

First Business Financial Services, Inc.

Form 10-Q

October 29, 2010

**Table of Contents**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
FORM 10-Q**

**Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended September 30, 2010**  
**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 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  
Telephone number

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 and 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 Field 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, or a non-accelerated filer. 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 October 22, 2010 was 2,535,095 shares.

**Table of Contents**

[This page intentionally left blank]

**FIRST BUSINESS FINANCIAL SERVICES, INC.  
INDEX FORM 10-Q**

|  |    |
|--|----|
| <u>PART I. Financial Information</u>   | 1  |
| <u>Item 1. Financial Statements</u>  | 1  |
| <u>Consolidated Balance Sheets</u>   | 1  |
| <u>Consolidated Statements of Income (Unaudited)</u>   | 2  |
| <u>Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income (Unaudited)</u> | 3  |
| <u>Consolidated Statements of Cash Flows (Unaudited)</u>   | 4  |
| <u>Notes to Unaudited Consolidated Financial Statements</u>  | 5  |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>   | 25 |
| <u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>                              | 42 |
| <u>Item 4T. Controls and Procedures</u>  | 43 |
| <u>PART II. Other Information</u>  | 43 |
| <u>Item 1. Legal Proceedings</u>   | 43 |
| <u>Item 1A. Risk Factors</u>   | 43 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>                             | 44 |
| <u>Item 3. Defaults Upon Senior Securities</u>   | 44 |
| <u>Item 4. Reserved</u>  | 44 |
| <u>Item 5. Other Information</u>   | 44 |
| <u>Item 6. Exhibits</u>  | 44 |
| <u>Signatures</u>  | 45 |
| <u>Exhibit 31.1</u>  |    |
| <u>Exhibit 31.2</u>  |    |
| <u>Exhibit 32</u>  |    |

**Table of Contents****PART I. Financial Information****Item 1. Financial Statements****First Business Financial Services, Inc.****Consolidated Balance Sheets**

|  | (Unaudited)<br>September<br>30,<br>2010 | December 31,<br>2009 |
|--|---|----------------------|
|  | (In Thousands, Except Share Data)       |                      |
| <b>Assets</b>  |   |                      |
| Cash and due from banks  | \$ 11,097                               | \$ 8,566             |
| Short-term investments   | 53,407                                  | 104,171              |
| Cash and cash equivalents  | 64,504                                  | 112,737              |
| Securities available-for-sale, at fair value   | 152,803                                 | 122,286              |
| Loans and leases receivable, net of allowance for loan and lease losses of \$15,684 and \$14,124, respectively   | 863,391                                 | 839,807              |
| Leasehold improvements and equipment, net  | 1,010                                   | 1,189                |
| Foreclosed properties  | 1,247                                   | 1,671                |
| Cash surrender value of bank-owned life insurance  | 16,760                                  | 16,254               |
| Investment in Federal Home Loan Bank stock, at cost  | 2,367                                   | 2,367                |
| Goodwill and other intangibles   | 36                                      | 2,740                |
| Accrued interest receivable and other assets   | 20,696                                  | 18,385               |
| Total assets   | \$ 1,122,814                            | \$ 1,117,436         |
| <b>Liabilities and Stockholders Equity</b>   |   |                      |
| Deposits   | \$ 998,130                              | \$ 984,374           |
| Federal Home Loan Bank and other borrowings  | 41,507                                  | 57,515               |
| Junior subordinated notes  | 10,315                                  | 10,315               |
| Accrued interest payable and other liabilities   | 17,351                                  | 10,839               |
| Total liabilities  | 1,067,303                               | 1,063,043            |
| 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, 2,617,635 and 2,616,010 shares issued, 2,535,428 and 2,539,306 shares outstanding at 2010 and 2009, respectively | 26                                      | 26                   |
| Additional paid-in capital   | 25,117                                  | 24,731               |
| Retained earnings  | 29,391                                  | 29,582               |
| Accumulated other comprehensive income   | 2,519                                   | 1,544                |

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

|   |              |              |
|---|--------------|--------------|
| Treasury stock (82,207 and 76,704 shares at 2010 and 2009, respectively), at cost | (1,542)      | (1,490)      |
| Total stockholders' equity  | 55,511       | 54,393       |
| Total liabilities and stockholders' equity  | \$ 1,122,814 | \$ 1,117,436 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

**Table of Contents****First Business Financial Services, Inc.  
Consolidated Statements of Income (Unaudited)**

|  | For the Three Months<br>Ended,<br>September 30, |           | For the Nine Months Ended,<br>September 30, |           |
|--|---|-----------|---|-----------|
|  | 2010  | 2009      | 2010  | 2009      |
|  | (In Thousands, Except Share Data)               |           |   |           |
| Interest income:   |   |           |   |           |
| Loans and leases   | \$ 13,031                                       | \$ 13,025 | \$ 38,964                                   | \$ 38,388 |
| Securities   | 1,120   | 1,191     | 3,420                                       | 3,636     |
| Short-term investments   | 25  | 19        | 98  | 48        |
| Total interest income  | 14,176  | 14,235    | 42,482                                      | 42,072    |
| Interest expense:  |   |           |   |           |
| Deposits   | 5,011   | 5,874     | 15,735                                      | 18,514    |
| Notes payable and other borrowings                               | 725   | 748       | 2,217                                       | 2,060     |
| Junior subordinated notes  | 280   | 280       | 832   | 832       |
| Total interest expense   | 6,016   | 6,902     | 18,784                                      | 21,406    |
| Net interest income  | 8,160   | 7,333     | 23,698                                      | 20,666    |
| Provision for loan and lease losses                              | 1,954   | 1,378     | 4,367                                       | 5,222     |
| Net interest income after provision for loan and<br>lease losses | 6,206   | 5,955     | 19,331                                      | 15,444    |
| Non-interest income:   |   |           |   |           |
| Trust and investment services income                             | 572   | 489       | 1,738                                       | 1,394     |
| Service charges on deposits                                      | 423   | 402       | 1,236                                       | 1,114     |
| Increase in cash surrender value of bank-owned<br>life insurance | 166   | 167       | 498   | 538       |
| Loan fees  | 252   | 316       | 737   | 780       |
| Credit, merchant and debit card fees                             | 56  | 49        | 163   | 147       |
| Gain on sale of available-for-sale securities                    |   | 322       |   | 322       |
| Other  | 202   | 136       | 614   | 587       |
| Total non-interest income  | 1,671   | 1,881     | 4,986                                       | 4,882     |
| Non-interest expense:  |   |           |   |           |
| Compensation   | 3,434   | 2,992     | 10,331                                      | 9,250     |
| Occupancy  | 360   | 373       | 1,108                                       | 1,113     |
| Equipment  | 115   | 138       | 375   | 438       |
| Data processing  | 294   | 275       | 889   | 841       |

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

|   |         |          |         |          |
|---|---------|----------|---------|----------|
| Marketing                                 | 180     | 135      | 557     | 467      |
| Professional fees                         | 335     | 404      | 1,175   | 1,340    |
| FDIC Insurance                            | 791     | 397      | 2,329   | 1,657    |
| Collateral liquidation costs              | 287     | 120      | 845     | 975      |
| Goodwill impairment                       |         |          | 2,689   |          |
| (Gain) loss on foreclosed properties, net | (6)     | 193      | 12      | 181      |
| Other                                     | 589     | 493      | 1,836   | 1,656    |
| Total non-interest expense                | 6,379   | 5,520    | 22,146  | 17,918   |
| Income before income tax expense          | 1,498   | 2,316    | 2,171   | 2,408    |
| Income tax expense                        | 529     | 963      | 1,828   | 989      |
| Net income                                | \$ 969  | \$ 1,353 | \$ 343  | \$ 1,419 |
| Earnings per common share:                |         |          |         |          |
| Basic                                     | \$ 0.38 | \$ 0.53  | \$ 0.14 | \$ 0.56  |
| Diluted                                   | 0.38    | 0.53     | 0.14    | 0.56     |
| Dividends declared per share              | 0.07    | 0.07     | 0.21    | 0.21     |

See accompanying Notes to Unaudited Consolidated Financial Statements.



**Table of Contents****First Business Financial Services, Inc.****Consolidated Statements of Changes in Stockholders Equity and Comprehensive Income (Unaudited)**

|  | Common<br>stock                   | Additional<br>paid-in<br>capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income | Treasury<br>stock | Total     |
|--|-----------------------------------|----------------------------------|----------------------|---|-------------------|-----------|
|  | (In Thousands, Except Share Data) |                                  |                      |   |                   |           |
| Balance at December 31,<br>2008                                      | \$ 26                             | \$ 24,088                        | \$ 29,252            | \$ 1,065  | \$ (1,425)        | \$ 53,006 |
| Comprehensive income:  |                                   |                                  |                      |   |                   |           |
| Net income   |                                   |                                  | 1,419                |   |                   | 1,419     |
| Unrealized securities gains<br>arising during the period             |                                   |                                  |                      | 1,551   |                   | 1,551     |
| Unrealized derivative losses<br>arising during the period            |                                   |                                  |                      | (1)   |                   | (1)       |
| Reclassification adjustment<br>for realized gains on securities      |                                   |                                  |                      | (322)   |                   | (322)     |
| Reclassification adjustment<br>for realized losses on<br>derivatives |                                   |                                  |                      | 3   |                   | 3         |
| Income tax effect  |                                   |                                  |                      | (483)   |                   | (483)     |
| Comprehensive income   |                                   |                                  |                      |   |                   | 2,167     |
| Share-based compensation<br>restricted shares                        |                                   | 481                              |                      |   |                   | 481       |
| Cash dividends (\$0.21 per<br>share)                                 |                                   |                                  | (534)                |   |                   | (534)     |
| Treasury stock purchased<br>(5,826 shares)                           |                                   |                                  |                      |   | (65)              | (65)      |
| Balance at September 30,<br>2009                                     | \$ 26                             | \$ 24,569                        | \$ 30,137            | \$ 1,813  | \$ (1,490)        | \$ 55,055 |

|  | Common<br>stock                   | Additional<br>paid-in<br>capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income | Treasury<br>stock | Total     |
|--|-----------------------------------|----------------------------------|----------------------|---|-------------------|-----------|
|  | (In Thousands, Except Share Data) |                                  |                      |   |                   |           |
| Balance at December 31,<br>2009                          | \$ 26                             | \$ 24,731                        | \$ 29,582            | \$ 1,544  | \$ (1,490)        | \$ 54,393 |
| Comprehensive income:                                    |                                   |                                  |                      |   |                   |           |
| Net income   |                                   |                                  | 343                  |   |                   | 343       |
| Unrealized securities gains<br>arising during the period |                                   |                                  |                      | 1,624   |                   | 1,624     |
| Income tax effect  |                                   |                                  |                      | (649)   |                   | (649)     |
| Comprehensive income                                     |                                   |                                  |                      |   |                   | 1,318     |

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

|   |    |    |     |        |    |        |    |       |    |         |    |        |
|---|----|----|-----|--------|----|--------|----|-------|----|---------|----|--------|
| Share-based compensation<br>restricted shares |    |    | 386 |        |    |        |    | 386   |    |         |    |        |
| Cash dividends (\$0.21 per<br>share)          |    |    |     | (534)  |    |        |    | (534) |    |         |    |        |
| Treasury stock purchased<br>(5,503 shares)    |    |    |     |        |    | (52)   |    | (52)  |    |         |    |        |
| Balance at September 30,<br>2010              | \$ | 26 | \$  | 25,117 | \$ | 29,391 | \$ | 2,519 | \$ | (1,542) | \$ | 55,511 |

See accompanying Notes to Unaudited Consolidated Financial Statements.

**Table of Contents****First Business Financial Services, Inc.  
Consolidated Statements of Cash Flows (Unaudited)**

|   | For the Nine Months Ended<br>September 30, |          |
|---|--|----------|
|   | 2010                                       | 2009     |
|   | (In Thousands)                             |          |
| <b>Operating activities</b>   |  |          |
| Net income  | \$ 343                                     | \$ 1,419 |
| Adjustments to reconcile net income to net cash provided by operating activities: |  |          |
| Deferred income taxes, net  | (2,125)                                    | (586)    |
| Provision for loan and lease losses   | 4,367                                      | 5,222    |
| Depreciation, amortization and accretion, net                                     | 1,102                                      | 565      |
| Share-based compensation  | 386  | 481      |
| Increase in cash surrender value of bank-owned life insurance                     | (498)                                      | (538)    |
| Gain on sale of available-for-sale securities                                     |  | (322)    |
| Origination of loans for sale   | (657)                                      | (3,164)  |
| Sale of loans originated for sale   | 659  | 3,173    |
| Gain on sale of loans originated for sale   | (2)  | (9)      |
| Loss on foreclosed properties and repossessed assets                              | 12   | 181      |
| Goodwill impairment   | 2,689                                      |          |
| (Increase) decrease in accrued interest receivable and other assets               | (758)                                      | 213      |
| Increase in accrued interest payable and other liabilities                        | 6,513                                      | 32       |
| Net cash provided by operating activities   | 12,031                                     | 6,667    |
| <b>Investing activities</b>   |  |          |
| Proceeds from maturities of available-for-sale securities                         | 27,575                                     | 24,106   |
| Proceeds from sales of available-for-sale securities                              |  | 15,003   |
| Purchases of available-for-sale securities  | (57,214)                                   | (49,019) |
| Proceeds from sale of foreclosed properties and repossessed assets                | 990  | 296      |
| Net increase in loans and leases  | (28,528)                                   | (23,051) |
| Investment in Aldine Capital Fund, L.P.   | (150)                                      |          |
| Purchases of leasehold improvements and equipment, net                            | (91)                                       | (182)    |
| Premium payment on bank owned life insurance policies                             | (8)  | (8)      |
| Net cash used in investing activities   | (57,426)                                   | (32,855) |
| <b>Financing activities</b>   |  |          |
| Net increase in deposits  | 13,756                                     | 97,798   |
| Repayment of FHLB advances  | (16,008)                                   | (15,008) |
| Net decrease in short-term borrowed funds   |  | (22,000) |
| Proceeds from other borrowings  |  | 31,000   |
| Repayment of other borrowings   |  | (31,000) |
| Cash dividends paid   | (534)                                      | (534)    |
| Purchase of treasury stock  | (52)                                       | (65)     |

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

|  |           |           |
|--|-----------|-----------|
| Net cash (used in) provided by financing activities      | (2,838)   | 60,191    |
| Net (decrease) increase in cash and cash equivalents     | (48,233)  | 34,003    |
| Cash and cash equivalents at the beginning of the period | 112,737   | 23,684    |
| Cash and cash equivalents at the end of the period       | \$ 64,504 | \$ 57,687 |

**Supplementary cash flow information**

|  |           |           |
|--|-----------|-----------|
| Interest paid on deposits and borrowings                 | \$ 18,738 | \$ 22,132 |
| Income taxes paid  | 3,798     | 188       |
| Transfer to foreclosed properties and repossessed assets | 578       | 640       |

See accompanying Notes to Unaudited Consolidated Financial Statements.

