OLD NATIONAL BANCORP /IN/
Form 10-Q
October 31, 2018

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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, 2018

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

For the transition period from ____________ to ____________

Commission File Number 1-15817

OLD NATIONAL BANCORP

(Exact name of Registrant as specified in its charter)

INDIANA	35-1539838

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

One Main Street

Evansville, Indiana	47708
(Address of principal executive offices)	(Zip Code)

(800) 731-2265

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (s232.405 of this chapter) during the preceding 12 months (or for shorter period that the registrant was required to submit such files). Yes No

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

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

Emerging growth company

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

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock. The registrant has one class of common stock (no par value) with 152,352,000 shares outstanding at September 30, 2018.

OLD NATIONAL BANCORP

FORM 10-Q

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GLOSSARY OF ABBREVIATIONS AND ACRONYMS

As used in this report, references to "Old National," "we," "our," "us," and similar terms refer to the consolidated entity consisting of Old National Bancorp and its wholly-owned affiliates. Old National Bancorp refers solely to the parent holding company, and Old National Bank refers to Old National's bank subsidiary.

The acronyms and abbreviations identified below are used in the Notes to Consolidated Financial Statements (Unaudited) as well as in the Management's Discussion and Analysis of Financial Condition and Results of Operations. You may find it helpful to refer to this page as you read this report.

Anchor (MN): Anchor Bancorp, Inc.

Anchor Bank (MN): Anchor Bank, N.A.

Anchor (WI): Anchor BanCorp Wisconsin Inc.

AnchorBank (WI): AnchorBank, fsb

AOCI: accumulated other comprehensive income (loss)

AQR: asset quality rating

ASC: Accounting Standards Codification

ASU: Accounting Standards Update

ATM: automated teller machine

Common Stock: Old National Bancorp common stock, without par value

CReED: Indiana Community Revitalization Enhancement District Tax Credit

DTI: debt-to-income

Dodd-Frank Act: Dodd-Frank Wall Street Reform and Consumer Protection Act

EITF: Emerging Issues Task Force

FASB: Financial Accounting Standards Board

FDIC: Federal Deposit Insurance Corporation

FHLB: Federal Home Loan Bank

FHTC: Federal Historic Tax Credit

FICO: Fair Isaac Corporation

GAAP: generally accepted accounting principles in the United States

Klein: Klein Financial, Inc.

LGD: loss given default

LIBOR: London Interbank Offered Rate

LIHTC: Low Income Housing Tax Credit

LTV: loan-to-value

N/A: not applicable

N/M: not meaningful

NASDAQ: The NASDAQ Stock Market LLC

NOW: negotiable order of withdrawal

OTTI: other-than-temporary impairment

PCI: purchased credit impaired

PD: probability of default

Renewable Energy: investment tax credits for solar projects

SAB: Staff Accounting Bulletin

SEC: Securities and Exchange Commission

TBA: to be announced

TDR: troubled debt restructuring

OLD NATIONAL BANCORP

CONSOLIDATED BALANCE SHEETS

(dollars and shares in thousands, except per share data)	September 30, 2018 (unaudited)	December 31, 2017	September 30, 2017 (unaudited)
Assets			
Cash and due from banks	$215,024	$222,753	$202,652
Money market and other interest-earning investments	71,737	67,679	49,715
Total cash and cash equivalents	286,761	290,432	252,367
Trading securities, at fair value	5,828	5,584	5,351
Investment securities - available-for-sale, at fair value:			
U.S. Treasury	5,237	5,551	5,615
U.S. government-sponsored entities and agencies	611,696	664,286	576,436
Mortgage-backed securities	1,508,692	1,667,682	1,450,736
States and political subdivisions	792,666	530,193	414,673
Other securities	354,165	328,495	328,377
Total investment securities - available-for-sale	3,272,456	3,196,207	2,775,837
Investment securities - held-to-maturity, at amortized cost			
(fair value $505,566; $727,703; and $740,564, respectively)	512,207	684,063	688,951
Federal Home Loan Bank/Federal Reserve Bank stock, at cost	136,206	119,686	117,354
Loans held for sale, at fair value	21,384	17,930	30,221
Loans:			
Commercial	2,949,277	2,717,269	2,049,054
Commercial real estate	4,481,554	4,354,552	3,370,211
Residential real estate	2,166,203	2,167,053	2,119,120
Consumer credit, net of unearned income	1,695,625	1,879,247	1,859,739
Total loans	11,292,659	11,118,121	9,398,124
Allowance for loan losses	(52,713)	(50,381)	(50,169)
Net loans	11,239,946	11,067,740	9,347,955
Premises and equipment, net	450,253	458,074	412,488
Accrued interest receivable	78,493	87,102	75,342
Goodwill	828,804	828,051	655,018
Other intangible assets	42,134	53,096	29,235
Company-owned life insurance	405,245	403,753	356,897
Net deferred tax assets	94,667	110,857	137,951
Loan servicing rights	24,336	24,661	24,900
Assets held for sale	9,381	7,180	8,196
Other real estate owned and repossessed personal property	3,563	8,810	10,259
Other assets	156,095	155,066	137,478
Total assets	$17,567,759	$17,518,292	$15,065,800
Liabilities			
Deposits:			
Noninterest-bearing demand	$3,588,370	$3,680,807	$3,034,696
Interest-bearing:			

