

FIRST BUSINESS FINANCIAL SERVICES, INC.  
Form 10-Q  
August 01, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the quarterly period ended June 30, 2014

OR  
 Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
Commission file number 001-34095

FIRST BUSINESS FINANCIAL SERVICES, INC.  
(Exact name of registrant as specified in its charter)

Wisconsin 39-1576570

(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

401 Charmany Drive, Madison, WI 53719

(Address of Principal Executive Offices) (Zip Code)  
(608) 238-8008

Registrant's telephone number, including area code

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

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

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

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

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

The number of shares outstanding of the registrant's sole class of common stock, par value \$0.01 per share, on July 24, 2014 was 3,945,220 shares.

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## PART I. Financial Information

## Item 1. Financial Statements

## First Business Financial Services, Inc.

## Consolidated Balance Sheets

|  | June 30,<br>2014<br>(unaudited)   | December 31,<br>2013 |
|--|-----------------------------------|----------------------|
|  | (In Thousands, Except Share Data) |                      |
| Assets   |                                   |                      |
| Cash and due from banks  | \$28,855                          | \$13,219             |
| Short-term investments   | 57,122                            | 68,067               |
| Cash and cash equivalents  | 85,977                            | 81,286               |
| Securities available-for-sale, at fair value   | 143,642                           | 180,118              |
| Securities held-to-maturity, at amortized cost   | 43,434                            | —                    |
| Loans and leases receivable, net of allowance for loan and lease losses of \$14,015 and \$13,901, respectively   | 993,721                           | 967,050              |
| Leasehold improvements and equipment, net  | 1,152                             | 1,155                |
| Foreclosed properties  | 329                               | 333                  |
| Cash surrender value of bank-owned life insurance  | 23,558                            | 23,142               |
| Investment in Federal Home Loan Bank stock, at cost  | 1,349                             | 1,255                |
| Accrued interest receivable and other assets   | 13,341                            | 14,316               |
| Total assets   | \$1,306,503                       | \$1,268,655          |
| Liabilities and Stockholders' Equity   |                                   |                      |
| Deposits   | \$1,166,697                       | \$1,129,855          |
| Federal Home Loan Bank and other borrowings  | 7,936                             | 11,936               |
| Junior subordinated notes  | 10,315                            | 10,315               |
| Accrued interest payable and other liabilities   | 5,907                             | 7,274                |
| Total liabilities  | 1,190,855                         | 1,159,380            |
| Commitments and contingencies  |                                   |                      |
| Stockholders' equity:  |                                   |                      |
| Preferred stock, \$0.01 par value, 2,500,000 shares authorized, none issued or outstanding   | —                                 | —                    |
| Common stock, \$0.01 par value, 25,000,000 shares authorized, 4,109,080 and 4,106,084 shares issued, 3,945,220 and 3,943,997 shares outstanding at June 30, 2014 and December 31, 2013, respectively | 41                                | 41                   |
| Additional paid-in capital   | 56,477                            | 56,002               |
| Retained earnings  | 62,328                            | 57,143               |
| Accumulated other comprehensive income (loss)  | 452                               | (342)                |
| Treasury stock, 163,860 and 162,087 shares at June 30, 2014 and December 31, 2013, respectively, at cost   | (3,650)                           | (3,569)              |
| Total stockholders' equity   | 115,648                           | 109,275              |
| Total liabilities and stockholders' equity   | \$1,306,503                       | \$1,268,655          |

See accompanying Notes to Unaudited Consolidated Financial Statements.

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Consolidated Statements of Income (Unaudited)

|   | For the Three Months Ended            |          | For the Six Months Ended |          |
|---|---------------------------------------|----------|--------------------------|----------|
|   | June 30,                              | 2013     | June 30,                 | 2013     |
|   | 2014                                  |          | 2014                     |          |
|   | (In Thousands, Except Per Share Data) |          |                          |          |
| Interest income:  |                                       |          |                          |          |
| Loans and leases  | \$12,651                              | \$12,283 | \$25,126                 | \$24,736 |
| Securities income   | 855                                   | 809      | 1,721                    | 1,619    |
| Short-term investments  | 59                                    | 50       | 119                      | 106      |
| Total interest income   | 13,565                                | 13,142   | 26,966                   | 26,461   |
| Interest expense:   |                                       |          |                          |          |
| Deposits  | 2,337                                 | 2,454    | 4,506                    | 5,052    |
| Notes payable and other borrowings                            | 152                                   | 218      | 310                      | 436      |
| Junior subordinated notes                                     | 277                                   | 277      | 551                      | 551      |
| Total interest expense  | 2,766                                 | 2,949    | 5,367                    | 6,039    |
| Net interest income   | 10,799                                | 10,193   | 21,599                   | 20,422   |
| Provision for loan and lease losses                           | (91                                   | ) 54     | 89                       | 134      |
| Net interest income after provision for loan and lease losses | 10,890                                | 10,139   | 21,510                   | 20,288   |
| Non-interest income:  |                                       |          |                          |          |
| Trust and investment services fee income                      | 1,110                                 | 970      | 2,178                    | 1,797    |
| Service charges on deposits                                   | 600                                   | 544      | 1,167                    | 1,027    |
| Loan fees   | 380                                   | 332      | 769                      | 690      |
| Increase in cash surrender value of bank-owned life insurance | 209                                   | 212      | 416                      | 419      |
| Other   | 59                                    | 116      | 149                      | 194      |
| Total non-interest income                                     | 2,358                                 | 2,174    | 4,679                    | 4,127    |
| Non-interest expense:   |                                       |          |                          |          |
| Compensation  | 4,741                                 | 4,507    | 9,798                    | 9,233    |
| Occupancy   | 315                                   | 312      | 638                      | 640      |
| Professional fees   | 895                                   | 434      | 1,527                    | 1,006    |
| Data processing   | 423                                   | 402      | 839                      | 804      |
| Marketing   | 364                                   | 352      | 711                      | 637      |
| Equipment   | 125                                   | 135      | 255                      | 274      |
| FDIC insurance  | 173                                   | 193      | 363                      | 398      |
| Collateral liquidation costs                                  | 85                                    | 73       | 243                      | 59       |
| Net loss on foreclosed properties                             | 4                                     | 79       | 4                        | 49       |
| Other   | 624                                   | 1,003    | 1,222                    | 1,568    |
| Total non-interest expense                                    | 7,749                                 | 7,490    | 15,600                   | 14,668   |
| Income before income tax expense                              | 5,499                                 | 4,823    | 10,589                   | 9,747    |
| Income tax expense  | 1,994                                 | 1,690    | 3,747                    | 3,370    |
| Net income  | \$3,505                               | \$3,133  | \$6,842                  | \$6,377  |
| Earnings per common share:                                    |                                       |          |                          |          |
| Basic   | \$0.89                                | \$0.80   | \$1.73                   | \$1.63   |
| Diluted   | 0.88                                  | 0.80     | 1.72                     | 1.62     |
| Dividends declared per share                                  | 0.21                                  | 0.14     | 0.42                     | 0.28     |

See accompanying Notes to Unaudited Consolidated Financial Statements.



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Consolidated Statements of Comprehensive Income (Unaudited)

|   | For the Three Months Ended<br>June 30, |         | For the Six Months Ended<br>June 30, |         |
|---|--|---------|--------------------------------------|---------|
|   | 2014                                   | 2013    | 2014                                 | 2013    |
|   | (In Thousands)                         |         |                                      |         |
| Net income  | \$3,505                                | \$3,133 | \$6,842                              | \$6,377 |
| Other comprehensive income (loss), before tax                       |  |         |                                      |         |
| Securities available-for-sale:                                      |  |         |                                      |         |
| Unrealized securities gains (losses) arising during the period      | 1,793                                  | (2,706) | 2,142                                | (3,011) |
| Securities held-to-maturity:  |  |         |                                      |         |
| Unrealized losses transferred to held-to-maturity                   | (874)                                  | —       | (874)                                | —       |
| Amortization of net unrealized losses transferred during the period | 25                                     | —       | 25                                   | —       |
| Income tax (expense) benefit  | (364)                                  | 1,045   | (499)                                | 1,149   |
| Comprehensive income  | \$4,085                                | \$1,472 | \$7,636                              | \$4,515 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

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First Business Financial Services, Inc.

Consolidated Statements of Changes in Stockholders' Equity (Unaudited)

|   | Common<br>shares<br>outstanding   | Common<br>stock | Additional<br>paid-in<br>capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income (loss) | Treasury<br>stock | Total     |
|---|-----------------------------------|-----------------|----------------------------------|----------------------|--|-------------------|-----------|
|   | (In Thousands, Except Share Data) |                 |                                  |                      |  |                   |           |
| Balance at December 31, 2012                    | 3,916,667                         | \$40            | \$53,504                         | \$45,599             | \$2,183  | \$(1,787)         | \$99,539  |
| Net income                                      | —                                 | —               | —                                | 6,377                | —  | —                 | 6,377     |
| Other comprehensive income                      | —                                 | —               | —                                | —                    | (1,862)  | —                 | (1,862)   |
| Exercise of stock options                       | 51,700                            | 1               | 1,137                            | —                    | —  | —                 | 1,138     |
| Share-based compensation -<br>restricted shares | —                                 | —               | 291                              | —                    | —  | —                 | 291       |
| Share-based compensation - tax<br>benefits      | —                                 | —               | 37                               | —                    | —  | —                 | 37        |
| Cash dividends (\$0.28 per share)               | —                                 | —               | —                                | (1,097)              | —  | —                 | (1,097)   |
| Treasury stock purchased                        | (50,020)                          | —               | —                                | —                    | —  | (1,185)           | (1,185)   |
| Balance at June 30, 2013                        | 3,918,347                         | \$41            | \$54,969                         | \$50,879             | \$321  | \$(2,972)         | \$103,238 |

|   | Common<br>shares<br>outstanding   | Common<br>stock | Additional<br>paid-in<br>capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income (loss) | Treasury<br>stock | Total     |
|---|-----------------------------------|-----------------|----------------------------------|----------------------|--|-------------------|-----------|
|   | (In Thousands, Except Share Data) |                 |                                  |                      |  |                   |           |
| Balance at December 31, 2013                    | 3,943,997                         | \$41            | \$56,002                         | \$57,143             | \$(342)  | \$(3,569)         | \$109,275 |
| Net income                                      | —                                 | —               | —                                | 6,842                | —  | —                 | 6,842     |
| Other comprehensive income                      | —                                 | —               | —                                | —                    | 794  | —                 | 794       |
| Exercise of stock options                       | 2,000                             | —               | 48                               | —                    | —  | —                 | 48        |
| Share-based compensation -<br>restricted shares | 996                               | —               | 389                              | —                    | —  | —                 | 389       |
| Share-based compensation - tax<br>benefits      | —                                 | —               | 38                               | —                    | —  | —                 | 38        |
| Cash dividends (\$0.42 per share)               | —                                 | —               | —                                | (1,657)              | —  | —                 | (1,657)   |
| Treasury stock purchased                        | (1,773)                           | —               | —                                | —                    | —  | (81)              | (81)      |
| Balance at June 30, 2014                        | 3,945,220                         | \$41            | \$56,477                         | \$62,328             | \$452  | \$(3,650)         | \$115,648 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

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## First Business Financial Services, Inc.

## Consolidated Statements of Cash Flows (Unaudited)

|   | For the Six Months Ended June 30, |           |
|---|-----------------------------------|-----------|
|   | 2014                              | 2013      |
|   | (In Thousands)                    |           |
| Operating activities  |                                   |           |
| Net income  | \$6,842                           | \$6,377   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                   |           |
| Deferred income taxes, net  | 443                               | 809       |
| Provision for loan and lease losses   | 89                                | 134       |
| Depreciation, amortization and accretion, net                                     | 870                               | 1,323     |
| Share-based compensation  | 389                               | 291       |
| Increase in cash surrender value of bank-owned life insurance                     | (416                              | ) (419    |
| Net loss on foreclosed properties, including impairment valuation                 | 4                                 | 49        |
| Excess tax benefit from share-based compensation                                  | (38                               | ) (37     |
| (Increase) decrease in accrued interest receivable and other assets               | (224                              | ) 1,564   |
| Decrease in accrued interest payable and other liabilities                        | (1,328                            | ) (4,226  |
| Net cash provided by operating activities   | 6,631                             | 5,865     |
| Investing activities  |                                   |           |
| Proceeds from maturities of available-for-sale securities                         | 25,038                            | 37,576    |
| Proceeds from maturities of held-to-maturity securities                           | 290                               | —         |
| Purchases of available-for-sale securities  | (31,648                           | ) (35,617 |
| Proceeds from sale of foreclosed properties                                       | —                                 | 1,070     |
| Net increase in loans and leases  | (26,760                           | ) (36,397 |
| Investment in limited partnerships  | —                                 | (500      |
| Distributions from limited partnerships   | 203                               | 664       |
| Investment in FHLB Stock  | (467                              | ) (1,185  |
| Proceeds from sale of FHLB Stock  | 373                               | 500       |
| Purchases of leasehold improvements and equipment, net                            | (159                              | ) (406    |
| Net cash used in investing activities   | (33,130                           | ) (34,295 |
| Financing activities  |                                   |           |
| Net increase in deposits  | 36,842                            | 50,725    |
| Repayment of FHLB advances  | —                                 | (469      |
| Repayment of subordinated notes payable   | (4,000                            | ) —       |
| Excess tax benefit from share-based compensation                                  | 38                                | 37        |
| Cash dividends paid   | (1,657                            | ) (823    |
| Exercise of stock options   | 48                                | 1,137     |
| Purchase of treasury stock  | (81                               | ) (1,185  |
| Net cash provided by financing activities   | 31,190                            | 49,422    |
| Net increase in cash and cash equivalents   | 4,691                             | 20,992    |
| Cash and cash equivalents at the beginning of the period                          | 81,286                            | 85,586    |
| Cash and cash equivalents at the end of the period                                | \$85,977                          | \$106,578 |
| Supplementary cash flow information   |                                   |           |
| Cash paid during the period for:  |                                   |           |
| Interest paid on deposits and borrowings  | \$5,160                           | \$6,313   |
| Income taxes paid   | 2,867                             | 3,411     |
| Non-cash investing and financing activities:                                      |                                   |           |
| Transfer of securities from available-for-sale to held-to-maturity                | 44,587                            | —         |



|   |      |     |
|---|------|-----|
| Unrealized loss on transfer from available-for-sale to held-to-maturity | (874 | ) — |
| Transfer to foreclosed properties                                       | —    | 110 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

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Notes to Unaudited Consolidated Financial Statements

Note 1 — Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations. The accounting and reporting practices of First Business Financial Services, Inc. (the “Corporation”), its wholly-owned subsidiaries, First Business Bank (“FBB”) and First Business Bank – Milwaukee (“FBB – Milwaukee”) have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). FBB and FBB – Milwaukee are sometimes referred to together as the “Banks.” FBB operates as a commercial banking institution in the Madison, Wisconsin market, consisting primarily of Dane County and the surrounding areas, with loan production offices in Oshkosh, Appleton, and Green Bay, Wisconsin. FBB also offers trust and investment services through First Business Trust & Investments (“FBTI”), a division of FBB. FBB – Milwaukee operates as a commercial banking institution in the Milwaukee, Wisconsin market, consisting primarily of Waukesha County and the surrounding areas. The Banks provide a full range of financial services to businesses, business owners, executives, professionals and high net worth individuals. The Banks are subject to competition from other financial institutions and service providers and are also subject to state and federal regulations. FBB has the following subsidiaries: First Business Capital Corp. (“FBCC”), First Madison Investment Corp. (“FMIC”), First Business Equipment Finance, LLC (“FBEF”) and FBB Real Estate, LLC (“FBBRE”). FMIC is located in and was formed under the laws of the state of Nevada. FBB-Milwaukee has one subsidiary, FBB – Milwaukee Real Estate, LLC (“FBBMRE”).

Basis of Presentation. The accompanying unaudited Consolidated Financial Statements were prepared in accordance with GAAP and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the Corporation's Consolidated Financial Statements and footnotes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2013. The unaudited Consolidated Financial Statements include the accounts of the Corporation and its wholly-owned subsidiaries. In accordance with the provisions of Accounting Standards Codification (“ASC”) Topic 810, the Corporation's ownership interest in FBFS Statutory Trust II (“Trust II”) has not been consolidated into the financial statements. All significant intercompany balances and transactions have been eliminated in consolidation.

Management of the Corporation is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements as well as reported amounts of revenues and expenses during the reporting period. Actual results could differ significantly from those estimates. Material estimates that could experience significant changes in the near-term include the value of foreclosed property, lease residuals, property under operating leases, securities, income taxes and the level of the allowance for loan and lease losses. The results of operations for the six-month period ended June 30, 2014 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2014. Certain amounts in prior periods may have been reclassified to conform to the current presentation. Subsequent events have been evaluated through the date of the issuance of the Consolidated Financial Statements. No significant subsequent events have occurred through this date requiring adjustment to the financial statements or disclosures.

The Corporation has not changed its significant accounting and reporting policies from those disclosed in the Corporation's Form 10-K for the year ended December 31, 2013 except as described further below in this Note 1. Recent Accounting Pronouncements.

In July 2013, the FASB issued ASU No. 2013-11, “Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exits.” This ASU provides that an unrecognized tax benefit, or a portion thereof, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use the deferred tax asset for such purpose. In these cases, the unrecognized tax benefit should be presented as a liability. This ASU is effective for fiscal years, and interim

periods within those years, beginning after December 15, 2013. The adoption of this standard did not have a material impact on the Corporation's consolidated financial position or results of operations.

In January 2014, the FASB issued ASU No. 2014-04, "Receivables—Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (a consensus of the FASB Emerging Issues Task Force)." This ASU clarifies that an in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan

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through completion of a deed in lieu of foreclosure or through a similar agreement. In addition, the amendments require interim and annual disclosure of both the amount of foreclosed residential real estate property held by the creditor and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure in accordance with local requirements of the applicable jurisdiction. This amendment is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. An entity can elect to adopt the amendments using either a modified retrospective method or a prospective transition method. Early adoption is permitted. The Corporation is in the process of evaluating the impact of this standard but does not expect this standard to have a material impact on the Corporation's consolidated financial position or results of operations.

In May 2014, the FASB issued Accounting Standards Update (ASU) No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." The ASU is a converged standard between the FASB and the IASB that provides a single comprehensive revenue recognition model for all contracts with customers across transactions and industries. The primary objective of the ASU is revenue recognition that represents the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The ASU is effective for interim and annual reporting periods beginning after December 15, 2016. The Corporation is in the process of evaluating the impact of this standard.

In June 2014, the FASB issued ASU No. 2014-12, "Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." This ASU requires a reporting entity to treat a performance target that affects vesting and that could be achieved after the requisite service period as a performance condition. A reporting entity should apply FASB ASC Topic 718, Compensation-Stock Compensation, to awards with performance conditions that affect vesting. For all entities, ASU 2014-12 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted. ASU 2014-12 may be adopted either prospectively for share-based payment awards granted or modified on or after the effective date, or retrospectively, using a modified retrospective approach. The modified retrospective approach would apply to share-based payment awards outstanding as of the beginning of the earliest annual period presented in the financial statements on adoption, and to all new or modified awards thereafter. While the Corporation does not have any performance-based awards outstanding as of the reporting date, the Corporation's equity incentive plan does allow for such awards. The Corporation is, therefore, in the process of evaluating the impact of this standard but does not expect this standard to have a material impact on the Corporation's consolidated financial position or results of operations.

Note 2 — Business Combinations

On May 22, 2014, the Corporation entered into an Agreement and Plan of Merger (the "Merger Agreement") with Aslin Group, Inc., a Delaware corporation ("Aslin Group"), and AGI Acquisition Corp., a Delaware corporation and a wholly owned subsidiary of the Corporation (the "Merger Sub").

The Merger Agreement contemplates that the Merger Sub will be merged with and into Aslin Group (the "Merger"), with Aslin Group continuing as the surviving corporation of the Merger, and each outstanding share of common stock of Aslin Group (other than shares held in the treasury of Aslin Group, owned by the Corporation or any subsidiary of the Corporation, or subject to validly exercised appraisal rights) will cease to be outstanding and will be converted into the right to receive a combination of shares of common stock of the Corporation and cash, as described in more detail below. Immediately following the Merger, Aslin Group will be merged with and into the Corporation in a second merger, with the Corporation continuing as the surviving corporation. As a result of the mergers, Aslin Group's wholly-owned subsidiary, Alterra Bank, will become a wholly-owned subsidiary of the Corporation. The separate corporate existence of Aslin Group will cease as of the effective time of the second merger.

Under the terms of the Merger Agreement, stockholders of Aslin Group will receive, in the aggregate, approximately \$16.6 million of the Corporation's common stock plus approximately \$13.5 million in cash. The number of shares of the Corporation's common stock to be issued to Aslin Group stockholders will be determined based on the volume-weighted average closing price of the Corporation's common stock on The NASDAQ Global Select Market according to the Bloomberg VWAP Price and Volume Dashboard during the 10 consecutive trading days ending on and including the third trading day immediately prior to the date the Merger closes; provided however that such price will be limited to a maximum of approximately \$51 per share and a minimum of \$34 per share. The mergers are subject to regulatory approvals, approval by Aslin Group stockholders and certain other customary closing conditions and are expected to close in late 2014. The Corporation anticipates that the acquisition of Aslin Group will not be considered a significant business combination, as defined in accordance with Regulation S-X, and, accordingly, pro-forma financial information is not required.

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## Note 3 — Earnings Per Common Share

Earnings per common share are computed using the two-class method. Basic earnings per common share are computed by dividing net income allocated to common shares by the weighted average number of shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include unvested restricted shares. Unvested restricted shares are considered participating securities because holders of these securities receive non-forfeitable dividends at the same rate as holders of the Corporation's common stock. Diluted earnings per share are computed by dividing net income allocated to common shares adjusted for reallocation of undistributed earnings of unvested restricted shares by the weighted average number of shares determined for the basic earnings per common share computation plus the dilutive effect of common stock equivalents using the treasury stock method. For both the three and six month periods ending June 30, 2014 and 2013, there were no average anti-dilutive employee share-based awards.

|  | For the Three Months Ended                    |           | For the Six Months Ended |           |
|--|---|-----------|--------------------------|-----------|
|  | June 30,                                      | 2013      | June 30,                 | 2013      |
|  | 2014  |           | 2014                     |           |
|  | (Dollars in Thousands, Except Per Share Data) |           |                          |           |
| Basic earnings per common share  |   |           |                          |           |
| Net income   | \$3,505                                       | \$3,133   | \$6,842                  | \$6,377   |
| Less: earnings allocated to participating securities                                   | 75  | 75        | 147                      | 152       |
| Basic earnings allocated to common shareholders  | \$3,430                                       | \$3,058   | \$6,695                  | \$6,225   |
| Weighted-average common shares outstanding, excluding participating securities         | 3,860,087                                     | 3,825,069 | 3,859,795                | 3,824,563 |
| Basic earnings per common share  | \$0.89  | \$0.80    | \$1.73                   | \$1.63    |
| Diluted earnings per common share  |   |           |                          |           |
| Earnings allocated to common shareholders  | \$3,430                                       | \$3,058   | \$6,695                  | \$6,225   |
| Reallocation of undistributed earnings   | —   | 1         | —                        | —         |
| Diluted earnings allocated to common shareholders                                      | \$3,430                                       | \$3,059   | \$6,695                  | \$6,225   |
| Weighted-average common shares outstanding, excluding participating securities         | 3,860,087                                     | 3,825,069 | 3,859,795                | 3,824,563 |
| Dilutive effect of share-based awards  | 23,268  | 11,414    | 22,203                   | 9,180     |
| Weighted-average diluted common shares outstanding, excluding participating securities | 3,883,355                                     | 3,836,483 | 3,881,998                | 3,833,743 |
| Diluted earnings per common share  | \$0.88  | \$0.80    | \$1.72                   | \$1.62    |

## Note 4 — Share-Based Compensation

The Corporation adopted the 2012 Equity Incentive Plan (the "Plan") during the quarter ended June 30, 2012. The Plan is administered by the Compensation Committee of the Board of Directors of the Corporation and provides for the grant of equity ownership opportunities through incentive stock options and nonqualified stock options (together, "Stock Options"), restricted stock, restricted stock units, dividend equivalent units, and any other type of award permitted by the Plan. As of June 30, 2014, 197,953 shares were available for future grants under the Plan. Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the Plan. The Corporation may issue new shares and shares from treasury for shares delivered under the Plan.