**Table of Contents**

**Notes to Unaudited Consolidated Financial Statements**

**Note 1 Principles of Consolidation**

The unaudited consolidated financial statements include the accounts and results of First Business Financial Services, Inc. (FBFS or the Corporation), and its wholly-owned subsidiaries, First Business Bank and First Business Bank Milwaukee. 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.

**Note 2 Basis of Presentation**

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (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. 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, 2009 except as described below in Note 3. There have been no significant changes in the methods or assumptions used in accounting policies requiring material estimates and assumptions.

In the opinion of management, all adjustments (consisting of normal recurring accruals) necessary for a fair presentation of the unaudited consolidated financial statements have been included in the unaudited consolidated financial statements. The results of operations for the three and nine month periods ended September 30, 2010 are not necessarily indicative of results that may be expected for any other interim period or the entire fiscal year ending December 31, 2010. Certain amounts in prior periods have been reclassified to conform to the current presentation. Subsequent events have been evaluated through the issuance of the unaudited consolidated financial statements.

**Note 3 Recent Accounting Pronouncements**

**Transfers and Servicing of Financial Assets.** In June 2009, the FASB issued Accounting Standards Update (ASU) No. 2009-16, Transfers and Servicing (Topic 860) which eliminates the concept of a qualifying special-purpose entity, changes the requirements for derecognizing financial assets and requires additional disclosures about a transferor's continuing involvement in transferred financial assets. This pronouncement became effective for interim and annual reporting periods beginning after November 15, 2009. The recognition and measurement provisions regarding transfers of financial assets shall be applied to transfers that occur on or after the effective date. The disclosure requirements must be applied to transfers that occurred before and after the effective date. The Corporation adopted this new pronouncement on January 1, 2010, as required. The sale accounting treatment for the Corporation's participation loans have been evaluated in accordance with the new standard. Refer to Note 8 Loans and Leases for additional information. The adoption of this standard did not have a material impact on the consolidated financial statements of the Corporation.

**Consolidation of Variable Interest Entities.** In December 2009, the FASB issued ASU No. 2009-17, Consolidation (Topic 810) Improvements to Financial Reporting for Enterprises Involved with Variable Interest Entities, amending prior guidance to change how a company determines when an entity that is insufficiently capitalized or is not controlled through voting (or similar rights) should be consolidated. This statement requires an enterprise to perform an analysis to determine whether the enterprise's variable interest or interests give it a controlling financial interest in a variable interest entity. This analysis identifies the primary beneficiary of a variable interest entity as the enterprise that has both of the following characteristics:

The power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance; and

The obligation to absorb losses of the entity that could potentially be significant to the variable interest entity or the right to receive benefits from the entity that could potentially be significant to the variable interest entity.

**Table of Contents**

Ongoing reassessments of whether an enterprise is the primary beneficiary of a variable interest entity are required. The Corporation adopted this accounting standard on January 1, 2010, as required. There was no impact to the unaudited consolidated financial statements due to the adoption of this standard.

**Consolidation.** In January 2010, the FASB issued ASU 2010-02, Consolidation (Topic 810) Accounting and Reporting for Decreases in Ownership of a Subsidiary a Scope Clarification which provides amendments to Subtopic 810-10 and related guidance within U.S. GAAP to clarify the scope of decrease in ownership provisions and transactions to which such provisions apply or do not apply. The amendments also expand the disclosures about the deconsolidation of a subsidiary or derecognition of a group of assets within the scope of Subtopic 810-10 including the valuation techniques used to measure the fair value of any retained investment, the nature of continuing involvement with the subsidiary and whether the transaction that resulted in the deconsolidation of the subsidiary or the derecognition of the group of assets was with a related party. The amendments in this update became effective beginning in the first interim or annual reporting period ending on or after December 15, 2009. The amendments in this update should be applied retrospectively to the first period that an entity adopted previous amendments to ASC 810-10 relating to non-controlling interests. The Corporation adopted this accounting standard on January 1, 2010, as required. There was no impact to the unaudited consolidated financial statements due to the adoption of this standard.

**Fair Value Measurements and Disclosures.** In January 2010, the FASB issued an accounting standard update, ASU 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements, providing additional guidance relating to fair value measurement disclosures. Specifically, the updated standard requires companies to separately disclose significant transfers into and out of Level 1 and Level 2 measurements in the fair value hierarchy and the reasons for those transfers. Significance should generally be based on earnings and total assets or liabilities, or when changes are recognized in other comprehensive income, based on total equity. Companies may take different approaches in determining when to recognize such transfers, including using the actual date of the event or change in circumstances causing the transfer, or using the beginning or ending of a reporting period. For Level 3 fair value measurements, the new guidance requires presentation of separate information about purchases, sales, issuances and settlements. Additionally, the FASB also clarified existing fair value measurement disclosure requirements relating to the level of disaggregation, inputs, and valuation techniques. This accounting standard became effective at the beginning of 2010, except for the detailed Level 3 disclosures, which will be effective at the beginning of 2011. The Corporation adopted the accounting standard, except for the detailed Level 3 disclosures, at the beginning of 2010. There was no impact to the unaudited consolidated financial statements due to the adoption of this standard.

**Derivatives and Hedging.** In March 2010, the FASB issued a clarification on the scope exception for embedded credit derivatives. The guidance eliminates the scope exception for bifurcation of embedded credit derivatives in interests in securitized financial assets, unless they are created solely by subordination of one financial debt instrument to another. The guidance became effective in the first reporting period beginning after June 15, 2010. There was no impact to the unaudited consolidated financial statements due to the implementation of this clarification.

**Allowance for Credit Losses.** In July 2010, the FASB issued ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. This new accounting guidance will require additional disclosures in the notes to the financial statements regarding the nature of credit risk inherent in the loan and lease portfolio, how the credit risk is analyzed and assessed in arriving at the allowance for credit losses and the changes in the loan portfolio and the allowance for credit losses. For the Corporation, period end disclosures will be required as of December 31, 2010 and disclosures about activity that occurs during the period are effective for interim and annual reporting periods beginning on or after December 15, 2010.

**Table of Contents****Note 4 Goodwill and Intangible assets**

Goodwill is not amortized, rather it is reviewed for impairment on an annual basis or more frequently if events or circumstances indicate potential for impairment. The goodwill impairment test is performed in two steps. The first step compares the fair value of the reporting unit with its carrying amount, including goodwill. If the fair value of the reporting unit exceeds its carrying amount, goodwill of the reporting unit is not considered impaired; however if the carrying amount of the reporting unit exceeds its fair value, the second step of the goodwill impairment test must be undertaken in order to measure the amount of impairment, if any. The second step of the goodwill impairment test compares the implied fair value of the reporting unit's goodwill with the carrying amount of that goodwill. The implied fair value of goodwill is determined in the same manner as how the amount of goodwill recognized in a business combination is determined. That is, the fair value of the reporting unit as determined under step one is allocated to all of the assets and liabilities of the reporting unit, including any unrecognized intangible assets. The excess of the fair value of the reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill. An impairment of goodwill is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value of the goodwill.

Management tests goodwill for impairment on an annual basis in June of each year, or more frequently if events or circumstances should warrant. In June 2010, the Corporation completed its annual impairment test on goodwill from the acquisition of the 49% interest in the Business Banc Group LTD. The methodology followed was consistent with previous annual tests. The fair value of the reporting unit was primarily derived utilizing an income approach or discounted cash flow methodology using stable cash flow assumptions based upon the reporting unit's most recent actual results and management's estimate of forecasted financial performance. The forecasted cash flows of the reporting unit were then discounted to present value using a risk-adjusted discount rate derived using the capital asset pricing model. The capital asset pricing model takes into consideration the long-term risk free rate, long-horizon equity risk premium, risk premium for size as well as any specific risk premium associated with the reporting unit. As a means to validate the calculated fair value of the reporting unit, consideration was also given to the estimated values of the other reporting units as compared to the market capitalization of the Corporation. In addition, management researched and considered comparables of both publicly-traded banks and market transactions but found limited recent information available for comparable size banking institutions with a commercial banking focus within the geographic area of the reporting unit and of comparable operating performance.

Due to the continued negative economic environment, the banking industry continued to experience downward pressure in financial performance and its future outlook and thus overall industry market capitalizations continued to trend downward through June 2010. The Corporation's stock had consistently traded below book value since December 2007, and the market capitalization of the Corporation had declined since the last annual impairment test. Prior to and through June 2010, management had continuously monitored the Corporation's business climate including the fact the Corporation's stock had traded below book value and determined at each quarter no new triggering event occurred.

In June 2010, management evaluated the impact of the continued negative economic environment and its continued downward pressure on the reporting unit's asset quality and financial performance, and considered their impact on the future cash flows of the reporting unit, in addition to reconciling the calculated values of all of its reporting units to the Corporation's market capitalization. After considering the various factors noted above, management concluded that the fair value of the reporting unit was less than the carrying value of the reporting unit and therefore did not pass the first step of the goodwill impairment test.

In order to measure the amount of the goodwill impairment, management proceeded with the completion of the second step of the goodwill impairment test in which the implied fair value of the reporting unit's goodwill was compared to the carrying value of the goodwill. During the three month period ending June 30, 2010, management concluded an impairment of the entire carrying value of the goodwill was warranted. As a result, during the nine months ended September 30, 2010, the Corporation recognized an impairment of goodwill of \$2.7 million.





**Table of Contents**

The goodwill impairment does not affect the Corporation's cash flows, liquidity, regulatory capital, regulatory capital ratios or future performance of the Corporation nor does it affect its ability to continue to service its client base. The change in the carrying amount of goodwill was as follows:

|  | As of and<br>for the nine<br>months<br>ended<br>September<br>30,<br>2010 | As of and for the<br>year<br>ended December 31,<br>2009 |
|--|--|---|
|  | (In thousands)   |   |
| Balance at the beginning of the period | \$ 2,689   | \$ 2,689  |
| Goodwill impairment                    | (2,689)  |   |
| Balance at the end of the period       | \$   | \$ 2,689  |

The Corporation has intangible assets that are amortized consisting of core deposit intangibles and other intangibles, representing a client list purchased from a brokerage/investment business. For the nine months ended September 30, 2010 and 2009, the Corporation recognized amortization expense of \$14,000 and \$16,000, respectively.

**Note 5 Earnings Per 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.

**Table of Contents**

For the three month periods ended September 30, 2010 and 2009, average anti-dilutive employee share-based awards totaled 174,861 and 229,956, respectively. For the nine month periods ended September 30, 2010 and 2009, average anti-dilutive employee share-based awards totaled 188,542 and 242,470, respectively.

|  | For the Three Months<br>Ended September 30, |              | For the Nine Months<br>Ended September 30, |              |
|--|---|--------------|--|--------------|
|  | 2010  | 2009         | 2010                                       | 2009         |
| Distributed earnings allocated to common stockholders                  | \$ 174,178                                  | \$ 172,234   | \$ 520,702                                 | \$ 514,723   |
| Undistributed earnings allocated to common stockholders                | 776,535                                     | 1,140,335    | (185,938)                                  | 854,372      |
| Income available to common stockholders for basic earnings per share   | 950,713                                     | 1,312,569    | 334,764                                    | 1,369,095    |
| Reallocation of undistributed earnings for diluted earnings per share  |   |              |  |              |
| Income available to common stockholders for diluted earnings per share | \$ 950,713                                  | \$ 1,312,569 | \$ 334,764                                 | \$ 1,369,095 |
| Basic average shares   | 2,489,278                                   | 2,462,289    | 2,479,706                                  | 2,452,336    |
| Dilutive effect of share-based awards                                  |   |              |  |              |
| Dilutive average shares  | 2,489,278                                   | 2,462,289    | 2,479,706                                  | 2,452,336    |
| Earnings per common share:   |   |              |  |              |
| Basic  | \$ 0.38                                     | \$ 0.53      | \$ 0.14                                    | \$ 0.56      |
| Diluted  | 0.38  | 0.53         | 0.14                                       | 0.56         |

**Note 6 Share-Based Compensation**

The Corporation adopted an equity incentive plan in 1993, as amended in 1995, an equity incentive plan in 2001 and the 2006 Equity Incentive Plan (the Plans). The Plans are administered by the Compensation Committee of the Board of Directors of FBFS and provide for the grant of equity ownership opportunities through incentive stock options, nonqualified stock options (Stock Options) and restricted shares. As of September 30, 2010, 137,232 shares were available for future grants under the 2001 and 2006 Equity Incentive Plans (2001 and 2006 Plans). Shares covered by awards that expire, terminate or lapse will again be available for the grant of awards under the 2001 and 2006 Plans. The Corporation may issue new shares and shares of treasury stock for shares delivered under the Plans.

**Stock Options**

The Corporation may grant Stock Options to senior executives and other employees under the Plans. Stock Options are generally granted with 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 2001 and 2006 Plans are subject to graded vesting, generally ranging from four to eight 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. The Corporation has not granted any Stock Options since the Corporation became a public entity nor has it modified, repurchased or cancelled any Stock Options during that period. Therefore, no stock-based compensation was recognized in the consolidated statement of income for the three months and nine months ended September 30, 2010 and 2009, except with respect to restricted share awards. As of September 30, 2010, all Stock Options granted and not previously forfeited have vested.



**Table of Contents**

Stock Option activity for the year ended December 31, 2009 and nine months ended September 30, 2010 was as follows:

|                                     | Options  | Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (Years) |
|-------------------------------------|----------|---------------------------------------|---|
| Outstanding at December 31, 2008    | 157,290  | \$ 22.07                              | 4.67  |
| Granted                             |          |                                       |   |
| Exercised                           |          |                                       |   |
| Forfeited                           | (14,500) | 22.63                                 |   |
| Outstanding at December 31, 2009    | 142,790  | 22.01                                 | 3.66  |
| Exercisable at December 31, 2009    | 142,790  |                                       | 3.66  |
| Outstanding as of December 31, 2009 | 142,790  | \$ 22.01                              | 3.66  |
| Granted                             |          |                                       |   |
| Exercised                           |          |                                       |   |
| Expired                             | (4,024)  | 19.38                                 |   |
| Forfeited                           |          |                                       |   |
| Outstanding at September 30, 2010   | 138,766  | \$ 22.08                              | 3.00  |
| Exercisable at September 30, 2010   | 138,766  | \$ 22.08                              | 3.00  |

**Restricted Shares**

Under the 2001 and 2006 Plans, the Corporation may grant restricted shares to plan participants, subject to forfeiture upon the occurrence of certain events until 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 2001 and 2006 Plans are subject to graded vesting. Compensation expense is recognized over the requisite service period of four years for the entire award on a straight-line basis. Upon vesting of restricted share awards, the benefits of tax deductions in excess of recognized compensation expense is recognized as a financing cash flow activity. For the nine months ended September 30, 2010 and 2009, restricted share awards vested on a date at which the market price was lower than the market value on the date of grant; therefore, there is no excess tax benefit reflected in the consolidated statements of cash flows for such periods.