Checking and NOW	3,011,544	3,115,822	2,539,233
Savings	2,920,712	3,035,622	2,932,488
Money market	1,185,439	1,139,077	648,378
Time	1,892,135	1,634,436	1,451,989
Total deposits	12,598,200	12,605,764	10,606,784
Federal funds purchased and interbank borrowings	450,031	335,033	317,021
Securities sold under agreements to repurchase	319,831	384,810	285,409
Federal Home Loan Bank advances	1,554,515	1,609,579	1,589,367
Other borrowings	251,662	248,782	219,314
Accrued expenses and other liabilities	172,840	179,927	141,082
Total liabilities	15,347,079	15,363,895	13,158,977
Shareholders' Equity			
Preferred stock, 2,000 shares authorized, no shares issued or outstanding	-	-	-
Common stock, $1.00 per share stated value, 300,000 shares authorized, 152,352; 152,040; and 135,523 shares issued and outstanding, respectively	152,352	152,040	135,523
Capital surplus	1,645,111	1,639,499	1,354,036
Retained earnings	503,147	413,130	451,461
Accumulated other comprehensive income (loss), net of tax	(79,930)	(50,272)	(34,197)
Total shareholders' equity	2,220,680	2,154,397	1,906,823
Total liabilities and shareholders' equity	$17,567,759	$17,518,292	$15,065,800

The accompanying notes to consolidated financial statements are an integral part of these statements.

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OLD NATIONAL BANCORP

CONSOLIDATED STATEMENTS OF INCOME (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars and shares in thousands, except per share data)	2018	2017	2018	2017
Interest Income				
Loans including fees:				
Taxable	$125,468	$97,685	$368,467	$282,075
Nontaxable	4,075	3,373	11,933	9,788
Investment securities:				
Taxable	19,391	15,330	56,562	46,516
Nontaxable	6,295	7,052	19,502	21,652
Money market and other interest-earning investments	140	85	347	171
Total interest income	155,369	123,525	456,811	360,202
Interest Expense				
Deposits	11,189	5,125	27,583	14,232
Federal funds purchased and interbank borrowings	1,191	655	2,855	1,433
Securities sold under agreements to repurchase	535	280	1,328	870
Federal Home Loan Bank advances	8,880	6,618	25,484	17,947
Other borrowings	2,732	2,369	8,184	7,108
Total interest expense	24,527	15,047	65,434	41,590
Net interest income	130,842	108,478	391,377	318,612
Provision for loan losses	750	311	3,576	2,013
Net interest income after provision for loan losses	130,092	108,167	387,801	316,599
Noninterest Income				
Wealth management fees	9,022	8,837	27,794	27,515
Service charges on deposit accounts	11,028	10,535	32,552	30,418
Debit card and ATM fees	4,706	4,248	14,651	12,920
Mortgage banking revenue	4,348	5,104	13,729	14,516
Investment product fees	5,073	5,193	15,170	15,186
Capital markets income	2,700	1,843	4,094	5,621
Company-owned life insurance	2,958	2,022	7,993	6,288
Net securities gains (losses)	135	2,972	2,417	7,547
Recognition of deferred gain on sale leaseback transactions	394	537	1,183	1,612
Other income	5,593	5,075	17,568	16,934
Total noninterest income	45,957	46,366	137,151	138,557
Noninterest Expense				
Salaries and employee benefits	63,158	57,783	193,929	171,953
Occupancy	12,578	11,670	38,731	34,343
Equipment	3,652	3,485	10,945	10,062
Marketing	3,406	2,646	11,065	9,369
Data processing	8,628	7,696	26,752	23,530
Communication	2,473	2,163	8,309	6,865
Professional fees	3,235	4,589	8,888	11,317
Loan expenses	1,564	1,542	5,151	4,866
Supplies	707	547	2,332	1,720
FDIC assessment	2,722	2,197	8,528	6,814

Other real estate owned expense	157	511	702	2,635
Amortization of intangibles	3,283	2,641	10,308	8,442
Amortization of tax credit investments	9,233	-	21,807	-
Other expense	4,580	6,232	19,546	16,488
Total noninterest expense	119,376	103,702	366,993	308,404
Income before income taxes	56,673	50,831	157,959	146,752
Income tax expense	5,325	11,459	14,627	32,534
Net income	$51,348	$39,372	$143,332	$114,218
Net income per common share - basic	$0.34	$0.30	$0.95	$0.85
Net income per common share - diluted	0.34	0.29	0.94	0.84
Weighted average number of common shares outstanding - basic	151,930	135,120	151,844	135,040
Weighted average number of common shares outstanding - diluted	152,784	135,796	152,616	135,693
Dividends per common share	$0.13	$0.13	$0.39	$0.39

The accompanying notes to consolidated financial statements are an integral part of these statements.