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## Stock Options

The Corporation may grant Stock Options to senior executives and other employees under the Plan. Stock Options generally have an exercise price that is equal to the fair value of the common shares on the date the option is awarded. Stock Options granted under the Plan are subject to graded vesting, generally ranging from 4 years to 8 years, and have a contractual term of 10 years. For any new awards issued, compensation expense is recognized over the requisite service period for the entire award on a straight-line basis. No Stock Options have been granted since the Corporation became a reporting company under the Securities Exchange Act of 1934, as amended, and no Stock Options have been modified, repurchased or cancelled since such time. For that reason, no stock-based compensation related to Stock Options was recognized in the Consolidated Financial Statements for the three and six months ended June 30, 2014 and 2013. As of June 30, 2014, all Stock Options granted and not previously forfeited have vested. The benefits of tax deductions as a result of disqualifying dispositions upon exercise of stock options are recognized as a financing cash flow.

Stock Option activity for the year ended December 31, 2013 and six months ended June 30, 2014 was as follows:

|                                     | Options | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) |
|-------------------------------------|---------|--|---|
| Outstanding at December 31, 2012    | 124,034 | \$22.43                                  | 0.75  |
| Granted                             | —       | —  |   |
| Exercised                           | (69,684 | ) 21.13                                  |   |
| Expired                             | (3,350  | ) 22.00                                  |   |
| Forfeited                           | —       | —  |   |
| Outstanding at December 31, 2013    | 51,000  | \$24.24                                  | 0.88  |
| Exercisable at December 31, 2013    | 51,000  | \$24.24                                  | 0.88  |
| Outstanding as of December 31, 2013 | 51,000  | \$24.24                                  | 0.88  |
| Granted                             | —       | —  |   |
| Exercised                           | (2,000  | ) 24.00                                  |   |
| Expired                             | —       | —  |   |
| Forfeited                           | —       | —  |   |
| Outstanding as of June 30, 2014     | 49,000  | \$24.24                                  | 0.38  |
| Exercisable at June 30, 2014        | 49,000  | \$24.24                                  | 0.38  |

## Restricted Stock

Under the Plan, the Corporation may grant restricted shares to plan participants, subject to forfeiture upon the occurrence of certain events until the dates specified in the participant's award agreement. While the restricted shares are subject to forfeiture, the participant may exercise full voting rights and will receive all dividends and other distributions paid with respect to the restricted shares. The restricted shares granted under the Plan are subject to graded vesting. Compensation expense is recognized over the requisite service period of generally four years for the entire award on a straight-line basis. Upon vesting of restricted share awards, the benefit of tax deductions in excess of recognized compensation expense is recognized as a financing cash flow activity.

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Restricted share activity for the year ended December 31, 2013 and the six months ended June 30, 2014 was as follows:

|   | Number of Restricted Shares | Weighted Average Grant-Date Fair Value |
|---|-----------------------------|--|
| Nonvested balance as of December 31, 2012 | 94,506                      | \$18.19                                |
| Granted                                   | 25,030                      | 33.00                                  |
| Vested                                    | (34,827 )                   | 16.88                                  |
| Forfeited                                 | —                           | —                                      |
| Nonvested balance as of December 31, 2013 | 84,709                      | 23.10                                  |
| Granted                                   | 996                         | 40.29                                  |
| Vested                                    | (1,540 )                    | 17.92                                  |
| Forfeited                                 | —                           | —                                      |
| Nonvested balance as of June 30, 2014     | 84,165                      | \$23.40                                |

As of June 30, 2014, \$1.4 million of deferred compensation expense was included in additional paid-in capital in the Consolidated Balance Sheets related to unvested restricted shares which the Corporation expects to recognize over a weighted-average period of approximately 2.4 years. As of June 30, 2014, all restricted shares that vested were delivered.

For the three and six months ended June 30, 2014 and 2013, share-based compensation expense related to restricted stock included in the Consolidated Statements of Income was as follows:

|   | For the Three Months Ended June 30, |        | For the Six Months Ended June 30, |        |
|---|-------------------------------------|--------|-----------------------------------|--------|
|   | 2014                                | 2013   | 2014                              | 2013   |
|   | (Dollars in Thousands)              |        |                                   |        |
| Total cost of share-based payment plans during the period | \$ 196                              | \$ 146 | \$ 389                            | \$ 291 |

## Note 5 — Securities

The amortized cost and estimated fair value of securities available-for-sale and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

|  | As of June 30, 2014 |                                |                                 |                      |
|--|---------------------|--------------------------------|---------------------------------|----------------------|
|  | Amortized cost      | Gross unrealized holding gains | Gross unrealized holding losses | Estimated fair value |
|  | (In Thousands)      |                                |                                 |                      |
| Available-for-sale:  |                     |                                |                                 |                      |
| U.S. Government agency obligations - government-sponsored enterprises  | \$7,250             | \$—                            | \$(84 )                         | \$7,166              |
| Municipal obligations  | —                   | —                              | —                               | —                    |
| Asset-backed securities  | 1,515               | —                              | (1 )                            | 1,514                |
| Collateralized mortgage obligations - government issued                | 80,800              | 1,956                          | (289 )                          | 82,467               |
| Collateralized mortgage obligations - government-sponsored enterprises | 52,492              | 204                            | (201 )                          | 52,495               |



\$142,057    \$2,160    \$(575    ) \$143,642

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|   | As of December 31, 2013 |   |  |                         |
|---|-------------------------|---|--|-------------------------|
|   | Amortized<br>cost       | Gross<br>unrealized<br>holding<br>gains | Gross<br>unrealized<br>holding<br>losses | Estimated<br>fair value |
|   | (In Thousands)          |   |  |                         |
| Available-for-sale:   |                         |   |  |                         |
| U.S. Government agency obligations -<br>government-sponsored enterprises  | \$ 16,380               | \$ 9                                    | \$(145 )                                 | \$ 16,244               |
| Municipal obligations   | 16,207                  | 35                                      | (753 )                                   | 15,489                  |
| Asset-backed securities   | 1,517                   | \$—                                     | (23 )                                    | 1,494                   |
| Collateralized mortgage obligations - government issued                   | 111,010                 | 2,238                                   | (1,279 )                                 | 111,969                 |
| Collateralized mortgage obligations - government-sponsored<br>enterprises | 35,561                  | 57                                      | (696 )                                   | 34,922                  |
|   | \$ 180,675              | \$ 2,339                                | \$(2,896 )                               | \$ 180,118              |

The amortized cost and estimated fair value of securities held-to-maturity and the corresponding amounts of gross unrecognized gains and losses were as follows:

|   | As of June 30, 2014 |  |   |                         |
|---|---------------------|--|---|-------------------------|
|   | Amortized<br>cost   | Gross<br>unrecognized<br>holding gains | Gross<br>unrecognized<br>holding losses | Estimated<br>fair value |
|   | (In Thousands)      |  |   |                         |
| Held-to-maturity:   |                     |  |   |                         |
| U.S. Government agency obligations -<br>government-sponsored enterprises  | \$ 1,474            | \$—                                    | \$(11 )                                 | \$ 1,463                |
| Municipal obligations   | 16,113              | —                                      | (141 )                                  | 15,972                  |
| Collateralized mortgage obligations - government<br>issued                | 15,776              | 10                                     | (60 )                                   | 15,726                  |
| Collateralized mortgage obligations -<br>government-sponsored enterprises | 10,071              | —                                      | (92 )                                   | 9,979                   |
|   | \$ 43,434           | \$ 10                                  | \$(304 )                                | \$ 43,140               |

During the quarter ended June 30, 2014, the Corporation transferred securities with an amortized cost of \$44.6 million, previously designated as available-for-sale, to held-to-maturity classification. The fair value of those securities as of the date of the transfer was \$43.7 million, reflecting a net unrealized loss of \$874,000. The fair value as of the transfer date became the new amortized cost over the life of the security. No gain or loss was recognized at the time of the transfer. This transfer was completed after consideration of the Corporation's ability and intent to hold these securities to maturity.

U.S. Government agency obligations - government-sponsored enterprises represent securities issued by the Federal Home Loan Mortgage Corporation ("FHLMC") and Federal National Mortgage Association ("FNMA"). Collateralized mortgage obligations - government issued represent securities guaranteed by the Government National Mortgage Association ("GNMA"). Collateralized mortgage obligations - government-sponsored enterprises include securities guaranteed by FHLMC and the FNMA. Asset-backed securities represent securities issued by the Student Loan Marketing Association ("SLMA") and are 97% guaranteed by the U.S. government. Municipal obligations include securities issued by various municipalities located primarily within the State of Wisconsin and are primarily general obligation bonds that are tax-exempt in nature. There were no sales of securities available-for-sale for the three and six

months ended June 30, 2014 and 2013.

At June 30, 2014 and December 31, 2013, securities with a fair value of \$37.6 million and \$42.3 million, respectively, were pledged to secure interest rate swap contracts, outstanding Federal Home Loan Bank (“FHLB”) advances, if any, and additional FHLB availability.

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The amortized cost and estimated fair value of securities by contractual maturity at June 30, 2014 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay certain obligations without call or prepayment penalties.

|                                    | Available-for-Sale |                      | Held-to-Maturity |                      |
|------------------------------------|--------------------|----------------------|------------------|----------------------|
|                                    | Amortized cost     | Estimated fair value | Amortized cost   | Estimated fair value |
|                                    | (In Thousands)     |                      |                  |                      |
| Due in one year or less            | \$—                | \$—                  | \$—              | \$—                  |
| Due in one year through five years | 7,789              | 7,724                | 2,277            | 2,263                |
| Due in five through ten years      | 51,569             | 51,955               | 13,133           | 13,020               |
| Due in over ten years              | 82,699             | 83,963               | 28,024           | 27,857               |
|                                    | \$142,057          | \$143,642            | \$43,434         | \$43,140             |

The tables below show the Corporation's gross unrealized losses and fair value of available-for-sale investments with unrealized losses and the gross unrecognized losses and fair value of held-to-maturity investments, aggregated by investment category and length of time that individual investments were in a continuous loss position at June 30, 2014 and December 31, 2013. At June 30, 2014 and December 31, 2013, the Corporation held 45 and 131 available-for-sale securities that were in a loss position, respectively. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. At June 30, 2014, the Corporation held 23 available-for-sale securities that had been in a continuous loss position for twelve months or greater.

The Corporation also has not specifically identified available-for-sale securities in a loss position that it intends to sell in the near term and does not believe that it will be required to sell any such securities. It is expected that the Corporation will recover the entire amortized cost basis of each security based upon an evaluation of the present value of the expected future cash flows. Accordingly, no other than temporary impairment was recorded in the Consolidated Statements of Income for the six months ended June 30, 2014 and 2013.

A summary of unrealized loss information for securities available-for-sale, categorized by security type follows:

|  | As of June 30, 2014 |                   |            |                   | Total      |                   |
|--|---------------------|-------------------|------------|-------------------|------------|-------------------|
|  | Fair value          | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses |
|  | (In Thousands)      |                   |            |                   |            |                   |
| Available-for-sale:  |                     |                   |            |                   |            |                   |
| U.S. Government agency obligations - government-sponsored enterprises  | \$2,491             | \$9               | \$4,675    | \$75              | \$7,166    | \$84              |
| Municipal obligations  | —                   | —                 | —          | —                 | —          | —                 |
| Asset-backed securities  | —                   | —                 | 1,514      | 1                 | 1,514      | 1                 |
| Collateralized mortgage obligations - government issued                | 8,347               | 23                | 11,934     | 266               | 20,281     | 289               |
| Collateralized mortgage obligations - government-sponsored enterprises | 17,669              | 70                | 4,672      | 131               | 22,341     | 201               |

|          |       |          |       |          |       |
|----------|-------|----------|-------|----------|-------|
| \$28,507 | \$102 | \$22,795 | \$473 | \$51,302 | \$575 |
|----------|-------|----------|-------|----------|-------|

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|  | As of December 31, 2013 |                   |                     |                   |            |                   |
|--|-------------------------|-------------------|---------------------|-------------------|------------|-------------------|
|  | Less than 12 months     |                   | 12 months or longer |                   | Total      |                   |
|  | Fair value              | Unrealized losses | Fair value          | Unrealized losses | Fair value | Unrealized losses |
|  | (In Thousands)          |                   |                     |                   |            |                   |
| Available-for-sale:  |                         |                   |                     |                   |            |                   |
| U.S. Government agency obligations - government-sponsored enterprises  | \$10,608                | \$145             | \$—                 | \$—               | \$10,608   | \$145             |
| Municipal obligations  | 12,001                  | 650               | 981                 | 103               | 12,982     | 753               |
| Asset-backed securities  | 1,494                   | \$23              | —                   | —                 | 1,494      | 23                |
| Collateralized mortgage obligations - government issued                | 34,021                  | 997               | 6,146               | 282               | 40,167     | 1,279             |
| Collateralized mortgage obligations - government-sponsored enterprises | 20,628                  | 506               | 5,418               | 190               | 26,046     | 696               |
|  | \$78,752                | \$2,321           | \$12,545            | \$575             | \$91,297   | \$2,896           |

The tables below show the Corporation's gross unrecognized losses and fair value of held-to-maturity investments, aggregated by investment category and length of time that individual investments were in a continuous loss position at June 30, 2014. At June 30, 2014, the Corporation held 95 held-to-maturity securities that were in an unrecognized loss position. Such securities have not experienced credit rating downgrades; however, they have primarily declined in value due to the current interest rate environment. There were no held-to-maturity securities that had been in a continuous loss position for twelve months or greater as of June 30, 2014. It is expected that the Corporation will recover the entire amortized cost basis of each held-to-maturity security based upon an evaluation of the present value of the expected future cash flows. Accordingly, no other than temporary impairment was recorded in the Consolidated Statements of Income for the six months ended June 30, 2014.

A summary of unrecognized loss information for securities held-to-maturity, categorized by security type follows:

|   | As of June 30, 2014 |                     |                     |                     |            |                     |
|---|---------------------|---------------------|---------------------|---------------------|------------|---------------------|
|   | Less than 12 months |                     | 12 months or longer |                     | Total      |                     |
|   | Fair value          | Unrecognized losses | Fair value          | Unrecognized losses | Fair value | Unrecognized losses |
|   | (In Thousands)      |                     |                     |                     |            |                     |
| Held-to-maturity:   |                     |                     |                     |                     |            |                     |
| U.S. Government agency obligations - government-sponsored enterprises | \$1,474             | \$11                | \$—                 | \$—                 | \$1,474    | \$11                |
| Municipal obligations   | 16,113              | 141                 | —                   | —                   | 16,113     | 141                 |
| Collateralized mortgage obligations - government issued               | 13,586              | 60                  | —                   | —                   | 13,586     | 60                  |
| Collateralized mortgage obligations - government-sponsored            | 10,071              | 92                  | —                   | —                   | 10,071     | 92                  |

enterprises

|          |       |     |     |          |       |
|----------|-------|-----|-----|----------|-------|
| \$41,244 | \$304 | \$— | \$— | \$41,244 | \$304 |
|----------|-------|-----|-----|----------|-------|

There were no securities designated as held-to-maturity as of December 31, 2013.

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## Note 6 — Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses

Loan and lease receivables consist of the following:

|   | June 30,<br>2014 | December 31,<br>2013 |
|---|------------------|----------------------|
|   | (In Thousands)   |                      |
| Commercial real estate                      |                  |                      |
| Commercial real estate — owner occupied     | \$141,704        | \$141,164            |
| Commercial real estate — non-owner occupied | 333,179          | 341,695              |
| Construction and land development           | 75,749           | 68,708               |
| Multi-family                                | 59,826           | 62,758               |
| 1-4 family                                  | 26,945           | 30,786               |
| Total commercial real estate                | 637,403          | 645,111              |
| Commercial and industrial                   | 325,900          | 293,552              |
| Direct financing leases, net                | 29,649           | 26,065               |
| Consumer and other                          |                  |                      |
| Home equity and second mortgages            | 4,370            | 5,272                |
| Other                                       | 11,293           | 11,972               |
| Total consumer and other                    | 15,663           | 17,244               |
| Total gross loans and leases receivable     | 1,008,615        | 981,972              |
| Less:                                       |                  |                      |
| Allowance for loan and lease losses         | 14,015           | 13,901               |
| Deferred loan fees                          | 879              | 1,021                |
| Loans and leases receivable, net            | \$993,721        | \$967,050            |

The total principal amount of loans transferred to third parties, which consisted solely of participation interests in originated loans, during the three months ended June 30, 2014 and 2013 was \$6.6 million and \$10.1 million, respectively. For the six months ended June 30, 2014 and 2013, \$11.7 million and \$13.9 million of loans were transferred to third parties, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting, including the requirements specific to loan participations, and therefore all of the loans transferred during the three and six months ended June 30, 2014 and June 30, 2013 have been derecognized in the unaudited Consolidated Financial Statements. The Corporation has a continuing involvement in each of the agreements by way of relationship management and servicing the loans; however, there are no further obligations to the third-party participant required of the Corporation in the event of a borrower's default, other than standard representations and warranties related to sold amounts. The loans were transferred at their fair value and no gain or loss was recognized upon the transfer, as the participation interest was transferred at or near the date of loan origination and the payments received for servicing the portion of the loans participated represents adequate compensation. The total amount of loan participations purchased on the Corporation's Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013 was \$490,000 and \$498,000, respectively.

The total amount of outstanding loans transferred to third parties as loan participations sold at June 30, 2014 and December 31, 2013 was \$45.4 million and \$52.1 million, respectively, all of which was treated as a sale and derecognized under the applicable accounting guidance in effect at the time of the transfers of the financial assets. The Corporation's continuing involvement with these loans is by way of partial ownership, relationship management and all servicing responsibilities. As of June 30, 2014 and December 31, 2013, the total amount of the Corporation's partial ownership of loans on the Corporation's Consolidated Balance Sheets was \$64.8 million and \$77.2 million, respectively. As of June 30, 2014 and December 31, 2013, no loans in this participation sold portfolio were considered impaired. The Corporation does not share in the participant's portion of the charge-offs.



At each of June 30, 2014 and December 31, 2013, the carrying amount of the loan purchased with deteriorated credit quality was \$1.4 million. This loan is classified as a non-performing troubled debt restructuring because the Corporation cannot reasonably estimate the timing of the cash flows expected to be collected and therefore the discount will not be accreted to earnings until the carrying amount is fully paid. During the six months ended June 30, 2014, there were no changes to the

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allowance for loan and lease losses relating to this loan, as it is a collateral dependent loan and was deemed to have sufficient collateral value as of June 30, 2014 to support the carrying value.

The following information illustrates ending balances of the Corporation's loan and lease portfolio, including impaired loans by class of receivable, and considering certain credit quality indicators as of June 30, 2014 and December 31, 2013:

| As of June 30, 2014                         | Category               |           |           |           | Total        |
|---|------------------------|-----------|-----------|-----------|--------------|
|   | I                      | II        | III       | IV        |              |
|   | (Dollars in Thousands) |           |           |           |              |
| Commercial real estate:                     |                        |           |           |           |              |
| Commercial real estate — owner occupied     | \$ 118,384             | \$ 9,236  | \$ 13,490 | \$ 594    | \$ 141,704   |
| Commercial real estate — non-owner occupied | 295,398                | 16,292    | 21,212    | 277       | 333,179      |
| Construction and land development           | 61,567                 | 2,248     | 6,637     | 5,297     | 75,749       |
| Multi-family                                | 54,191                 | 5,611     | —         | 24        | 59,826       |
| 1-4 family                                  | 18,317                 | 5,014     | 3,019     | 595       | 26,945       |
| Total commercial real estate                | 547,857                | 38,401    | 44,358    | 6,787     | 637,403      |
| Commercial and industrial                   | 296,645                | 12,967    | 9,624     | 6,664     | 325,900      |
| Direct financing leases, net                | 26,387                 | 2,916     | 346       | —         | 29,649       |
| Consumer and other:                         |                        |           |           |           |              |
| Home equity and second mortgages            | 3,649                  | 20        | 147       | 554       | 4,370        |
| Other                                       | 10,516                 | —         | —         | 777       | 11,293       |
| Total consumer and other                    | 14,165                 | 20        | 147       | 1,331     | 15,663       |
| Total gross loans and leases receivable     | \$ 885,054             | \$ 54,304 | \$ 54,475 | \$ 14,782 | \$ 1,008,615 |
| Category as a % of total portfolio          | 87.75                  | % 5.38    | % 5.40    | % 1.47    | % 100.00     |

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| As of December 31, 2013                     | Category               |           |           |           | Total      |
|---|------------------------|-----------|-----------|-----------|------------|
|   | I                      | II        | III       | IV        |            |
|   | (Dollars in Thousands) |           |           |           |            |
| Commercial real estate:                     |                        |           |           |           |            |
| Commercial real estate — owner occupied     | \$ 118,764             | \$ 11,259 | \$ 10,802 | \$ 339    | \$ 141,164 |
| Commercial real estate — non-owner occupied | 290,865                | 29,444    | 21,103    | 283       | 341,695    |
| Construction and land development           | 53,493                 | 1,972     | 7,754     | 5,489     | 68,708     |
| Multi-family                                | 57,049                 | 5,678     | —         | 31        | 62,758     |
| 1-4 family                                  | 19,197                 | 7,611     | 3,312     | 666       | 30,786     |
| Total commercial real estate                | 539,368                | 55,964    | 42,971    | 6,808     | 645,111    |
| Commercial and industrial                   | 268,109                | 11,688    | 5,712     | 8,043     | 293,552    |
| Direct financing leases, net                | 23,171                 | 2,421     | 473       | —         | 26,065     |
| Consumer and other:                         |                        |           |           |           |            |
| Home equity and second mortgages            | 4,408                  | 134       | 150       | 580       | 5,272      |
| Other                                       | 11,177                 | —         | —         | 795       | 11,972     |
| Total consumer and other                    | 15,585                 | 134       | 150       | 1,375     | 17,244     |
| Total gross loans and leases receivable     | \$ 846,233             | \$ 70,207 | \$ 49,306 | \$ 16,226 | \$ 981,972 |
| Category as a % of total portfolio          | 86.18                  | % 7.15    | % 5.02    | % 1.65    | % 100.00   |

Credit underwriting through a committee process is a key component of the Corporation's operating philosophy. Business development officers have relatively low individual lending authority limits, and thus a significant portion of the Corporation's new credit extensions require approval from a loan approval committee regardless of the type of loan or lease, asset quality grade of the credit, amount of the credit, or the related complexities of each proposal. In addition, the Corporation makes every effort to ensure that there is appropriate collateral at the time of origination to protect the Corporation's interest in the related loan or lease.