Restricted share activity for the year ended December 31, 2009 and the nine months ended September 30, 2010 was as follows:

|   | Number of<br>Restricted<br>Shares | Weighted<br>Average<br>Grant-Date<br>Fair Value |
|---|-----------------------------------|---|
| Nonvested balance as of December 31, 2008 | 104,949                           | \$ 19.12  |
| Granted                                   | 6,500                             | 10.07   |

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

|  |          |    |       |
|--|----------|----|-------|
| Vested                                     | (34,273) |    | 19.77 |
| Forfeited                                  | (6,914)  |    | 19.99 |
| Nonvested balance as of December 31, 2009  | 70,262   | \$ | 17.88 |
| Granted                                    | 2,000    |    | 10.15 |
| Vested                                     | (29,930) |    | 19.49 |
| Forfeited                                  | (375)    |    | 14.55 |
| Nonvested balance as of September 30, 2010 | 41,957   | \$ | 16.39 |

**Table of Contents**

As of September 30, 2010, \$529,000 of deferred compensation expense was included in additional paid-in capital in the consolidated balance sheet related to unvested restricted shares which the Corporation expects to recognize over four years. As of September 30, 2010, all restricted shares that vested were delivered. For the nine months ended September 30, 2010 and 2009, share-based compensation expense included in the consolidated statements of income totaled \$386,000 and \$481,000, respectively.

**Note 7 Securities**

The amortized cost and estimated fair values of securities available-for-sale were as follows:

|  | Amortized<br>cost | As of September 30, 2010<br>Gross<br>unrealized<br>holding<br>gains |       | Gross<br>unrealized<br>holding<br>losses | Estimated<br>fair value |
|--|-------------------|---|-------|--|-------------------------|
|  |                   | (In Thousands)  |       |  |                         |
| U.S. Treasury bills  | \$ 3,270          | \$  |       | \$                                       | \$ 3,270                |
| Collateralized mortgage obligations government agencies              | 144,565           |   | 4,077 | (21)                                     | 148,621                 |
| Collateralized mortgage obligations government-sponsored enterprises | 896               |   | 16    |  | 912                     |
|  | \$ 148,731        | \$  | 4,093 | \$ (21)                                  | \$ 152,803              |

|  | Amortized<br>cost | As of December 31, 2009<br>Gross<br>unrealized<br>holding<br>gains |       | Gross<br>unrealized<br>holding<br>losses | Estimated<br>fair value |
|--|-------------------|--|-------|--|-------------------------|
|  |                   | (In Thousands)   |       |  |                         |
| Collateralized mortgage obligations government agencies              | \$ 116,109        | \$   | 2,615 | \$ (215)                                 | \$ 118,509              |
| Collateralized mortgage obligations government-sponsored enterprises | 3,729             |  | 48    |  | 3,777                   |
|  | \$ 119,838        | \$   | 2,663 | \$ (215)                                 | \$ 122,286              |

Collateralized mortgage obligations government agencies represent securities guaranteed by the Government National Mortgage Association. Collateralized mortgage obligations government-sponsored enterprises include securities guaranteed by the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.

The amortized cost and estimated fair value of securities available-for-sale by contractual maturity at September 30, 2010 are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations without call or prepayment penalties.

| Amortized<br>Cost<br>(In Thousands) | Estimated<br>Fair Value |
|-------------------------------------|-------------------------|
|-------------------------------------|-------------------------|

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

|                                    |            |            |
|------------------------------------|------------|------------|
| Due in one year or less            | \$ 3,270   | \$ 3,270   |
| Due in one year through five years | 666        | 706        |
| Due in five through ten years      | 2,511      | 2,601      |
| Due in over ten years              | 142,284    | 146,226    |
|                                    | \$ 148,731 | \$ 152,803 |

**Table of Contents**

The table below shows the Corporation's gross unrealized losses and fair value of investments, aggregated by investment category and length of time that individual investments have been in a continuous unrealized loss position at September 30, 2010 and December 31, 2009. At September 30, 2010 and December 31, 2009, the Corporation had 3 out of 130 securities and 10 out of 112 securities that were in an unrealized loss position, respectively. Such securities have declined in value due to the current interest rate environment and have not experienced credit rating downgrades. At September 30, 2010 the Corporation did not hold any securities that had been in a continuous loss position for twelve months or greater. The Corporation also has not specifically identified 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 results of operations for the three and nine months ended September 30, 2010 and 2009.

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

|   | Less than 12 months |                   | As of September 30, 2010<br>12 months or longer |                   | Total      |                   |
|---|---------------------|-------------------|---|-------------------|------------|-------------------|
|   | Fair value          | Unrealized losses | Fair value                                      | Unrealized losses | Fair value | Unrealized losses |
|   | (In Thousands)      |                   |   |                   |            |                   |
| Collateralized mortgage obligations government agencies | \$ 2,385            | \$ 21             | \$  | \$                | \$ 2,385   | \$ 21             |
|   | \$ 2,385            | \$ 21             | \$  | \$                | \$ 2,385   | \$ 21             |
|   | Less than 12 months |                   | As of December 31, 2009<br>12 months or longer  |                   | Total      |                   |
|   | Fair value          | Unrealized losses | Fair value                                      | Unrealized losses | Fair value | Unrealized losses |
|   | (In Thousands)      |                   |   |                   |            |                   |
| Collateralized mortgage obligations government agencies | \$ 17,220           | \$ 215            | \$  | \$                | \$ 17,220  | \$ 215            |
|   | \$ 17,220           | \$ 215            | \$  | \$                | \$ 17,220  | \$ 215            |

There were no sales of securities available for sale in the three and nine month periods ended September 30, 2010. For the three and nine months ended September 30, 2009, the Corporation sold certain available-for-sale collateralized mortgage obligations government-sponsored enterprise securities. Proceeds from sale were \$15.0 million and resulted in gross realized gains of \$325,000 and gross realized losses of \$3,000.

At September 30, 2010 and December 31, 2009, securities with a fair value of \$32.9 million and \$55.9 million, respectively, were pledged to secure public deposits, interest rate swap contracts and outstanding Federal Home Loan Bank (FHLB) advances. Securities pledged also provide for future availability for additional advances from the FHLB.





**Table of Contents****Note 8 Loans and Leases**

Loans and leases receivable consisted of the following:

|                                       | September<br>30,<br>2010 | December 31,<br>2009 |
|---------------------------------------|--------------------------|----------------------|
|                                       | (In Thousands)           |                      |
| First mortgage loans:                 |                          |                      |
| Commercial real estate                | \$ 456,312               | \$ 441,806           |
| Construction and land development     | 60,012                   | 64,194               |
| Multi-family                          | 42,961                   | 43,959               |
| 1-4 family                            | 54,157                   | 56,131               |
| Total first mortgage loans            | 613,442                  | 606,090              |
| Commercial and industrial loans       | 229,116                  | 199,661              |
| Direct financing leases, net          | 21,331                   | 27,607               |
| Home equity loans and second mortgage | 5,224                    | 7,879                |
| Other                                 | 10,760                   | 13,260               |
| Loans and leases receivable, gross    | 879,873                  | 854,497              |
| Less:                                 |                          |                      |
| Allowance for loan and lease losses   | 15,684                   | 14,124               |
| Deferred loan fees                    | 798                      | 566                  |
| Loans and leases receivable, net      | \$ 863,391               | \$ 839,807           |

The total principal amount of loans transferred to third parties, which consisted solely of participation interests in originated loans, during the three and nine months ended September 30, 2010 was \$17.8 million and \$30.2 million, respectively. Each of the transfers of these financial assets met the qualifications for sale accounting, and therefore \$17.8 million and \$30.2 million for the three and nine months ended September 30, 2010, respectively, 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 required of the Corporation in the event of 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.

The total amount of outstanding loans transferred to third parties as loan participations at September 30, 2010 was \$54.1 million, all of which were 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 continues to have involvement with these loans by way of the relationship management and all servicing responsibilities. As of September 30, 2010, none of the loans in this participation sold portfolio were considered impaired nor has the Corporation recognized any charge-offs associated with any retained portion of this pool of loans as measured by the Corporation's allowance for loan and lease loss measurement process and policies.

**Table of Contents**

Non-accrual loans and leases consisted of the following at September 30, 2010 and December 31, 2009, respectively:

|   | September<br>30,<br>2010 | December 31,<br>2009 |
|---|--------------------------|----------------------|
|   | (Dollars In Thousands)   |                      |
| Non-accrual loans and leases  |                          |                      |
| First mortgage loans:   |                          |                      |
| Commercial real estate  | \$ 10,304                | \$ 8,482             |
| Construction and land development                                   | 3,290                    | 3,317                |
| Multi-family  | 4,683                    | 1,760                |
| 1-4 family  | 3,503                    | 3,015                |
| Total first mortgage loans  | 21,780                   | 16,574               |
| Commercial and industrial   | 5,419                    | 7,086                |
| Direct financing leases, net  |                          | 1                    |
| Home equity and second mortgage                                     | 1,042                    | 872                  |
| Other   | 2,677                    | 3,292                |
| Total non-accrual loans and leases                                  | 30,918                   | 27,825               |
| Foreclosed properties and repossessed assets, net                   | 1,247                    | 1,671                |
| Total non-performing assets   | \$ 32,165                | \$ 29,496            |
| Performing troubled debt restructurings                             |                          | \$                   |
| Total non-accrual loans and leases to gross loans and leases        | 3.51%                    | 3.26%                |
| Total non-performing assets to total assets                         | 2.86                     | 2.64                 |
| Allowance for loan lease losses to gross loans and leases           | 1.78                     | 1.65                 |
| Allowance for loan and lease losses to non-accrual loans and leases | 50.73                    | 50.76                |

As of September 30, 2010 and December 31, 2009, there were approximately \$10.9 million and \$606,000 of non-performing troubled debt restructurings which are included in the appropriate non-accrual loans and lease categories in the above table.

**Table of Contents****Note 9 Allowance for Loan and Lease Losses**

A summary of the activity in the allowance for loan and lease losses is presented below:

|   | For the Three Months Ended<br>September 30, |           | For the Nine Months Ended<br>September 30, |           |
|---|---|-----------|--|-----------|
|   | 2010  | 2009      | 2010                                       | 2009      |
|   | (In Thousands)                              |           |  |           |
| Allowance at beginning of period                | \$ 15,091                                   | \$ 12,690 | \$ 14,124                                  | \$ 11,846 |
| Charge-offs:                                    |   |           |  |           |
| Commercial real estate and other first mortgage | (1,339)                                     | (1,131)   | (2,214)                                    | (2,059)   |
| Commercial and industrial                       | (89)  | (3)       | (337)                                      | (1,813)   |
| Direct financing leases                         |   |           |  | (231)     |
| Home equity and second mortgage                 | (75)  | (130)     | (75)                                       | (157)     |
| Other   | (135)                                       |           | (462)                                      | (8)       |
| Total charge-offs                               | (1,638)                                     | (1,264)   | (3,088)                                    | (4,268)   |
| Recoveries:                                     |   |           |  |           |
| Commercial real estate and other first mortgage | 13  |           | 16   |           |
| Commercial and industrial                       | 264   | 1         | 265  | 3         |
| Direct financing leases                         |   |           |  |           |
| Home equity and second mortgage                 |   |           |  | 2         |
| Other   |   |           |  |           |
| Total recoveries                                | 277   | 1         | 281  | 5         |
| Net charge-offs                                 | (1,361)                                     | (1,263)   | (2,807)                                    | (4,263)   |
| Provision for loan and lease losses             | 1,954                                       | 1,378     | 4,367                                      | 5,222     |
| Allowance at end of period                      | \$ 15,684                                   | \$ 12,805 | \$ 15,684                                  | \$ 12,805 |

The following represents information regarding the Corporation's impaired loans:

|  | As of and<br>for<br>the Nine<br>Months<br>Ended<br>September<br>30,<br>2010 | As of and for<br>the Year<br>Ended<br>December 31,<br>2009 |
|--|---|--|
|  | (In Thousands)  |  |
| Impaired loans and leases with no impairment reserves required | \$ 18,192   | \$ 13,243  |
| Impaired loans and leases with impairment reserves required    | 12,726  | 14,582   |
| Total impaired loans and leases                                | 30,918  | 27,825   |
| Less:  |   |  |

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

|  |           |           |
|--|-----------|-----------|
| Impairment reserve (included in allowance for loan and lease losses) | 2,903     | 1,846     |
| Net impaired loans and leases  | \$ 28,015 | \$ 25,979 |
| Average net impaired loans and leases                                | \$ 29,810 | \$ 20,395 |
| Foregone interest income attributable to impaired loans and leases   | \$ 1,885  | \$ 1,758  |
| Interest income recognized on impaired loans and leases              | (77)      | (149)     |
| Net foregone interest income on impaired loans and leases            | \$ 1,808  | \$ 1,609  |

**Table of Contents**

Net foregone interest income on impaired loans and leases for the nine months ended September 30, 2009 was \$1.2 million.

**Note 10 Deposits**

Deposits consisted of the following:

|                                  | September 30, 2010 |                          |   | December 31, 2009 |                          |                       |
|----------------------------------|--------------------|--------------------------|---|-------------------|--------------------------|-----------------------|
|                                  | Balance            | Weighted average balance | Weighted average rate<br>(Dollars In Thousands) | Balance           | Weighted average balance | Weighted average rate |
| Transaction accounts:            |                    |                          |   |                   |                          |                       |
| Demand deposits                  | \$ 74,558          | \$ 63,741                | %   | \$ 87,687         | \$ 51,665                | %                     |
| NOW accounts                     | 76,079             | 78,722                   | 0.37  | 65,191            | 67,061                   | 0.40                  |
| Total transaction accounts:      | 150,637            | 142,463                  |   | 152,878           | 118,726                  |                       |
| Money market accounts            | 268,330            | 252,646                  | 1.11  | 262,276           | 214,751                  | 1.38                  |
| Certificates of deposit          | 87,373             | 84,900                   | 2.09  | 98,431            | 121,801                  | 2.34                  |
| Brokered certificates of deposit | 491,790            | 476,325                  | 3.38  | 470,789           | 460,691                  | 3.98                  |
| Total deposits                   | \$ 998,130         | \$ 956,334               |   | \$ 984,374        | \$ 915,969               |                       |

**Note 11 Borrowings**

Borrowings consisted of the following:

|                            | September 30, 2010 |                          |   | December 31, 2009 |                          |                       |
|----------------------------|--------------------|--------------------------|---|-------------------|--------------------------|-----------------------|
|                            | Balance            | Weighted average balance | Weighted average rate<br>(Dollars In Thousands) | Balance           | Weighted average balance | Weighted average rate |
| Fed funds purchased        | \$                 | \$                       | %   | \$                | \$ 1,700                 | 0.61%                 |
| FHLB advances              | 2,497              | 17,094                   | 4.73  | 18,505            | 18,873                   | 4.66                  |
| Senior line of credit      | 10                 | 10                       | 4.04  | 10                | 38                       | 4.41                  |
| Subordinated notes payable | 39,000             | 39,000                   | 5.48  | 39,000            | 39,000                   | 4.92                  |
| Junior subordinated notes  | 10,315             | 10,315                   | 10.75   | 10,315            | 10,315                   | 10.78                 |
|                            | \$ 51,822          | \$ 66,419                | 6.12  | \$ 67,830         | \$ 69,926                | 5.61                  |
| Short-term borrowings      | \$ 2,010           |                          |   | \$ 16,010         |                          |                       |
| Long-term borrowings       | 49,812             |                          |   | 51,820            |                          |                       |
|                            | \$ 51,822          |                          |   | \$ 67,830         |                          |                       |

As of September 30, 2010, the Corporation was in compliance with its debt covenants under its senior line of credit. Beginning in March 2010, the Corporation pays an unused line fee on its secured senior line of credit. For the nine months ended September 30, 2010, the Corporation incurred unused line fee interest expense of \$7,000.