OLD NATIONAL BANCORP

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Net income	$51,348	$39,372	$143,332	$114,218
Other comprehensive income (loss):				
Change in debt securities available-for-sale:				
Unrealized holding gains (losses) for the period	(18,159)	(3,955)	(51,280)	42,452
Reclassification for securities transferred to held-to-maturity	-	-	14,007	-
Reclassification adjustment for securities gains realized in income	(135)	(2,972)	(2,417)	(7,547)
Income tax effect	4,188	2,513	9,368	(12,764)
Unrealized gains (losses) on available-for-sale debt securities	(14,106)	(4,414)	(30,322)	22,141
Change in securities held-to-maturity:				
Adjustment for securities transferred to available-for-sale	-	-	19,412	-
Adjustment for securities transferred from available-for-sale	-	-	(14,007)	-
Amortization of unrealized losses on securities transferred from available-for-sale	628	456	1,740	1,358
Income tax effect	(146)	(156)	(1,291)	(465)
Changes from securities held-to-maturity	482	300	5,854	893
Cash flow hedges:				
Net unrealized derivative gains (losses) on cash flow hedges	725	217	6,804	(1,590)
Reclassification adjustment for (gains) losses realized in net income	(226)	1,429	553	4,962
Income tax effect	(122)	(625)	(1,805)	(1,281)
Changes from cash flow hedges	377	1,021	5,552	2,091
Defined benefit pension plans:				
Amortization of net loss recognized in income	27	27	81	81
Income tax effect	(7)	(11)	(20)	(31)
Changes from defined benefit pension plans	20	16	61	50
Other comprehensive income (loss), net of tax	(13,227)	(3,077)	(18,855)	25,175

Comprehensive income	$38,121	$36,295	$124,477	$139,393

The accompanying notes to consolidated financial statements are an integral part of these statements.

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OLD NATIONAL BANCORP

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (unaudited)

(dollars in thousands)	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance at December 31, 2016	$135,159	$1,348,338	$390,292	$ (59,372)	$ 1,814,417
Net income	-	-	114,218	-	114,218
Other comprehensive income (loss)	-	-	-	25,175	25,175
Dividends - common stock ($0.39 per share)	-	-	(52,841)	-	(52,841)
Common stock issued	18	285	-	-	303
Common stock repurchased	(108)	(1,809)	-	-	(1,917)
Share-based compensation expense	-	4,684	-	-	4,684
Stock activity under incentive compensation plans	454	2,538	(208)	-	2,784
Balance at September 30, 2017	$135,523	$1,354,036	$451,461	$ (34,197)	$ 1,906,823
Balance at December 31, 2017	$152,040	$1,639,499	$413,130	$ (50,272)	$ 2,154,397
Cumulative effect of change in accounting principles (Note 3)	-	-	(4,127)	(52)	(4,179)
Reclassification of certain tax effects related to the Tax Cuts and Jobs Act of 2017 (Note 3)	-	-	10,751	(10,751)	-
Net income	-	-	143,332	-	143,332
Other comprehensive income (loss)	-	-	-	(18,855)	(18,855)
Dividends - common stock ($0.39 per share)	-	-	(59,394)	-	(59,394)
Common stock issued	22	349	-	-	371
Common stock repurchased	(102)	(1,674)	-	-	(1,776)
Share-based compensation expense	-	5,629	-	-	5,629
Stock activity under incentive compensation plans	392	1,308	(545)	-	1,155
Balance at September 30, 2018	$152,352	$1,645,111	$503,147	$ (79,930)	$ 2,220,680

The accompanying notes to consolidated financial statements are an integral part of these statements.

OLD NATIONAL BANCORP

CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited)

	Nine Months Ended September 30,	
(dollars in thousands)	2018	2017
Cash Flows From Operating Activities		
Net income	$143,332	$114,218
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation	17,666	16,178
Amortization of other intangible assets	10,308	8,442
Amortization of tax credit investments	21,807	-
Net premium amortization on investment securities	11,290	11,263
Accretion income related to acquired loans	(29,525)	(33,207)
Share-based compensation expense	5,629	4,684
Excess tax (benefit) expense on share-based compensation	416	126
Provision for loan losses	3,576	2,013
Net securities (gains) losses	(2,417)	(7,547)
Recognition of deferred gain on sale leaseback transactions	(1,183)	(1,612)
Net (gains) losses on sales of loans and other assets	(215)	(5,082)
Increase in cash surrender value of company-owned life insurance	(7,993)	(6,288)
Residential real estate loans originated for sale	(377,702)	(336,238)
Proceeds from sales of residential real estate loans	378,849	403,128
(Increase) decrease in interest receivable	5,112	6,039
(Increase) decrease in other real estate owned	5,247	8,287
(Increase) decrease in other assets	700	8,498
Increase (decrease) in accrued expenses and other liabilities	(4,392)	(4,370)
Total adjustments	37,173	74,314
Net cash flows provided by (used in) operating activities	180,505	188,532
Cash Flows From Investing Activities		
Purchases of investment securities available-for-sale	(448,567)	(566,089)
Purchases of Federal Home Loan Bank/Federal Reserve Bank stock	(16,520)	(15,647)
Proceeds from maturities, prepayments, and calls of investment securities available-for-sale	316,239	337,766
Proceeds from sales of investment securities available-for-sale	136,648	284,315
Proceeds from maturities, prepayments, and calls of investment securities held-to-maturity	49,520	53,586
Proceeds from sales of Federal Home Loan Bank/Federal Reserve Bank stock	-	9
Proceeds from sales of trading securities	128	127
Proceeds from sale of student loan portfolio	70,674	-
Net principal collected from (loans made to) loan customers	(211,199)	(356,057)
Proceeds from settlements on company-owned life insurance	6,501	2,347
Proceeds from sales of premises and equipment and other assets	6,013	15,058
Purchases of premises and equipment and other assets	(24,704)	(17,675)
Net cash flows provided by (used in) investing activities	(115,267)	(262,260)
Cash Flows From Financing Activities		
Net increase (decrease) in:		
Deposits	(7,703)	(136,469)
Federal funds purchased and interbank borrowings	114,998	104,018
Securities sold under agreements to repurchase	(64,979)	(81,643)

