224	\$ 134	1.08	\$ 33,226	\$ 169	0.50
Securities:									
Taxable	268,791	9,577	3.56	347,712	10,202	2.93	635,914	15,865	2.49
Non-taxable (TE)	277,555	10,558	3.80	208,142	9,137	4.39	36,643	1,295	3.53
Total securities	546,346	20,135	3.69	555,854	19,339	3.48	672,557	17,160	2.55
Dividends from FHLBC and FRBC	9,305	469	5.04	8,127	370	4.55	7,944	333	4.19
Loans and loans held-for-sale 1	1,778,996	88,922	5.00	1,537,742	70,950	4.55	1,218,931	56,263	4.54
Total interest earning assets	2,352,187	109,860	4.67	2,113,947	90,793	4.25	1,932,658	73,925	3.78
Cash and due from banks	34,021	-	-	33,738	-	-	31,689	-	-
Allowance for loan and lease losses	(18,930)	-	-	(16,390)	-	-	(15,955)	-	-
	180,528	-	-	187,503	-	-	194,356	-	-

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Other noninterest bearing assets									
Total assets	\$ 2,547,806			\$ 2,318,798			\$ 2,142,748		
Liabilities and Stockholders' Equity NOW									
accounts	\$ 436,702	\$ 978	0.22	\$ 425,435	\$ 424	0.10	\$ 389,266	\$ 358	0.09
Money market accounts	307,259	843	0.27	278,826	349	0.13	273,101	274	0.10
Savings accounts	291,611	335	0.11	261,974	177	0.07	256,905	157	0.06
Time deposits	443,520	5,829	1.31	389,771	4,227	1.08	404,285	3,640	0.90
Interest bearing deposits	1,479,092	7,985	0.54	1,356,006	5,177	0.38	1,323,557	4,429	0.33
Securities sold under repurchase agreements	44,122	462	1.05	31,478	17	0.05	34,016	4	0.01
Other short-term borrowings	71,041	1,429	2.01	67,959	741	1.08	26,518	102	0.38
Junior subordinated debentures	57,663	3,716	6.44	57,615	4,002	6.95	57,567	4,334	7.53
Senior notes	44,109	2,688	6.09	44,010	2,689	6.11	2,050	112	5.46
Subordinated debt	-	-	-	-	-	-	42,910	949	2.18
Notes payable and other borrowings	14,696	398	2.71	-	-	-	477	8	1.65
Total interest bearing liabilities	1,710,723	16,678	0.97	1,557,068	12,626	0.81	1,487,095	9,938	0.67
Noninterest bearing deposits	608,762	-	-	547,719	-	-	476,422	-	-
Other liabilities	16,742	-	-	22,131	-	-	12,929	-	-
Stockholders' equity	211,579	-	-	191,880	-	-	166,302	-	-
Total liabilities and stockholders' equity	\$ 2,547,806			\$ 2,318,798			\$ 2,142,748		
		\$ 93,182			\$ 78,167			\$ 63,987	

Net interest income (TE)				
Net interest margin (TE)		3.96		3.70
Interest bearing liabilities to earning assets	72.73	%	73.66	%
				76.95
				%
				3.31

1 Interest income from loans is shown on a tax equivalent basis, which is a non-GAAP financial measure as discussed below, and includes fees of \$1.1 million, \$2.4 million and \$2.5 million for 2018, 2017 and 2016, respectively. Nonaccrual loans are included in the above stated average balances.

For purposes of discussion, net interest income and net interest income to interest earning assets have been adjusted to a non-GAAP tax equivalent (“TE”) basis using a marginal rate of 21% for 2018 and 35% for 2017 and 2016 to more appropriately compare returns on tax-exempt loans and securities to other earning assets. The table below provides a reconciliation of each non-GAAP TE measure to the GAAP equivalent:

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	Effect of Tax Equivalent Adjustment					
	2018	2017	2016			
Interest income (GAAP)	\$ 107,617	\$ 87,505	\$ 73,379			
Taxable equivalent adjustment - loans	26	90	93			
Taxable equivalent adjustment - securities	2,217	3,198	453			
Interest income (TE)	109,860	90,793	73,925			
Less: interest expense (GAAP)	16,678	12,626	9,938			
Net interest income (TE)	\$ 93,182	\$ 78,167	\$ 63,987			
Net interest income (GAAP)	\$ 90,939	\$ 74,879	\$ 63,441			
Average interest earning assets	\$ 2,352,187	\$ 2,113,947	\$ 1,932,658			
Net interest income to total interest earning assets (GAAP)	3.87	% 3.54	% 3.28	%		
Net interest income to total interest earning assets (TE)	3.96	% 3.70	% 3.31	%		

The following table allocates the changes in net interest income to changes in either average balances or average rates for interest earning assets and interest bearing liabilities. Interest income is measured on a tax-equivalent basis using a 21% marginal rate for 2018 and a 35% marginal rate for 2017 and 2016. Interest income not yet received on nonaccrual loans is reversed upon transfer to nonaccrual status; future receipt of interest income is a reduction to principal while in nonaccrual status.