**Table of Contents****Note 12 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 vs. entry 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 inputs that are supported by little or no market activity and that 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.

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

|  | Fair Value Measurements Using |          |         |          |
|--|-------------------------------|----------|---------|----------|
|  | Level 1                       | Level 2  | Level 3 | Total    |
|  | (In Thousands)                |          |         |          |
| <b>September 30, 2010</b>  |                               |          |         |          |
| Assets:  |                               |          |         |          |
| U.S. Treasury bills  | \$                            | \$ 3,270 | \$      | \$ 3,270 |
| Collateralized mortgage obligations government agencies              |                               | 148,621  |         | 148,621  |
| Collateralized mortgage obligations government sponsored enterprises |                               | 912      |         | 912      |
| Interest rate swaps  |                               | 3,967    |         | 3,967    |
| Liabilities:   |                               |          |         |          |
| Interest rate swaps  | \$                            | \$ 3,967 | \$      | \$ 3,967 |



**Table of Contents**

|                                     |                                  | Fair Value Measurements Using |            |         | Total      |
|-------------------------------------|----------------------------------|-------------------------------|------------|---------|------------|
|                                     |                                  | Level 1                       | Level 2    | Level 3 |            |
|                                     |                                  | (In Thousands)                |            |         |            |
| <b>December 31, 2009</b>            |                                  |                               |            |         |            |
| Assets:                             |                                  |                               |            |         |            |
| Collateralized mortgage obligations | government agencies              | \$                            | \$ 118,509 | \$      | \$ 118,509 |
| Collateralized mortgage obligations | government sponsored enterprises |                               | 3,777      |         | 3,777      |
| Interest rate swaps                 |                                  |                               | 1,297      |         | 1,297      |

## Liabilities:

|                     |  |    |          |    |          |
|---------------------|--|----|----------|----|----------|
| Interest rate swaps |  | \$ | \$ 1,297 | \$ | \$ 1,297 |
|---------------------|--|----|----------|----|----------|

There were no transfers in or out of Level 1 or 2 during the nine months ended September 30, 2010 or the year ended December 31, 2009.

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

|                       |           | As of and for the nine months ended September 30, 2010 |                               |          |         |                |
|-----------------------|-----------|--|-------------------------------|----------|---------|----------------|
|                       |           | Balance at<br>September<br>30, 2010                    | Fair Value Measurements Using |          |         | Total<br>Gains |
|                       |           |  | Level 1                       | Level 2  | Level 3 | (Losses)       |
|                       |           | (In Thousands)   |                               |          |         |                |
| Impaired loans        | \$ 17,630 | \$   | \$ 14,709                     | \$ 2,921 | \$      |                |
| Foreclosed properties | 1,247     |  | 1,247                         |          | (127)   |                |
| Goodwill              |           |  |                               |          | (2,689) |                |

|                       |           | As of and for the year ended December 31, 2009 |                               |          |         |                |
|-----------------------|-----------|--|-------------------------------|----------|---------|----------------|
|                       |           | Balance at<br>December<br>31, 2009             | Fair Value Measurements Using |          |         | Total<br>Gains |
|                       |           |  | Level 1                       | Level 2  | Level 3 | (Losses)       |
|                       |           | (In Thousands)                                 |                               |          |         |                |
| Impaired loans        | \$ 17,596 | \$   | \$ 14,820                     | \$ 2,775 | \$      |                |
| Foreclosed properties | 1,671     |  | 1,671                         |          | (525)   |                |

Impaired loans that are collateral dependent were written down to their fair value of \$17.6 million and \$17.6 million at September 30, 2010 and December 31, 2009, 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 recent sales of similar assets or observable market data for operational or carrying costs. In cases where such inputs were unobservable, the loan balance is reflected within Level 3 of the hierarchy.

Certain non-financial assets subject to measurement at fair value on a non-recurring basis included goodwill and foreclosed properties. Foreclosed properties, upon initial recognition, are remeasured 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 Level 2 inputs based on observable market data, typically an appraisal, or Level 3 inputs based upon assumptions specific to the individual property or equipment. Subsequent impairments of foreclosed properties are recorded as a loss on foreclosed properties. During the nine months ended September 30, 2010, \$578,000 of outstanding loans were transferred to foreclosed properties as the Corporation claimed title to the respective assets. During the nine months ended September 30, 2010, the Corporation completed an evaluation of certain of its foreclosed assets. Based upon the evaluation and the results of the impairment calculation, we recognized impairment losses of \$127,000 on foreclosed properties for the nine months ended September 30, 2010. At September 30, 2010 and December 31, 2009, foreclosed properties, at fair value, were \$1.2 million and \$1.7 million, respectively.

**Table of Contents**

The Corporation's goodwill is subject to an annual impairment evaluation. The Corporation conducts its annual evaluation in June of each year. Based upon the results of this analysis in June 2010, the Corporation determined that goodwill of the reporting unit was fully impaired as of June 30, 2010. For the nine months ended September 30, 2010, the Corporation recorded an impairment of goodwill in the amount of \$2.7 million. There was no impairment of goodwill for the nine months ended September 30, 2009. Refer to Note 4 for further information.

**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:

|   | September 30, 2010 |              | December 31, 2009  |              |
|---|--------------------|--------------|--------------------|--------------|
|   | Carrying<br>Amount | Fair Value   | Carrying<br>Amount | Fair Value   |
|   | (In Thousands)     |              |                    |              |
| Financial assets:                           |                    |              |                    |              |
| Cash and cash equivalents                   | \$ 64,504          | \$ 64,504    | \$ 112,737         | \$ 112,737   |
| Securities available-for-sale               | 152,803            | 152,803      | 122,286            | 122,286      |
| Loans and lease receivables                 | 863,391            | 860,906      | 839,807            | 820,286      |
| Federal Home Loan Bank stock                | 2,367              | 2,367        | 2,367              | 2,367        |
| Cash surrender value of life insurance      | 16,760             | 16,760       | 16,254             | 16,254       |
| Accrued interest receivable                 | 3,287              | 3,287        | 3,212              | 3,212        |
| Interest rate swaps                         | 3,967              | 3,967        | 1,297              | 1,297        |
| Financial liabilities:                      |                    |              |                    |              |
| Deposits                                    | \$ 998,130         | \$ 1,015,595 | \$ 984,374         | \$ 1,000,027 |
| Federal Home Loan Bank and other borrowings | 41,507             | 41,578       | 57,515             | 58,125       |
| Junior subordinated notes                   | 10,315             | 7,227        | 10,315             | 7,237        |
| Interest rate swaps                         | 3,967              | 3,967        | 1,297              | 1,297        |
| Accrued interest payable                    | 4,404              | 4,404        | 4,359              | 4,359        |
| Off balance sheet items:                    |                    |              |                    |              |
| Standby letters of credit                   | 47                 | 47           | 38                 | 38           |
| 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.

**Table of Contents**

The carrying amounts reported for cash and cash equivalents, accrued interest receivable and accrued interest payable approximate fair value because of their short-term nature and because they do not present unanticipated credit concerns.

**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.

**Loans and Leases:** 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.

**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 amount.

**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 counter party.

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 has considered the impact of netting and any applicable credit enhancements, such as collateral postings, thresholds, mutual puts and guarantees.

**Table of Contents**

**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.

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 have not been considered in the estimates.

**Note 13 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 nonperformance 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 considered the impact of netting and any applicable credit enhancements such as collateral postings, thresholds and guarantees.

At September 30, 2010, the aggregate amortizing notional value of interest rate swaps with various commercial borrowers was \$51.1 million. The Corporation receives fixed rates and pays floating rates based upon LIBOR on the swaps with commercial borrowers. The aggregate amortizing notional value of interest rate swaps with dealer counterparties was also \$51.1 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 2013 through 2019. The commercial borrower swaps were reported on the Corporation's balance sheet as a derivative asset of \$4.0 million and were included in accrued interest receivable and other assets. Dealer counterparty swaps were reported on the Corporation's balance sheet as a net derivative liability of \$4.0 million due to master netting and settlement contracts with dealer counterparties and were included in accrued interest payable and other liabilities as of September 30, 2010.

**Table of Contents**

The table below provides information about the location and fair value of the Corporation's derivative instruments as of September 30, 2010 and December 31, 2009.

|                        |            | Interest Rate Swap Contracts |                       |
|------------------------|------------|------------------------------|-----------------------|
|                        |            | Asset Derivatives            | Liability Derivatives |
| Balance Sheet Location | Fair Value | Balance Sheet Location       | Fair Value            |
| (In Thousands)         |            |                              |                       |

**Derivatives not designated as hedging instruments**

|                    |              |          |                   |          |
|--------------------|--------------|----------|-------------------|----------|
| September 30, 2010 | Other assets | \$ 3,967 | Other liabilities | \$ 3,967 |
| December 31, 2009  | Other assets | \$ 1,297 | Other liabilities | \$ 1,297 |

The location and amount of gains and losses reported in the consolidated statements of income for the three and nine months ended September 30, 2010 and 2009 are as follows:

For the three months ended September 30, 2010

| Instrument                    | Amount Recognized in | Other Comprehensive Income on Derivative Gain/(Loss) Effective Portion | Income Statement Location Effective Portion | Amount reclassified from Accumulated | Other Comprehensive Income Effective Portion | Income Statement Location Ineffective Portion | Amount of Gain/(Loss) Recorded Ineffective Portion |
|-------------------------------|----------------------|--|---|--------------------------------------|--|---|--|
|                               |                      |  |   |                                      |  |   |  |
| Interest rate swaps non hedge | \$                   |  | N/A   | \$                                   |  | Other noninterest income                      | \$ 817   |
| Interest rate swaps non-hedge | \$                   |  | N/A   | \$                                   |  | Other noninterest income                      | \$ (817)   |

For the three months ended September 30, 2009

| Instrument | Amount Recognized in | Other Comprehensive Income on | Income | Amount reclassified from Accumulated | Other | Income | Amount of |
|------------|----------------------|-------------------------------|--------|--------------------------------------|-------|--------|-----------|
|            |                      |                               |        |                                      |       |        |           |

Edgar Filing: First Business Financial Services, Inc. - Form 10-Q

| Instrument                    | Derivative<br>Gain/(Loss)<br><i>Effective<br/>Portion</i> | Statement<br>Location<br><i>Effective<br/>Portion</i> | Comprehensive<br>Income<br><i>Effective<br/>Portion</i><br>(In Thousands) | Statement<br>Location<br><i>Ineffective<br/>Portion</i><br><br>Other<br>noninterest<br>income<br><br>Other<br>noninterest<br>income | Gain/(Loss)<br>Recorded<br><i>Ineffective<br/>Portion</i> |
|-------------------------------|---|---|---|---|---|
| Interest rate swaps non hedge | \$  | N/A   | \$  |   | \$ 871  |
| Interest rate swaps non-hedge | \$  | N/A   | \$  |   | \$ (871)  |

**Table of Contents**

For the nine months ended September 30, 2010

| Instrument                       | Amount<br>Recognized<br>in<br>Other<br>Comprehensive<br>Income<br>on<br>Derivative<br>Gain/(Loss)<br><i>Effective<br/>Portion</i> | Income<br>Statement<br>Location<br><i>Effective<br/>Portion</i> | Amount<br>reclassified<br>from<br>Accumulated                    |   | Amount of<br>Gain/(Loss)<br>Recorded<br><i>Ineffective<br/>Portion</i> |
|----------------------------------|---|---|--|---|--|
|                                  |   |   | Other<br>Comprehensive<br>Income<br><i>Effective<br/>Portion</i> | Income<br>Statement<br>Location<br><i>Ineffective<br/>Portion</i> |  |
| Interest rate swaps non<br>hedge | \$  | N/A   | \$   | Other<br>noninterest<br>income                                    | \$ 2,837   |
| Interest rate swaps non<br>hedge | \$  | N/A   | \$   | Other<br>noninterest<br>income                                    | \$ (2,837)   |

For the nine months ended September 30, 2009

| Instrument                       | Amount<br>Recognized<br>in<br>Other<br>Comprehensive<br>Income<br>on<br>Derivative<br>Gain/(Loss)<br><i>Effective<br/>Portion</i> | Income<br>Statement<br>Location<br><i>Effective<br/>Portion</i> | Amount<br>reclassified<br>from<br>Accumulated                    |   | Amount of<br>Gain/(Loss)<br>Recorded<br><i>Ineffective<br/>Portion</i> |
|----------------------------------|---|---|--|---|--|
|                                  |   |   | Other<br>Comprehensive<br>Income<br><i>Effective<br/>Portion</i> | Income<br>Statement<br>Location<br><i>Ineffective<br/>Portion</i> |  |
| Interest rate swaps hedge        | \$ (1)  | Interest<br>expense   | \$ (3)   | N/A   | \$   |
| Interest rate swaps non<br>hedge |   | N/A   |  | Other<br>noninterest<br>income                                    | (183)  |
| Interest rate swaps non<br>hedge |   | N/A   |  | Other<br>noninterest<br>income                                    | 462  |

**Note 14 Stockholders Equity**

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 and the Banks' capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. In the event that (i) the FDIC or the Wisconsin Department of Financial Institutions (the Division) should increase minimum required levels of capital; (ii) the total assets of the Banks increase significantly; (iii) the income for the Banks decreases significantly; or (iv) any combination of the foregoing occurs, then the FDIC or the Division may limit the amount of dividends the Boards of Directors of the Banks may declare or pay to the Corporation. In addition, the Board of Directors of the Corporation may be similarly restricted by its regulator as to the level of dividend the Corporation may declare or pay. 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 September 30, 2010, that the Corporation and the Banks met all applicable capital adequacy requirements.

**Table of Contents**

As of September 30, 2010, 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. In addition, the Banks exceeded the minimum net worth requirement of 6.0% required by the State of Wisconsin at December 31, 2009, the latest evaluation date.