Other borrowings	2,427	(116)
Payments for maturities of Federal Home Loan Bank advances	(998,801)	(893,363)
Proceeds from Federal Home Loan Bank advances	945,000	1,130,000
Cash dividends paid on common stock	(59,394)	(52,841)
Common stock repurchased	(1,776)	(1,917)
Proceeds from exercise of stock options	948	2,604
Common stock issued	371	303
Net cash flows provided by (used in) financing activities	(68,909)	70,576
Net increase (decrease) in cash and cash equivalents	(3,671)	(3,152)
Cash and cash equivalents at beginning of period	290,432	255,519
Cash and cash equivalents at end of period	$286,761	$252,367
Supplemental cash flow information:		
Total interest paid	$65,880	$43,205
Total taxes paid (net of refunds)	$1,681	$2,958
Securities transferred from held-to-maturity to available-for-sale	$447,026	$-
Securities transferred from available-for-sale to held-to-maturity	$323,990	$-

The accompanying notes to consolidated financial statements are an integral part of these statements.

OLD NATIONAL BANCORP

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

NOTE 1 – BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements include the accounts of Old National Bancorp and its wholly-owned affiliates (hereinafter collectively referred to as "Old National") and have been prepared in conformity with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry. Such principles require management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and the disclosures of contingent assets and liabilities at the date of the financial statements and amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. In the opinion of management, the consolidated financial statements contain all the normal and recurring adjustments necessary for a fair statement of the financial position of Old National as of September 30, 2018 and 2017, and December 31, 2017, and the results of its operations for the three and nine months ended September 30, 2018 and 2017. Interim results do not necessarily represent annual results. These financial statements should be read in conjunction with Old National's Annual Report for the year ended December 31, 2017.

All significant intercompany transactions and balances have been eliminated. Certain prior year amounts have been reclassified to conform to the 2018 presentation. Such reclassifications had no effect on net income or shareholders' equity and were insignificant amounts.

NOTE 2 – REVENUE RECOGNITION

In May 2014, the FASB issued an update (ASU No. 2014-09, *Revenue from Contracts with Customers*) creating FASB Topic 606, *Revenue from Contracts with Customers*. The guidance in this update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards (for example, insurance contracts or lease contracts). The scope of this update explicitly excludes net interest income, as well as other revenues from transactions involving financial instruments, such as loans and securities. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. The guidance provides steps to follow to achieve the core principle. An entity should disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers. The amendments in this update became effective for annual periods and interim periods within those annual periods beginning after December 15, 2017 and did not have a material impact on the consolidated financial statements. Old National finalized the in-depth assessment and identified the revenue line items within the scope of this new guidance. For Old National, the revenue streams that are affected by this update are presented within noninterest income.

In March 2016, the FASB issued ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*. The amendments relate to when another party, along with the entity, is involved in providing a good or service to a customer. Topic 606 requires an entity to determine whether the nature of its promise is to provide that good or service to the customer (that is, the entity is a principal) or to arrange for the good or service to be provided to the customer by the other party (that is, the entity is an agent). This determination is based upon whether the entity controls the good or the service before it is transferred to the customer. Topic 606 includes indicators to assist in this evaluation. The amendments in this update affect the guidance in ASU No. 2014-09 above. The effective date is the same as the effective date of ASU No. 2014-09.

In April 2016, the FASB issued ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*. The amendments clarify the following two aspects of Topic 606: identifying performance obligations, and the licensing implementation guidance. Before an entity can identify its performance obligations in a contract with a customer, the entity first identifies the promised goods or services in the contract. The amendments in this update are expected to reduce the cost and complexity of applying the guidance on identifying promised goods or services. To identify performance obligations in a contract, an entity evaluates whether promised goods and services are distinct. Topic 606 includes two criteria for assessing whether promises to transfer goods or services are distinct. One of those criteria is that the promises are separately identifiable. This update will improve the guidance on assessing that criterion. Topic 606 also includes implementation guidance on determining whether as entity's promise to grant a license provides a customer with either a right to use the entity's intellectual property, which is satisfied at a point in time, or a right to access the entity's intellectual property, which is satisfied over time. The amendments in this update are intended to improve the operability and understandability of the licensing implementation guidance. The amendments in this update affect the guidance in ASU No. 2014-09 above. The effective date is the same as the effective date of ASU No. 2014-09.

In May 2016, the FASB issued ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*. The amendments do not change the core revenue recognition principle in Topic 606. The amendments provide clarifying guidance in certain narrow areas and add some practical expedients.

In December 2016, the FASB issued ASU No. 2016-20, *Revenue from Contracts with Customers (Topic 606): Technical Corrections and Improvements*. The FASB decided to issue a separate update for technical corrections and improvements to Topic 606 and other Topics amended by ASU No. 2014-09 to increase awareness of the proposals and to expedite improvements to ASU No. 2014-09. The amendment affects narrow aspects of the guidance issued in ASU No. 2014-09.