Each credit is evaluated for proper risk rating upon origination, at the time of each subsequent renewal, upon receipt and evaluation of updated financial information from the Corporation's borrowers, or as other circumstances dictate. The Corporation uses a nine grade risk rating system to monitor the ongoing credit quality of its loans and leases. The risk rating grades follow a consistent definition, and are then applied to specific loan types based on the nature of the loan. Each risk rating is subjective and, depending on the size and nature of the credit, subject to various levels of review and concurrence on the stated risk rating. In addition to its nine grade risk rating system, the Corporation groups loans into four loan and related risk categories which determine the level and nature of review by management. Category I — Loans and leases in this category are performing in accordance with the terms of the contract and generally exhibit no immediate concerns regarding the security and viability of the underlying collateral, financial stability of the borrower, integrity or strength of the borrower's management team or the industry in which the borrower operates. Loans and leases in this category are not subject to additional monitoring procedures above and beyond what is required at the origination or renewal of the loan or lease. The Corporation monitors Category I loans and leases through payment performance, continued maintenance of its personal relationships with such borrowers and continued review of such borrowers' compliance with the terms of their respective agreements.

Category II — Loans and leases in this category are beginning to show signs of deterioration in one or more of the Corporation's core underwriting criteria such as financial stability, management strength, industry trends and collateral values. Management will place credits in this category to allow for proactive monitoring and resolution with the borrower to possibly mitigate the area of concern and prevent further deterioration or risk of loss to the Corporation. Category II loans are considered performing but are monitored frequently by the assigned business development

officer and by subcommittees of the Banks' loan committees.

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Category III — Loans and leases in this category are identified by management as warranting special attention. However, the balance in this category is not intended to represent the amount of adversely classified assets held by the Banks. Category III loans and leases generally exhibit undesirable characteristics such as evidence of adverse financial trends and conditions, managerial problems, deteriorating economic conditions within the related industry, or evidence of adverse public filings and may exhibit collateral shortfall positions. Management continues to believe that it will collect all required principal and interest in accordance with the original terms of the contracts relating to the loans and leases in this category, and therefore Category III loans are considered performing with no specific reserves established for this category. Category III loans are monitored by management and loan committees of the Banks on a monthly basis and the Banks' Boards of Directors at each of their regularly scheduled meetings.

Category IV — Loans and leases in this category are considered to be impaired. Impaired loans and leases have been placed on non-accrual as management has determined that it is unlikely that the Banks will receive the required principal and interest in accordance with the contractual terms of the agreement. Impaired loans are individually evaluated to assess the need for the establishment of specific reserves or charge-offs. When analyzing the adequacy of collateral, the Corporation obtains external appraisals at least annually for impaired loans and leases. External appraisals are obtained from the Corporation's approved appraiser listing and are independently reviewed to monitor the quality of such appraisals. To the extent a collateral shortfall position is present, a specific reserve or charge-off will be recorded to reflect the magnitude of the impairment. Loans and leases in this category are monitored by management and loan committees of the Banks on a monthly basis and the Banks' Boards of Directors at each of their regularly scheduled meetings.

Utilizing regulatory classification terminology, the Corporation identified \$29.3 million and \$22.8 million of loans and leases as Substandard as of June 30, 2014 and December 31, 2013, respectively. No loans were considered Special Mention, Doubtful or Loss as of either June 30, 2014 or December 31, 2013. The population of Substandard loans are all Category IV loans and a subset of Category III loans.

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The delinquency aging of the loan and lease portfolio by class of receivable as of June 30, 2014 and December 31, 2013 were as follows:

| As of June 30, 2014                  | 30-59<br>days past<br>due | 60-89<br>days past<br>due | Greater<br>than 90<br>days past<br>due | Total past<br>due | Current   | Total loans |
|--------------------------------------|---------------------------|---------------------------|--|-------------------|-----------|-------------|
|                                      | (Dollars in Thousands)    |                           |  |                   |           |             |
| Accruing loans and leases            |                           |                           |  |                   |           |             |
| Commercial real estate:              |                           |                           |  |                   |           |             |
| Owner occupied                       | \$—                       | \$—                       | \$—                                    | \$—               | \$141,190 | \$141,190   |
| Non-owner occupied                   | —                         | —                         | —                                      | —                 | 332,902   | 332,902     |
| Construction and land<br>development | —                         | —                         | —                                      | —                 | 70,517    | 70,517      |
| Multi-family                         | —                         | —                         | —                                      | —                 | 59,802    | 59,802      |
| 1-4 family                           | —                         | —                         | —                                      | —                 | 26,569    | 26,569      |
| Commercial and industrial            | —                         | —                         | —                                      | —                 | 319,268   | 319,268     |
| Direct financing leases, net         | —                         | —                         | —                                      | —                 | 29,649    | 29,649      |
| Consumer and other:                  |                           |                           |  |                   |           |             |
| Home equity and second<br>mortgages  | 18                        | —                         | —                                      | 18                | 4,004     | 4,022       |
| Other                                | —                         | —                         | —                                      | —                 | 10,516    | 10,516      |
| Total                                | 18                        | —                         | —                                      | 18                | 994,417   | 994,435     |
| Non-accruing loans and leases        |                           |                           |  |                   |           |             |
| Commercial real estate:              |                           |                           |  |                   |           |             |
| Owner occupied                       | \$—                       | \$—                       | \$—                                    | \$—               | \$514     | \$514       |
| Non-owner occupied                   | —                         | —                         | —                                      | —                 | 277       | 277         |
| Construction and land<br>development | —                         | —                         | —                                      | —                 | 5,232     | 5,232       |
| Multi-family                         | —                         | —                         | —                                      | —                 | 24        | 24          |
| 1-4 family                           | —                         | —                         | 113                                    | 113               | 263       | 376         |
| Commercial and industrial            | 30                        | —                         | 6,464                                  | 6,494             | 138       | 6,632       |
| Direct financing leases, net         | —                         | —                         | —                                      | —                 | —         | —           |
| Consumer and other:                  |                           |                           |  |                   |           |             |
| Home equity and second<br>mortgages  | —                         | —                         | —                                      | —                 | 348       | 348         |
| Other                                | —                         | —                         | 777                                    | 777               | —         | 777         |
| Total                                | 30                        | —                         | 7,354                                  | 7,384             | 6,796     | 14,180      |
| Total loans and leases               |                           |                           |  |                   |           |             |
| Commercial real estate:              |                           |                           |  |                   |           |             |
| Owner occupied                       | \$—                       | \$—                       | \$—                                    | \$—               | \$141,704 | \$141,704   |
| Non-owner occupied                   | —                         | —                         | —                                      | —                 | 333,179   | 333,179     |
| Construction and land<br>development | —                         | —                         | —                                      | —                 | 75,749    | 75,749      |
| Multi-family                         | —                         | —                         | —                                      | —                 | 59,826    | 59,826      |
| 1-4 family                           | —                         | —                         | 113                                    | 113               | 26,832    | 26,945      |
| Commercial and industrial            | 30                        | —                         | 6,464                                  | 6,494             | 319,406   | 325,900     |
| Direct financing leases, net         | —                         | —                         | —                                      | —                 | 29,649    | 29,649      |
| Consumer and other:                  |                           |                           |  |                   |           |             |
|                                      | 18                        | —                         | —                                      | 18                | 4,352     | 4,370       |

Home equity and second mortgages

|                      |      |     |         |         |             |             |
|----------------------|------|-----|---------|---------|-------------|-------------|
| Other                | —    | —   | 777     | 777     | 10,516      | 11,293      |
| Total                | \$48 | \$— | \$7,354 | \$7,402 | \$1,001,213 | \$1,008,615 |
| Percent of portfolio | —    | % — | % 0.73  | % 0.73  | % 99.27     | % 100.00    |

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| As of December 31, 2013              | 30-59<br>days past<br>due | 60-89<br>days past<br>due | Greater<br>than 90<br>days past<br>due | Total past<br>due | Current   | Total loans |
|--------------------------------------|---------------------------|---------------------------|--|-------------------|-----------|-------------|
|                                      | (Dollars in Thousands)    |                           |  |                   |           |             |
| Accruing loans and leases            |                           |                           |  |                   |           |             |
| Commercial real estate:              |                           |                           |  |                   |           |             |
| Owner occupied                       | \$—                       | \$—                       | \$—                                    | \$—               | \$140,825 | \$140,825   |
| Non-owner occupied                   | —                         | —                         | —                                      | —                 | 341,412   | 341,412     |
| Construction and land<br>development | —                         | —                         | —                                      | —                 | 63,286    | 63,286      |
| Multi-family                         | —                         | —                         | —                                      | —                 | 62,727    | 62,727      |
| 1-4 family                           | —                         | —                         | —                                      | —                 | 30,265    | 30,265      |
| Commercial and industrial            | —                         | —                         | —                                      | —                 | 285,541   | 285,541     |
| Direct financing leases, net         | —                         | —                         | —                                      | —                 | 26,065    | 26,065      |
| Consumer and other:                  |                           |                           |  |                   |           |             |
| Home equity and second<br>mortgages  | —                         | —                         | —                                      | —                 | 4,819     | 4,819       |
| Other                                | —                         | —                         | —                                      | —                 | 11,177    | 11,177      |
| Total                                | —                         | —                         | —                                      | —                 | 966,117   | 966,117     |
| Non-accruing loans and leases        |                           |                           |  |                   |           |             |
| Commercial real estate:              |                           |                           |  |                   |           |             |
| Owner occupied                       | \$—                       | \$—                       | \$254                                  | \$254             | \$85      | \$339       |
| Non-owner occupied                   | —                         | —                         | —                                      | —                 | 283       | 283         |
| Construction and land<br>development | —                         | —                         | —                                      | —                 | 5,422     | 5,422       |
| Multi-family                         | —                         | —                         | —                                      | —                 | 31        | 31          |
| 1-4 family                           | —                         | 180                       | 123                                    | 303               | 218       | 521         |
| Commercial and industrial            | 1,944                     | 1,407                     | 53                                     | 3,404             | 4,607     | 8,011       |
| Direct financing leases, net         | —                         | —                         | —                                      | —                 | —         | —           |
| Consumer and other:                  |                           |                           |  |                   |           |             |
| Home equity and second<br>mortgages  | —                         | —                         | 85                                     | 85                | 368       | 453         |
| Other                                | —                         | —                         | 795                                    | 795               | —         | 795         |
| Total                                | 1,944                     | 1,587                     | 1,310                                  | 4,841             | 11,014    | 15,855      |
| Total loans and leases               |                           |                           |  |                   |           |             |
| Commercial real estate:              |                           |                           |  |                   |           |             |
| Owner occupied                       | \$—                       | \$—                       | \$254                                  | \$254             | \$140,910 | \$141,164   |
| Non-owner occupied                   | —                         | —                         | —                                      | —                 | 341,695   | 341,695     |
| Construction and land<br>development | —                         | —                         | —                                      | —                 | 68,708    | 68,708      |
| Multi-family                         | —                         | —                         | —                                      | —                 | 62,758    | 62,758      |
| 1-4 family                           | —                         | 180                       | 123                                    | 303               | 30,483    | 30,786      |
| Commercial and industrial            | 1,944                     | 1,407                     | 53                                     | 3,404             | 290,148   | 293,552     |
| Direct financing leases, net         | —                         | —                         | —                                      | —                 | 26,065    | 26,065      |
| Consumer and other:                  |                           |                           |  |                   |           |             |
| Home equity and second<br>mortgages  | —                         | —                         | 85                                     | 85                | 5,187     | 5,272       |
| Other                                | —                         | —                         | 795                                    | 795               | 11,177    | 11,972      |



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|                      |         |         |         |         |           |           |   |
|----------------------|---------|---------|---------|---------|-----------|-----------|---|
| Total                | \$1,944 | \$1,587 | \$1,310 | \$4,841 | \$977,131 | \$981,972 |   |
| Percent of portfolio | 0.20    | % 0.16  | % 0.13  | % 0.49  | % 99.51   | % 100.00  | % |

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The Corporation's total impaired assets consisted of the following at June 30, 2014 and December 31, 2013, respectively.

|   | June 30,<br>2014       | December 31,<br>2013 |   |  |
|---|------------------------|----------------------|---|--|
|   | (Dollars in Thousands) |                      |   |  |
| Non-accrual loans and leases  |                        |                      |   |  |
| Commercial real estate:   |                        |                      |   |  |
| Commercial real estate — owner occupied   | \$514                  | \$339                |   |  |
| Commercial real estate — non-owner occupied   | 277                    | 283                  |   |  |
| Construction and land development   | 5,232                  | 5,422                |   |  |
| Multi-family  | 24                     | 31                   |   |  |
| 1-4 family  | 376                    | 521                  |   |  |
| Total non-accrual commercial real estate  | 6,423                  | 6,596                |   |  |
| Commercial and industrial   | 6,632                  | 8,011                |   |  |
| Direct financing leases, net  | —                      | —                    |   |  |
| Consumer and other:   |                        |                      |   |  |
| Home equity and second mortgages  | 348                    | 453                  |   |  |
| Other   | 777                    | 795                  |   |  |
| Total non-accrual consumer and other loans  | 1,125                  | 1,248                |   |  |
| Total non-accrual loans and leases  | 14,180                 | 15,855               |   |  |
| Foreclosed properties, net  | 329                    | 333                  |   |  |
| Total non-performing assets   | 14,509                 | 16,188               |   |  |
| Performing troubled debt restructurings   | 602                    | 371                  |   |  |
| Total impaired assets   | \$15,111               | \$16,559             |   |  |
|   | June 30,<br>2014       | December 31,<br>2013 |   |  |
| Total non-accrual loans and leases to gross loans and leases                                | 1.41                   | % 1.61               | % |  |
| Total non-performing assets to total gross loans and leases plus foreclosed properties, net | 1.44                   | 1.65                 |   |  |
| Total non-performing assets to total assets   | 1.11                   | 1.28                 |   |  |
| Allowance for loan and lease losses to gross loans and leases                               | 1.39                   | 1.42                 |   |  |
| Allowance for loan and lease losses to non-accrual loans and leases                         | 98.84                  | 87.68                |   |  |

As of June 30, 2014 and December 31, 2013, \$7.7 million and \$8.1 million of the non-accrual loans were considered troubled debt restructurings, respectively. As of June 30, 2014, there were no unfunded commitments associated with troubled debt restructured loans and leases.

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|   | As of June 30, 2014 |                                      |                                       | As of December 31, 2013 |                                      |                                       |
|---|---------------------|--------------------------------------|---------------------------------------|-------------------------|--------------------------------------|---------------------------------------|
|   | Number of Loans     | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | Number of Loans         | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| (Dollars in Thousands)                      |                     |                                      |                                       |                         |                                      |                                       |
| Troubled debt restructurings:               |                     |                                      |                                       |                         |                                      |                                       |
| Commercial real estate owner occupied       | 2                   | \$ 624                               | \$ 594                                | 1                       | \$ 110                               | \$ 84                                 |
| Commercial real estate — non-owner occupied | 4                   | 390                                  | 277                                   | 3                       | 385                                  | 283                                   |
| Construction and land development           | 3                   | 6,060                                | 5,297                                 | 3                       | 6,060                                | 5,489                                 |
| Multi-family                                | 1                   | 184                                  | 24                                    | 1                       | 184                                  | 31                                    |
| 1-4 family                                  | 9                   | 861                                  | 595                                   | 10                      | 911                                  | 666                                   |
| Commercial and industrial                   | 3                   | 356                                  | 182                                   | 5                       | 1,935                                | 565                                   |
| Direct financing leases, net                | —                   | —                                    | —                                     | —                       | —                                    | —                                     |
| Consumer and other:                         |                     |                                      |                                       |                         |                                      |                                       |
| Home equity and second mortgages            | 6                   | 843                                  | 554                                   | 6                       | 752                                  | 580                                   |
| Other                                       | 1                   | 2,077                                | 777                                   | 1                       | 2,076                                | 795                                   |
| Total                                       | 29                  | \$ 11,395                            | \$ 8,300                              | 30                      | \$ 12,413                            | \$ 8,493                              |

All loans and leases modified as a troubled debt restructuring are evaluated for impairment. The nature and extent of the impairment of restructured loans, including those which have experienced a default, is considered in the determination of an appropriate level of the allowance for loan and lease losses.

As of June 30, 2014 and December 31, 2013, the Corporation's troubled debt restructurings grouped by type of concession were as follows:

|   | As of June 30, 2014 |                     | As of December 31, 2013 |                     |
|---|---------------------|---------------------|-------------------------|---------------------|
|   | Number of Loans     | Recorded Investment | Number of Loans         | Recorded Investment |
| (Dollars in Thousands)                                |                     |                     |                         |                     |
| Commercial real estate                                |                     |                     |                         |                     |
| Extension of term                                     | 1                   | \$48                | 1                       | \$55                |
| Combination of extension and interest rate concession | 18                  | 6,739               | 17                      | 6,498               |
| Commercial and industrial                             |                     |                     |                         |                     |
| Extension of term                                     | —                   | —                   | 1                       | 49                  |
| Combination of extension and interest rate concession | 3                   | 182                 | 4                       | 516                 |
| Consumer and other                                    |                     |                     |                         |                     |
| Extension of term                                     | 1                   | 777                 | 2                       | 880                 |
| Combination of extension and interest rate concession | 6                   | 554                 | 5                       | 495                 |
| Total   | 29                  | \$8,300             | 30                      | \$8,493             |

There were no loans and leases modified in a troubled debt restructuring during the previous 12 months which subsequently defaulted during the six months ended June 30, 2014.

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The following represents additional information regarding the Corporation's impaired loans and leases by class:

## Impaired Loans and Leases

As of and for the Six Months Ended June 30, 2014

|                                      | Recorded investment | Unpaid principal balance | Impairment reserve | Average recorded investment <sup>(1)</sup> | Foregone interest income | Interest income recognized | Net foregone interest income |
|--------------------------------------|---------------------|--------------------------|--------------------|--|--------------------------|----------------------------|------------------------------|
| (In Thousands)                       |                     |                          |                    |  |                          |                            |                              |
| With no impairment reserve recorded: |                     |                          |                    |  |                          |                            |                              |
| Commercial real estate:              |                     |                          |                    |  |                          |                            |                              |
| Owner occupied                       | \$80                | \$80                     | \$—                | \$ 207                                     | \$8                      | \$78                       | \$(70 )                      |
| Non-owner occupied                   | 225                 | 225                      | —                  | 226  | 5                        | —                          | 5                            |
| Construction and land development    | 5,297               | 7,968                    | —                  | 5,419                                      | 80                       | —                          | 80                           |
| Multi-family                         | 24                  | 391                      | —                  | 28   | 26                       | —                          | 26                           |
| 1-4 family                           | 189                 | 189                      | —                  | 239  | 5                        | 12                         | (7 )                         |
| Commercial and industrial            | 200                 | 210                      | —                  | 323  | 7                        | 220                        | (213 )                       |
| Direct financing leases, net         | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| Consumer and other:                  |                     |                          |                    |  |                          |                            |                              |
| Home equity and second mortgages     | 498                 | 498                      | —                  | 676  | 12                       | —                          | 12                           |
| Other                                | 777                 | 1,443                    | —                  | 780  | 43                       | —                          | 43                           |
| Total                                | 7,290               | 11,004                   | —                  | 7,898                                      | 186                      | 310                        | (124 )                       |
| With impairment reserve recorded:    |                     |                          |                    |  |                          |                            |                              |
| Commercial real estate:              |                     |                          |                    |  |                          |                            |                              |
| Owner occupied                       | \$514               | \$514                    | \$115              | \$ 173                                     | \$8                      | \$—                        | \$8                          |
| Non-owner occupied                   | 52                  | 92                       | 52                 | 53   | 2                        | —                          | 2                            |
| Construction and land development    | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| Multi-family                         | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| 1-4 family                           | 406                 | 411                      | 175                | 414  | 9                        | —                          | 9                            |
| Commercial and industrial            | 6,464               | 6,464                    | 208                | 6,688                                      | 236                      | —                          | 236                          |
| Direct financing leases, net         | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| Consumer and other:                  |                     |                          |                    |  |                          |                            |                              |
| Home equity and second mortgages     | 56                  | 56                       | 56                 | 59   | 2                        | —                          | 2                            |
| Other                                | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| Total                                | 7,492               | 7,537                    | 606                | 7,387                                      | 257                      | —                          | 257                          |
| Total:                               |                     |                          |                    |  |                          |                            |                              |
| Commercial real estate:              |                     |                          |                    |  |                          |                            |                              |
| Owner occupied                       | \$594               | \$594                    | \$115              | \$ 380                                     | \$16                     | \$78                       | \$(62 )                      |
| Non-owner occupied                   | 277                 | 317                      | 52                 | 279  | 7                        | —                          | 7                            |
|                                      | 5,297               | 7,968                    | —                  | 5,419                                      | 80                       | —                          | 80                           |

|                                   |          |          |       |          |       |       |       |
|-----------------------------------|----------|----------|-------|----------|-------|-------|-------|
| Construction and land development |          |          |       |          |       |       |       |
| Multi-family                      | 24       | 391      | —     | 28       | 26    | —     | 26    |
| 1-4 family                        | 595      | 600      | 175   | 653      | 14    | 12    | 2     |
| Commercial and industrial         | 6,664    | 6,674    | 208   | 7,011    | 243   | 220   | 23    |
| Direct financing leases, net      | —        | —        | —     | —        | —     | —     | —     |
| Consumer and other:               |          |          |       |          |       |       |       |
| Home equity and second mortgages  | 554      | 554      | 56    | 735      | 14    | —     | 14    |
| Other                             | 777      | 1,443    | —     | 780      | 43    | —     | 43    |
| Grand total                       | \$14,782 | \$18,541 | \$606 | \$15,285 | \$443 | \$310 | \$133 |

(1) Average recorded investment is calculated primarily using daily average balances.