The following table summarizes the Corporation's and Banks' capital ratios and the ratios required by their federal regulators at September 30, 2010 and December 31, 2009, respectively:

|  | Actual     |        | Minimum Required for<br>Capital<br>Adequacy Purposes |       | Minimum Required to be<br>Well<br>Capitalized Under Prompt<br>Corrective Action<br>Requirements |        |
|--|------------|--------|--|-------|---|--------|
|  | Amount     | Ratio  | Amount   | Ratio | Amount  | Ratio  |
| As of September 30, 2010                 |            |        |  |       |   |        |
| Total capital (to risk-weighted assets)  |            |        |  |       |   |        |
| Consolidated                             | \$ 106,413 | 11.15% | \$ 76,371  | 8.00% | N/A   | N/A    |
| First Business Bank                      | 99,148     | 11.71  | 67,709   | 8.00  | \$ 84,636   | 10.00% |
| First Business Bank<br>Milwaukee         | 14,599     | 13.69  | 8,533  | 8.00  | 10,666  | 10.00  |
| Tier 1 capital (to risk-weighted assets) |            |        |  |       |   |        |
| Consolidated                             | \$ 62,956  | 6.59%  | \$ 38,185  | 4.00% | N/A   | N/A    |
| First Business Bank                      | 88,532     | 10.46  | 33,854   | 4.00  | \$ 50,782   | 6.00%  |
| First Business Bank<br>Milwaukee         | 13,256     | 12.43  | 4,266  | 4.00  | 6,400   | 6.00   |
| Tier 1 capital (to average assets)       |            |        |  |       |   |        |
| Consolidated                             | \$ 62,956  | 5.78%  | \$ 43,552  | 4.00% | N/A   | N/A    |
| First Business Bank                      | 88,532     | 9.45   | 37,479   | 4.00  | \$ 46,849   | 5.00%  |
| First Business Bank<br>Milwaukee         | 13,256     | 8.77   | 6,044  | 4.00  | 7,555   | 5.00   |

**Table of Contents**

|  | Actual     |        | Minimum Required for<br>Capital<br>Adequacy Purposes |       | Minimum Required to be<br>Well<br>Capitalized Under Prompt<br>Corrective Action<br>Requirements |        |
|--|------------|--------|--|-------|---|--------|
|  | Amount     | Ratio  | Amount   | Ratio | Amount  | Ratio  |
| As of December 31, 2009                  |            |        |  |       |   |        |
| Total capital (to risk-weighted assets)  |            |        |  |       |   |        |
| Consolidated                             | \$ 101,571 | 11.16% | \$ 72,797  | 8.00% | N/A   | N/A    |
| First Business Bank                      | 94,251     | 11.62  | 64,906   | 8.00  | \$ 81,132   | 10.00% |
| First Business Bank<br>Milwaukee         | 14,246     | 14.69  | 7,757  | 8.00  | 9,696   | 10.00  |
| Tier 1 capital (to risk-weighted assets) |            |        |  |       |   |        |
| Consolidated                             | \$ 60,109  | 6.61%  | \$ 36,399  | 4.00% | N/A   | N/A    |
| First Business Bank                      | 84,082     | 10.36  | 32,453   | 4.00  | \$ 48,679   | 6.00%  |
| First Business Bank<br>Milwaukee         | 13,027     | 13.44  | 3,878  | 4.00  | 5,818   | 6.00   |
| Tier 1 capital (to average assets)       |            |        |  |       |   |        |
| Consolidated                             | \$ 60,109  | 5.53%  | \$ 43,485  | 4.00% | N/A   | N/A    |
| First Business Bank                      | 84,082     | 9.08   | 37,042   | 4.00  | \$ 46,302   | 5.00%  |
| First Business Bank<br>Milwaukee         | 13,027     | 8.13   | 6,406  | 4.00  | 8,007   | 5.00   |

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations****Forward-Looking Statements**

When used in this report the words or phrases may, could, should, hope, might, believe, expect, plan, 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 and competition. These risks could cause actual results to differ materially from what FBFS has anticipated or projected. These risk factors and uncertainties should be carefully considered by potential investors. See **Item 1A Risk Factors** in our Annual Report on Form 10-K for the year ended December 31, 2009 for discussion relating to risk factors impacting the Corporation. Investors should not place undue reliance on any such forward-looking statement, which speaks only as of the date on which it was made. The factors described within this Form 10-Q could affect the financial performance of FBFS 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, FBFS cautions that, while its 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 result in, or be achieved or accomplished.

**Table of Contents**

FBFS does not intend to, and specifically disclaims any obligation to, update any forward-looking statements. The following discussion and analysis is intended as a review of significant events and factors affecting the financial condition and results of operations of FBFS for the periods indicated. The discussion should be read in conjunction with the Consolidated Financial Statements and the Notes thereto presented in this Form 10-Q.

**General**

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

**Overview**

FBFS is a registered bank holding company incorporated under the laws of the State of Wisconsin and is engaged in the commercial banking business through its wholly-owned banking subsidiaries, First Business Bank and First Business Bank Milwaukee. All of the operations of FBFS are conducted through the Banks and certain subsidiaries of First Business Bank. The Corporation operates 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. The Corporation does not utilize a branch network to attract retail clients.

**General Overview**

Total assets were \$1.123 billion as of September 30, 2010 compared to \$1.117 billion as of December 31, 2009.

Net income for the three months ended September 30, 2010 was \$969,000 compared to net income of \$1.4 million for the three months ended September 30, 2009. Net income for the nine months ended September 30, 2010 was \$343,000 compared to net income of \$1.4 million for the nine months ended September 30, 2009. During the nine months ended September 30, 2010, specifically in June 2010, we recorded an impairment of goodwill in the amount of \$2.7 million. The goodwill impairment is an accounting adjustment that does not affect cash flows, liquidity, regulatory capital, regulatory capital ratios or the future operations of our Corporation.

Net income excluding the impact of the goodwill impairment for the nine months ended September 30, 2010 was \$3.0 million, an increase of 113.7%, from \$1.4 million for the nine months ended September 30, 2009.

Diluted income per common share for the three months ended September 30, 2010 was \$0.38 compared to diluted earnings per common share of \$0.53 for the three months ended September 30, 2009. Diluted income per common share for the nine months ended September 30, 2010 was \$0.14 compared to diluted earnings per share of \$0.56 for the nine months ended September 30, 2009. Diluted income per common share for the nine months ended September 30, 2010 includes a \$1.06 per share goodwill impairment charge. Excluding the impairment of goodwill, diluted earnings per common share was \$1.20 for the nine months ended September 30, 2010.

Net interest margin increased to 3.12% for the three months ended September 30, 2010 compared to 2.88% for the three months ended September 30, 2009. Net interest margin increased to 3.03% for the nine months ended September 30, 2010 compared to 2.76% for the nine months ended September 30, 2009.

Top line revenue increased 12.3% to \$28.7 million for the nine months ended September 30, 2010 compared to \$25.5 million for the nine months ended September 30, 2009.



**Table of Contents**

Loan and lease loss provision was \$2.0 million for the three months ended September 30, 2010 compared to \$1.4 million for same time period in the prior year. Loan and lease loss provision was \$4.4 million for the nine months ended September 30, 2010 compared to \$5.2 million for the nine months ended September 30, 2009. Allowance for loan and lease loss as a percentage of gross loans and leases was 1.78% at September 30, 2010 compared to 1.65% at December 31, 2009.

Annualized return on average equity and return on average assets were 6.96% and 0.35%, respectively, for the three month period ended September 30, 2010, compared to 9.88% and 0.51%, respectively, for the same time period in 2009. Annualized return on average equity and return on average assets were 0.82% and 0.04%, respectively for the nine month period ended September 30, 2010, compared to 3.49% and 0.18%, respectively, for the nine months ended September 30, 2009. Excluding the goodwill impairment, annualized return on average assets was 0.37% for the nine months ended September 30, 2010. Excluding the goodwill impairment, annualized returns on average equity was 7.22% for the nine months ended September 30, 2010.

In the bullet points above, we present for the nine months ended September 30, 2010 (1) net income and earnings per share, in each case excluding the goodwill impairment and (2) annualized returns on average assets and annualized returns on average equity, calculated using net income excluding goodwill impairment. Each of these presented measures is a non-GAAP measure. We use these measures because we believe they provide greater comparability of the profitability to all periods presented.

**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 6.7% and 12.3% for the three and nine months ended September 30, 2010, respectively, as compared to the same periods in the prior year. The components of top line revenue were as follows:

|                        | For the Three Months Ended<br>September 30, |          |                                  | For the Nine Months Ended<br>September 30, |           |        |
|------------------------|---|----------|----------------------------------|--|-----------|--------|
|                        | 2010  | 2009     | Change<br>(Dollars In Thousands) | 2010                                       | 2009      | Change |
| Net interest income    | \$ 8,160                                    | \$ 7,333 | 11.3%                            | \$ 23,698                                  | \$ 20,666 | 14.7%  |
| Non-interest income    | 1,671                                       | 1,881    | (11.2)                           | 4,986                                      | 4,882     | 2.1    |
| Total top line revenue | \$ 9,831                                    | \$ 9,214 | 6.7                              | \$ 28,684                                  | \$ 25,548 | 12.3   |

**Adjusted Net Income.** Adjusted net income is comprised of our net income as presented under generally accepted accounting principles (GAAP) adjusted for the after tax effects of the provision for loan and lease losses, actual net charge-offs incurred during the year and other one-time unusual events including but not limited to impairment of goodwill. Adjusted net income allows our management team to better analyze the growth of our earnings, including a comparison to our benchmark peers, without the impact that the loan and lease provision may have on net income in periods of rapid growth or reduction in the loan and lease portfolio. Institutions with different loan and lease growth rates may not have comparable provisions for loan and lease loss amounts and net charge-off activity. In our judgment, presenting net income excluding the after tax effects of the provision for loan and lease losses and including actual net charge-offs allows investors to trend, analyze and benchmark our results of operations in a more meaningful manner. Adjusted net income 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. Due to a lower level of loan charge-off activity and improved top line revenue among other factors, our adjusted net income has improved by 98.9% for the nine months ended September 30, 2010 compared to the same period of the prior year.





**Table of Contents**

A reconciliation of net income to adjusted net income is as follows:

|  | For the Three Months Ended<br>September 30, |          |         | For the Nine Months Ended<br>September 30, |          |         |
|--|---|----------|---------|--|----------|---------|
|  | 2010  | 2009     | Change  | 2010                                       | 2009     | Change  |
|  | (Dollars In Thousands)                      |          |         | (Dollars In Thousands)                     |          |         |
| Net income, presented under US GAAP            | \$ 969                                      | \$ 1,353 | (28.4)% | \$ 343                                     | \$ 1,419 | (75.8)% |
| Add back:                                      |   |          |         |  |          |         |
| Provision for loan and lease losses, after tax | 1,187                                       | 838      | 41.6    | 2,654                                      | 3,174    | (16.4)  |
| Goodwill impairment                            |   |          |         | 2,689                                      |          | *       |
| Less:  |   |          |         |  |          |         |
| Net charge-offs, after tax                     | 827   | 768      | 7.7     | 1,706                                      | 2,592    | (34.2)  |
| Adjusted net income                            | \$ 1,329                                    | \$ 1,423 | (6.6)   | \$ 3,980                                   | \$ 2,001 | 98.9    |

\* Not meaningful

**Return on Equity.** Annualized return on equity for the three months ended September 30, 2010 was 6.96% compared to 9.88% for the three months ended September 30, 2009. The decline in the return on equity is due to a lower level of net income and is not impacted by the goodwill impairment recognized during the second quarter of 2010. Annualized return on equity for the nine months ended September 30, 2010 was 0.82% compared to 3.49% for the same time period of the prior year. The decrease in return on equity for the nine month period from the comparable period of the prior year was driven by the goodwill impairment of \$2.7 million recognized in June 2010. Excluding the impairment of goodwill, annualized return on equity for the nine months ended September 30, 2010 was 7.22%. The goodwill impairment is an accounting adjustment that does not affect cash flows, liquidity, regulatory capital, regulatory capital ratios, or the future operations of our Corporation. Management has primarily focused its attention on the return on equity excluding the goodwill impairment to analyze the improvement in profitability of the Corporation from the comparable reporting periods of the prior year. The increase in the adjusted return on equity ratio for the nine months ended September 30, 2010 is primarily attributable to the improvement in net income before the goodwill impairment. We view return on equity to be an important measure of profitability, and we are continuing to focus on improving our return on equity by enhancing the overall profitability of our client relationships, controlling our expenses and minimizing our costs of credit. See [General Overview](#) for a discussion of our net income excluding the goodwill impairment, a non-GAAP financial measure, used in the calculation of annualized return on equity excluding goodwill impairment, above.

**Net Interest Income.** Net interest income depends 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 procedures to prepare and respond to such changes.

**Table of Contents**

The table below 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 nine months ended September 30, 2010 compared to the same periods of 2009.

|   | Three Months |         |                 | Nine Months           |         |        |                 |         |
|---|--------------|---------|-----------------|-----------------------|---------|--------|-----------------|---------|
|   | Rate         | Volume  | Rate/<br>Volume | Net<br>(In Thousands) | Rate    | Volume | Rate/<br>Volume | Net     |
| <b>Interest-Earning Assets</b>                        |              |         |                 |                       |         |        |                 |         |
| Commercial real estate and other mortgage loans       | \$ 328       | \$ (52) | \$ (2)          | \$ 274                | \$ 524  | \$ 353 | \$ 8            | \$ 885  |
| Commercial loans                                      | (199)        | 166     | (8)             | (41)                  | 557     | (277)  | (13)            | 267     |
| Direct financing leases                               | (5)          | (107)   | 1               | (111)                 | 45      | (265)  | (8)             | (228)   |
| Other loans   | (72)         | (61)    | 17              | (116)                 | (239)   | (157)  | 48              | (348)   |
| Total loans and leases receivable                     | 52           | (54)    | 8               | 6                     | 887     | (346)  | 35              | 576     |
| Mortgage-related securities                           | (277)        | 268     | (62)            | (71)                  | (788)   | 731    | (159)           | (216)   |
| Investment securities                                 |              |         |                 |                       |         |        |                 |         |
| Federal Home Loan Bank Stock                          |              |         |                 |                       |         |        |                 |         |
| Short-term investments                                | 1            | 4       | 1               | 6                     |         | 50     |                 | 50      |
| Total net change in income on interest-earning assets | (224)        | 218     | (53)            | (59)                  | 99      | 435    | (124)           | 410     |
| <b>Interest-Bearing Liabilities</b>                   |              |         |                 |                       |         |        |                 |         |
| NOW accounts  | (23)         | 10      | (3)             | (16)                  | (17)    | 32     | (3)             | 12      |
| Money market  | (233)        | 84      | (25)            | (174)                 | (320)   | 511    | (83)            | 108     |
| Certificates of deposit                               | (8)          | (254)   | 3               | (259)                 | (355)   | (686)  | 108             | (933)   |
| Brokered certificates of deposit                      | (695)        | 335     | (54)            | (414)                 | (2,314) | 417    | (69)            | (1,966) |
| Total deposits  | (959)        | 175     | (79)            | (863)                 | (3,006) | 274    | (47)            | (2,779) |
| FHLB advances   | 1            | (50)    |                 | (49)                  | 17      | (66)   | (2)             | (51)    |
| Other borrowings                                      | 28           | (1)     | (1)             | 26                    | 303     | (78)   | (17)            | 208     |
| Junior subordinated notes                             |              |         |                 |                       |         |        |                 |         |
|   | (930)        | 124     | (80)            | (886)                 | (2,686) | 130    | (66)            | (2,622) |