On January 1, 2018, Old National adopted ASU 2014-09, *Revenue from Contracts with Customers* and all subsequent amendments to the ASU (collectively, "Topic 606") utilizing the modified retrospective application. A significant majority of Old National's revenues are not subject to the new guidance. Services within the scope of Topic 606 include wealth management fees, service charges on deposit accounts, debit card and ATM fees, and investment product fees. Old National enters into various contracts with customers to provide these traditional banking services on a routine basis. Old National's performance obligations are generally service-related and provided on a daily, monthly, or quarterly basis. The performance obligations are generally satisfied as services are rendered and the fees are collected at such time, or shortly thereafter. It is not typical for contracts to require significant judgment to determine the transaction price. The implementation of this update did not have a material impact on the measurement, timing, or recognition of revenue. Accordingly, no cumulative effect adjustment to opening retained earnings was deemed necessary. Results for reporting periods beginning after adoption are presented under Topic 606. As allowed under the update, results for prior periods continue to be reported under the accounting standards in effect for those periods.

<u>Wealth management fees</u>: Old National earns wealth management fees based upon asset custody and investment management services provided to individual and institutional customers. Most of these customers receive monthly or quarterly billings for services rendered based upon the market value of assets in custody. Fees that are transaction based are recognized at the point in time that the transaction is executed.

<u>Service charges on deposit accounts</u>: Old National earns fees from deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees and overdraft fees are recognized at a point in time, since the customer generally has a right to cancel the depository arrangement at any time. The arrangement is considered a day-to-day contract with ongoing renewals and optional purchases, so the duration of the contract does not extend beyond the services already performed. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which Old National satisfies its performance obligation.

<u>Debit card and ATM fees</u>: Debit card and ATM fees include ATM usage fees and debit card interchange income. As with the transaction-based fees on deposit accounts, the ATM fees are recognized at the point in time that Old National fulfills the customer's request. Old National earns interchange fees from cardholder transactions processed through card association networks. Interchange rates are generally set by the card associations based upon purchase volumes and other factors. Interchange fees represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

Investment product fees: Investment product fees are the commissions and fees received from a registered broker/dealer and investment adviser that provide those services to Old National customers. Old National acts as an agent in arranging the relationship between the customer and the third-party service provider. These fees are recognized monthly from the third-party broker based upon services already performed, net of the processing fees charged to Old National by the broker.

The consolidated statements of income include all categories of noninterest income.

The following table reflects only the categories of noninterest income that are within the scope of Topic 606:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Wealth management fees	$9,022	$8,837	$27,794	$27,515
Service charges on deposit accounts	11,028	10,535	32,552	30,418
Debit card and ATM fees	4,706	4,248	14,651	12,920
Investment product fees	5,073	5,193	15,170	15,186
Other income:				
Merchant processing fees	779	684	2,198	1,914
Gain (loss) on other real estate owned	260	206	981	823
Safe deposit box fees	221	190	849	704
Insurance premiums and commissions	83	170	265	437
Total	$31,172	$30,063	$94,460	$89,917

The adoption of Topic 606 did not have a material impact on our consolidated financial position, results of operations, equity, or cash flows as of the adoption date or for the three or nine months ended September 30, 2018.

NOTE 3 – RECENT ACCOUNTING PRONOUNCEMENTS

Accounting Guidance Adopted in 2018

FASB ASC 825 – In January 2016, the FASB issued an update (ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities). The amendments in this update impact public business entities as follows: (1) require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (2) simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; and when a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value; (3) eliminate the requirement to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (4) require entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) require an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (6) require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (7) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The amendments in this update became effective for annual periods and interim periods within those annual periods beginning after December 15, 2017 and did not have a material impact on the consolidated financial statements.

FASB ASC 740 – In October 2016, the FASB issued ASU No. 2016-16, Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. Current guidance prohibits the recognition of current and deferred income taxes for an intra-entity asset transfer until the asset has been sold to an outside party. This prohibition on recognition is an exception to the principle of comprehensive recognition of current and deferred income taxes in generally accepted accounting principles. The exception has led to diversity in practice and is a source of complexity in financial reporting. FASB decided that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. Consequently, the amendments in this update eliminate the exception for an intra-entity transfer of an asset other than inventory. The amendments in this update do not include new disclosure requirements; however, existing disclosure requirements might be applicable when accounting for the current and deferred income taxes for an intra-entity transfer of an asset other than inventory. The amendments in this update became effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within those annual reporting periods. The amendments in this update were applied on a modified retrospective basis through a cumulative-effect reduction of $1.0 million directly to retained earnings as of the beginning of 2018.

FASB ASC 805 – In January 2017, the FASB issued ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. The amendments in this update provide a more robust framework to use in determining when a set of assets and activities is a business. Because the current definition of a business is interpreted broadly and can be difficult to apply, stakeholders indicated that analyzing transactions is inefficient and costly and that the definition does not permit the use of reasonable judgment. The amendments provide more consistency in applying the guidance, reduce the costs of application, and make the definition of a business more operable. The amendments in this update became effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. Old National has completed its evaluation of adopting the new guidance on the consolidated financial statements and there is no impact to record.