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## Impaired Loans and Leases

As of and for the Year Ended December 31, 2013

|                                      | Recorded investment | Unpaid principal balance | Impairment reserve | Average recorded investment <sup>(1)</sup> | Foregone interest income | Interest income recognized | Net Foregone Interest Income |
|--------------------------------------|---------------------|--------------------------|--------------------|--|--------------------------|----------------------------|------------------------------|
| (In Thousands)                       |                     |                          |                    |  |                          |                            |                              |
| With no impairment reserve recorded: |                     |                          |                    |  |                          |                            |                              |
| Commercial real estate:              |                     |                          |                    |  |                          |                            |                              |
| Owner occupied                       | \$339               | \$339                    | \$—                | \$ 715                                     | \$57                     | \$50                       | \$7                          |
| Non-owner occupied                   | 229                 | 229                      | —                  | 1,586                                      | 198                      | 17                         | 181                          |
| Construction and land development    | 5,489               | 8,160                    | —                  | 5,777                                      | 203                      | 3                          | 200                          |
| Multi-family                         | 31                  | 398                      | —                  | 366  | 93                       | —                          | 93                           |
| 1-4 family                           | 244                 | 244                      | —                  | 405  | 31                       | 34                         | (3 )                         |
| Commercial and industrial            | 555                 | 766                      | —                  | 434  | 97                       | 114                        | (17 )                        |
| Direct financing leases, net         | —                   | —                        | —                  | 6  | —                        | —                          | —                            |
| Consumer and other:                  |                     |                          |                    |  |                          |                            |                              |
| Home equity and second mortgages     | 518                 | 518                      | —                  | 593  | 37                       | 3                          | 34                           |
| Other                                | 795                 | 1,461                    | —                  | 942  | 100                      | —                          | 100                          |
| Total                                | 8,200               | 12,115                   | —                  | 10,824                                     | 816                      | 221                        | 595                          |
| With impairment reserve recorded:    |                     |                          |                    |  |                          |                            |                              |
| Commercial real estate:              |                     |                          |                    |  |                          |                            |                              |
| Owner occupied                       | \$—                 | \$—                      | \$—                | \$ —                                       | \$—                      | \$—                        | \$—                          |
| Non-owner occupied                   | 54                  | 94                       | 54                 | 88   | 6                        | —                          | 6                            |
| Construction and land development    | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| Multi-family                         | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| 1-4 family                           | 422                 | 422                      | 155                | 437  | 18                       | —                          | 18                           |
| Commercial and industrial            | 7,488               | 7,488                    | 131                | 670  | 42                       | —                          | 42                           |
| Direct financing leases, net         | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| Consumer and other:                  |                     |                          |                    |  |                          |                            |                              |
| Home equity and second mortgages     | 62                  | 62                       | 62                 | 65   | 5                        | —                          | 5                            |
| Other                                | —                   | —                        | —                  | —  | —                        | —                          | —                            |
| Total                                | 8,026               | 8,066                    | 402                | 1,260                                      | 71                       | —                          | 71                           |
| Total:                               |                     |                          |                    |  |                          |                            |                              |
| Commercial real estate:              |                     |                          |                    |  |                          |                            |                              |
| Owner occupied                       | \$339               | \$339                    | \$—                | \$ 715                                     | \$57                     | \$50                       | \$7                          |
| Non-owner occupied                   | 283                 | 323                      | 54                 | 1,674                                      | 204                      | 17                         | 187                          |
| Construction and land development    | 5,489               | 8,160                    | —                  | 5,777                                      | 203                      | 3                          | 200                          |

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|                                  |          |          |       |          |       |       |       |
|----------------------------------|----------|----------|-------|----------|-------|-------|-------|
| Multi-family                     | 31       | 398      | —     | 366      | 93    | —     | 93    |
| 1-4 family                       | 666      | 666      | 155   | 842      | 49    | 34    | 15    |
| Commercial and industrial        | 8,043    | 8,254    | 131   | 1,104    | 139   | 114   | 25    |
| Direct financing leases, net     | —        | —        | —     | 6        | —     | —     | —     |
| Consumer and other:              |          |          |       |          |       |       |       |
| Home equity and second mortgages | 580      | 580      | 62    | 658      | 42    | 3     | 39    |
| Other                            | 795      | 1,461    | —     | 942      | 100   | —     | 100   |
| Grand total                      | \$16,226 | \$20,181 | \$402 | \$12,084 | \$887 | \$221 | \$666 |

(1) Average recorded investment is calculated primarily using daily average balances.



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The difference between the loans and leases recorded investment and the unpaid principal balance of \$3.8 million and \$4.0 million as of June 30, 2014 and December 31, 2013 represents partial charge-offs resulting from confirmed losses due to the value of the collateral securing the loans and leases being below the carrying values of the loans and leases. Impaired loans and leases also included \$602,000 and \$371,000 of loans as of June 30, 2014 and December 31, 2013, that were performing troubled debt restructurings, and thus, while not on non-accrual, were reported as impaired, due to the concession in terms. When a loan is placed on non-accrual, interest accrual is discontinued and previously accrued but uncollected interest is deducted from interest income. Cash payments collected on non-accrual loans are first applied to principal. Foregone interest represents the interest that was contractually due on the note but not received or recorded. To the extent the amount of principal on a non-accrual note is fully collected and additional cash is received, the Corporation will recognize interest income.

To determine the level and composition of the allowance for loan and lease losses, the Corporation breaks out the portfolio by segments and risk ratings. First, the Corporation evaluates loans and leases for potential impairment classification. The Corporation analyzes each loan and lease determined to be impaired on an individual basis to determine a specific reserve based upon the estimated value of the underlying collateral for collateral-dependent loans, or alternatively, the present value of expected cash flows. The Corporation applies historical trends from established risk factors to each category of loans and leases that has not been individually evaluated for the purpose of establishing the general portion of the allowance.

A summary of the activity in the allowance for loan and lease losses by portfolio segment is as follows:

|  | As of and for the Six Months Ended June 30, 2014 |                                 |                       |                                    |             |   |
|--|--|---------------------------------|-----------------------|------------------------------------|-------------|---|
|  | Commercial<br>real estate                        | Commercial<br>and<br>industrial | Consumer<br>and other | Direct<br>financing<br>leases, net | Total       |   |
|  | (Dollars in Thousands)                           |                                 |                       |                                    |             |   |
| Allowance for credit losses:                                       |  |                                 |                       |                                    |             |   |
| Beginning balance  | \$9,055  | \$4,235                         | \$273                 | \$338                              | \$13,901    |   |
| Charge-offs  | —  | —                               | —                     | —                                  | —           |   |
| Recoveries   | 17   | 1                               | 7                     | —                                  | 25          |   |
| Provision  | (304)  | 410                             | (39)                  | 22                                 | 89          |   |
| Ending balance   | \$8,768  | \$4,646                         | \$241                 | \$360                              | \$14,015    |   |
| Ending balance: individually evaluated<br>for impairment           | \$342  | \$208                           | \$56                  | \$—                                | \$606       |   |
| Ending balance: collectively evaluated for<br>impairment           | \$8,426  | \$4,438                         | \$185                 | \$360                              | \$13,409    |   |
| Ending balance: loans acquired with<br>deteriorated credit quality | \$—  | \$—                             | \$—                   | \$—                                | \$—         |   |
| Loans and lease receivables:                                       |  |                                 |                       |                                    |             |   |
| Ending balance, gross  | \$637,403  | \$325,900                       | \$15,663              | \$29,649                           | \$1,008,615 |   |
| Ending balance: individually evaluated<br>for impairment           | \$5,416  | \$6,664                         | \$1,331               | \$—                                | \$13,411    |   |
| Ending balance: collectively evaluated for<br>impairment           | \$630,616  | \$319,236                       | \$14,332              | \$29,649                           | \$993,833   |   |
| Ending balance: loans acquired with<br>deteriorated credit quality | \$1,371  | \$—                             | \$—                   | \$—                                | \$1,371     |   |
| Allowance as % of gross loans                                      | 1.38   | % 1.43                          | % 1.54                | % 1.21                             | % 1.39      | % |

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|  | As of and for the Six Months Ended June 30, 2013 |                                 |                       |                                    |            |   |
|--|--|---------------------------------|-----------------------|------------------------------------|------------|---|
|  | Commercial<br>real estate                        | Commercial<br>and<br>industrial | Consumer<br>and other | Direct<br>financing<br>leases, net | Total      |   |
|  | (Dollars in Thousands)                           |                                 |                       |                                    |            |   |
| Allowance for credit losses:                                       |  |                                 |                       |                                    |            |   |
| Beginning balance  | \$ 10,693  | \$ 4,129                        | \$ 371                | \$ 207                             | \$ 15,400  |   |
| Charge-offs  | (641 )   | ( 13 )                          | ( 4 )                 | —                                  | (658 )     |   |
| Recoveries   | 318  | 1                               | 2                     | 5                                  | 326        |   |
| Provision  | 95   | 103                             | (42 )                 | (22 )                              | 134        |   |
| Ending balance   | \$ 10,465  | \$ 4,220                        | \$ 327                | \$ 190                             | \$ 15,202  |   |
| Ending balance: individually evaluated for<br>impairment           | \$ 739   | \$ 37                           | \$ 67                 | \$ —                               | \$ 843     |   |
| Ending balance: collectively evaluated for<br>impairment           | \$ 9,726   | \$ 4,183                        | \$ 260                | \$ 190                             | \$ 14,359  |   |
| Ending balance: loans acquired with<br>deteriorated credit quality | \$ —   | \$ —                            | \$ —                  | \$ —                               | \$ —       |   |
| Loans and lease receivables:                                       |  |                                 |                       |                                    |            |   |
| Ending balance, gross  | \$ 644,686                                       | \$ 272,799                      | \$ 16,201             | \$ 15,252                          | \$ 948,938 |   |
| Ending balance: individually evaluated for<br>impairment           | \$ 8,342   | \$ 736                          | \$ 1,669              | \$ 35                              | \$ 10,782  |   |
| Ending balance: collectively evaluated for<br>impairment           | \$ 634,809                                       | \$ 272,063                      | \$ 14,532             | \$ 15,217                          | \$ 936,621 |   |
| Ending balance: loans acquired with<br>deteriorated credit quality | \$ 1,535   | \$ —                            | \$ —                  | \$ —                               | \$ 1,535   |   |
| Allowance as % of gross loans                                      | 1.62   | % 1.55                          | % 2.02                | % 1.25                             | % 1.60     | % |

## Note 7 — Deposits

The composition of deposits at June 30, 2014 and December 31, 2013 was as follows. Weighted average balances represent year-to-date averages.

|  | June 30, 2014          |                                |                          | December 31, 2013 |                                |                          |
|--|------------------------|--------------------------------|--------------------------|-------------------|--------------------------------|--------------------------|
|  | Balance                | Weighted<br>average<br>balance | Weighted<br>average rate | Balance           | Weighted<br>average<br>balance | Weighted<br>average rate |
|  | (Dollars in Thousands) |                                |                          |                   |                                |                          |
| Non-interest-bearing<br>transaction accounts | \$ 148,989             | \$ 139,397                     | —                        | % \$ 151,275      | \$ 138,920                     | —                        |
| Interest-bearing transaction<br>accounts     | 83,477                 | 79,313                         | 0.23                     | 77,004            | 62,578                         | 0.20                     |
| Money market accounts                        | 450,352                | 456,206                        | 0.51                     | 456,065           | 450,558                        | 0.53                     |
| Certificates of deposit                      | 46,582                 | 49,119                         | 0.96                     | 51,979            | 60,276                         | 1.01                     |
| Brokered certificates of deposit             | 437,297                | 404,728                        | 1.49                     | 393,532           | 393,726                        | 1.68                     |
| Total deposits                               | \$ 1,166,697           | \$ 1,128,763                   | 0.80                     | \$ 1,129,855      | \$ 1,106,058                   | 0.88                     |

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## Note 8 — FHLB Advances, Other Borrowings and Junior Subordinated Notes Payable

The composition of borrowed funds at June 30, 2014 and December 31, 2013 was as follows. Weighted average balances represent year-to-date averages.

|                            | June 30, 2014          |                          |                       |   | December 31, 2013 |                          |                       |   |
|----------------------------|------------------------|--------------------------|-----------------------|---|-------------------|--------------------------|-----------------------|---|
|                            | Balance                | Weighted average balance | Weighted average rate |   | Balance           | Weighted average balance | Weighted average rate |   |
|                            | (Dollars in Thousands) |                          |                       |   |                   |                          |                       |   |
| Federal funds purchased    | \$—                    | \$224                    | 0.81                  | % | \$—               | \$260                    | 0.74                  | % |
| FHLB advances              | —                      | 6,282                    | 0.16                  |   | —                 | 6,471                    | 0.19                  |   |
| Line of credit             | 10                     | 10                       | 3.27                  |   | 10                | 10                       | 3.41                  |   |
| Subordinated notes payable | 7,926                  | 8,279                    | 7.19                  |   | 11,926            | 11,926                   | 6.92                  |   |
| Junior subordinated notes  | 10,315                 | 10,315                   | 10.68                 |   | 10,315            | 10,315                   | 10.78                 |   |
|                            | \$18,251               | \$25,110                 | 6.86                  |   | \$22,251          | \$28,982                 | 6.78                  |   |
| Short-term borrowings      | \$10                   |                          |                       |   | \$10              |                          |                       |   |
| Long-term borrowings       | 18,241                 |                          |                       |   | 22,241            |                          |                       |   |
|                            | \$18,251               |                          |                       |   | \$22,251          |                          |                       |   |

As of June 30, 2014, the Corporation was in compliance with its debt covenants under its third party senior line of credit. The Corporation pays an unused line fee on its secured senior line of credit. During both of the six months ended June 30, 2014 and 2013, the Corporation incurred \$7,000 additional interest expense due to this fee.

## Note 9 — Fair Value Disclosures

The Corporation determines the fair market values of its financial instruments based on the fair value hierarchy established in ASC Topic 820, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Fair value is defined as the price that would be received in an orderly transaction that is not a forced liquidation or distressed sale at the measurement date and is based on exit prices. Fair value includes assumptions about risk such as nonperformance risk in liability fair values and is a market-based measurement, not an entity-specific measurement. The standard describes three levels of inputs that may be used to measure fair value.

Level 1 — Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.

Level 2 — Level 2 inputs are inputs, other than quoted prices included with Level 1, that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 — Level 3 inputs are supported by little or no market activity and are significant to the fair value of the assets or liabilities.

In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

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Assets and liabilities measured at fair value on a recurring basis, segregated by fair value hierarchy level, are summarized below:

| June 30, 2014   | Fair Value Measurements Using |          |         | Total    |
|---|-------------------------------|----------|---------|----------|
|   | Level 1<br>(In Thousands)     | Level 2  | Level 3 |          |
| Assets:   |                               |          |         |          |
| Securities available-for-sale:  |                               |          |         |          |
| Asset backed securities   | \$—                           | \$1,514  | \$—     | \$1,514  |
| U.S. Government agency obligations -<br>government-sponsored enterprises  | —                             | 7,166    | —       | 7,166    |
| Collateralized mortgage obligations - government issued                   | —                             | 82,467   | —       | 82,467   |
| Collateralized mortgage obligations - government-sponsored<br>enterprises | —                             | 52,495   | —       | 52,495   |
| Interest rate swaps   | —                             | 555      | —       | 555      |
| Liabilities:  |                               |          |         |          |
| Interest rate swaps   | \$—                           | \$555    | \$—     | \$555    |
| December 31, 2013   | Fair Value Measurements Using |          |         | Total    |
|   | Level 1<br>(In Thousands)     | Level 2  | Level 3 |          |
| Assets:   |                               |          |         |          |
| Securities available-for-sale:  |                               |          |         |          |
| Municipal obligations   | \$—                           | \$15,489 | \$—     | \$15,489 |
| Asset backed securities   | —                             | 1,494    | —       | 1,494    |
| U.S. Government agency obligations -<br>government-sponsored enterprises  | —                             | 16,244   | —       | 16,244   |
| Collateralized mortgage obligations - government issued                   | —                             | 111,969  | —       | 111,969  |
| Collateralized mortgage obligations - government-sponsored<br>enterprises | —                             | 34,922   | —       | 34,922   |
| Interest rate swaps   | —                             | 946      | —       | 946      |
| Liabilities:  |                               |          |         |          |
| Interest rate swaps   | \$—                           | \$946    | \$—     | \$946    |

For assets and liabilities measured at fair value on a recurring basis, there were no transfers between the levels during the six months ended June 30, 2014 or the year ended December 31, 2013 related to the above measurements.

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Assets and liabilities measured at fair value on a non-recurring basis, segregated by fair value hierarchy are summarized below:

|                       | Balance at<br>June 30,<br>2014<br>(In Thousands)     | As of and for the Six Months Ended June 30, 2014<br>Fair Value Measurements Using |          |         | Total<br>Gains<br>(Losses) |
|-----------------------|--|---|----------|---------|----------------------------|
|                       |  | Level 1   | Level 2  | Level 3 |                            |
| Impaired loans        | \$11,963   | \$—   | \$6,465  | \$5,498 | \$—                        |
| Foreclosed properties | 329  | 223   | 106      | —       | (4 )                       |
|                       | Balance at<br>December 31,<br>2013<br>(In Thousands) | As of and for the Year Ended December 31, 2013<br>Fair Value Measurements Using   |          |         | Total<br>Gains<br>(Losses) |
|                       |  | Level 1   | Level 2  | Level 3 |                            |
| Impaired loans        | \$13,719   | \$—   | \$13,666 | \$53    | \$—                        |
| Foreclosed properties | 333  | —   | 333      | —       | (59 )                      |

Impaired loans that are collateral dependent were written down to their net realizable value of \$12.0 million and \$13.7 million at June 30, 2014 and December 31, 2013, respectively, through the establishment of specific reserves or by recording charge-offs when the carrying value exceeded the fair value. Valuation techniques consistent with the market approach, income approach, or cost approach were used to measure fair value and primarily included observable inputs for the individual impaired loans being evaluated such as current appraisals, recent sales of similar assets or other observable market data, and are reflected within Level 2 of the hierarchy. In cases where an input is unobservable, specifically discounts applied to appraisal values to adjust such values to current market conditions or to reflect net realizable value, the impaired loan balance is reflected within Level 3 of the hierarchy. The quantification of unobservable inputs for Level 3 impaired loan values range from 19% - 100%. The weighted average of those unobservable inputs as of the measurement date of June 30, 2014 was 34%. The majority of the impaired loans in the Level 3 category are considered collateral dependent loans.

Non-financial assets subject to measurement at fair value on a non-recurring basis included foreclosed properties. Foreclosed properties, upon initial recognition, are re-measured and reported at fair value through a charge-off to the allowance for loan and lease losses, if deemed necessary, based upon the fair value of the foreclosed property. The fair value of a foreclosed property, upon initial recognition, is estimated using a market approach or Level 2 inputs based on observable market data, typically a current appraisal, or Level 3 inputs based upon assumptions specific to the individual property or equipment. Level 3 inputs typically include unobservable inputs such as management applied discounts used to further reduce values to a net realizable value and may be used in situations when observable inputs become stale. Foreclosed property fair value inputs may transition to Level 1 upon receipt of an accepted offer for the sale of the related foreclosed property. As of June 30, 2014, there were no foreclosed properties supported by a Level 3 valuation. The activity of the Corporation's foreclosed properties is summarized as follows:

|  | As of and for the<br>Six Months Ended<br>June 30, 2014<br>(In Thousands) | As of and for the<br>Year Ended<br>December 31,<br>2013 |
|--|--|---|
| Foreclosed properties at the beginning of the period                       | \$333  | \$1,574   |
| Loans transferred to foreclosed properties, at lower of cost or fair value | —  | 1,381   |
| Proceeds from sale of foreclosed properties                                | —  | (2,739 )  |
| Net gain on sale of foreclosed properties                                  | —  | 176   |
| Impairment valuation   | (4 )   | (59 )   |

|  |       |       |
|--|-------|-------|
| Foreclosed properties at the end of the period | \$329 | \$333 |
|--|-------|-------|

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## Fair Value of Financial Instruments

The Corporation is required to disclose estimated fair values for its financial instruments. Fair value estimates, methods, and assumptions, consistent with exit price concepts for fair value measurements, are set forth below:

|   | June 30, 2014  |             |           |           |          |
|---|----------------|-------------|-----------|-----------|----------|
|   | Carrying       | Fair Value  |           |           |          |
|   | Amount         | Total       | Level 1   | Level 2   | Level 3  |
|   | (In Thousands) |             |           |           |          |
| Financial assets:                           |                |             |           |           |          |
| Cash and cash equivalents                   | \$85,977       | \$85,982    | \$65,993  | \$5,739   | \$14,250 |
| Securities available-for-sale               | 143,642        | 143,642     | —         | 143,642   | —        |
| Securities held-to-maturity                 | 43,434         | 43,140      | —         | 43,140    | —        |
| Loans and lease receivables, net            | 993,721        | 990,424     | —         | 6,465     | 983,959  |
| Federal Home Loan Bank stock                | 1,349          | 1,349       | —         | —         | 1,349    |
| Cash surrender value of life insurance      | 23,558         | 23,558      | 23,558    | —         | —        |
| Accrued interest receivable                 | 3,284          | 3,284       | 3,284     | —         | —        |
| Interest rate swaps                         | 555            | 555         | —         | 555       | —        |
| Financial liabilities:                      |                |             |           |           |          |
| Deposits                                    | \$1,166,697    | \$1,168,820 | \$682,818 | \$486,002 | \$—      |
| Federal Home Loan Bank and other borrowings | 7,936          | 7,809       | —         | 7,809     | —        |
| Junior subordinated notes                   | 10,315         | 7,100       | —         | —         | 7,100    |
| Interest rate swaps                         | 555            | 555         | —         | 555       | —        |
| Accrued interest payable                    | 1,259          | 1,259       | 1,259     | —         | —        |
| Off-balance-sheet items:                    |                |             |           |           |          |
| Standby letters of credit                   | 142            | 142         | —         | —         | 142      |
| Commitments to extend credit                | —              | *           | *         | *         | *        |

\*Not meaningful

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|   | December 31, 2013  |             |           |           |          |
|---|--------------------|-------------|-----------|-----------|----------|
|   | Carrying<br>Amount | Fair Value  |           |           |          |
|   |                    | Total       | Level 1   | Level 2   | Level 3  |
|   | (In Thousands)     |             |           |           |          |
| Financial assets:                           |                    |             |           |           |          |
| Cash and cash equivalents                   | \$81,286           | \$81,295    | \$66,266  | \$4,029   | \$11,000 |
| Securities available-for-sale               | 180,118            | 180,118     | —         | 180,118   | —        |
| Loans and lease receivables, net            | 967,050            | 963,937     | —         | 13,666    | 950,271  |
| Federal Home Loan Bank stock                | 1,255              | 1,255       | —         | —         | 1,255    |
| Cash surrender value of life insurance      | 23,142             | 23,142      | 23,142    | —         | —        |
| Accrued interest receivable                 | 3,231              | 3,231       | 3,231     | —         | —        |
| Interest rate swaps                         | 946                | 946         | —         | 946       | —        |
| Financial liabilities:                      |                    |             |           |           |          |
| Deposits                                    | \$1,129,855        | \$1,131,002 | \$684,344 | \$446,658 | \$—      |
| Federal Home Loan Bank and other borrowings | 11,936             | 11,979      | —         | 11,979    | —        |
| Junior subordinated notes                   | 10,315             | 7,084       | —         | —         | 7,084    |
| Interest rate swaps                         | 946                | 946         | —         | 946       | —        |
| Accrued interest payable                    | 1,052              | 1,052       | 1,052     | —         | —        |
| Off balance sheet items:                    |                    |             |           |           |          |
| Standby letters of credit                   | 219                | 219         | —         | —         | 219      |
| Commitments to extend credit                | —                  | *           | *         | *         | *        |

## \*Not meaningful

Disclosure of fair value information about financial instruments, for which it is practicable to estimate that value, is required whether or not recognized in the Consolidated Balance Sheets. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not necessarily represent the underlying value of the Corporation.