Total net change in  
expense on  
interest-bearing  
liabilities

Net change in net  
interest income

|        |       |       |        |          |        |         |          |
|--------|-------|-------|--------|----------|--------|---------|----------|
| \$ 706 | \$ 94 | \$ 27 | \$ 827 | \$ 2,785 | \$ 305 | \$ (58) | \$ 3,032 |
|--------|-------|-------|--------|----------|--------|---------|----------|

**Table of Contents**

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 three months ended September 30, 2010 and 2009. The average balances are derived from average daily balances.

|  | Average<br>balance | For the Three Months Ended September 30, |   | Average<br>balance | Average<br>yield/cost |                       |
|--|--------------------|--|---|--------------------|-----------------------|-----------------------|
|  |                    | 2010<br>Interest                         | Average<br>yield/cost<br>(Dollars In Thousands) |                    | 2009<br>Interest      | Average<br>yield/cost |
| <b>Interest-Earning Assets</b>                                 |                    |  |   |                    |                       |                       |
| Commercial real estate and other mortgage loans <sup>(1)</sup> | \$ 599,562         | \$ 8,491                                 | 5.66%   | \$ 603,362         | \$ 8,217              | 5.45%                 |
| Commercial and industrial loans <sup>(1)</sup>                 | 218,629            | 4,053                                    | 7.42  | 210,102            | 4,094                 | 7.79                  |
| Direct financing leases <sup>(1)</sup>                         | 22,254             | 344                                      | 6.18  | 29,124             | 455                   | 6.25                  |
| Other loans  | 16,456             | 143                                      | 3.48  | 21,487             | 259                   | 4.82                  |
| Total loans and leases receivable <sup>(1)</sup>               | 856,901            | 13,031                                   | 6.08  | 864,075            | 13,025                | 6.03                  |
| Mortgage-related securities <sup>(2)</sup>                     | 142,794            | 1,120                                    | 3.14  | 116,550            | 1,191                 | 4.09                  |
| Investment securities <sup>(2)</sup>                           | 36                 |  |   |                    |                       |                       |
| Federal Home Loan Bank stock                                   | 2,367              |  |   | 2,367              |                       |                       |
| Short-term investments   | 42,510             | 25                                       | 0.24  | 34,615             | 19                    | 0.22                  |
| Total interest-earning assets                                  | 1,044,608          | 14,176                                   | 5.43  | 1,017,607          | 14,235                | 5.60                  |
| Non-interest-earning assets                                    | 48,246             |  |   | 42,883             |                       |                       |
| Total assets   | \$ 1,092,854       |  |   | \$ 1,060,490       |                       |                       |
| <b>Interest-Bearing Liabilities</b>                            |                    |  |   |                    |                       |                       |
| NOW accounts   | \$ 77,709          | 50                                       | 0.26  | \$ 67,288          | 66                    | 0.39                  |
| Money market   | 240,460            | 603                                      | 1.00  | 216,984            | 777                   | 1.43                  |
| Certificates of deposits                                       | 85,764             | 429                                      | 2.00  | 135,909            | 688                   | 2.02                  |
| Brokered certificates of deposit                               | 487,427            | 3,929                                    | 3.22  | 452,552            | 4,343                 | 3.84                  |
| Total interest-bearing deposits                                | 891,360            | 5,011                                    | 2.25  | 872,733            | 5,874                 | 2.69                  |
| FHLB advances  | 14,324             | 172                                      | 4.80  | 18,509             | 221                   | 4.78                  |
| Other borrowings   | 39,010             | 553                                      | 5.67  | 39,118             | 527                   | 5.39                  |
| Junior subordinated notes                                      | 10,315             | 280                                      | 10.86   | 10,315             | 280                   | 10.86                 |
| Total interest-bearing liabilities                             | 955,009            | 6,016                                    | 2.52  | 940,675            | 6,902                 | 2.93                  |
|  | 69,028             |  |   | 53,383             |                       |                       |

|   |              |          |              |          |       |
|---|--------------|----------|--------------|----------|-------|
| Non-interest-bearing demand deposit accounts                            |              |          |              |          |       |
| Other non-interest-bearing liabilities                                  | 13,099       |          | 11,642       |          |       |
| Total liabilities   | 1,037,136    |          | 1,005,700    |          |       |
| Stockholders' equity  | 55,718       |          | 54,790       |          |       |
| Total liabilities and stockholders' equity                              | \$ 1,092,854 |          | \$ 1,060,490 |          |       |
| Net interest income/interest rate spread                                |              | \$ 8,160 | 2.91%        | \$ 7,333 | 2.67% |
| Net interest-earning assets   | \$ 89,599    |          | \$ 76,932    |          |       |
| Net interest margin   |              |          | 3.12%        |          | 2.88% |
| Average interest-earning assets to average interest-bearing liabilities | 109.38%      |          | 108.18%      |          |       |
| Return on average assets  | 0.35         |          | 0.51         |          |       |
| Return on average equity  | 6.96         |          | 9.88         |          |       |
| Average equity to average assets  | 5.10         |          | 5.17         |          |       |
| Non-interest expense to average assets                                  | 2.33         |          | 2.08         |          |       |

(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.

**Table of Contents**

Net interest income increased by \$827,000, or 11.3%, during the three months ended September 30, 2010 compared to the same period in 2009. The increase in net interest income is primarily attributable to favorable rate variances from lower cost of deposits. Overall, favorable rate variances added \$706,000 to net interest income. The Federal Reserve held interest rates constant across the three-month periods ended September 30, 2010 and September 30, 2009.

Therefore the majority of the increase in net interest income associated with rate variances was caused by pricing deposits commensurate with current market conditions and demands along with replacing higher yielding maturing brokered certificates of deposits at lower current market rates.

Net interest margin increased 24 basis points to 3.12% for the three months ended September 30, 2010 from 2.88% for the three months ended September 30, 2009. The improvement in net interest margin is primarily due to a 41 basis point decline in the cost of interest-bearing liabilities to 2.52% for the three months ended September 30, 2010 from 2.93% for the comparable period of 2009. This was partially offset by a decline of 17 basis points in the yield on average earning assets to 5.43% for the three months ended September 30, 2010 from 5.60% for the three months ended September 30, 2009.

The yield on average earning assets for the three months ended September 30, 2010 was negatively affected by the overall change in the investment portfolio. We have invested in collateralized mortgage obligations with structured cash flow payments. The cash flows generated from these expected prepayments are typically reinvested in additional collateralized mortgage obligations. Given the continued low rate environment, the overall coupon on new security purchases has typically been lower than the rates on securities that experience prepayments. This has caused the investment yield to decline by approximately 95 basis points. The yield on loans and leases receivable increased by approximately 5 basis points to 6.08% for the three months ended September 30, 2010 from 6.03% for the comparable period of the prior year. The improvement in the overall yields on the loan and lease portfolio is mainly the result of pricing and mix of the loan and lease portfolio as we continue to improve our credit spreads on our fixed rate loan portfolio commensurate with current economic conditions and market demands and a continued increase in the dollar amount and number of variable rate loans with interest rate floors in excess of the current market rates.

The overall weighted average rate paid on interest-bearing liabilities was 2.52% for the three months ended September 30, 2010, a decrease of 41 basis points from 2.93% for the three months ended September 30, 2009. The decrease in the overall rate on the interest-bearing liabilities was primarily caused by the replacement of maturing certificates of deposits, including brokered certificates of deposits, at lower current market rates and a lower rate paid on our money market accounts.

**Table of Contents**

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 nine months ended September 30, 2010 and 2009. The average balances are derived from average daily balances.

|  | For the Nine Months Ended September 30, |                  |   |                    |                  |                       |
|--|---|------------------|---|--------------------|------------------|-----------------------|
|  | Average<br>balance                      | 2010<br>Interest | Average<br>yield/cost<br>(Dollars In Thousands) | Average<br>balance | 2009<br>Interest | Average<br>yield/cost |
| <b>Interest-Earning Assets</b>                                 |   |                  |   |                    |                  |                       |
| Commercial real estate and other mortgage loans <sup>(1)</sup> | \$ 599,002                              | \$ 25,168        | 5.60%   | \$ 590,412         | \$ 24,283        | 5.48%                 |
| Commercial and industrial loans <sup>(1)</sup>                 | 212,411                                 | 12,177           | 7.64  | 217,476            | 11,910           | 7.30                  |
| Direct financing leases <sup>(1)</sup>                         | 24,447                                  | 1,180            | 6.44  | 30,102             | 1,408            | 6.24                  |
| Other loans  | 17,508                                  | 439              | 3.34  | 21,875             | 787              | 4.80                  |
| Total loans and leases receivable <sup>(1)</sup>               | 853,368                                 | 38,964           | 6.09  | 859,865            | 38,388           | 5.95                  |
| Mortgage-related securities <sup>(2)</sup>                     | 134,457                                 | 3,420            | 3.39  | 111,953            | 3,636            | 4.33                  |
| Investment securities  | 12                                      |                  |   |                    |                  |                       |
| Federal Home Loan Bank stock                                   | 2,367                                   |                  |   | 2,367              |                  |                       |
| Short-term investments   | 53,552                                  | 98               | 0.24  | 25,943             | 48               | 0.25                  |
| Total interest-earning assets                                  | 1,043,756                               | 42,482           | 5.43  | 1,000,128          | 42,072           | 5.61                  |
| Non-interest-earning assets                                    | 47,883                                  |                  |   | 39,834             |                  |                       |
| Total assets   | \$ 1,091,639                            |                  |   | \$ 1,039,962       |                  |                       |
| <b>Interest-Bearing Liabilities</b>                            |   |                  |   |                    |                  |                       |
| NOW accounts   | 78,722                                  | 219              | 0.37  | \$ 68,212          | 207              | 0.40                  |
| Money market   | 252,646                                 | 2,105            | 1.11  | 201,183            | 1,997            | 1.32                  |
| Certificates of deposits                                       | 84,900                                  | 1,328            | 2.09  | 121,869            | 2,261            | 2.47                  |
| Brokered certificates of deposit                               | 476,325                                 | 12,083           | 3.38  | 462,604            | 14,049           | 4.05                  |
| Total interest-bearing deposits                                | 892,593                                 | 15,735           | 2.35  | 853,868            | 18,514           | 2.89                  |
| FHLB advances  | 17,094                                  | 607              | 4.73  | 18,997             | 658              | 4.62                  |
| Other borrowings   | 39,010                                  | 1,610            | 5.50  | 41,320             | 1,402            | 4.52                  |
| Junior subordinated notes                                      | 10,315                                  | 832              | 10.75   | 10,315             | 832              | 10.75                 |
| Total interest-bearing liabilities                             | 959,012                                 | 18,784           | 2.61  | 924,500            | 21,406           | 3.09                  |
|  | 63,741                                  |                  |   | 48,504             |                  |                       |

|   |              |           |              |           |       |
|---|--------------|-----------|--------------|-----------|-------|
| Non-interest-bearing demand deposit accounts                            |              |           |              |           |       |
| Other non-interest-bearing liabilities                                  | 12,885       |           | 12,703       |           |       |
| Total liabilities   | 1,035,638    |           | 985,707      |           |       |
| Stockholders' equity  | 56,001       |           | 54,255       |           |       |
| Total liabilities and stockholders' equity                              | \$ 1,091,639 |           | \$ 1,039,962 |           |       |
| Net interest income/interest rate spread                                |              | \$ 23,698 | 2.82%        | \$ 20,666 | 2.52% |
| Net interest-earning assets   | \$ 84,744    |           | \$ 75,628    |           |       |
| Net interest margin   |              |           | 3.03%        |           | 2.76% |
| Average interest-earning assets to average interest-bearing liabilities | 108.84%      |           | 108.18%      |           |       |
| Return on average assets  | 0.04         |           | 0.18         |           |       |
| Return on average equity  | 0.82         |           | 3.49         |           |       |
| Average equity to average assets  | 5.13         |           | 5.22         |           |       |
| Non-interest expense to average assets                                  | 2.70         |           | 2.30         |           |       |

(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.



**Table of Contents**

Net interest income increased by \$3.0 million, or 14.7%, during the nine months ended September 30, 2010 compared to the same period in 2009. The increase in net interest income was primarily attributable to favorable rate variances from lower cost of deposits. Overall, favorable rate variances added \$2.8 million to net interest income. The Federal Reserve held interest rates constant across the nine-month periods ended September 30, 2010 and September 30, 2009. Therefore, consistent with the third quarter of 2010 discussion, the majority of the increase in net interest income associated with rate variances was caused by pricing loans and deposits commensurate with current market conditions and demands.

Net interest margin increased 27 basis points to 3.03% for the nine months ended September 30, 2010 from 2.76% for the nine months ended September 30, 2009. The improvement in net interest margin was primarily due to a 30 basis point increase in net interest spread, which is the difference between the yield earned on earning assets offset by the cost of interest-bearing deposits, partially offset by a declining value of net free funds.

The yield on average earning assets for the nine months ended September 30, 2010 was negatively affected by approximately 17 basis points due to the level of low yielding short-term investments held at the Federal Reserve Bank compared to a negative effect of eight basis points in the comparable period of 2009. Similar to the discussion for the three months ended September 30, 2010, the overall yield on earning assets has declined due to the replacement of collateralized mortgage obligations with lower yielding securities. The impact on the earning asset yield as it relates to mortgage-related securities was approximately 11 basis points. The yield on our loan and lease portfolio has increased by 14 basis points. The improvement in the overall yields on the loan and lease portfolio is mainly the result of pricing and mix of the loan and lease portfolio as we continue to improve our credit spreads on our fixed rate loan portfolio commensurate with current economic conditions and market demands and a continued increase in the dollar amount and number of new and renewed variable rate loans with interest rate floors in excess of the current market rates. In addition the yield on our loan and lease receivable portfolio is positively impacted by the existence of one-time fees collected in lieu of interest. These fees had a positive impact for the first nine months of 2010 of approximately 13 basis points on our overall yield on loans and leases receivable during the first nine months of 2010 compared to approximately four basis points for the first nine months of 2009.

The overall weighted average rate paid on interest-bearing liabilities was 2.61% for the nine months ended September 30, 2010, a decrease of 48 basis points from 3.09% for the nine months ended September 30, 2009. The decrease in the overall rate on the interest-bearing liabilities is primarily caused by the replacement of maturing certificates of deposits, including brokered certificates of deposits, at lower current market rates and a lower overall rate paid on our money market accounts. The existence of excess liquidity and success in attracting in-market deposits has provided the opportunity for us to be able to manage our liability structure both in terms of composition and rate to assist in providing an enhanced net interest margin.

We expect to have continued elevated levels of non-accrual loans and the predictability of the payments collected in lieu of interest is uncertain; however, we believe that current market conditions will support continued improvement in pricing on our loan and deposit products. During the third quarter of 2010, we were able to re-pay maturing FHLB advances without replacing the debt which should provide for continued decline in our overall cost of funds.