FASB ASC 610 – In February 2017, the FASB issued ASU No. 2017-05, Other Income – Gains and Losses from the Derecognition of Nonfinancial Assets (Topic 610): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets. Subtopic 610-20 was originally issued as part of ASU No. 2014-09 to provide guidance for recognizing gains and losses from the transfer of nonfinancial assets in contracts with noncustomers. This update was issued to help clarify uncertainties and complexities of ASU 2014-09. The amendments in this update define the term in substance nonfinancial asset, in part, as a financial asset promised to a counterparty in a contract if substantially all of its fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to the counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty are in substance nonfinancial assets. The amendments in this update also clarify that nonfinancial assets within the scope of Subtopic 610-20 may include nonfinancial assets transferred within a legal entity to a counterparty. The amendments in this update require an entity to derecognize a distinct nonfinancial asset or distinct in substance nonfinancial asset in a partial sale transaction when it (1) does not have (or ceases to have) a controlling financial interest in the legal entity that holds the asset in accordance with Topic 810 and (2) transfers control of the asset in accordance with Topic 606. Once an entity transfers control of a distinct nonfinancial asset or distinct in substance nonfinancial asset, it is required to measure any noncontrolling interest it receives (or retains) at fair value. The amendments were effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period and did not have a material impact on the consolidated financial statements.

FASB ASC 715 – In March 2017, the FASB issued ASU No. 2017-07, Compensation – Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The amendments in this update require that an employer disaggregate the service cost component from the other components of net benefit cost. The amendments also provide explicit guidance on how to present the service cost component and the other components of net benefit cost in the income statement and allow only the service cost component of net benefit cost to be eligible for capitalization. The amendments in this update improve the consistency, transparency, and usefulness of financial information to users that have communicated that the service cost component generally is analyzed differently from the other components of net benefit cost. The amendments in this update became effective for annual periods and interim periods within those annual periods beginning after December 15, 2017 and did not have a material impact on the consolidated financial statements.

FASB ASC 718 – In May 2017, the FASB issued ASU No. 2017-09, Compensation – Stock Compensation (Topic 718): Scope of Modification Accounting. The amendments in this update provide guidance about which changes to the terms and conditions of a share-based payment award require an entity to apply modification accounting. An entity should account for the effect of a modification unless all the following are met: (1) the fair value of the modified award is the same as the fair value of the original award immediately before the original award is modified – if the modification does not affect any of the inputs to the valuation technique that the entity uses to value the award, the entity is not required to estimate the value immediately before and after the modification; (2) the vesting conditions of the modified award are the same as the vesting conditions of the original award immediately before the original award is modified; (3) the classification of the modified award as an equity instrument or a liability instrument is the same as the classification of the original award immediately before the original award is modified. The amendments in this update became effective for annual periods and interim periods within those annual periods beginning after December 15, 2017 and did not have a material impact on the consolidated financial statements.

FASB ASC 815 – In August 2017, the FASB issued ASU No. 2017-12, Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities. The amendments in the update make certain targeted improvements to simplify the application of the hedge accounting guidance in GAAP. The amendments in this update better align an entity's risk management activities and financial reporting for hedging relationships through changes to both the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. To meet that objective, the amendments expand and refine hedge accounting for both nonfinancial and financial risk components and align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements. This update addresses several limitations that GAAP placed on the risk components, how an entity can designate the hedged item in a fair value hedge of interest rate risk, and how an entity can measure changes in fair value of the hedged item attributable to interest rate risk. In addition to the amendments to the designation and measurement guidance for qualifying hedging relationships, the amendments in this update also align the recognition and presentation of the effects of the hedging instrument and the hedged item in the financial statements to increase the understandability of the results of an entity's intended hedging strategies. The amendments in this update require an entity to present the earnings effect of the hedging instrument in the same income statement line item in which the earnings effect of the hedged item is reported. Prior to the issuance of this update, GAAP provided special hedge accounting only for the portion of the hedge deemed to be "highly effective" and required an entity to separately reflect the amount by which the hedging instrument did not offset the hedged item, which is referred to as the "ineffective" amount. However, the concept and reporting of hedge ineffectiveness were difficult for financial statement users to understand and, at times, for preparers to explain. The FASB decided on an approach that no longer separately measures and reports hedge ineffectiveness. This update also includes certain targeted improvements to ease the application of current guidance related to the assessment of hedge effectiveness. Prior to the issuance of this update, GAAP contained specific requirements for initial and ongoing quantitative hedge effectiveness testing and strict requirements for specialized effectiveness testing methods that allowed an entity to forgo quantitative hedge effectiveness assessments for qualifying relationships. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2018. Early adoption is permitted in any interim period. Management elected to early adopt this update effective January 1, 2018 using the modified retrospective method. The impact of the adoption resulted in a reduction to Old National's opening retained earnings of $3.2 million. In addition, as permitted by the amendments in the update, Old National reclassified $447.0 million in state and political subdivision securities with unrealized holding gains of $26.1 million from the held-to-maturity portfolio to the available-for-sale portfolio.

FASB ASC 220 – In February 2018, the FASB issued ASU No. 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The amendments in this ASU help organizations address certain stranded income tax effects in AOCI resulting from the Tax Cuts and Jobs Act. The ASU provides financial statement preparers with an option to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The amendments are effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Management has elected to early adopt this update effective January 1, 2018, which resulted in a reclassification that decreased beginning accumulated other comprehensive income and increased beginning retained earnings by $10.8 million.

FASB ASC 825 – In February 2018, the FASB issued an update (ASU No. 2018-03, Technical Corrections and Improvements to Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities). The amendments in this update clarified the guidance in ASU No. 2016-01 specifically for equity securities without a readily determinable fair value and financial liabilities for which the fair value option is elected. The amendments in this update became effective for annual periods beginning after December 15, 2017 and interim periods within those fiscal years beginning after June 15, 2018 and did not have a material impact on the consolidated financial statements.