## Analysis of Year-to-Year Changes in Net Interest Income

	2018 Compared to 2017			2017 Compared to 2016		
	Change Due to			Change Due to		
	Average Balance	Average Rate	Total Change	Average Balance	Average Rate	Total Change
Interest and dividend income						
Interest earning deposits	\$ 73	\$ 127	\$ 200	\$ 42	\$ (77)	\$ (35)
Securities:						
Taxable	(11,252)	10,627	(625)	(9,260)	3,597	(5,663)
Tax-exempt	2,369	(948)	1,421	7,456	386	7,842
Dividends from FHLBC and FRBC	57	42	99	8	29	37
Loans and loans held-for-sale	11,045	6,927	17,972	14,557	130	14,687
Total interest and dividend income	2,292	16,775	19,067	12,803	4,065	16,868
Interest expense						
NOW accounts	12	542	554	35	31	66
Money market accounts	39	455	494	6	69	75
Savings accounts	22	136	158	3	17	20
Time deposits	632	970	1,602	(125)	712	587

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Securities sold under repurchase agreements	10	435	445	-	13	13
Other short-term borrowings	34	654	688	293	346	639
Junior subordinated debentures	3	(289)	(286)	4	(336)	(332)
Senior notes	6	(7)	(1)	2,562	15	2,577
Subordinated debt	-	-	-	(475)	(474)	(949)
Notes payable and other borrowings	398	-	398	(4)	(4)	(8)
Total interest expense	1,156	2,896	4,052	2,299	389	2,688
Net interest and dividend income	\$ 1,136	\$ 13,879	\$ 15,015	\$ 10,504	\$ 3,676	\$ 14,180

1 The changes in net interest income are created by changes in both interest rates and volumes. In the table above, volume variances are computed using the change in volume multiplied by previous year's rate. Rate variances are computed using the change in rate multiplied by the previous year's volume. The change in interest due to both rate and volume has been allocated between factors in proportion to the relationship of absolute dollar amounts of the change in each.

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## II. Investment Portfolio

The following table presents the composition of the securities portfolio by major category as of December 31 of each year indicated:

## Securities Portfolio Composition

	2018		2017		2016	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available-for-sale						
U.S. Treasury	\$ 4,006	\$ 3,923	\$ 4,002	\$ 3,947	\$ -	\$ -
U.S. government agencies	11,112	10,951	13,062	13,061	-	-
U.S. government agency mortgage-backed States and political subdivisions	14,407	14,075	12,372	12,214	42,511	41,534
Corporate bonds	277,112	274,067	272,240	278,092	68,718	68,703
Collateralized mortgage obligations	-	-	823	833	10,957	10,630
Asset-backed securities	66,494	64,429	66,892	65,939	174,352	170,927
Collateralized loan obligations	108,574	109,514	113,983	112,932	146,391	138,407
Total securities available-for-sale	65,162	64,289	54,271	54,421	102,504	101,637
	\$ 546,867	\$ 541,248	\$ 537,645	\$ 541,439	\$ 545,433	\$ 531,838

Some of our holdings of U.S. government agency mortgage-backed securities (“MBS”) and collateralized mortgage obligations (“CMOs”) are issuances of government-sponsored enterprises, such as Fannie Mae and Freddie Mac, which are not backed by the full faith and credit of the U.S. government. Some holdings of MBS and CMOs are issued by Ginnie Mae, which does carry the full faith and credit of the U.S. government. We also hold some MBS and CMOs that were not issued by U.S. government agencies and are typically credit-enhanced via over-collateralization and/or subordination. Holdings of asset-backed securities (“ABS”) were largely comprised of securities backed by student loans issued under the U.S. Department of Education’s (“DOE”) FFEL program, which generally provides a minimum 97% U.S. DOE guarantee of principal. These ABS securities also have added credit enhancement through over-collateralization and/or subordination. The majority of holdings issued by states and political subdivisions are general obligation or revenue bonds that have S&P or Moody’s ratings of AA- or higher. Other state and political

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subdivision issuances are unrated and generally consist of smaller investment amounts that involve issuers in our markets. The credit quality of these issuers is monitored and none have been identified as posing a material risk of loss. We also hold collateralized loan obligation (“CLOs”) securities that are generally backed by a pool of debt issued by multiple middle-sized and large businesses. The Company’s CLO S&P or Moody’s ratings distribution consists of 58% rated A, 26% rated AA and 14% rated AAA. CLO credit enhancement is achieved through over-collateralization and/or subordination.

Securities Portfolio Maturity and Yields

The following table presents the expected maturities or call dates and weighted average yield (nontax equivalent) of securities by major category as of December 31, 2018. Securities not due at a single maturity date are shown only in the total column.