Therefore, we believe that a net interest margin above 3.00% can be sustained, although no assurances can be given. The net interest margin is dependent upon various factors, including competitive pricing pressures, balance sheet mix from client behavior relative to loan or deposit products, asset liability management strategies employed by us and the slope of the yield curve in the future.

**Provision for Loan and Lease Losses.** The provision for loan and lease losses totaled \$2.0 million and \$1.4 million for the three months ended September 30, 2010 and 2009, respectively. The provision for loan and lease losses was \$4.4 million and \$5.2 million for the nine months ended September 30, 2010 and 2009, 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 net charge-offs recorded in the period and the amount of reserves established for impaired loans that present collateral shortfall positions.



**Table of Contents**

During the three and nine months ended September 30, 2010, the factors influencing the provision for loan and lease losses were the following:

|  | For the three months ended<br>September 30, |          | For the nine months ended<br>September 30, |          |
|--|---|----------|--|----------|
|  | 2010  | 2009     | 2010                                       | 2009     |
|  | (In Thousands)                              |          |  |          |
| <b>Changes in the provision for loan and lease losses associated with:</b>             |   |          |  |          |
| Establishment/modification of specific reserves on impaired loans, net                 | \$ 246                                      | \$ (119) | \$ 2,151                                   | \$ 877   |
| Increase in allowance for loan and lease loss reserve due to subjective factor changes | 213   | 425      | 213  | 1,084    |
| Charge-offs in excess of specific reserves   | 1,296                                       | 936      | 1,995                                      | 3,113    |
| Recoveries   | (277)                                       | (2)      | (281)                                      | (4)      |
| Change in inherent risk of the loan and lease portfolio                                | 476   | 138      | 289  | 152      |
| Total provision for loan and lease losses  | \$ 1,954                                    | \$ 1,378 | \$ 4,367                                   | \$ 5,222 |

Refer to **Asset Quality** for further information.

**Non-interest income.** Non-interest income, consisting primarily of fees earned for trust and investment services, service charges on deposits, income from bank-owned life insurance and loan fees, decreased by \$210,000, or 11.2%, to \$1.7 million for the three months ended September 30, 2010 from \$1.9 million for the three months ended September 30, 2009. The decrease was primarily due to a decrease in loan fees and the sale of securities in third quarter of 2009 that did not repeat in the third quarter of 2010, partially offset by an increase in trust and investment service fee income.

Trust and investment services fee income increased \$83,000, or 17.0%, to \$572,000 for the three months ended September 30, 2010 from \$489,000 for the three months ended September 30, 2009. Trust and investment services fee income is driven by the amount of assets under management and administration and is influenced by the timing and volatility of the equity markets coupled with our ability to continue to add clients to our portfolio. At September 30, 2010, we had \$375.1 million of trust assets under management compared to \$323.3 million at December 31, 2009 and \$296.0 million at September 30, 2009. Assets under administration were \$116.6 million at September 30, 2010 compared to \$124.2 million at December 31, 2009 and \$118.2 million at September 30, 2009. Our sales pipeline continues to be strong and we expect to continue to increase our assets under management, but we expect that assets under management and trust and investment services fee income will continue to be affected by market volatility for the foreseeable future.

Loan fees decreased by \$64,000, or 20.3%, to \$252,000 for the three months ended September 30, 2010 from \$316,000 for the three months ended September 30, 2009. Loan fees represent non-deferrable fees earned on loan activity and the revenue generated through the collateral audit process used to ensure the integrity of the collateral associated with our asset based commercial loans. The decrease in loan fees was directly related to decreased audit fee revenue recognized on a smaller number of collateral audits substantially completed.

During the third quarter of 2009, we sold approximately \$15.0 million of collateralized mortgage obligations of government-sponsored enterprises in an effort to improve the overall risk profile of the investment portfolio. A gain of approximately \$322,000 was recognized on the sale of these securities. No securities were sold in the comparable period of the current year.

Non-interest income increased \$104,000, or 2.1%, to \$5.0 million for the nine months ended September 30, 2010 from \$4.9 million for the nine months ended September 30, 2009. While trust and investment services income experienced a 24.7% increase, non-interest income for the nine months ended September 30, 2009 included additional sources of

income that did not repeat in 2010, including gains on sales of available-for-sale securities and from the recognition of the initial fair value of new derivative instruments. For the nine months ended September 30, 2009, net gains on sales of available for sale securities was \$322,000 and the initial fair value recognition for new derivative instruments was approximately \$279,000.

**Table of Contents**

Trust and investment services fee income increased \$344,000, or 24.7%, to \$1.7 million for the nine months ended September 30, 2010 from \$1.4 million for the comparable period of the prior year. The equity markets experienced a significant decline during the first nine months of 2009 with the lowest point being in March 2009. As trust and investment services fee income is directly correlated to the market values of our assets under management, our trust and investment services fee income was negatively impacted by the resulting decline in our assets under management during the nine months ended September 30, 2009. The increase in income during the nine months ended September 30, 2010 over the same period during the prior year represents a rebuilding of assets under management through market recovery coupled with successful sales efforts to contract new assets under our management.

Other non interest income increased \$27,000, or 4.6%, to \$614,000 for the nine months ended September 30, 2010 from \$587,000 for the comparable period of the prior year. The increase in other non interest income is due to the collection of other miscellaneous fee income and gains on disposals of equipment previously leased by our clients of \$302,000 partially offset by a reduction of initial fair value gains on derivative contracts of \$279,000, as noted below. We continue to offer interest rate swap products directly to our qualified commercial borrowers. We economically hedge these client derivative transactions by simultaneously entering into offsetting interest rate swap contracts with dealer counterparties. 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 demand for this product has significantly declined due to movement in interest rates and a more normal correlation of key rates. During the nine months ended September 30, 2010, we did not enter into any new derivative transactions. We recorded in the consolidated income statements a gain relating to the initial fair value recognition for the swaps which totaled \$279,000 for the nine months ended September 30, 2009 and this is included in other income. No gains were recognized for the nine months ended September 30, 2010. Changes in fair value of non-hedge derivative contracts are included in other income in the consolidated statements of income. The derivative contracts have mirror-image terms, which results in the positions changes in fair value primarily offsetting through earnings each period. Each of the swap contracts includes a credit valuation which was not a significant component of the fair value of the interest rate swap contracts for the three months ended September 30, 2010 or 2009.

**Non-interest expense.** Non-interest expense increased by \$859,000, or 15.6%, to \$6.4 million for the three months ended September 30, 2010 from \$5.5 million for the comparable period of 2009. The increase in non-interest expense is primarily caused by an increase in compensation expense, FDIC insurance costs and collateral liquidation costs, partially offset by declining expenses associated with gains and losses on foreclosed properties.

Compensation expense increased by \$442,000, or 14.8%, to \$3.4 million for the three months ended September 30, 2010 from \$3.0 million for the three months ended September 30, 2009. The overall increase in compensation expense relates to the level of the non-equity incentive compensation accrual recorded. We have accrued for a higher level of performance in 2010 based upon our results and the program's established criteria.

FDIC insurance expense was \$791,000 for the three months ended September 30, 2010, an increase of \$394,000, or 99.2%, from \$397,000 for the three months ended September 30, 2009. The primary reasons for the increase in FDIC insurance expense for the quarter ending September 30, 2010 are overall higher premium rates due to enacted regulations, increased costs due to our participation in the temporary liquidity guarantee program as well as the increased rate applied to the Banks' overall larger deposit base. On December 30, 2009, the Banks prepaid their 2010-2012 FDIC premiums pursuant to temporary FDIC regulations, and we are amortizing the expense over the coverage period. On October 19, 2010, the FDIC announced that it would forego a scheduled three basis point increase on banks that had been scheduled to go into effect on January 1, 2011.

Collateral liquidation costs associated with certain of our problem commercial loans for the three months ended September 30, 2010 were \$287,000, an increase of 139.2%, from \$120,000 for the three months ended September 30, 2009. These expenses represent costs incurred to work through our impaired loans. Collateral liquidation costs include legal expenses, rent expenses, shipping costs, warranty expenses, taxes incurred by the client and other necessary expenses required to protect our security interests. As we continue to have an elevated amount of impaired loans, we are incurring costs to evaluate and implement individual exit strategies for the impaired loans. The amount of collateral liquidation costs are influenced by the timing and level of effort required for each individual loan. Our ability to recoup these costs from our clients is uncertain and therefore we have expensed them as incurred through

our consolidated results of operations.

**Table of Contents**

During the three months ended September 30, 2010, we recognized a net gain on foreclosed properties of \$6,000 compared to a loss of \$193,000 for the three months ended September 30, 2009. We continue to be successful in disposing of our foreclosed properties. We believe that we have our foreclosed assets recorded at the current fair value and have not transferred any new assets into this category during the third quarter of 2010.

Non-interest expense for the nine months ended September 30, 2010 increased \$4.2 million, or 23.6%, to \$22.1 million from \$17.9 million for the nine months ended September 30, 2009. The increase in non-interest expense is primarily due to an impairment of goodwill of \$2.7 million, an increase in compensation expense of \$1.1 million and an increase in FDIC insurance expense of \$672,000, partially offset by a decline in collateral liquidation costs of \$130,000.

During the three months ended June 30, 2010, we recorded a goodwill impairment of \$2.7 million. Due to the continued negative environment, the banking industry continues to experience downward pressure in financial performance and its future outlook and thus overall industry market capitalizations continue to trend downward. Our stock price has consistently traded below book value since December 2007. We evaluated the impact of the continued negative economic environment and its continued downward pressure on the reporting unit's asset quality and financial performance, and considered their impact on the future cash flows of the reporting unit, in addition to reconciling the calculated values of all of its reporting units to our market capitalization. After considering the factors noted above, management concluded that the fair value of the reporting unit was less than the carrying value. Management completed the second step of the annual goodwill impairment test to measure the amount of the impairment and concluded that an impairment equivalent to the entire carrying amount of the goodwill was warranted. Please refer to Note 4 in the notes to the unaudited consolidated financial statements for further information.

Compensation expense has increased primarily due to the accrual of amounts expected to be paid under our non-equity incentive compensation program. FDIC insurance expense has increased primarily due to increased rates charged by the FDIC on our increased outstanding balance of deposits. The decline in collateral liquidation costs is caused by an unusual, disproportionate amount of costs incurred on one particular credit during the first quarter of 2009 which did not recur during the nine months ended September 30, 2010.

**Income Taxes.** Income tax expense was \$1.9 million for the nine months ended September 30, 2010 compared to \$989,000 for the nine months ended September 30, 2009. During the nine months ended September 30, 2010, we recorded a goodwill impairment of \$2.7 million. Income tax expense for the nine months ended September 30, 2010 is recorded at what we believe to be the best estimate of the annualized effective tax rate recognizing discrete items such as goodwill impairment in the periods in which they occur. The goodwill impairment is treated as a permanent difference and is not deductible for income tax purposes.

**Financial Condition**

**General.** Our total assets increased by \$5.4 million to \$1.123 billion at September 30, 2010 from \$1.117 billion at December 31, 2009, an increase of less than 1%.

**Table of Contents**

**Short-term investments.** Short-term investments decreased by \$50.8 million to \$53.4 million at September 30, 2010 from \$104.2 million at December 31, 2009. We continue to value the safety and soundness provided by the Federal Reserve Bank, and during this difficult economic environment, we view on-balance sheet liquidity as a critical element to maintaining adequate liquidity to meet our cash and collateral obligations and therefore are continuing to keep elevated levels of cash on deposit with the Federal Reserve Bank. We do, however, plan to utilize excess liquidity to pay down maturing debt, pay down maturing brokered certificates of deposit, or invest in U.S. Government backed securities to maintain adequate liquidity at an improved margin. Should loan growth opportunities be presented, we would also expect to utilize excess liquidity to fund loan portfolio growth. During the three months ended September 30, 2010, in addition to funding loan growth, we utilized excess liquidity to pay down approximately \$16 million of maturing debt and invested in U.S. Government backed securities. We also experienced loan growth which was funded through the utilization of excess liquidity.

**Securities.** Securities available-for-sale increased by \$30.5 million, or 25.0%, to \$152.8 million at September 30, 2010 from \$122.3 million at December 31, 2009, primarily due to additional purchases of government agency collateralized mortgage obligations. Our available-for-sale investment portfolio primarily consists of collateralized mortgage obligations and is used to provide a source of liquidity, including the ability to pledge securities, while maximizing the earnings potential of our assets. The estimated prepayment streams associated with this portfolio also allow us to better match our short-term liabilities. We purchase investment securities intended to protect our net interest margin while maintaining an acceptable risk profile. While collateralized mortgage obligations present prepayment risk and extension risk, we believe the overall credit risk associated with these investments is minimal as substantially all of the obligations we hold were issued by the Government National Mortgage Association (GNMA), a U.S. Government agency. We do not hold any Federal National Mortgage Association or Federal Home Loan Mortgage Corp preferred stock.

During the nine months ended September 30, 2010, we recognized unrealized holding gains of \$1.6 million through other comprehensive income. All of the securities we hold have active trading markets, and we are not currently experiencing difficulties in pricing our securities. Our portfolio is sensitive to fluctuations in the interest rate environment and has limited sensitivity to credit risk due to the nature of the issuers of our securities as previously discussed. If interest rates decline and the credit quality of the securities remain positive, the market value of our debt securities portfolio should improve. If interest rates increase and the credit quality of the securities remain positive, the market value of our debt securities portfolio should decline. No securities within our portfolio were deemed to be other-than-temporarily impaired as of September 30, 2010.

**Loans and Leases Receivable.** Loans and leases receivable, net of allowance for loan and lease losses, increased \$23.6 million, or 2.8%, to \$863.4 million at September 30, 2010 from \$839.8 million at December 31, 2009. We principally originate commercial business loans and commercial real estate loans. The overall mix of the loan and lease portfolio at September 30, 2010 remained generally consistent with the mix at December 31, 2009, continuing to have a concentration in commercial real estate mortgage loans at 69.7% of our total loan portfolio. Economic conditions and demand for new loans remained weak in the geographic markets we serve during the nine months ended September 30, 2010; however, we believe we are beginning to see signs of improvement. We are also seeing opportunities to increase our market share by successfully attracting top quality clients from our competitors. We continue to compete with other lenders for fewer high quality loan opportunities which has put pressure on our ability to grow our loan and lease portfolio at growth rates we experienced prior to 2009. We remain committed to our underwriting standards and continue to seek high quality assets to continue our growth plan.

The allowance for loan and lease losses as a percentage of gross loans and leases was 1.78% and 1.65% as of September 30, 2010 and December 31, 2009, respectively. Non-accrual loans and leases as a percentage of gross loans and leases increased to 3.51% at September 30, 2010 compared to 3.26% at December 31, 2009. We continue to work through many of our problem loans and are experiencing success in certain of our exit strategies, however, we continue to identify new loans or leases where we believe that the borrowers do not have adequate liquidity to make their payments in accordance with the terms of the contractual arrangements. Therefore, we consider these assets to be impaired and have placed them on non-accrual. During the three and nine months ended September 30, 2010, we recorded net charge-offs of approximately \$1.4 million and \$2.8 million, respectively on previously identified



impaired loans and leases within our loan and lease portfolio due to declining real estate and equipment values supporting our loans where the collateral is no longer sufficient to cover the outstanding principal and the borrowers do not have any other means to repay the obligation. Charge-offs are not concentrated in any specific industry or in any specific area within our primary markets.