Accounting Guidance Issued But Not Yet Adopted

FASB ASC 842 – In February 2016, the FASB issued its new lease accounting guidance in ASU No. 2016-02, Leases (Topic 842). Under the new guidance, lessees will be required to recognize the following for all leases, with the exception of short-term leases, at the commencement date: (1) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged.

In July 2018, the FASB issued ASU No. 2018-10, *Codification Improvements to Topic 842, Leases* and ASU No. 2018-11, *Leases (Topic 842): Targeted Improvements*. ASU No. 2018-10 provides improvements related to ASU No. 2016-02 to increase stakeholders' awareness of the amendments and to expedite the improvements. The amendments affect narrow aspects of the guidance issued in ASU No. 2016-02. ASU No. 2018-11 allows entities adopting ASU No. 2016-02 to choose an additional (and optional) transition method, under which an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. ASU No. 2018-11 also allows lessors to not separate non-lease components from the associated lease component if certain conditions are met. Old National anticipates electing these practical expedients permitted by ASU 2018-11.

The amendments in these updates become effective for annual periods and interim periods within those annual periods beginning after December 15, 2018. Old National has formed a cross functional team to plan and execute the adoption of this standard. The implementation efforts are ongoing, including the review of our leases and related accounting policies, review of contracts for embedded leases, and the implementation of a new lease software solution. Based on leases outstanding at September 30, 2018, Old National does not expect the new standard to have a material impact on the income statement, but anticipates a $125 million to $140 million increase in assets and liabilities. Decisions to repurchase, modify, or renew leases prior to the implementation date will impact this range.

FASB ASC 326 – In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("CECL"). The main objective of this amendment is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. The amendment requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to enhance their credit loss estimates. The amendment requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2019. Early adoption will be permitted beginning after December 15, 2018.

As previously disclosed, Old National formed a cross functional committee to oversee the adoption of the ASU at the effective date. A working group was also formed and has developed a project plan focused on understanding the ASU, researching issues, identifying data needs for modeling inputs, technology requirements, modeling considerations, and ensuring overarching governance has been achieved for each objective and milestone. The project plan is targeting data and model validation completion in early 2019, with parallel processing of our existing allowance for loan losses model with the CECL for 2 – 4 quarters prior to implementation, depending on how model completion and validation occurs over the remainder of 2018. Currently, the working group has identified seven distinct loan portfolios for which a model has been or is in the process of being developed. For four of the loan portfolios, the data sets have been identified, populated, and internally validated. Additionally, models have been built, tested, and internally validated. During the remainder of 2018, Old National is focused on the completion of its remaining models, refining assumptions, and continued review and challenge of its models. Concurrent with this, Old National is also focused on researching and resolving interpretive accounting issues in the ASU, contemplating various related accounting policies, developing processes and related controls, and considering various reporting disclosures.

As of the beginning of the first reporting period in which the new standard is effective, Old National expects to recognize a one-time cumulative effect adjustment increasing the allowance for loan losses, since the ASU covers credit losses over the expected life of a loan as well as considering future changes in macroeconomic conditions. The magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements cannot yet be reasonably estimated.

FASB ASC 350 – In January 2017, the FASB issued ASU No. 2017-04, Intangibles: Goodwill and Other: Simplifying the Test for Goodwill Impairment. To simplify the subsequent measurement of goodwill, the amendments eliminate Step 2 from the goodwill impairment test. The annual, or interim, goodwill impairment test is performed by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. In addition, the income tax effects of tax deductible goodwill on the carrying amount of the reporting unit should be considered when measuring the goodwill impairment loss, if applicable. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the qualitative impairment test is necessary. The amendments should be applied on a prospective basis. The nature of and reason for the change in accounting principle should be disclosed upon transition. The amendments in this update should be adopted for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted on testing dates after January 1, 2017. Old National is currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

FASB ASC 310 – In March 2017, the FASB issued ASU No. 2017-08, Receivables – Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities. This update amends the amortization period for certain purchased callable debt securities held at a premium. FASB is shortening the amortization period for the premium to the earliest call date. Under current GAAP, entities generally amortize the premium as an adjustment of yield over the contractual life of the instrument. Concerns were raised that current GAAP excludes certain callable debt securities from consideration of early repayment of principal even if the holder is certain that the call will be exercised. As a result, upon the exercise of a call on a callable debt security held at a premium, the unamortized premium is recorded as a loss in earnings. There is diversity in practice (1) in the amortization period for premiums of callable debt securities and (2) in how the potential for exercise of a call is factored into current impairment assessments. The amendments in this update become effective for annual periods and interim periods within those annual periods beginning after December 15, 2018. Old National is currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

FASB ASC 718 – In June 2018, the FASB issued ASU No. 2018-07, Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. The amendments in this update expand the scope of Topic 718, Compensation—Stock Compensation (which currently only includes share-based payments to employees) to include share-based payments issued to nonemployees for goods or services. Consequently, the accounting for share-based payments to nonemployees and employees will be substantially aligned. The ASU supersedes Subtopic 505-50, Equity—Equity-Based Payments to Non-Employees. The amendments in this update become effective for annual periods beginning after December 15, 2018, including interim periods within that fiscal year and will not have a material impact on the consolidated financial statements.