Cash and cash equivalents: The carrying amounts reported for cash and due from banks, interest-bearing deposits held by the Corporation, accrued interest receivable and accrued interest payable approximate fair value because of their immediate availability and because they do not present unanticipated credit concerns. The carrying value of commercial paper, included in the cash and cash equivalents category, approximates fair value due to the short-term maturity structure of the instrument. As of June 30, 2014 and December 31, 2013, the Corporation held \$14.3 million and \$11.0 million, respectively, of commercial paper. The fair value of commercial paper is considered a Level 3 input due to the lack of available independent pricing sources. The carrying value of brokered certificates of deposit purchased is equivalent to the purchase price of the instruments as the Corporation has not elected a fair value option for these instruments. The fair value of brokered certificates of deposits purchased is based on the discounted value of contractual cash flows using a discount rate reflective of rates currently offered for deposits of similar remaining maturities. As of June 30, 2014 and December 31, 2013, the Corporation held \$5.7 million and \$4.0 million, respectively, of brokered certificates of deposits.



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**Securities:** The fair value measurements of investment securities are determined by a third-party pricing service which considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, trade execution data, market consensus prepayment speeds, credit information and the securities' terms and conditions, among other things. The fair value measurements are subject to independent verification to another pricing source on a quarterly basis to review for reasonableness. In addition, the Corporation reviews the third-party valuation methodology on a periodic basis. Any significant differences in valuation are reviewed with appropriate members of management who have the relevant technical expertise to assess the results. The Corporation has determined that these valuations are classified in Level 2 of the fair value hierarchy. When the independent pricing service does not provide a fair value measurement for a particular security, the Corporation will estimate the fair value based on specific information about each security. Fair values derived in this manner are classified in Level 3 of the fair value hierarchy.

**Loans and Leases:** The fair value estimation process for the loan portfolio uses an exit price concept and reflects discounts that the Corporation believes are consistent with liquidity discounts in the market place. Fair values are estimated for portfolios of loans with similar financial characteristics. The fair value of performing and nonperforming loans is calculated by discounting scheduled and expected cash flows through the estimated maturity using estimated market rates that reflect the credit and interest rate risk inherent in the portfolio of loans and then applying a discount factor based upon the embedded credit risk of the loan and the fair value of collateral securing nonperforming loans when the loan is collateral dependent. The estimate of maturity is based on the Banks' historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions. Significant unobservable inputs include, but are not limited to, discounts (investor yield premiums) applied to fair value calculations to further determine the exit price value of a portfolio of loans.

**Federal Home Loan Bank Stock:** The carrying amount of FHLB stock equals its fair value because the shares may be redeemed by the FHLB at their carrying amount of \$100 per share.

**Cash Surrender Value of Life Insurance:** The carrying amount of the cash surrender value of life insurance approximates its fair value as the carrying value represents the current settlement amount.

**Deposits:** The fair value of deposits with no stated maturity, such as demand deposits and money market accounts, is equal to the amount payable on demand. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the intangible value that results from the funding provided by deposit liabilities compared to borrowing funds in the market.

**Borrowed Funds:** Market rates currently available to the Corporation and Banks for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

**Financial Instruments with Off-Balance-Sheet Risks:** The fair value of the Corporation's off-balance-sheet instruments is based on quoted market prices and fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the credit standing of the related counterparty. Commitments to extend credit and standby letters of credit are generally not marketable. Furthermore, interest rates on any amounts drawn under such commitments would generally be established at market rates at the time of the draw. Fair value would principally derive from the present value of fees received for those products.

**Interest Rate Swaps:** The carrying amount and fair value of existing derivative financial instruments are based upon independent valuation models, which use widely accepted valuation techniques, including discounted cash flow analysis on the expected cash flows of each derivative contract. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, the Corporation considers the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and guarantees.

**Limitations:** Fair value estimates are made at a discrete point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Corporation's entire holding of a particular financial instrument. Because no

market exists for a significant portion of the Corporation's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

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Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and are not considered in the estimates.

## Note 10 — Derivative Financial Instruments

The Corporation offers interest rate swap products directly to qualified commercial borrowers. The Corporation economically hedges client derivative transactions by entering into offsetting interest rate swap contracts executed with a third party. Derivative transactions executed as part of this program are not designated as accounting hedge relationships and are marked to market through earnings each period. The derivative contracts have mirror-image terms, which results in the positions' changes in fair value primarily offsetting through earnings each period. The credit risk and risk of non-performance embedded in the fair value calculations is different between the dealer counterparties and the commercial borrowers, which may result in a difference in the changes in the fair value of the mirror-image swaps. The Corporation incorporates credit valuation adjustments to appropriately reflect both its own non-performance risk and the counterparty's risk in the fair value measurements. When evaluating the fair value of its derivative contracts for the effects of non-performance and credit risk, the Corporation considers the impact of netting and any applicable credit enhancements such as collateral postings, thresholds and guarantees.

At June 30, 2014, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was \$27.7 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. These interest rate swaps mature in March, 2016 through February, 2023. Commercial borrower swaps are completed independently with each borrower and are not subject to master netting arrangements. These commercial borrower swaps were reported on the Consolidated Balance Sheets as a derivative asset of \$555,000, included in accrued interest receivable and other assets, and as a derivative liability of \$271,000, included in accrued interest payable and other liabilities. In the event of default on a commercial borrower interest rate swap by the counterparty, a right of offset exists to allow for the commercial borrower to set off amounts due against the related commercial loan. As of June 30, 2014, no interest rate swaps were in default and therefore all values for the commercial borrower swaps are recorded on a gross basis within the Corporation's financial position.

At June 30, 2014, the aggregate amortizing notional value of interest rate swaps with dealer counterparties was also \$27.7 million. The Corporation pays fixed rates and receives floating rates based upon LIBOR on the swaps with dealer counterparties. These interest rate swaps mature in March, 2016 through February, 2023. Dealer counterparty swaps are subject to master netting agreements among the contracts within each of the Banks and are reported on the Consolidated Balance Sheets as a net derivative liability of \$284,000. The value of these swaps was included in accrued interest payable and other liabilities as of June 30, 2014. The gross amount of dealer counterparty swaps, without regard to the enforceable master netting agreement, was a gross derivative liability of \$555,000 and \$271,000 gross derivative asset. No right of offset exists with the dealer counterparty swaps.

The table below provides information about the location and fair value of the Corporation's derivative instruments as of June 30, 2014 and December 31, 2013.

|   | Interest Rate Swap Contracts                                     |            | Liability Derivatives     |            |
|---|--|------------|---------------------------|------------|
|   | Asset Derivatives<br>Balance Sheet<br>Location<br>(In Thousands) | Fair Value | Balance Sheet<br>Location | Fair Value |
| Derivatives not designated as hedging instruments |  |            |                           |            |
| June 30, 2014                                     | Other assets   | \$555      | Other liabilities         | \$555      |
| December 31, 2013                                 | Other assets   | \$946      | Other liabilities         | \$946      |

No derivative instruments held by the Corporation for the six months ended June 30, 2014 were considered hedging instruments. All changes in the fair value of these instruments are recorded in other non-interest income. Given the mirror-image terms of the outstanding derivative portfolio, the change in fair value for the six months ended June 30, 2014 and 2013 had an insignificant impact on the unaudited Consolidated Statements of Income.

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Note 11 — Regulatory Capital

The Corporation and the Banks are subject to various regulatory capital requirements administered by Federal and State of Wisconsin banking agencies. Failure to meet minimum capital requirements can result in certain mandatory, and possibly additional discretionary actions on the part of regulators, that if undertaken, could have a direct material effect on the Banks' assets, liabilities and certain off-balance-sheet items as calculated under regulatory practices. The Corporation's and the Banks' capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. The Corporation regularly reviews and updates when appropriate its Capital and Liquidity Action Plan (the "Capital Plan"), which is designed to help ensure appropriate capital adequacy, to plan for future capital needs and to ensure that the Corporation serves as a source of financial strength to the Banks. The Corporation's and the Banks' Boards of Directors and management teams adhere to the appropriate regulatory guidelines on decisions which affect their respective capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.

As a bank holding company, the Corporation's ability to pay dividends is affected by the policies and enforcement powers of the Board of Governors of the Federal Reserve system (the "Federal Reserve"). Federal Reserve guidance urges companies to strongly consider eliminating, deferring or significantly reducing dividends if: (i) net income available to common shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividend; (ii) the prospective rate of earnings retention is not consistent with the bank holding company's capital needs and overall current prospective financial condition; or (iii) the bank holding company will not meet, or is in danger of not meeting, its minimum regulatory capital ratios. Management intends, when appropriate under regulatory guidelines, to consult with the Federal Reserve Bank of Chicago and provide it with information on the Corporation's then-current and prospective earnings and capital position in advance of declaring any cash dividends.

The Banks are also subject to certain legal, regulatory and other restrictions on their ability to pay dividends to the Corporation. As a bank holding company, the payment of dividends by the Banks to the Corporation is one of the sources of funds the Corporation could use to pay dividends, if any, in the future and to make other payments. Future dividend decisions by the Banks and the Corporation will continue to be subject to compliance with various legal, regulatory and other restrictions as defined from time to time.

Qualitative measures established by regulation to ensure capital adequacy require the Corporation and the Banks to maintain minimum amounts and ratios of total and Tier 1 capital to risk-weighted assets and of Tier 1 capital to average assets. Tier 1 capital generally consists of stockholders' equity plus certain qualifying debentures and other specified items less intangible assets such as goodwill. Risk-based capital requirements presently address credit risk related to both recorded and off-balance-sheet commitments and obligations. Management believes, as of June 30, 2014, that the Corporation and the Banks met all applicable capital adequacy requirements.

As of June 30, 2014, the most recent notification from the Federal Deposit Insurance Corporation and the State of Wisconsin Department of Financial Institutions categorized the Banks as well capitalized under the regulatory framework for prompt corrective action.

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The following table summarizes the Corporation's and Banks' capital ratios and the ratios required by their federal regulators at June 30, 2014 and December 31, 2013, respectively:

|   | Actual                           |       | Minimum Required for<br>Capital Adequacy Purposes |       | Minimum Required to Be<br>Well<br>Capitalized Under Prompt<br>Corrective Action<br>Requirements |       |   |
|---|----------------------------------|-------|---|-------|---|-------|---|
|   | Amount<br>(Dollars in Thousands) | Ratio | Amount  | Ratio | Amount  | Ratio |   |
| As of June 30, 2014                         |                                  |       |   |       |   |       |   |
| Total capital<br>(to risk-weighted assets)  |                                  |       |   |       |   |       |   |
| Consolidated                                | \$ 146,617                       | 12.80 | % \$ 91,619                                       | 8.00  | % N/A   | N/A   |   |
| First Business Bank                         | 126,527                          | 12.47 | 81,165  | 8.00  | \$ 101,457  | 10.00 | % |
| First Business Bank —<br>Milwaukee          | 18,598                           | 14.19 | 10,482  | 8.00  | 13,103  | 10.00 |   |
| Tier 1 capital<br>(to risk-weighted assets) |                                  |       |   |       |   |       |   |
| Consolidated                                | \$ 124,676                       | 10.89 | % \$ 45,810                                       | 4.00  | % N/A   | N/A   |   |
| First Business Bank                         | 114,160                          | 11.25 | 40,583  | 4.00  | \$ 60,874   | 6.00  | % |
| First Business Bank —<br>Milwaukee          | 16,960                           | 12.94 | 5,241   | 4.00  | 7,862   | 6.00  |   |
| Tier 1 capital<br>(to average assets)       |                                  |       |   |       |   |       |   |
| Consolidated                                | \$ 124,676                       | 9.73  | % \$ 51,271                                       | 4.00  | % N/A   | N/A   |   |
| First Business Bank                         | 114,160                          | 10.54 | 43,312  | 4.00  | \$ 54,140   | 5.00  | % |
| First Business Bank —<br>Milwaukee          | 16,960                           | 7.93  | 8,553   | 4.00  | 10,691  | 5.00  |   |

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|   | Actual                           |       | Minimum Required for<br>Capital Adequacy Purposes |       | Minimum Required to Be<br>Well<br>Capitalized Under Prompt<br>Corrective Action<br>Requirements |       |   |
|---|----------------------------------|-------|---|-------|---|-------|---|
|   | Amount<br>(Dollars in Thousands) | Ratio | Amount  | Ratio | Amount  | Ratio |   |
| As of December 31,<br>2013                  |                                  |       |   |       |   |       |   |
| Total capital<br>(to risk-weighted assets)  |                                  |       |   |       |   |       |   |
| Consolidated                                | \$ 145,352                       | 13.16 | % \$ 88,373                                       | 8.00  | % N/A   | N/A   |   |
| First Business Bank                         | 123,331                          | 12.57 | 78,516  | 8.00  | \$ 98,145   | 10.00 | % |
| First Business Bank —<br>Milwaukee          | 17,944                           | 14.66 | 9,790   | 8.00  | 12,238  | 10.00 |   |
| Tier 1 capital<br>(to risk-weighted assets) |                                  |       |   |       |   |       |   |
| Consolidated                                | \$ 119,617                       | 10.83 | \$ 44,186   | 4.00  | % N/A   | N/A   |   |
| First Business Bank                         | 111,062                          | 11.32 | 39,258  | 4.00  | \$ 58,887   | 6.00  | % |
| First Business Bank —<br>Milwaukee          | 16,414                           | 13.41 | 4,895   | 4.00  | 7,343   | 6.00  |   |
| Tier 1 capital<br>(to average assets)       |                                  |       |   |       |   |       |   |
| Consolidated                                | \$ 119,617                       | 9.35  | \$ 51,153   | 4.00  | % N/A   | N/A   |   |
| First Business Bank                         | 111,062                          | 10.35 | 42,913  | 4.00  | \$ 53,641   | 5.00  | % |
| First Business Bank —<br>Milwaukee          | 16,414                           | 7.64  | 8,595   | 4.00  | 10,744  | 5.00  |   |

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

#### General

Unless otherwise indicated or unless the context requires otherwise, all references in this Report to the "Corporation," "we," "us," "our," or similar references mean First Business Financial Services, Inc. together with our subsidiaries. "FBB" and "FBB - Milwaukee" are used to refer to our subsidiaries, First Business Bank and First Business Bank - Milwaukee, respectively, and the "Banks" is used to refer to FBB and FBB - Milwaukee together.

#### Forward-Looking Statements

When used in this report the words or phrases "may," "could," "should," "hope," "might," "believe," "expect," "plan," "assume," "estimate," "anticipate," "project," "likely," or similar expressions are intended to identify "forward-looking statements." Such statements are subject to risks and uncertainties, including, without limitation, changes in economic conditions in the market areas of FBB or FBB - Milwaukee, changes in policies by regulatory agencies, fluctuation in interest rates, demand for loans in the market areas of FBB or FBB - Milwaukee, borrowers defaulting in the repayment of loans, competition and certain matters relating to our pending acquisition of Aslin Group, Inc. ("Aslin Group"), as described below. These risks could cause actual results to differ materially from what we have anticipated or projected. These risk factors and uncertainties should be carefully considered by our shareholders and potential investors. See Item 1A — Risk Factors in our Annual Report on Form 10-K for the year ended December 31, 2013 for discussion relating to risk factors impacting us. Investors should not place undue reliance on any such forward-looking statements, which speak only as of the date made. The factors described within this Form 10-Q could affect our financial performance and could cause actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods.

Where any such forward-looking statement includes a statement of the assumptions or bases underlying such forward-looking statement, we caution that, while our management believes such assumptions or bases are reasonable and are made in good faith, assumed facts or bases can vary from actual results, and the differences between assumed facts or bases and actual results can be material, depending on the circumstances. Where, in any forward-looking statement, an expectation or belief is expressed as to future results, such expectation or belief is expressed in good faith and believed to have a reasonable basis, but there can be no assurance that the statement of expectation or belief will be achieved or accomplished.

We do not intend to, and specifically disclaim any obligation to, update any forward-looking statements.

The following discussion and analysis is intended as a review of significant events and factors affecting our financial condition and results of operations for the periods indicated. The discussion should be read in conjunction with the Unaudited Consolidated Financial Statements and the Notes thereto presented in this Form 10-Q.

#### Overview

We are a registered bank holding company incorporated under the laws of the State of Wisconsin and are engaged in the commercial banking business through our wholly-owned banking subsidiaries, FBB and FBB - Milwaukee. All of our operations are conducted through the Banks and certain subsidiaries of FBB. We operate as a business bank focusing on delivering a full line of commercial banking products and services tailored to meet the specific needs of small- and medium-sized businesses, business owners, executives, professionals and high net worth individuals. We do not utilize a branch network to attract retail clients. In 2014, we plan to continue to diligently focus on maintaining asset quality, increasing transaction deposit account relationships and balances in an effort to support ongoing efforts to increase fee revenue associated with treasury management services and maintaining our efficiency ratio. We believe this strategy will create opportunities to capitalize on economic expansion as well as any current disruption to our competitors' businesses in our core Wisconsin markets. In addition to growth relating to our pending acquisition of Aslin Group, we believe significant opportunity exists for organic growth within our existing markets.

#### Entry into a Material Definitive Agreement to Acquire Aslin Group, Inc.

On May 22, 2014, we entered into a definitive agreement to acquire Aslin Group, including Alterra Bank, Aslin Group's wholly owned subsidiary ("Alterra"). The cash-and-stock transaction is valued at an estimated \$30.1 million. Alterra's competitive position, established commercial banking team, focus on commercial clients and complementary



limited branch business model will expand our growth into the Kansas City metropolitan market, where we already operate our national equipment finance business. Upon closing of the acquisition, it is anticipated that Alterra's brand, Overland Park and Leawood offices and Kansas state banking charter will be maintained, with Ms. Pamela Berneking joining First Business and continuing

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in her current role as President and CEO of Alterra Bank. Following the acquisition, the Alterra Bank's board of directors, with a majority of local Kansas directors, is also expected to remain substantially intact. Under the terms of the definitive agreement, each outstanding share of common stock of Aslin Group will be converted into the right to receive merger consideration valued at \$14,435.59, which will be payable in \$6,496.02 of cash and \$7,939.57 of First Business common stock. The number of First Business common shares to be issued will be calculated based on First Business's 10 day volume weighted average stock price as of the market close of the third business day prior to the effective date of the transaction. However, for purposes of the calculation, the volume weighted average share price cannot exceed approximately \$51 per share or fall below approximately \$34 per share. The merger is subject to regulatory approvals, approval by Aslin Group stockholders and certain other customary closing conditions and is expected to close in late 2014.

## Operational Highlights

Total assets were \$1.307 billion as of June 30, 2014 compared to \$1.269 billion as of December 31, 2013.

Net income for the three months ended June 30, 2014 was \$3.5 million compared to net income of \$3.1 million for the three months ended June 30, 2013. Net income for the six months ended June 30, 2014 was \$6.8 million compared to net income of \$6.4 million for the six months ended June 30, 2013.

Diluted earnings per common share for the three months ended June 30, 2014 were \$0.88 compared to diluted earnings per common share of \$0.80 for the three months ended June 30, 2013. Diluted earnings per common share for the six months ended June 30, 2014 were \$1.72 compared to diluted earnings per common share of \$1.62 for the six months ended June 30, 2013.

Net interest margin increased by six basis points to 3.52% for the three months ended June 30, 2014 compared to 3.46% for the three months ended June 30, 2013. Net interest margin increased by five basis points to 3.55% for the six months ended June 30, 2014 compared to 3.50% for the six months ended June 30, 2013.

Top line revenue, the sum of net interest income and non-interest income, increased 6.4% to \$13.2 million for the three months ended June 30, 2014 compared to \$12.4 million for the three months ended June 30, 2013. For the six months ended June 30, 2014, top line revenue increased 7.0% to \$26.3 million as compared to \$24.5 million for the six months ended June 30, 2013.

Annualized return on average assets and annualized return on average equity were 1.09% and 12.29%, respectively, for the three-month period ended June 30, 2014, compared to 1.02% and 12.05%, respectively, for the same time period in 2013. Annualized return on average assets and annualized return on average equity were 1.07% and 12.15%, respectively, for the six-month period ended June 30, 2014, compared to 1.04% and 12.42%, respectively, for the six-month period ended June 30, 2013.

Our effective tax rate was 35.4% and 34.6% for the six months ended June 30, 2014 and 2013, respectively.

We recorded a negative \$91,000 provision for loan and lease losses for the three months ended June 30, 2014 compared to an expense of \$54,000 for the same period in the prior year. Provision for loan and lease losses was \$89,000 for the six months ended June 30, 2014 compared to \$134,000 for the comparable period of 2013.

Allowance for loan and lease losses as a percentage of gross loans and leases was 1.39% at June 30, 2014 and 1.42% at December 31, 2013.

Non-performing assets as a percentage of total assets was 1.11% at June 30, 2014 compared to 1.28% at December 31, 2013.

Non-accrual loans declined by \$1.7 million, or 10.6%, to \$14.2 million at June 30, 2014 from \$15.9 million at December 31, 2013.

## Results of Operations

## Top Line Revenue

Top line revenue is comprised of net interest income and non-interest income. This measurement is also commonly referred to as operating revenue. Top line revenue grew 6.4% and 7.0% for the three and six months ended June 30, 2014, respectively, as compared to the same periods in the prior year. The components of top line revenue were as follows:



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|                        | For the Three Months Ended June 30, |          |        | For the Six Months Ended June 30, |          |        |   |
|------------------------|-------------------------------------|----------|--------|-----------------------------------|----------|--------|---|
|                        | 2014                                | 2013     | Change | 2014                              | 2013     | Change |   |
|                        | (Dollars in Thousands)              |          |        |                                   |          |        |   |
| Net interest income    | \$10,799                            | \$10,193 | 5.9    | % \$21,599                        | \$20,422 | 5.8    | % |
| Non-interest income    | 2,358                               | 2,174    | 8.5    | 4,679                             | 4,127    | 13.4   |   |
| Total top line revenue | \$13,157                            | \$12,367 | 6.4    | \$26,278                          | \$24,549 | 7.0    |   |

**Pre-tax Adjusted Earnings**

Pre-tax adjusted earnings is comprised of our pre-tax income adding back (1) our provision for loan and leases losses, (2) other identifiable costs of credit and (3) other discrete items that are unrelated to our primary business activities. In our judgment, the presentation of pre-tax adjusted earnings allows our management team, investors and analysts to better assess the growth of our business by removing the volatility that is associated with costs of credit and other discrete items and facilitates a more streamlined comparison of growth to our benchmark peers. Pre-tax adjusted earnings is a non-GAAP financial measure that does not represent and should not be considered as an alternative to net income derived in accordance with GAAP. Our pre-tax adjusted earnings metric improved by 9.2% and 7.6% for the three and six months ended June 30, 2014, respectively, as compared to the three and six months ended June 30, 2013.