	Within One Year		After One But Within Five Years		After Five But Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Securities available-for-sale										
U.S. Treasury	\$ -	-	\$ 3,923	1.85 %	\$ -	-	\$ -	-	\$ 3,923	1.85 %
U.S. government agencies	-	-	-	-	-	-	10,951	2.93 %	10,951	2.93
States and political subdivisions	495	0.56 %	2,938	2.21	6,275	3.25 %	264,359	3.02	274,067	3.01
	495	0.56	6,861	2.00	6,275	3.25	275,310	3.02	288,941	2.99
Mortgage-backed securities and collateralized mortgage obligations	-	-	-	-	-	-	-	-	78,504	3.24
Asset-backed securities	-	-	-	-	-	-	-	-	109,514	3.65
Collateralized loan obligations									64,289	5.05
Total securities available-for-sale	\$ 495	0.56 %	\$ 6,861	2.00 %	\$ 6,275	3.25 %	\$ 275,310	3.02 %	\$ 541,248	3.41 %

As of December 31, 2018, net unrealized losses on available-for-sale securities totaled \$5.6 million, which offset by deferred income taxes resulted in an overall decrease to equity capital of \$4.0 million. As of December 31, 2017, net unrealized gains on available-for-sale securities totaled \$3.8 million, which offset by deferred income taxes resulted in an overall increase to equity capital of \$2.2 million.

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At December 31, 2018, there were three issuers of ABS and CMOs where the book value of our holdings were greater than 10% of our stockholders' equity, as follows:

Issuer	December 31, 2018	
	Amortized Cost	Fair Value
GCO Education Loan Funding Corp	\$ 27,739	\$ 27,763
Towd Point Mortgage Trust	34,308	33,318
Student Loan Marketing Association "(SLMA)"	25,808	26,119

## III.Loan Portfolio

## Types of Loans

The following table presents the composition of the loan portfolio at December 31 for the years indicated:

	2018	2017	2016	2015	2014
Commercial	\$ 314,849	\$ 273,234	\$ 229,030	\$ 116,343	\$ 119,717
Leases	79,224	68,325	55,451	25,712	8,038
Real estate - commercial	820,605	750,991	736,247	605,721	600,629
Real estate - construction	108,053	85,162	64,720	19,806	44,795
Real estate - residential	408,438	312,497	275,571	245,025	253,321
HELOC	140,442	112,833	101,626	105,532	116,549
Other <sup>1</sup>	14,451	14,580	16,164	15,576	16,283
Gross loans, excluding PCI loans	1,886,062	1,617,622	1,478,809	1,133,715	1,159,332
PCI loans, net of purchase accounting adjustments	10,965	—	—	—	—
Gross loans	1,897,027	1,617,622	1,478,809	1,133,715	1,159,332
Allowance for loan and lease losses	(19,006)	(17,461)	(16,158)	(16,223)	(21,637)
Loans, net	\$ 1,878,021	\$ 1,600,161	\$ 1,462,651	\$ 1,117,492	\$ 1,137,695

1 The “Other” class includes consumer loans and overdrafts.

### Maturity and Rate Sensitivity of Loans to Changes in Interest Rates

The following table sets forth the remaining contractual maturities for loan categories at December 31, 2018:

	One Year or Less	Over 1 Year Through 5 Years		Over 5 Years		Total
		Fixed Rate	Floating Rate	Fixed Rate	Floating Rate	
Commercial	\$ 159,424	\$ 87,751	\$ 54,149	\$ 4,399	\$ 9,126	\$ 314,849
Leases	3,282	63,288	-	11,861	793	79,224
Real estate - commercial	143,637	393,703	84,726	57,467	145,254	824,787
Real estate - construction	68,685	7,460	21,731	5,480	5,442	108,798
Real estate - residential	34,879	167,667	16,355	17,506	178,069	414,476
HELOC	4,746	2,351	12,752	55,748	64,845	140,442
Other <sup>1</sup>	5,047	3,698	5,108	401	197	14,451
Total <sup>2</sup>	\$ 419,700	\$ 725,918	\$ 194,821	\$ 152,862	\$ 403,726	\$ 1,897,027

1 The “Other” class includes consumer loans and overdrafts; column one includes demand notes.

2 The “Total” is inclusive of PCI loans, net of purchase accounting adjustments of \$11.0 million within the appropriate loan category.

While there are no significant concentrations of loans where the customers’ ability to honor loan terms is dependent upon a single economic sector, the real estate related categories represented 77.9% and 78.0% of the portfolio at December 31, 2018 and 2017, respectively. We had no concentration of loans exceeding 10% of total loans that were not otherwise disclosed as a category of loans at December 31, 2018.



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## Risk Elements

The following table sets forth the amounts of nonperforming assets at December 31 for the years indicated:

	2018	2017	2016	2015	2014
Nonaccrual loans	\$ 13,741	\$ 14,388	\$ 15,283	\$ 14,389	\$ 26,926
Performing troubled debt restructured loans accruing interest	1,683	988	718	165	154
Loans past due 90 days or more and still accruing interest	917	248	-	65	-
Total nonperforming loans	16,341	15,624	16,001	14,619	27,080
Other real estate owned	7,175	8,371	11,916	19,141	