**Table of Contents**

Given continued charge-offs and increased indicators of impairment of loans and leases, we recorded a \$2.0 million and \$4.4 million provision for loan and lease losses in the three and nine months ended September 30, 2010. Taking into consideration the level of charge-offs recorded and the need for additional specific reserves on impaired loans with estimated collateral shortfalls, we concluded that an appropriate allowance for loan and lease losses as of September 30, 2010 was \$15.7 million or 1.78% of gross loans and leases. Refer to the **Asset Quality** section for more information.

**Deposits.** As of September 30, 2010, deposits increased by \$13.8 million to \$998.1 million from \$984.4 million at December 31, 2009. The increase in overall deposits from December 31, 2009 is due to an increase in brokered certificates of deposit of approximately \$21.0 million. Due to our business banking focus that provides for a larger average deposit relationship, activity within a few of our client relationships can influence our in-market deposit ending balances at each measurement period. Overall, our average in-market deposits increased by 9.2% to \$480.0 million for the nine months ended September 30, 2010 compared to \$439.8 million for the year ended December 31, 2009. We continue to focus on gathering local deposits through a variety of methods including offering competitive rates and targeted treasury management initiatives. Brokered certificates of deposit continue to be a significant source of our funding and totaled \$491.8 million at September 30, 2010 compared to \$470.8 million at December 31, 2009.

**Federal Home Loan Bank and other borrowings.** As of September 30, 2010, Federal Home Loan Bank and other borrowings decreased by approximately \$16.0 million to \$41.5 million from \$57.5 million at December 31, 2009. The reason for the decline is due the maturity of \$16.0 million of outstanding Federal Home Loan Bank advances that were not replaced.

**Asset Quality**

**Non-performing Assets.** Non-performing assets consisted of non-accrual loans and leases and foreclosed properties totaling \$32.2 million, or 2.86%, of total assets, as of September 30, 2010, an increase in non-performing assets of 9.0% from December 31, 2009. Non-performing assets were \$29.5 million, or 2.64% of total assets, at December 31, 2009. The increase in non-performing assets was the result of continued identification of 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 ability to sell land, inadequate cash flow from the operations of the underlying businesses, or final determinations by our clients to file bankruptcy. While impaired loans and leases exhibit weaknesses that inhibit repayment in compliance with the original note or lease terms, 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. As part of underwriting process as well as our ongoing monitoring efforts, we try to ensure that we have adequate collateral to protect our interest in the related loan or lease. As a result of this practice, a significant portion of our non-performing loans or leases either do not require additional specific reserves or a minimal amount of required specific reserve as we believe the loans and leases are adequately collateralized as of the measurement period. This practice leads to a declining allowance for loan and lease loss to non-accrual loans and leases ratio. We then reserve for any shortfalls based upon our collateral evaluation. We expect current economic conditions to remain the same for the near term. As a result, we expect that we will continue to experience elevated levels of impaired loans and leases.

**Table of Contents**

Our non-accrual loans and leases consisted of the following at September 30, 2010 and December 31, 2009, respectively:

|  | September<br>30,<br>2010 | December 31,<br>2009 |
|--|--------------------------|----------------------|
|  | (Dollars In Thousands)   |                      |
| Non-accrual loans and leases   |                          |                      |
| First mortgage loans:  |                          |                      |
| Commercial real estate   | \$ 10,304                | \$ 8,482             |
| Construction and land development  | 3,290                    | 3,317                |
| Multi-family   | 4,683                    | 1,760                |
| 1-4 family   | 3,503                    | 3,015                |
| Total first mortgage loans   | 21,780                   | 16,574               |
| Commercial and industrial  | 5,419                    | 7,086                |
| Direct financing leases, net   |                          | 1                    |
| Home equity and second mortgage  | 1,042                    | 872                  |
| Other  | 2,677                    | 3,292                |
| Total non-accrual loans and leases   | 30,918                   | 27,825               |
| Foreclosed properties and repossessed assets   | 1,247                    | 1,671                |
| Total non-performing assets  | \$ 32,165                | \$ 29,496            |
| Performing troubled debt restructurings  | \$                       | \$                   |
| Total non-accrual loans and leases to gross loans and leases                                 | 3.51%                    | 3.26%                |
| Total non-performing assets to total assets  | 2.86                     | 2.64                 |
| Allowance for loan and lease losses to gross loans and leases                                | 1.78                     | 1.65                 |
| Allowance for loan and lease losses to non-accrual loans and leases                          | 50.73                    | 50.76                |
| A summary of our current period non-accrual loan activity is as follows (In Thousands):      |                          |                      |
| Non-accrual loans as of December 31, 2009  |                          | \$ 27,825            |
| Loans transferred into non-accrual status  |                          | 18,721               |
| Loans returned to accrual status   |                          | (2,145)              |
| Loans transferred to foreclosed properties   |                          | (578)                |
| Loans charged-off  |                          | (2,812)              |
| Loans fully paid-off   |                          | (2,885)              |
| Principal payments applied to non-accrual loans  |                          | (7,208)              |
| Non-accrual loans as of September 30, 2010   |                          | \$ 30,918            |
| A summary of our current period foreclosed properties activity is as follows (In Thousands): |                          |                      |
| Foreclosed properties as of December 31, 2009  |                          | \$ 1,671             |
| Loans transferred to foreclosed properties   |                          | 578                  |
| Proceeds from sale of foreclosed properties  |                          | (990)                |

|  |          |
|--|----------|
| Gain on sale of foreclosed properties          | 115      |
| Impairment valuation                           | (127)    |
| Foreclosed properties as of September 30, 2010 | \$ 1,247 |

**Table of Contents**

The following represents information regarding our impaired loans:

|  | As of and<br>for<br>the Nine<br>Months<br>Ended<br>September<br>30,<br>2010 | As of and for<br>the Year<br>Ended<br>December 31,<br>2009 |
|--|---|--|
|  | (In Thousands)  |  |
| Impaired loans and leases with no impairment reserves required       | \$ 18,192   | \$ 13,243  |
| Impaired loans and leases with impairment reserves required          | 12,726  | 14,582   |
| Total impaired loans and leases                                      | 30,918  | 27,825   |
| Less:  |   |  |
| Impairment reserve (included in allowance for loan and lease losses) | 2,903   | 1,846  |
| Net impaired loans and leases  | \$ 28,015   | \$ 25,979  |
| Average impaired loans and leases                                    | \$ 29,810   | \$ 20,395  |
| Foregone interest income attributable to impaired loans and leases   | \$ 1,885  | \$ 1,758   |
| Interest income recognized on impaired loans and leases              | (77)  | (149)  |
| Net foregone interest income on impaired loans and leases            | \$ 1,808  | \$ 1,609   |

Net foregone interest income on impaired loans and leases for the nine months ended September 30, 2009 was \$1.2 million.

When we believe that we will not recover our principal on a loan or lease, we record a charge-off for the amount we deem uncollectible. We record the charge-off through our allowance for loan and lease losses. For the three and nine months ended September 30, 2010, we recorded net charge-offs of \$1.4 million and \$2.8 million, respectively, as compared to recording net charge-offs for the three and nine months ended September 30, 2009 of \$1.3 million and \$4.3 million, respectively. We continue to proactively monitor our loan and lease portfolio for further deterioration and apply our prescribed allowance for loan and lease loss reserve methodology. We believe that our allowance for loan and lease loss reserve was recorded at the appropriate value at September 30, 2010; however, given ongoing complexities with legal actions on certain of our large impaired loans and the lack of significant improvement in economic conditions or declines in collateral values, further charge-offs and increased provisions for loan losses could be recorded if additional facts and circumstances lead us to a different conclusion.

**Table of Contents**

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

|  | For the Three Months Ended<br>September 30, |           | For the Nine Months Ended<br>September 30, |           |
|--|---|-----------|--|-----------|
|  | 2010  | 2009      | 2010                                       | 2009      |
|  | (Dollars In Thousands)                      |           |  |           |
| Allowance at beginning of period                                       | \$ 15,091                                   | \$ 12,690 | \$ 14,124                                  | \$ 11,846 |
| Charge-offs:   |   |           |  |           |
| Commercial real estate and other first mortgage                        | (1,339)                                     | (1,131)   | (2,214)                                    | (2,059)   |
| Commercial and industrial  | (89)  | (3)       | (337)                                      | (1,813)   |
| Direct financing leases  |   |           |  | (231)     |
| Home equity and second mortgage  | (75)  | (130)     | (75)                                       | (157)     |
| Other  | (135)                                       |           | (462)                                      | (8)       |
| Total charge-offs  | (1,638)                                     | (1,264)   | (3,088)                                    | (4,268)   |
| Recoveries:  |   |           |  |           |
| Commercial real estate and other first mortgage                        | 13  |           | 16   |           |
| Commercial and industrial  | 264   | 1         | 265  | 3         |
| Direct financing leases  |   |           |  |           |
| Home equity and second mortgage  |   |           |  | 2         |
| Other  |   |           |  |           |
| Total recoveries   | 277   | 1         | 281  | 5         |
| Net charge-offs  | (1,361)                                     | (1,263)   | (2,807)                                    | (4,263)   |
| Provision for loan and lease losses                                    | 1,954                                       | 1,378     | 4,367                                      | 5,222     |
| Allowance at end of period   | \$ 15,684                                   | \$ 12,805 | \$ 15,684                                  | \$ 12,805 |
| Annualized net charge-offs as a % of average<br>gross loans and leases | 0.64%                                       | 0.58%     | 0.43%                                      | 0.66%     |

**Liquidity and Capital Resources**

During the three and nine months ended September 30, 2010 and the year ended December 31, 2009, the Banks did not make any dividend payments to the Corporation. The Banks are subject to certain regulatory limitations regarding their ability to pay dividends to the Corporation. Management believes that the Corporation will not be adversely affected by these dividend limitations. The Corporation's principal liquidity requirements at September 30, 2010 are the repayment of interest payments due on subordinated and junior subordinated notes. The Corporation expects to meet its liquidity needs through existing cash on hand, established cash flow sources such as payments from subsidiaries for services provided, its line of credit in the amount of \$10.5 million of which \$10,000 was outstanding on September 30, 2010 and through any future dividends received from the Banks. The Corporation and its subsidiaries continue to have a strong capital base and the Corporation's regulatory capital ratios continue to be above the defined minimum regulatory ratios. Refer to Note 14 in the notes to the unaudited consolidated financial statements for further information. During the nine months ended September 30, 2010, we recorded a goodwill impairment of \$2.7 million. This accounting adjustment did not have an impact on our capital ratios.

We manage our liquidity to ensure that funds are available to each of our Banks to satisfy the cash flow requirements of depositors and borrowers and to ensure the Corporation's own cash requirements are met. The Banks maintain liquidity by obtaining funds from several sources, including principal and interest payments 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.

**Table of Contents**

We had \$491.8 million of outstanding brokered deposits at September 30, 2010, compared to \$470.8 million of brokered deposits as of December 31, 2009. We are committed to our continued efforts to raise in-market deposits and reduce our overall dependence on brokered certificates of deposit. However, brokered deposits 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 deposits within a short time period. Access to such deposits allows us the flexibility to decline pursuing single service deposit relationships in markets that have experienced unfavorable pricing levels. In addition, the administrative costs associated with brokered deposits are considerably lower than those that would be incurred to administer a similar level of local deposits with a similar maturity structure. 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 likely continue to use brokered deposits to compensate for shortfalls in deposit gathering in maturity periods, typically three to five years, needed to effectively match the interest rate sensitivity measured through our defined asset/liability management process. In order to provide for ongoing liquidity and funding, all of our brokered deposits are certificates of deposit that do not allow for withdrawal at the option of the depositor before the stated maturity. The Banks have been able to access the brokered certificate of deposit market as needed at rates and terms comparable to market standards. In the event that there is a disruption in the availability of brokered deposits at maturity, the Banks have managed the maturity structure so that at least one year of maturities could be funded through borrowings with the Federal Home Loan Bank or Federal Reserve Discount Window utilizing currently unencumbered securities as collateral. 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 and have the ability to raise local market deposits by offering attractive rates to generate the level required to fulfill the liquidity need. The Banks are required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. We believe that 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.

**Contractual Obligations and Off-balance Sheet Arrangements**

There have been no significant changes to the Corporation's contractual obligations and off-balance arrangements disclosed in our Form 10-K for the year ended December 31, 2009. 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 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. 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.



**Table of Contents**

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. 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, 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 and ability to utilize such instruments should they be necessary 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 September 30, 2010 has not changed materially since December 31, 2009.

**Item 4T. 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). 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 September 30, 2010.

There was no change in the Corporation's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during the quarter ended September 30, 2010 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**

There have been no material changes to risk factors as previously disclosed in Item 1A. to Part I of the Corporation's Form 10-K for the year ended December 31, 2009.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(a) None.

(b) None.

(c) Issuer Purchases of Equity Securities

| Period                                 | Total   |                                    | Total Number<br>of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans<br>or Programs | Approximate<br>Dollar Value of<br>Shares that May<br>Yet Be<br>Purchased<br>Under<br>the Plans or<br>Programs <sup>(2)</sup> |
|--|---|------------------------------------|--|--|
|  | Number of<br>Shares<br>Purchased <sup>(1)</sup> | Average<br>Price Paid<br>Per Share |  |  |
| July 1, 2010 – July 31, 2010           | 3,403   | 9.35                               |  | \$ 177,150   |
| August 1, 2010 – August 31, 2010       | 197   | 8.91                               |  | 177,150  |
| September 1, 2010 – September 30, 2010 | 321   | 9.05                               |  | 177,150  |

(1) The shares in this column represent the 3,921 shares that were surrendered to us to satisfy income tax withholding obligations in connection with the vesting of restricted shares during the three months ended September 30, 2010.

(2) On November 20, 2007, the Corporation publicly announced a stock repurchase program whereby the Corporation

would repurchase up to approximately \$1,000,000 of the Corporation's outstanding stock. As of September 30, 2010, approximately \$177,150 remains available to repurchase the Corporation's outstanding stock. There currently is no expiration date to this stock repurchase program.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Reserved**

**Item 5. Other Information.**

None.

**Item 6. Exhibits.**

- (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. paragraph 1350.

**Table of Contents**

**Signatures**

Pursuant to the requirements of Section 12 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.**

October 29, 2010

/s/ Corey A. Chambas

Corey A. Chambas  
Chief Executive Officer

October 29, 2010

/s/ James F. Ropella

James F. Ropella  
Chief Financial Officer

**Table of Contents**

**FIRST BUSINESS FINANCIAL SERVICES, INC.  
Exhibit Index to Quarterly Report on Form 10-Q**

**Exhibit  
Number**

|      |   |
|------|---|
| 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. paragraph 1350 |