The information provided below reconciles pre-tax adjusted earnings to the most comparable GAAP measure.

|                                     | For the Three Months Ended June 30, |         |        | For the Six Months Ended June 30, |         |        |   |
|-------------------------------------|-------------------------------------|---------|--------|-----------------------------------|---------|--------|---|
|                                     | 2014                                | 2013    | Change | 2014                              | 2013    | Change |   |
|                                     | (Dollars in Thousands)              |         |        |                                   |         |        |   |
| Income before income tax expense    | \$5,499                             | \$4,823 | 14.0   | % \$10,589                        | \$9,747 | 8.6    | % |
| Add back:                           |                                     |         |        |                                   |         |        |   |
| Provision for loan and lease losses | (91                                 | ) 54    | (268.5 | ) 89                              | 134     | (33.6  | ) |
| Net loss on foreclosed properties   | 4                                   | 79      | (94.9  | ) 4                               | 49      | (91.8  | ) |
| Pre-tax adjusted earnings           | \$5,412                             | \$4,956 | 9.2    | \$10,682                          | \$9,930 | 7.6    |   |

**Return on Average Assets and Return on Average Equity**

Annualized return on average assets ("ROAA") for the three months ended June 30, 2014 improved to 1.09% for the three months ended June 30, 2014 as compared to an ROAA of 1.02% for the three months ended June 30, 2013.

ROAA for the six months ended June 30, 2014 was 1.07% compared to 1.04% for the six months ended June 30, 2013. The improvement in ROAA for both time periods presented was primarily due to an increase in net income.

ROAA is a critical metric used by us to measure the profitability of our organization and how efficiently our assets are deployed. The improved ROAA measure indicates continued efficient deployment of assets. ROAA is a measurement that allows us to better benchmark our profitability to our peers without the need to consider different degrees of leverage which can ultimately influence return on equity measures.

Annualized return on average equity ("ROAE") for the three months ended June 30, 2014 was 12.29% compared to 12.05% for the three months ended June 30, 2013. ROAE for the six months ended June 30, 2014 was 12.15% compared to 12.42% for the six months ended June 30, 2013. We view return on average equity to be an important measure of profitability, and we continue to focus on improving our return to our shareholders by enhancing the overall profitability of our client relationships, controlling our expenses and minimizing our costs of credit.

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## Efficiency Ratio

Efficiency ratio is a non-GAAP measure representing non-interest expense excluding the effects of losses or gains on foreclosed properties and amortization of other intangible assets, if any, divided by top line revenue. In the judgment of our management, the efficiency ratio allows investors and analysts to better assess the Company's operating expenses in relation to its top line revenue by removing the volatility that is associated with certain one-time and other discrete items. The information provided below reconciles the efficiency ratio to its most comparable GAAP measure.

|                                   | For the Three Months Ended |          | For the Six Months Ended June |          |   |
|-----------------------------------|----------------------------|----------|-------------------------------|----------|---|
|                                   | June 30,<br>2014           | 2013     | 30,<br>2014                   | 2013     |   |
|                                   | Dollars in Thousands       |          |                               |          |   |
| Total non-interest expense        | \$7,749                    | \$7,490  | \$15,600                      | \$14,668 |   |
| Less:                             |                            |          |                               |          |   |
| Net loss on foreclosed properties | 4                          | 79       | 4                             | 49       |   |
| Total operating expense           | \$7,745                    | \$7,411  | \$15,596                      | \$14,619 |   |
| Net interest income               | \$10,799                   | \$10,193 | \$21,599                      | \$20,422 |   |
| Total non-interest income         | 2,358                      | 2,174    | 4,679                         | 4,127    |   |
| Less:                             |                            |          |                               |          |   |
| Gain on sale of securities        | —                          | —        | —                             | —        |   |
| Total operating revenue           | \$13,157                   | \$12,367 | \$26,278                      | \$24,549 |   |
| Efficiency ratio                  | 58.87                      | % 59.93  | % 59.35                       | % 59.55  | % |

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## Net Interest Income

Net interest income levels depend on the amounts of and yields on interest-earning assets as compared to the amounts of and rates paid on interest-bearing liabilities. Net interest income is sensitive to changes in market rates of interest and the asset/liability management processes to prepare for and respond to such changes.

The following table provides information with respect to (1) the change in interest income attributable to changes in rate (changes in rate multiplied by prior volume), (2) the change in interest income attributable to changes in volume (changes in volume multiplied by prior rate) and (3) the change in interest income attributable to changes in rate/volume (changes in rate multiplied by changes in volume) for the three and six months ended June 30, 2014 compared to the same period of 2013.

|   | Increase (Decrease) for the Three Months<br>Ended June 30,<br>2014 Compared to 2013 |        |                 |          | Increase (Decrease) for the Six Months<br>Ended June 30,<br>2014 Compared to 2013 |         |                 |          |
|---|---|--------|-----------------|----------|---|---------|-----------------|----------|
|   | Rate  | Volume | Rate/<br>Volume | Net      | Rate  | Volume  | Rate/<br>Volume | Net      |
|   | (In Thousands)  |        |                 |          |   |         |                 |          |
| Interest-earning assets                                     |   |        |                 |          |   |         |                 |          |
| Commercial real estate and other mortgage loans             | \$(128 )  | \$(7 ) | \$1             | \$(134 ) | \$(867 )  | \$230   | \$(12 )         | \$(649 ) |
| Commercial and industrial loans                             | (459 )  | 935    | (104 )          | 372      | (740 )  | 1,701   | (154 )          | 807      |
| Direct financing leases                                     | (15 )   | 162    | (13 )           | 134      | (36 )   | 304     | (29 )           | 239      |
| Consumer and other loans                                    | (6 )  | 2      | —               | (4 )     | (12 )   | 6       | (1 )            | (7 )     |
| Total loans and leases receivable                           | (608 )  | 1,092  | (116 )          | 368      | (1,655 )  | 2,241   | (196 )          | 390      |
| Mortgage-related securities                                 | 94  | (30 )  | (4 )            | 60       | 209   | (91 )   | (13 )           | 105      |
| Other investment securities                                 | 20  | (28 )  | (5 )            | (13 )    | 37  | (33 )   | (4 )            | —        |
| FHLB Stock  | —   | —      | —               | —        | —   | —       | —               | —        |
| Short-term investments                                      | 21  | (9 )   | (4 )            | 8        | 41  | (21 )   | (9 )            | 11       |
| Total net change in income on interest-earning assets       | (473 )  | 1,025  | (129 )          | 423      | (1,368 )  | 2,096   | (222 )          | 506      |
| Interest-bearing liabilities                                |   |        |                 |          |   |         |                 |          |
| Transaction accounts  | 4   | 12     | 2               | 18       | 7   | 25      | 3               | 35       |
| Money market  | (24 )   | 11     | —               | (13 )    | (113 )  | 17      | (2 )            | (98 )    |
| Certificates of deposit                                     | (8 )  | (40 )  | 2               | (46 )    | (21 )   | (79 )   | 5               | (95 )    |
| Brokered certificates of deposit                            | (230 )  | 179    | (25 )           | (76 )    | (644 )  | 316     | (60 )           | (388 )   |
| Total deposits  | (258 )  | 162    | (21 )           | (117 )   | (771 )  | 279     | (54 )           | (546 )   |
| FHLB advances   | 1   | (6 )   | —               | (5 )     | (2 )  | (6 )    | 1               | (7 )     |
| Other borrowings  | 8   | (66 )  | (3 )            | (61 )    | 12  | (127 )  | (4 )            | (119 )   |
| Junior subordinated debentures                              | —   | —      | —               | —        | —   | —       | —               | —        |
| Total net change in expense on interest-bearing liabilities | (249 )  | 90     | (24 )           | (183 )   | (761 )  | 146     | (57 )           | (672 )   |
| Net change in net interest income                           | \$(224 )  | \$935  | \$(105 )        | \$606    | \$(607 )  | \$1,950 | \$(165 )        | \$1,178  |

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The table below shows our average balances, interest, average yields/rates, net interest margin and the spread between the combined average yields earned on interest-earning assets and average rates on interest-bearing liabilities for the three months ended June 30, 2014 and 2013. The average balances are derived from average daily balances.

|  | For the Three Months Ended June 30,<br>2014  |          |                       | 2013               |          |                       |   |  |
|--|--|----------|-----------------------|--------------------|----------|-----------------------|---|--|
|  | Average<br>balance<br>(Dollars in Thousands) | Interest | Average<br>yield/rate | Average<br>balance | Interest | Average<br>yield/rate |   |  |
| Interest-earning assets  |  |          |                       |                    |          |                       |   |  |
| Commercial real estate and other mortgage loans <sup>(1)</sup> | \$636,174                                    | \$7,702  | 4.84                  | % \$636,705        | \$7,836  | 4.92                  | % |  |
| Commercial and industrial loans <sup>(1)</sup>                 | 323,045                                      | 4,476    | 5.54                  | 263,099            | 4,104    | 6.24                  |   |  |
| Direct financing leases <sup>(1)</sup>                         | 27,457                                       | 316      | 4.60                  | 14,542             | 182      | 5.01                  |   |  |
| Consumer and other loans <sup>(1)</sup>                        | 17,044                                       | 157      | 3.68                  | 16,828             | 161      | 3.83                  |   |  |
| Total loans and leases receivable <sup>(1)</sup>               | 1,003,720                                    | 12,651   | 5.04                  | 931,174            | 12,283   | 5.28                  |   |  |
| Mortgage-related securities <sup>(2)</sup>                     | 156,073                                      | 746      | 1.91                  | 163,099            | 686      | 1.68                  |   |  |
| Other investment securities <sup>(3)</sup>                     | 27,497                                       | 109      | 1.59                  | 35,698             | 122      | 1.37                  |   |  |
| FHLB stock   | 1,427  | 1        | 0.44                  | 1,725              | 1        | 0.20                  |   |  |
| Short-term investments   | 37,451                                       | 58       | 0.62                  | 45,621             | 50       | 0.43                  |   |  |
| Total interest-earning assets                                  | 1,226,168                                    | 13,565   | 4.43                  | 1,177,317          | 13,142   | 4.47                  |   |  |
| Non-interest-earning assets                                    | 56,063                                       |          |                       | 56,817             |          |                       |   |  |
| Total assets   | \$1,282,231                                  |          |                       | \$1,234,134        |          |                       |   |  |
| Interest-bearing liabilities                                   |  |          |                       |                    |          |                       |   |  |
| Transaction accounts   | \$80,027                                     | 45       | 0.22                  | \$55,767           | 27       | 0.19                  |   |  |
| Money market   | 449,907                                      | 571      | 0.51                  | 441,459            | 584      | 0.53                  |   |  |
| Certificates of deposit  | 47,332                                       | 115      | 0.97                  | 63,014             | 161      | 1.02                  |   |  |
| Brokered certificates of deposit                               | 422,024                                      | 1,606    | 1.52                  | 381,479            | 1,682    | 1.76                  |   |  |
| Total interest-bearing deposits                                | 999,290                                      | 2,337    | 0.94                  | 941,719            | 2,454    | 1.04                  |   |  |
| FHLB advances  | 9,418  | 4        | 0.17                  | 24,621             | 9        | 0.15                  |   |  |
| Other borrowings   | 8,381  | 148      | 7.06                  | 12,271             | 209      | 6.81                  |   |  |
| Junior subordinated notes                                      | 10,315                                       | 277      | 10.74                 | 10,315             | 277      | 10.74                 |   |  |
| Total interest-bearing liabilities                             | 1,027,404                                    | 2,766    | 1.08                  | 988,926            | 2,949    | 1.19                  |   |  |
| Non-interest-bearing demand deposit accounts                   | 134,892                                      |          |                       | 133,019            |          |                       |   |  |
| Other non-interest-bearing liabilities                         | 5,882  |          |                       | 8,164              |          |                       |   |  |
| Total liabilities  | 1,168,178                                    |          |                       | 1,130,109          |          |                       |   |  |
| Stockholders' equity   | 114,053                                      |          |                       | 104,025            |          |                       |   |  |
| Total liabilities and stockholders' equity                     | \$1,282,231                                  |          |                       | \$1,234,134        |          |                       |   |  |
| Net interest income  |  | \$10,799 |                       |                    | \$10,193 |                       |   |  |
| Interest rate spread   |  |          | 3.35                  | %                  |          | 3.28                  | % |  |
| Net interest-earning assets                                    | \$198,764                                    |          |                       | \$188,391          |          |                       |   |  |
| Net interest margin  |  |          | 3.52                  | %                  |          | 3.46                  | % |  |
|  | 119.35                                       | %        |                       | 119.05             | %        |                       |   |  |

Average interest-earning assets  
to average interest-bearing  
liabilities

|   |       |       |
|---|-------|-------|
| Return on average assets                  | 1.09  | 1.02  |
| Return on average equity                  | 12.29 | 12.05 |
| Average equity to average<br>assets       | 8.89  | 8.43  |
| Non-interest expense to<br>average assets | 2.42  | 2.43  |

(1) The average balances of loans and leases include non-performing loans and leases. Interest income related to non-performing loans and leases is recognized when collected.

(2) Includes amortized cost basis of assets available for sale and held to maturity.

(3) Yields on tax-exempt municipal obligations are not presented on a tax-equivalent basis in this table.



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The table below shows our average balances, interest, average rates, net interest margin and the spread between the combined average rates earned on interest-earning assets and average cost of interest-bearing liabilities for the six months ended June 30, 2014 and 2013. The average balances are derived from average daily balances.

|  | For the Six Months Ended June 30, |          |                    |                 |          |                    |   |  |  |
|--|-----------------------------------|----------|--------------------|-----------------|----------|--------------------|---|--|--|
|  | 2014                              |          |                    | 2013            |          |                    |   |  |  |
|  | Average balance                   | Interest | Average yield/cost | Average balance | Interest | Average yield/cost |   |  |  |
|  | (Dollars in Thousands)            |          |                    |                 |          |                    |   |  |  |
| Interest-earning assets  |                                   |          |                    |                 |          |                    |   |  |  |
| Commercial real estate and other mortgage loans <sup>(1)</sup> | \$636,491                         | \$15,199 | 4.78               | % \$627,378     | \$15,848 | 5.05               | % |  |  |
| Commercial and industrial loans <sup>(1)</sup>                 | 310,938                           | 9,000    | 5.79               | 257,487         | 8,193    | 6.36               |   |  |  |
| Direct financing leases <sup>(1)</sup>                         | 26,760                            | 614      | 4.59               | 14,777          | 375      | 5.08               |   |  |  |
| Consumer and other loans <sup>(1)</sup>                        | 17,064                            | 313      | 3.67               | 16,770          | 320      | 3.82               |   |  |  |
| Total loans and leases receivable <sup>(1)</sup>               | 991,253                           | 25,126   | 5.07               | 916,412         | 24,736   | 5.40               |   |  |  |
| Mortgage-related securities <sup>(2)</sup>                     | 153,788                           | 1,491    | 1.94               | 164,545         | 1,386    | 1.68               |   |  |  |
| Other investment securities <sup>(3)</sup>                     | 29,711                            | 230      | 1.55               | 34,606          | 231      | 1.34               |   |  |  |
| FHLB stock   | 1,344                             | 2        | 0.30               | 1,436           | 2        | 0.24               |   |  |  |
| Short-term investments   | 40,671                            | 117      | 0.58               | 50,947          | 106      | 0.42               |   |  |  |
| Total interest-earning assets                                  | 1,216,767                         | 26,966   | 4.43               | 1,167,946       | 26,461   | 4.53               |   |  |  |
| Non-interest-earning assets                                    | 56,878                            |          |                    | 58,381          |          |                    |   |  |  |
| Total assets   | \$1,273,645                       |          |                    | \$1,226,327     |          |                    |   |  |  |
| Interest-bearing liabilities                                   |                                   |          |                    |                 |          |                    |   |  |  |
| Transaction accounts   | \$79,313                          | 90       | 0.23               | \$54,825        | 55       | 0.20               |   |  |  |
| Money market   | 456,206                           | 1,157    | 0.51               | 450,281         | 1,255    | 0.56               |   |  |  |
| Certificates of deposit  | 49,119                            | 236      | 0.96               | 64,563          | 331      | 1.03               |   |  |  |
| Brokered certificates of deposit                               | 404,728                           | 3,023    | 1.49               | 370,429         | 3,411    | 1.84               |   |  |  |
| Total interest-bearing deposits                                | 989,366                           | 4,506    | 0.91               | 940,098         | 5,052    | 1.07               |   |  |  |
| FHLB advances  | 6,282                             | 5        | 0.16               | 13,046          | 12       | 0.19               |   |  |  |
| Other borrowings   | 8,513                             | 305      | 7.17               | 12,160          | 424      | 6.97               |   |  |  |
| Junior subordinated notes                                      | 10,315                            | 551      | 10.68              | 10,315          | 551      | 10.70              |   |  |  |
| Total interest-bearing liabilities                             | 1,014,476                         | 5,367    | 1.06               | 975,619         | 6,039    | 1.24               |   |  |  |
| Non-interest-bearing demand deposit accounts                   | 139,397                           |          |                    | 138,230         |          |                    |   |  |  |
| Other non-interest-bearing liabilities                         | 7,150                             |          |                    | 9,780           |          |                    |   |  |  |
| Total liabilities  | 1,161,023                         |          |                    | 1,123,629       |          |                    |   |  |  |
| Stockholders' equity   | 112,622                           |          |                    | 102,698         |          |                    |   |  |  |
| Total liabilities and stockholders' equity                     | \$1,273,645                       |          |                    | \$1,226,327     |          |                    |   |  |  |
| Net interest income  |                                   | \$21,599 |                    |                 | \$20,422 |                    |   |  |  |
| Interest rate spread   |                                   |          | 3.37               | %               |          | 3.29               | % |  |  |
| Net interest-earning assets                                    | \$202,291                         |          |                    | \$192,327       |          |                    |   |  |  |
| Net interest margin  |                                   |          | 3.55               | %               |          | 3.50               | % |  |  |
|  | 119.94                            | %        |                    | 119.71          | %        |                    |   |  |  |

Average interest-earning assets  
to average interest-bearing  
liabilities

|   |       |       |
|---|-------|-------|
| Return on average assets                  | 1.07  | 1.04  |
| Return on average equity                  | 12.15 | 12.42 |
| Average equity to average<br>assets       | 8.84  | 8.37  |
| Non-interest expense to<br>average assets | 2.45  | 2.39  |

(1) The average balances of loans and leases include non-performing loans and leases. Interest income related to non-performing loans and leases is recognized when collected.

(2) Includes amortized cost basis of assets available for sale and held to maturity.

(3) Yields on tax-exempt municipal obligations are not presented on a tax-equivalent basis in this table.

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## Comparison of Net Interest Income for the Three Months Ended June 30, 2014 and 2013

Net interest income increased \$606,000, or 5.9%, during the three months ended June 30, 2014 compared to the same period in 2013. The increase in net interest income was primarily attributable to favorable volume-related variances due to growth in the loans and leases portfolio and favorable rate variances on the cost of funds for the interest-bearing liabilities, partially offset by unfavorable rate variances on the loans and the leases portfolio.

The yield on average earning assets for the three months ended June 30, 2014 was 4.43% compared to 4.47% for the three months ended June 30, 2013. The decline in the yield on average earning assets was attributable to several factors. The total loans and leases receivable yield was 5.04% for the three months ended June 30, 2014 compared to 5.28% for the three months ended June 30, 2013. A significant portion of the commercial real estate portfolio is comprised of fixed rate loans with terms generally up to five years. As these loans reached their maturity they were renewed at current market rates, which were generally lower than the original rate of the loan and subject to competitive pricing pressures. As a result, the overall yield on the commercial real estate portfolio declined. The marketplace for commercial and industrial loans also continues to be subject to competitive pressures, contributing to the decline in yield on this portfolio. Irregular prepayment activity and the associated fees collected in lieu of interest partially offset the decline in yields. Growth within the overall loan and lease portfolio more than offset the decline in interest income caused by declining yields on the loan and lease portfolio.

The overall weighted average rate paid on interest-bearing liabilities was 1.08% for the three months ended June 30, 2014, a decrease of 11 basis points from 1.19% for the three months ended June 30, 2013. The decrease in the overall rate on the interest-bearing liabilities was primarily caused by a decreasing rate paid on our interest-bearing deposits, specifically brokered certificates of deposit.

The weighted average rate paid on our interest-bearing deposits was 0.94% for the three months ended June 30, 2014, a decrease of 10 basis points from 1.04% for the three months ended June 30, 2013. The continued low interest rate environment has allowed us to decrease the overall rate paid on our in-market deposits. We have been successful in attracting in-market deposit relationships, specifically interest-bearing transaction accounts. Further, the weighted average rate paid on our interest-bearing deposits was reduced by the replacement of maturing brokered certificates of deposit at lower current rates. The ongoing low rate environment combined with the maturity structure of our brokered certificates of deposit continued to provide us the opportunity to manage our liability structure in both maturity terms and rate to deliver an enhanced net interest margin for the three months ended June 30, 2014 as compared to the three months ended June 30, 2013.

Net interest margin increased six basis points to 3.52% for the three months ended June 30, 2014 compared to 3.46% for the three months ended June 30, 2013. Changing the mix of our deposit base reduced our overall cost of funds and positively affected our net interest margin by approximately seven basis points. In addition, repaying a portion of our third party subordinated debt, as discussed below, positively affected our net interest margin by approximately three basis points. These positive items were offset by an unfavorable impact of five basis points in net interest margin due to the interest rates associated with the new loans and leases yielding less than the average yield on the existing portfolio.

## Comparison of Net Interest Income for the Six Months Ended June 30, 2014 and 2013

Net interest income increased by \$1.2 million, or 5.8%, during the six months ended June 30, 2014 compared to the same period in 2013. The increase in net interest income during the six-month period was primarily attributable to favorable rate variances from lower cost brokered certificates of deposit and lower cost money market deposits, favorable volume-related variances due to the paydown of other borrowings, and an overall favorable variance affiliated with a modest increase in interest income on the loan and lease portfolio. The yield on average earning assets for the six months ended June 30, 2014 was 4.43% compared to 4.53% for the six months ended June 30, 2013. The decline in the yield on average earning assets was driven by the overall decline in the yield on the loan and lease portfolio, which declined 33 basis points to 5.07% for the six months ended June 30, 2014 from 5.40% for the six months ended June 30, 2013. The reasons for the decline in the yield earned on the loan and lease portfolio are consistent with explanations provided for the second quarter results discussed above.

The overall weighted average rate paid on interest-bearing liabilities was 1.06% for the six months ended June 30, 2014, a decrease of 18 basis points from 1.24% for the six months ended June 30, 2013. The decrease in the overall

rate on the interest-bearing liabilities was primarily caused by the replacement of certain maturing certificates of deposit, principally brokered certificates of deposit, at lower current market rates, lower rates paid on our money market accounts and favorable volume-related variances due to paydown of other borrowings, as discussed below. The continued low rate environment combined with the maturity structure of our brokered certificates of deposit provided us the opportunity to be able to manage our liability structure in both maturity terms and rate to deliver an enhanced net interest margin for the first six months of 2014 relative to 2013. During January 2014, we paid down our third party subordinated debt by \$4.0 million. This payment caused

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the average balance of other borrowings to decline by \$3.6 million, or 30.0%, to \$8.5 million for the six months ended June 30, 2014 from \$12.2 million for the six months ended June 30, 2013.

Net interest margin increased approximately five basis points to 3.55% for the six months ended June 30, 2014 compared to 3.50% for the six months ended June 30, 2013. Reducing our overall cost of funds by way of changing the mix of our deposit base positively affected our net interest margin by approximately 12 basis points. In addition, repaying a portion of our third party subordinated debt positively affected our net interest margin by approximately three basis points. These positive items were partially offset by an 11 basis point reduction in net interest margin due to the net decline of interest income on our loan and lease portfolio among other factors.

**Provision for Loan and Lease Losses**

We recorded a negative provision of \$91,000 and an expense of \$54,000 for the three months ended June 30, 2014 and 2013, respectively. The provision for loan and lease losses totaled \$89,000 and \$134,000 for the six months ended June 30, 2014 and 2013, respectively. We determine our provision for loan and lease losses based upon credit risk and other subjective factors pursuant to our allowance for loan and lease loss methodology, the magnitude of current and historical net charge-offs recorded in the period and the amount of reserves established for impaired loans that present collateral shortfall positions.

During the three and six months ended June 30, 2014 and 2013, the factors influencing the provision for loan and lease losses were the following:

|  | For the Three Months Ended<br>June 30, |         | For the Six Months Ended<br>June 30, |         |
|--|--|---------|--------------------------------------|---------|
|  | 2014                                   | 2013    | 2014                                 | 2013    |
|  | (In Thousands)                         |         |                                      |         |
| Components of the provision for loan and lease losses:                                     |  |         |                                      |         |
| Net additions of specific reserves on impaired loans                                       | \$99                                   | \$(77)  | ) \$205                              | \$(61)  |
| Net decrease in allowance for loan and lease loss reserve due to subjective factor changes | (496)                                  | ) (569) | ) (502)                              | ) (619) |
| Charge-offs in excess of specific reserves   | —                                      | 34      | —                                    | 45      |
| Recoveries   | (6)                                    | ) (288) | ) (26)                               | ) (326) |
| Change in inherent risk of the loan and lease portfolio                                    | 312                                    | 954     | 412                                  | 1,095   |
| Total provision for loan and lease losses  | \$ (91)                                | ) \$ 54 | \$ 89                                | \$ 134  |

The net additions of specific reserves on impaired loans represents new specific reserves established on impaired loans for which, although collateral shortfalls are present, we believe we will recover our principal, offset by any release of previously established reserves that are no longer required. A decrease in allowance for loan and lease losses reserves due to subjective factor changes reflects management's evaluation of the level of risk within the portfolio based upon the level and trend of certain criteria such as delinquencies, volume and average loan size, average risk rating, technical defaults, geographic concentrations, loans and leases on management attention watch lists, unemployment rates in our market areas, experience in credit granting functions, and changes in underwriting standards. As our asset quality metrics improve and the level and trend of the factors improve for a sustainable period of time, the level of general reserve due to these factors may be reduced, causing an overall reduction in the level of the required reserve deemed to be appropriate by management. Conversely, increases in the level and trend of these factors may warrant an increase to our overall allowance for loan loss. Charge-offs in excess of specific reserves represent an additional provision for loan and lease losses required to maintain the allowance for loan and leases at a level deemed appropriate by management. This amount is net of the release of any specific reserve that may have already been provided. Charge-offs in excess of specific reserves can occur in situations where: (i) a loan has previously been partially written down to its estimated fair value and continues to decline, (ii) rapid deterioration of a credit requires an immediate partial or full charge-off, or (iii) the specific reserve was not adequate to cover the amount of the required charge-off. Change in the inherent risk of the portfolio can be influenced by growth or migration in and out of an impaired loan classification where a specific evaluation of a particular credit may be required rather than the application of a general reserve ratio. Refer to [Asset Quality](#) for further information regarding the overall credit

quality of our loan and lease portfolio.

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Non-interest Income

Comparison of Non-Interest Income for the Three Months Ended June 30, 2014 and 2013

Non-interest income, consisting primarily of fees earned for trust and investment services, service charges on deposits, increase in cash surrender value of bank-owned life insurance, and loan fees, increased \$184,000, or 8.5%, to \$2.4 million for the three months ended June 30, 2014 from \$2.2 million for the three months ended June 30, 2013. The increase was primarily due to increased fees earned for trust and investment services.

Trust and investment services fee income increased by \$140,000, or 14.4%, to \$1.1 million for the three months ended June 30, 2014 from \$970,000 for the three months ended June 30, 2013. Trust and investment services fee income is primarily driven by the amount of assets under management and can be positively or negatively influenced by the timing and magnitude of volatility within the capital markets.

At June 30, 2014, we had \$703.6 million of trust assets under management compared to \$763.9 million at December 31, 2013 and \$676.9 million at June 30, 2013. Assets under administration were \$186.0 million at June 30, 2014 compared to \$195.1 million at December 31, 2013 and \$175.9 million at June 30, 2013. In accordance with our operating philosophy, we focus on obtaining and managing larger-than-average client relationships. Our assets under management and administration can be influenced by the addition or loss of a client relationship. The decline in assets under management at June 30, 2014 relative to December 31, 2013 was primarily due to the mutual agreement between us and a client to discontinue providing trust services to a group sponsored investment program. While the assets within the relationship were significant, the fees for services were not. Therefore, the impact to revenue this period was not material nor is it expected to be in future periods.

Comparison of Non-Interest Income for the Six Months Ended June 30, 2014 and 2013

Non-interest income increased \$552,000, or 13.4%, to \$4.7 million for the six months ended June 30, 2014 from \$4.1 million for the six months ended June 30, 2013. The increase was primarily due to an increase in trust and investment services fee income. Trust and investment services fee income increased by \$381,000, or 21.2%, to \$2.2 million for the six months ended June 30, 2014 from \$1.8 million for the six months ended June 30, 2013. Consistent with the second quarter results discussed above, trust and investment services fee income was primarily driven by the amount of assets under management as market values continue to improve. Assets under management can be positively or negatively influenced by the timing and magnitude of volatility within the equity markets, which will therefore influence the level of fee income recognized.

Non-Interest Expense

Comparison of Non-Interest Expense for the Three Months Ended June 30, 2014 and 2013

Non-interest expense increased by \$259,000, or 3.5%, to \$7.7 million for the three months ended June 30, 2014 from \$7.5 million for the comparable period of 2013. The increase in non-interest expense was primarily caused by an increase in compensation expense and professional fees expense, partially offset by a decline in other non-interest expense.

Compensation expense increased by \$234,000, or 5.2%, to \$4.7 million for the three months ended June 30, 2014 from \$4.5 million for the three months ended June 30, 2013. The increase was due to increased salary expense resulting from annual merit increases and employee benefit costs on a larger base of employees. The number of full-time equivalent employees increased 5.6% to 151 at June 30, 2014 from 143 at June 30, 2013.

Professional fees expense increased by \$461,000, or 106.2%, to \$895,000 for the three months ended June 30, 2014 from \$434,000 for the three months ended June 30, 2013. The increase was primarily related to costs incurred in connection with the agreement to acquire Aslin Group. Through June 30, 2014, total merger-related costs totaled \$320,000.

Other non-interest expense decreased by \$379,000, or 37.8%, to \$624,000 for the three months ended June 30, 2014 from \$1.0 million for the three months ended June 30, 2013. The decrease was primarily the result of a non-recurring second quarter 2013 adjustment posted to the overall carrying value of our investment in one of our limited partnerships to reflect the proper allocation of certain of the partnership's returns to the general partner after the fund attained certain preferred rates of return.





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## Comparison of Non-Interest Expense for the Six Months Ended June 30, 2014 and 2013

Non-interest expense increased by \$932,000, or 6.4%, to \$15.6 million for the six months ended June 30, 2014 from \$14.7 million for the comparable period of 2013. The increase in non-interest expense was primarily caused by an increase in compensation expense and professional fees, partially offset by a decrease in other non-interest expenses. Compensation expense increased by \$565,000, or 6.1%, to \$9.8 million for the six months ended June 30, 2014 from \$9.2 million for the six months ended June 30, 2013. The increase was due to increased salary expense due to an increased employee base.

Professional fees increased by \$521,000, or 51.8%, to \$1.5 million for the six months ended June 30, 2014 from \$1.0 million for the six months ended June 30, 2013. Similar to the quarterly results discussion above, the increase was primarily related to costs incurred in connection with the agreement to acquire Aslin Group. Through June 30, 2014, total merger related costs totaled \$320,000.

Other non-interest expense decreased by \$346,000, or 22.1%, to \$1.2 million for the six months ended June 30, 2014 as compared to \$1.6 million for the six months ended June 30, 2013. The decrease was primarily the result of a non-recurring second quarter 2013 adjustment posted to the overall carrying value of our investment in one of our limited partnerships to reflect the proper allocation of certain of the partnership's returns to the general partner after the fund attained certain preferred rates of return.

## Income Taxes

Income tax expense was \$3.7 million for the six months ended June 30, 2014, with an effective tax rate of 35.4%, compared to income tax expense of \$3.4 million for the six months ended June 30, 2013, with an effective tax rate of 34.6%. The effective tax rate differs from the federal statutory corporate tax rate as follows:

|   | For the Six Months Ended |   |      |   |
|---|--------------------------|---|------|---|
|   | June 30,                 |   | 2013 |   |
|   | 2014                     | % | 34.4 | % |
| Statutory federal tax rate                                    | 34.4                     | % | 34.4 | % |
| State taxes, net of federal benefit                           | 4.7                      |   | 4.6  |   |
| FIN 48 expense, net of federal benefit                        | —                        |   | —    |   |
| Bank owned life insurance                                     | (1.4                     | ) | (1.5 | ) |
| Tax-exempt security and loan income, net of TEFRA adjustments | (3.4                     | ) | (3.4 | ) |
| Non-deductible transaction costs                              | 0.7                      |   | —    |   |
| Discrete items  | —                        |   | 0.1  |   |
| Other   | 0.4                      |   | 0.4  |   |
|   | 35.4                     | % | 34.6 | % |

Generally, the provision for income taxes is determined by applying an estimated annual effective income tax rate to income before taxes and adjusting for discrete items. Typically, the rate is based on the most recent annualized forecast of pre-tax income, book versus tax differences and tax credits, if any. If we conclude that a reliable estimated annual effective tax rate cannot be determined, the actual effective tax rate for the year-to-date period may be used.

We re-evaluate the income tax rates each quarter. Therefore, the current projected effective tax rate for the entire year may change.

## Financial Condition

General. Our total assets increased by \$37.8 million, or 3.0%, to \$1.307 billion as of June 30, 2014 compared to \$1.269 billion at December 31, 2013. The increase was primarily driven by growth of approximately \$26.7 million, or 2.8%, in our loan and lease portfolio to \$993.7 million as of June 30, 2014 compared to \$967.1 million at December 31, 2013.

Short-term investments. Short-term investments decreased by \$10.9 million to \$57.1 million at June 30, 2014 from \$68.1 million at December 31, 2013. Our short-term investments primarily consist of interest-bearing deposits held at the Federal Reserve Bank ("FRB"). We value the safety and soundness provided by the FRB and therefore we incorporate short-term investments in our on-balance-sheet liquidity program. As of June 30, 2014, our total investment in commercial paper,



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which is also considered a short-term investment, was \$14.3 million as compared to \$11.0 million at December 31, 2013. We approach our decisions to purchase commercial paper with similar rigor and underwriting standards applied to our loan and lease portfolio. The original maturities of the commercial paper are usually sixty days or less and provide an attractive yield in comparison to other short-term alternatives. These investments also assist us in maintaining a shorter duration of our overall investment portfolio which we believe is necessary to take advantage of an anticipated rising rate environment. In general, the level of our short-term investments will be influenced by the timing of deposit gathering, scheduled maturities of brokered deposits, funding of loan growth when opportunities are presented, and the level of our available-for-sale securities portfolio. The decline in total short-term investments is primarily due to the decline of our balances maintained on deposit at the FRB. Please refer to Liquidity and Capital Resources for further discussion.

**Securities.** Securities available-for-sale decreased by \$36.5 million to \$143.6 million at June 30, 2014 compared to \$180.1 million at December 31, 2013. During the six months ended June 30, 2014, we recognized unrealized holding gains of \$2.1 million before income taxes through other comprehensive income. The decrease in the securities available-for-sale was primarily due to the transfer of approximately \$43.7 million of certain U.S. agency obligations, collateralized mortgage obligations and municipal obligations from the available-for-sale portfolio to the held-to-maturity portfolio. This transfer was completed to assist with general interest rate risk management and provides some flexibility in enhancing yield on the investment portfolio without taking on additional economic risk that may negatively affect our overall equity position. As of the transfer date, the unrealized holding loss was approximately \$874,000. This unrealized loss will continue to be reported as a separate component of stockholders' equity and will be amortized over the remaining life of the securities as an adjustment to the yield. The corresponding discount on these securities will offset this adjustment to yield which results in no impact to the income statement.

The securities identified primarily consisted of securities with greater price risk in rising interest rate environments. As of June 30, 2014, our overall securities portfolio, including available-for-sale securities and held-to-maturity securities, had an estimated weighted average maturity of 3.9 years. Generally, our investment philosophy remains unchanged from our statements made in our most recent Annual Report on Form 10-K. However, we will now consider purchases of securities with longer durations for held-to-maturity designation, when appropriate.

We use a third-party pricing service as our primary source of market prices for our securities portfolio. On a quarterly basis, we validate the reasonableness of prices received from this source through independent verification of a representative sample of the portfolio, data integrity validation through comparison of current price to prior period prices, and an expectation-based analysis of movement in prices based upon the changes in the related yield curves and other market factors. On a periodic basis, we review the third-party pricing vendor's methodology for pricing relevant securities and the results of its internal control assessments. No securities within our portfolio were deemed to be other-than-temporarily impaired as of June 30, 2014. There were no sales of securities during the three and six months ended June 30, 2014 and 2013.

**Loans and Leases Receivable.** Loans and leases receivable, net of allowance for loan and lease losses, increased by \$26.7 million, or 2.8%, to \$993.7 million at June 30, 2014 from \$967.1 million at December 31, 2013 with the majority of the growth exhibited in our commercial and industrial portfolio, specifically in our asset-based lending specialty finance area. We continue to have a concentration in commercial real estate, as commercial real estate loans represent approximately 63% of our total loans as of June 30, 2014. Over the past five years there has been a generally declining trend in this concentration level as we continue to direct our efforts toward growing our commercial and industrial portfolio. The types of loans and leases we originate and the various risks associated with these originations remain consistent with information previously outlined in our most recent Annual Report on Form 10-K.

Our commercial and industrial portfolio increased \$32.3 million, or 11.0%, to \$325.9 million at June 30, 2014 from \$293.6 million at December 31, 2013. This increase was partially offset by a \$7.7 million, or 1.2%, decline in our commercial real estate portfolio to \$637.4 million at June 30, 2014 from \$645.1 million at December 31, 2013. We believe the overall increase in loan demand reflects increased confidence within our marketplace. While we continue to experience significant competition as banks operating in our primary geographic area attempt to deploy excess liquidity, we remain committed to our underwriting standards and will not deviate from those standards for the sole purpose of growing our loan and lease portfolio. We expect our new loan and lease activity to be more than adequate

to replace normal amortization and to continue to grow in future quarters.

The allowance for loan and lease losses as a percentage of gross loans and leases was 1.39% at June 30, 2014, a decline of three basis points from 1.42% as of December 31, 2013. Non-accrual loans and leases as a percentage of gross loans and leases decreased to 1.41% at June 30, 2014 compared to 1.61% at December 31, 2013.

Non-performing loans decreased \$1.7 million, or 10.6%, to \$14.2 million at June 30, 2014 compared to \$15.9 million at December 31, 2013. We have generally experienced improvement in our various asset quality ratios over the last several quarters. Primarily due to the further improvement in our asset quality ratios and modification of certain of our subjective factors in determining the general reserve

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portion of the allowance for loan and lease losses, the level of our allowance for loan and lease losses declined from December 31, 2013. Please refer to Asset Quality for additional information.

Deposits. As of June 30, 2014, deposits increased by \$36.8 million to \$1.167 billion from \$1.130 billion at December 31, 2013. The increase in deposits was primarily due to an increase in brokered certificates of deposit, which increased by \$43.8 million to \$437.3 million at June 30, 2014 from \$393.5 million at December 31, 2013, partially offset by a decline in the level of in-market deposits of \$6.9 million at June 30, 2014 from \$736.3 million at December 31, 2013. Deposit ending balances associated with in-market relationships will fluctuate based upon maturity of time deposits, client demands for the use of their cash, our ability to service and maintain client relationships and new client deposit relationships.

Our strategic efforts continue to be focused on adding in-market relationships and related transaction deposit accounts. We measure the success of in-market deposit gathering efforts based on the number of and the average balances of our deposit accounts as compared to ending balances due to the volatility of some of our larger relationships. Our Banks' in-market deposits are obtained primarily from the South Central, Northeastern and Southeastern regions of Wisconsin. Of our total year-to-date average deposits, approximately \$724.0 million, or 64.1%, were considered in-market deposits for the six months ended June 30, 2014. This compares to in-market deposits of \$707.9 million, or 65.6%, for the year-to-date average at June 30, 2013.

The Banks' liquidity policies limit the amount of brokered certificates of deposit to 75% of total deposits, with an operating goal of 50% or less of brokered certificates of deposit to total deposits. As of June 30, 2014, the ratio of brokered certificates of deposits to total deposits was 37.5%. We will continue to use brokered deposits in specific maturity periods needed to effectively mitigate interest rate risk measured through our asset/liability management process and support asset growth initiatives while taking into consideration our operating goals and desired level of usage of brokered certificates of deposit. Refer to Liquidity and Capital Resources for further information regarding our use and monitoring of brokered certificates of deposit.

FHLB Advances and Other Borrowings. As of June 30, 2014, FHLB advances and other borrowings decreased by \$4.0 million, or 33.5%, to \$7.9 million from \$11.9 million at December 31, 2013. The primary reason for the decrease in other borrowings was due to a \$4.0 million paydown of third party subordinated debt in the first quarter of 2014.

Asset Quality

Non-performing Assets. Our total impaired assets consisted of the following at June 30, 2014 and December 31, 2013, respectively:

|   | June 30,<br>2014       | December 31,<br>2013 |
|---|------------------------|----------------------|
|   | (Dollars in Thousands) |                      |
| Non-accrual loans and leases                |                        |                      |
| Commercial real estate:                     |                        |                      |
| Commercial real estate - owner occupied     | \$514                  | \$339                |
| Commercial real estate - non-owner occupied | 277                    | 283                  |
| Construction and land development           | 5,232                  | 5,422                |
| Multi-family                                | 24                     | 31                   |
| 1-4 family                                  | 376                    | 521                  |
| Total non-accrual commercial real estate    | 6,423                  | 6,596                |
| Commercial and industrial                   | 6,632                  | 8,011                |
| Direct financing leases, net                | —                      | —                    |
| Consumer and other:                         |                        |                      |
| Home equity and second mortgages            | 348                    | 453                  |
| Other                                       | 777                    | 795                  |
| Total non-accrual consumer and other loans  | 1,125                  | 1,248                |
| Total non-accrual loans and leases          | 14,180                 | 15,855               |
| Foreclosed properties, net                  | 329                    | 333                  |

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|  |          |          |   |
|--|----------|----------|---|
| Total non-performing assets  | 14,509   | 16,188   |   |
| Performing troubled debt restructurings  | 602      | 371      |   |
| Total impaired assets  | \$15,111 | \$16,559 |   |
| <br>   |          |          |   |
| Total non-accrual loans and leases to gross loans and leases                       | 1.41     | % 1.61   | % |
| Total non-performing assets to total loans and leases plus other real estate owned | 1.44     | 1.65     |   |
| Total non-performing assets to total assets  | 1.11     | 1.28     |   |
| Allowance for loan and lease losses to gross loans and leases                      | 1.39     | 1.42     |   |
| Allowance for loan and lease losses to non-accrual loans and leases                | 98.84    | 87.68    |   |

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As of June 30, 2014 and December 31, 2013, \$7.7 million and \$8.1 million of the non-accrual loans were considered troubled debt restructurings, respectively.

A summary of our non-accrual loan and lease activity from December 31, 2013 through June 30, 2014 is as follows: (In Thousands)

|  |          |   |
|--|----------|---|
| Non-accrual loans and leases as of the beginning of the period         | \$15,855 |   |
| Loans and leases transferred to non-accrual status                     | 534      |   |
| Non-accrual loans and leases returned to accrual status                | (228     | ) |
| Non-accrual loans and leases transferred to foreclosed properties      | —        |   |
| Non-accrual loans and leases partially or fully charged-off            | —        |   |
| Cash received and applied to principal of non-accrual loans and leases | (1,981   | ) |
| Non-accrual loans and leases as of the end of the period               | \$14,180 |   |

We use a wide variety of available metrics to assess the overall asset quality of the portfolio and no one metric is used independently to make a final conclusion as to the asset quality of the portfolio. As of June 30, 2014, non-performing assets as a percentage of total assets declined to 1.11% from 1.28% at December 31, 2013. This is primarily due to cash collections on previously identified impaired loans and credits returning to performing status, partially offset by the identification of a new impaired loan. Total non-performing assets to total loans and leases and foreclosed properties as of June 30, 2014 and December 31, 2013 were 1.44% and 1.65%, respectively. We believe the decline in this ratio provides insight as to our success in working problem assets through the entire process and mitigating further losses.

We also monitor early stage delinquencies to assist in the identification of potential future problems. As of June 30, 2014, the payment performance did not point to any new areas of concern, as approximately 99% of the loan and lease portfolio was in a current payment status. This metric can change rapidly however, if factors unknown to us change. We also monitor our asset quality through our established categories as defined in Note 6 - Loan and Lease Receivables, Impaired Loans and Leases and Allowance for Loan and Lease Losses of our unaudited Consolidated Financial Statements. We are seeing positive trends with improving percentages of loans and leases in our higher quality loan categories which is indicative of overall credit quality improvement. While asset quality has improved, we will continue to actively monitor the credit quality of our loan and lease portfolios. Through this monitoring effort, we may identify additional loans and leases for which the borrowers or lessees are having difficulties making the required principal and interest payments based upon factors including, but not limited to, the inability to sell the underlying collateral, inadequate cash flow from the operations of the underlying businesses, liquidation events, or bankruptcy filings. We are proactively working with our impaired loan borrowers to find meaningful solutions to difficult situations that are in the best interests of the Banks. Given our current level of non-accrual loans, any improvement in reducing this balance further will likely be at a slower pace than what has been accomplished over the last several years. We expect to demonstrate an overall declining trend of non-accrual loan balances; however, we may experience some volatility in this trend from time to time.

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The following represents additional information regarding our impaired loans and leases:

|  | As of and for the Six Months Ended |          | As of and for the |
|--|------------------------------------|----------|-------------------|
|  | June 30,                           |          | Year Ended        |
|  | 2014                               | 2013     | December 31,      |
|  | (In Thousands)                     |          | 2013              |
| Impaired loans and leases with no impairment reserves required       | \$7,290                            | \$10,115 | \$8,200           |
| Impaired loans and leases with impairment reserves required          | 7,492                              | 2,202    | 8,026             |
| Total impaired loans and leases                                      | 14,782                             | 12,317   | 16,226            |
| Less:  |                                    |          |                   |
| Impairment reserve (included in allowance for loan and lease losses) | 606                                | 843      | 402               |
| Net impaired loans and leases  | \$14,176                           | \$11,474 | \$15,824          |
| Average impaired loans and leases                                    | \$15,285                           | \$13,427 | \$12,084          |
| Foregone interest income attributable to impaired loans and leases   | \$443                              | \$509    | \$887             |
| Less: Interest income recognized on impaired loans and leases        | 310                                | 204      | 221               |
| Net foregone interest income on impaired loans and leases            | \$133                              | \$305    | \$666             |

Nonperforming assets also include foreclosed properties. A summary of our current period foreclosed properties activity is as follows:

(In Thousands)

|  |       |
|--|-------|
| Foreclosed properties as of December 31, 2013              | \$333 |
| Loans transferred to foreclosed properties                 | —     |
| Payments to priority lien holders of foreclosed properties | —     |
| Proceeds from sale of foreclosed properties                | —     |
| Net gain on sale of foreclosed properties                  | —     |
| Impairment valuation                                       | (4 )  |
| Foreclosed properties as of March 31, 2014                 | \$329 |

Allowance for loan and lease losses. The allowance for loan and lease losses as a percentage of gross loans and leases was 1.39% as of June 30, 2014 and 1.42% as of December 31, 2013. Consistent with the continued improved asset quality trends, management has determined a lower level of required reserves for probable loans and lease losses was warranted. During the six months ended June 30, 2014, we recorded net recoveries on impaired loans and leases of approximately \$25,000, comprised of no charge-offs and \$25,000 of recoveries. During the six months ended June 30, 2013, we recorded net charge-offs on impaired loans and leases of approximately \$332,000, comprised of \$658,000 of charge-offs and \$326,000 of recoveries.

Based upon our observations in our primary market areas, generally commercial real estate values have stabilized, which significantly reduced our level of required charge-offs, as collateral dependent loans are reflected at their net realizable values. Nevertheless, we may continue to experience some level of periodic charge-offs in the future as exit strategies are considered and executed. Loans and leases with previously established specific reserves may ultimately result in a charge-off under a variety of scenarios. There have been no substantive changes to our methodology for estimating the appropriate level of allowance for loan and lease loss reserves from what was previously outlined in our



most recent Annual Report on Form 10-K. Based upon this methodology, which includes actively monitoring the asset quality and inherent risks within the loan and lease portfolio, management concluded that an allowance for loan and lease losses of \$14.0 million, or 1.39% of total loans and leases, was appropriate as of June 30, 2014. Given ongoing complexities with current workout situations and the measured

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pace of improvement in economic conditions, further charge-offs and increased provisions for loan and leases losses may be recorded if additional facts and circumstances lead us to a different conclusion. In addition, various federal and state regulatory agencies review appropriateness of the allowance for loan and lease losses. These agencies could require certain loan and lease balances to be classified differently or charged off if their credit evaluations differ from those of management, based on their judgments about information available to them at the time of their examination. As of June 30, 2014 and December 31, 2013, our allowance for loan and lease losses to total non-accrual loans and leases was 98.84% and 87.68%, respectively. Impaired loans and leases exhibit weaknesses that inhibit repayment in compliance with the original terms of the note or lease. However, the measurement of impairment on loans and leases may not always result in a specific reserve included in the allowance for loan and lease losses. Specific reserves are established on impaired loans when evidence of a collateral shortfall exists and we believe that there continues to be potential for us to recover our outstanding principal. When we are reasonably certain that we will not recover our principal on a loan or lease, we record a charge-off for the amount to recognize the loan or lease at its net realizable value. As part of the underwriting process, as well as our ongoing credit management efforts, we try to ensure that we have appropriate collateral to protect our interest in the related loan or lease. As a result of this practice, a significant portion of our outstanding balance of non-performing loans or leases either does not require additional specific reserves or requires only a minimal amount of required specific reserve, as we believe the loans and leases are adequately collateralized as of the measurement period. In addition, management is proactive in recording charge-offs to bring loans to their net realizable value in situations where it is determined with certainty that we will not recover the entire amount of our principal. This practice may lead to a lower allowance for loan and lease loss to non-accrual loans and leases ratio as compared to our peers or industry expectations. As asset quality continues to improve, our allowance for loan and lease loss is measured more through general characteristics, including historical loss experience, of our portfolio rather than through specific identification and we therefore expect to see this ratio continue to rise. Conversely, if we identify further impaired loans, this ratio could fall if the impaired loans are adequately collateralized and therefore require no specific or general reserve. Given our business practices and evaluation of our existing loan and lease portfolio, we believe this coverage ratio was appropriate for the probable losses inherent in our loan and lease portfolio as of June 30, 2014.

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A tabular summary of the activity in the allowance for loan and lease losses follows:

|   | As of and for the Three Months<br>Ended June 30, |           | As of and for the Six Months<br>Ended June 30, |           |
|---|--|-----------|--|-----------|
|   | 2014   | 2013      | 2014   | 2013      |
|   | (Dollars in Thousands)                           |           |  |           |
| Allowance at beginning of period  | \$14,101   | \$15,507  | \$13,901                                       | \$15,400  |
| Charge-offs:  |  |           |  |           |
| Commercial real estate  |  |           |  |           |
| Commercial real estate — owner occupied   | —  | —         | —  | —         |
| Commercial real estate — non-owner occupied   | —  | (599 )    | —  | (599 )    |
| Construction and land development   | —  | (8 )      | —  | (8 )      |
| Multi-family  | —  | —         | —  | —         |
| 1-4 family  | —  | (26 )     | —  | (34 )     |
| Commercial and industrial   | —  | (14 )     | —  | (14 )     |
| Direct financing leases   | —  | —         | —  | —         |
| Consumer and other  | —  | —         | —  | —         |
| Home equity and second mortgages  | —  | —         | —  | —         |
| Other   | —  | —         | —  | (4 )      |
| Total charge-offs   | —  | (647 )    | —  | (659 )    |
| Recoveries:   |  |           |  |           |
| Commercial real estate  |  |           |  |           |
| Commercial real estate — owner occupied   | —  | —         | 8  | —         |
| Commercial real estate — non-owner occupied   | —  | 31        | 4  | 60        |
| Construction and land development   | —  | 253       | —  | 254       |
| Multi-family  | —  | —         | —  | —         |
| 1-4 family  | 2  | 2         | 5  | 5         |
| Commercial and industrial   | 1  | —         | 1  | 1         |
| Direct financing leases   | —  | —         | —  | 5         |
| Consumer and other  | —  | —         | —  | —         |
| Home equity and second mortgages  | 2  | 1         | 7  | 2         |
| Other   | —  | —         | —  | —         |
| Total recoveries  | 5  | 287       | 25   | 327       |
| Net recoveries (charge-offs)  | 5  | (359 )    | 25   | (332 )    |
| Provision for loan and lease losses   | (91 )  | 54        | 89   | 134       |
| Allowance at end of period  | \$14,015   | \$15,202  | \$14,015                                       | \$15,202  |
| Annualized net recoveries (charge-offs) as a % of<br>average gross loans and leases | —  | % (0.15 ) | % 0.01   | % (0.07 ) |

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## Liquidity and Capital Resources

The Corporation expects to meet its liquidity needs through existing cash on hand, established cash flow sources, its third party senior line of credit, and dividends received from the Banks. While the Banks are subject to certain regulatory limitations regarding their ability to pay dividends to the Corporation, we do not believe that the Corporation will be adversely affected by these dividend limitations. The Corporation's principal liquidity requirements at June 30, 2014 were the interest payments due on subordinated and junior subordinated notes. In April 2014, FBB declared a dividend in the amount of \$2.0 million bringing year-to-date dividend declarations to \$4.0 million through June 30, 2014. During the year ended December 31, 2013, FBB declared and paid dividends totaling \$8.0 million. The capital ratios of the Corporation and its subsidiaries continue to meet all applicable regulatory capital adequacy requirements. The Corporation's and the Banks' respective Boards of Directors and management teams adhere to the appropriate regulatory guidelines on decisions which affect their capital positions, including but not limited to, decisions relating to the payment of dividends and increasing indebtedness.

The Banks maintain liquidity by obtaining funds from several sources. The Banks' primary sources of funds are principal and interest repayments on loans receivable and mortgage-related securities, deposits and other borrowings, such as federal funds and FHLB advances. The scheduled payments of loans and mortgage-related securities are generally a predictable source of funds. Deposit flows and loan prepayments, however, are greatly influenced by general interest rates, economic conditions and competition.

We view on-balance-sheet liquidity as a critical element to maintaining adequate liquidity to meet our cash and collateral obligations. We define our on-balance-sheet liquidity as the total of our short-term investments, our unencumbered securities available-for-sale at fair value and our unencumbered pledged loans. As of June 30, 2014 and December 31, 2013, our immediate on-balance-sheet liquidity was \$293.7 million and \$272.6 million, respectively. At June 30, 2014 and December 31, 2013, the Banks had \$36.9 million and \$53.0 million on deposit with the FRB, respectively. Any excess funds not used for loan funding or satisfying other cash obligations were maintained as part of our on-balance-sheet liquidity in our interest-bearing accounts with the FRB, as we value the safety and soundness provided by the FRB. We plan to utilize excess liquidity to fund loan and lease portfolio growth, pay down maturing debt, allow run-off of maturing brokered certificates of deposit, or invest in securities to maintain adequate liquidity at an improved margin.

We had \$437.3 million of outstanding brokered deposits at June 30, 2014, compared to \$393.5 million of brokered deposits as of December 31, 2013, which represented 37.5% and 34.8%, respectively, of the ending balance of total deposits. We are committed to our continued efforts to raise in-market deposits. However, when appropriate, we will use brokered certificates of deposits to fund fixed rate loans while maintaining an acceptable level of brokered deposits to total deposits. Brokered certificates of deposit are an efficient source of funding for the Banks and allow them to gather funds across a larger geographic base at price levels and maturities that are more attractive than single service deposits when required to raise a similar level of in-market deposits within a short time period. Access to such deposits allows us the flexibility to refrain from pursuing single service deposit relationships in markets that have experienced unfavorable pricing levels. In addition, the administrative costs associated with brokered certificates of deposit are considerably lower than those that would be incurred to administer a similar level of local deposits with a similar maturity structure. During the time frames necessary to accumulate brokered deposits in an orderly manner, we will use FHLB short-term advances to meet our temporary funding needs. The FHLB short-term advances will typically have terms of one week to one month to cover the overall expected funding demands.

Our in-market relationships remain stable; however, deposit balances associated with those relationships will fluctuate. We expect to establish new client relationships and continue marketing efforts aimed at increasing the balances in existing clients' deposit accounts. Nonetheless, we will continue to use brokered deposits in specific maturity periods, typically three to five years, needed to effectively mitigate the interest rate risk measured through our asset/liability management process or in shorter time periods if in-market deposit balances decline. In order to provide for ongoing liquidity and funding, all of our brokered deposits are certificates of deposit which do not allow for withdrawal at the option of the depositor before the stated maturity. The Banks' liquidity policies limit the amount of brokered deposits to 75% of total deposits, with an operating goal of 50% or less of brokered deposits to total deposits. The Banks were in compliance with the policy limits and the operating goal as of June 30, 2014 and

December 31, 2013.

The Banks were able to access the brokered certificate of deposit market as needed at rates and terms comparable to market standards during the six-month period ended June 30, 2014. In the event there is a disruption in the availability of brokered deposits at maturity, the Banks have managed the maturity structure, in compliance with our approved liquidity policy, so at least one year of maturities could be funded through on-balance-sheet liquidity. These potential funding sources include deposits with the FRB and borrowings from the FHLB or Federal Reserve Discount Window utilizing currently unencumbered securities and acceptable loans as collateral. As of June 30, 2014, the available liquidity was in excess of the stated minimum and was equal to approximately 35 months of maturities. As on-balance-sheet liquidity is utilized to fund growth, asset quality continues to improve and the ratio of in-market deposits to total deposits remains within an acceptable

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range, management may consider reducing the number of months of maturity coverage slightly while remaining confident in its ability to manage the maturities of brokered certificates of deposits in the event of a disruption in the brokered market. We believe the Banks will also have access to the unused federal funds lines, cash flows from borrower repayments, and cash flows from security maturities. The Banks also have the ability to raise local market deposits by offering attractive rates to generate the level required to fulfill their liquidity needs.

The Banks are required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. We believe the Banks have sufficient liquidity to match the balance of net withdrawable deposits and short-term borrowings in light of present economic conditions and deposit flows.

We expect to complete a subordinated debt offering prior to the closing of the merger with Aslin Group to fund the cash portion of the merger consideration to be paid to Aslin Group stockholders in the transaction.

### Contractual Obligations and Off-Balance-Sheet Arrangements

As of June 30, 2014, there were no significant changes to our contractual obligations and off-balance-sheet arrangements disclosed in our Annual Report on Form 10-K for the year ended December 31, 2013. We continue to believe that we have adequate capital and liquidity available from various sources to fund projected contractual obligations and commitments.

### Item 3. Quantitative and Qualitative Disclosures about Market Risk

Interest rate risk, or market risk, arises from exposure of our financial position to changes in interest rates. It is our strategy to reduce the impact of interest rate risk on net interest margin and net interest income by maintaining a favorable match between the maturities and repricing dates of interest-earning assets and interest-bearing liabilities. This strategy is monitored by the Banks' respective Asset/Liability Management Committees, in accordance with policies approved by the Banks' respective Boards of Directors. These committees meet regularly to review the sensitivity of each Bank's assets and liabilities to changes in interest rates, liquidity needs and sources, and pricing and funding strategies.

We use two techniques to measure interest rate risk. The first is simulation of earnings. In this measurement technique the balance sheet is modeled as an ongoing entity whereby future growth, pricing, and funding assumptions are implemented. These assumptions are modeled under different rate scenarios that include a simultaneous, instant and sustained change in interest rates. The second measurement technique used is static gap analysis. Gap analysis involves measurement of the difference in asset and liability repricing on a cumulative basis within a specified time frame. In general, a positive gap indicates that more interest-earning assets than interest-bearing liabilities reprice/mature in a time frame and a negative gap indicates the opposite. In addition to the gap position, other determinants of net interest income are the shape of the yield curve, general rate levels and the corresponding effect of contractual interest rate floors, reinvestment spreads, balance sheet growth and mix and interest rate spreads. We manage the structure of interest-earning assets and interest-bearing liabilities by adjusting their mix, yield, maturity and/or repricing characteristics based on market conditions. Currently, we do not employ any derivatives to assist in managing our interest rate risk exposure; however, management has the authorization, as permitted within applicable approved policies, and ability to utilize such instruments should they be appropriate to manage interest rate exposure. The process of asset and liability management requires management to make a number of assumptions as to when an asset or liability will reprice or mature. Management believes that its assumptions approximate actual experience and considers them reasonable, although the actual amortization and repayment of assets and liabilities may vary substantially. Our economic sensitivity to changes in interest rates at June 30, 2014 has not changed materially since December 31, 2013.



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Item 4. Controls and Procedures

Disclosure Controls and Procedures

The Corporation's management, with the participation of the Corporation's Chief Executive Officer and Chief Financial Officer, has evaluated the Corporation's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based upon that evaluation, the Corporation's Chief Executive Officer and Chief Financial Officer have concluded that the Corporation's disclosure controls and procedures were effective as of June 30, 2014.

Changes in Internal Control over Financial Reporting

There was no change in the Corporation's internal controls over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) that occurred during the quarter ended June 30, 2014 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

PART II. Other Information

Item 1. Legal Proceedings

From time to time, the Corporation and its subsidiaries are engaged in legal proceedings in the ordinary course of their respective businesses. Management believes that any liability arising from any such proceedings currently existing or threatened will not have a material adverse effect on the Corporation's financial position, results of operations, or cash flows.

Item 1A. Risk Factors

In addition to the risk factors previously disclosed in Item 1A. to Part I of the Corporation's Form 10-K for the year ended December 31, 2013, the following additional risk factors have been identified in connection with the merger of Aslin Group that may impact the financial condition or results of operations of the Corporation.

We may fail to realize all of the anticipated benefits of the merger.

The success of the merger will depend, in part, on our ability to successfully combine Aslin Group's organization into our own. If we are not able to achieve this objective, the anticipated benefits of the merger may not be realized fully or at all or may take longer than expected to be realized.

We and Aslin Group have operated and, until the completion of the merger, will continue to operate, independently. It is possible that the integration process or other factors could result in the loss or departure of key employees, the disruption of the ongoing business of Aslin Group or inconsistencies in standards, controls, procedures and policies. It is also possible that clients, customers, depositors and counterparties of Aslin Group could choose to discontinue their relationships with the combined company post-merger because they prefer doing business with Aslin Group or for any other reason, which would adversely affect the future performance of the combined company. These transition matters could have an adverse effect on us and/or Aslin Group during the pre-merger period and for an undetermined period of time after the completion of the merger.

Our results of operations after the merger may be affected by factors different from those currently affecting our results of operations.

Our business and that of Aslin Group differ in certain respects and, accordingly, the results of operations of the combined company and the market price of the combined company's common stock may be affected by factors different from those currently affecting our independent results of operations.

Further, the merger is subject to the receipt of consents and approvals from governmental entities that may impose conditions that could have an adverse effect on the combined company following the merger. Before the merger may be completed, approvals must be obtained from the Board of Governors of the Federal Reserve System and the Office of the State Bank Commissioner of Kansas. These governmental entities may impose conditions on the granting of



such approvals and consents. Although we do not currently expect that any such material conditions or changes would be imposed, there can be no assurance that they will not be, and such conditions or changes could have the effect of delaying completion of the merger or imposing additional costs or limiting the revenues of the combined company following the merger, any of which might have an adverse effect on the combined company following the merger. In addition, we and Aslin Group have each agreed to take

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certain actions prior to the closing of the merger. Such actions may entail costs and may adversely affect us, Aslin Group, or the combined company following the merger.

The merger is subject to certain closing conditions that, if not satisfied or waived, will result in the merger not being completed, which could materially and adversely affect our business, financial condition and results of operations. The merger is subject to customary conditions to closing, including the receipt of required regulatory approvals and approval of the Aslin Group stockholders. If any condition to the merger is not satisfied or waived, to the extent permitted by law, the merger will not be completed. In addition, we and Aslin Group may terminate the Merger Agreement under certain circumstances even if the Merger Agreement is approved by Aslin Group stockholders. If we and Aslin Group do not complete the merger, the trading price of our common stock may decline to the extent that the current price reflects a market assumption that the merger will be completed. In addition, neither company would realize any of the expected benefits of having completed the merger. If the merger is not completed, additional risks could materialize, which could materially and adversely affect our business, financial condition and results of operations.

The combined company expects to incur substantial expenses related to the merger.

The combined company expects to incur substantial expenses in connection with completing the merger. Although we have assumed that a certain level of transaction and combination expenses would be incurred, there are a number of factors beyond our control that could affect the total amount or the timing of our combination expenses. Many of the expenses that will be incurred, by their nature, are difficult to estimate accurately at the present time. Due to these factors, the transaction and integration expenses associated with the merger could, particularly in the near term, exceed the savings that the combined company expects to achieve from the elimination of duplicative expenses and the realization of economies of scale and cost savings related to the combination of the businesses following the completion of the merger. As a result of these expenses, both we and Aslin Group expect to take charges against our respective earnings before and after the completion of the merger. The charges taken in connection with the merger are expected to be significant, although the aggregate amount and timing of such charges are uncertain at the present time.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) None.

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(b) Not applicable.

(c) Issuer Purchases of Equity Securities

| Period                         | Total Number of Shares Purchased <sup>(1)</sup> | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs |
|--------------------------------|---|------------------------------|--|--|
| April 1, 2014 - April 30, 2014 | —   | \$—                          | —  | \$—  |
| May 1, 2014 - May 31, 2014     | 398   | \$41.30                      | —  | \$—  |
| June 1, 2014 - June 30, 2014   | 1,177   | \$48.60                      | —  | \$—  |
| Total                          | 1,575   | \$46.76                      | —  | \$—  |

The shares in this column represent (i) the 587 shares that were surrendered to us to satisfy income tax withholding (1) obligations in connection with the vesting of restricted shares; and (ii) 988 shares used to exercise stock options as part of a cashless exercise.

Item 3. Defaults Upon Senior Securities

Not applicable.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

2.1 Agreement and Plan of Merger Between Aslin Group, Inc., AGI Acquisition Corp., and First Business Financial Services, Inc. (incorporated by reference to Exhibit 2.1 to the Current Report on Form 8-K filed on May 23, 2014)

2.2 Voting Agreement by and among First Business Financial Services, Inc., and the persons and entities listed on Schedule I therein (incorporated by reference to Exhibit 2.2 to the Current Report on Form 8-K filed on May 23, 2014)

31.1 Certification of the Chief Executive Officer

31.2 Certification of the Chief Financial Officer

32 Certification of the Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350

101 The following financial information from First Business Financial Services, Inc.'s Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) Consolidated Balance Sheets as of June 30, 2014 and December 31, 2013, (ii) Consolidated Statements of Income for the three and six months ended June 30, 2014 and 2013, (iii) Consolidated Statements of Comprehensive Income for the three and six months ended June 30, 2014 and 2013, (iv) Consolidated

Statements of Changes in Stockholders' Equity for the six months ended June 30, 2014 and 2013, (v)  
Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013, and (vi) the Notes  
to Unaudited Consolidated Financial Statements+

+ Submitted electronically with this Quarterly Report.

Signatures

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST BUSINESS FINANCIAL SERVICES, INC.

August 1, 2014

/s/ Corey A. Chambas  
Corey A. Chambas  
Chief Executive Officer

August 1, 2014

/s/ James F. Ropella  
James F. Ropella  
Chief Financial Officer

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FIRST BUSINESS FINANCIAL SERVICES, INC.

Exhibit Index to Quarterly Report on Form 10-Q

Exhibit Number

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