FASB ASC 958 – In June 2018, the FASB issued ASU No. 2018-08, Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made. The amendments in this update clarify and improve the scope and accounting guidance around contributions of cash and other assets received and made by not-for-profit organizations and business enterprises. The ASU clarifies and improves current guidance about whether a transfer of assets, or the reduction, settlement, or cancellation of liabilities, is a contribution or an exchange transaction. It provides criteria for determining whether the resource provider is receiving commensurate value in return for the resources transferred which, depending on the outcome, determines whether the organization follows contribution guidance or exchange transaction guidance in the revenue recognition and other applicable standards. It also provides a more robust framework for determining whether a contribution is conditional or unconditional, and for distinguishing a donor-imposed condition from a donor-imposed restriction. This is important because such classification affects the timing of contribution revenue and expense recognition. The new ASU does not apply to transfers of assets from governments to businesses. The amendments in this update become effective for a public business entity for transactions in which the entity serves as a resource recipient to annual periods beginning after June 15, 2018, including interim periods within those annual periods. The amendments in this update become effective for a public business entity for a public business for transactions in which the entity serves as a resource provider to annual periods beginning after December 15, 2018, including interim periods within those annual periods. Early adoption is permitted. Old National is currently evaluating the impact of adopting the new guidance on the consolidated financial statements.

In July 2018, the FASB issued an update (ASU No. 2018-09, *Codification Improvements)*. The amendments in this update affect a wide variety of topics in the Codification and are intended to clarify the Codification or correct the unintended application of guidance that is not expected to have a significant effect on current accounting practice. The transition and effective date guidance is based on the facts and circumstances of each amendment. Old National is currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

FASB ASC 820 – In August 2018, the FASB issued ASU No. 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement. The updated guidance improves the disclosure requirements on fair value measurements. The ASU removes certain disclosures required by Topic 820 related to transfers between Level 1 and Level 2 of the fair value hierarchy; the policy for timing of transfers between levels; the valuation processes for Level 3 fair value measurements; and for nonpublic entities, the changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the reporting period. The ASU modifies certain disclosures required by Topic 820 related to disclosure of transfers into and out of Level 3 of the fair value hierarchy and purchases and issues of Level 3 assets and liabilities for nonpublic entities; the requirement to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse only if the investee has communicated the timing to the entity or announced the timing publicly for investments in certain entities that calculate net asset value; and clarification that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date. The ASU adds certain disclosure requirements related to changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. For certain unobservable inputs, an entity may disclose other quantitative information in lieu of the weighted average if the entity determines that other quantitative information would be a more reasonable and rational method to reflect the distribution of unobservable inputs used to develop Level 3 fair value measurements. The amendments in this update become effective for fiscal years, and interim periods within those fiscal years beginning after December 15, 2019. Early adoption is permitted. Old National is currently evaluating the impact of adopting the new guidance on the consolidated financial statements, but it is not expected to have a material impact.

FASB ASC 715 – In August 2018, the FASB issued ASU No. 2018-14, Compensation – Retirement Benefits – Defined Benefit Plans – General (Subtopic 715-20): Disclosure Framework – Changes to the Disclosure Requirements for Defined Benefit Plans. The amendments in this update modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. The amendments in this update become effective for fiscal years ending after December 15, 2020 and will not have a material impact on the consolidated financial statements.

FASB ASC 350 – In August 2018, the FASB issued ASU No. 2018-15, Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract. The amendments in this update align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software. The amendments in this update become effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Early adoption is permitted. Old National is currently evaluating the impact of adopting the new guidance on the consolidated financial statements.

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NOTE 4 – ACQUISITION AND DIVESTITURE ACTIVITY

Acquisitions

Anchor Bancorp, Inc.

Effective November 1, 2017, Old National completed the acquisition of St. Paul, Minnesota-based Anchor (MN) through a stock and cash merger. Anchor (MN) was a bank holding company with Anchor Bank (MN) as its wholly-owned subsidiary. Founded in 1967 and with 17 total branches, Anchor Bank (MN) was one of the largest community banks headquartered in the Twin Cities, and also served Mankato, Minnesota. Anchor Bank (MN) has no affiliation with the former AnchorBank (WI) in Madison, Wisconsin, which Old National acquired in 2016. Old National believes that it will be able to achieve cost savings by integrating the two companies and combining accounting, data processing, retail and lending support, and other administrative functions, which will enable Old National to achieve economies of scale in these areas.

Pursuant to the merger agreement, each holder of Anchor (MN) common stock received $2.625 in cash and 1.350 shares of Old National Common Stock per share of Anchor (MN) common stock such holder owned. The total fair value of consideration for Anchor (MN) was $332.8 million, consisting of $31.9 million of cash and the issuance of 16.5 million shares of Old National Common Stock valued at $300.8 million. This acquisition was accounted for under the acquisition method of accounting. Accordingly, Old National recognized amounts for identifiable assets acquired and liabilities assumed at their estimated acquisition date fair values. Through September 30, 2018, transaction and integration costs of $18.1 million associated with this acquisition have been expensed and remaining integration costs will be expensed in future periods as incurred.

During the six months ended June 30, 2018, immaterial adjustments were made to the preliminary valuation of the assets acquired and liabilities assumed. These adjustments affected goodwill, definite lived intangible assets, premises and equipment, other assets, and deposits. As of June 30, 2018, Old National finalized its valuation of all assets acquired and liabilities assumed, resulting in no material change to acquisition accounting adjustments. A summary of the fair values of the acquired assets, liabilities assumed, and resulting goodwill follows (in thousands):

Cash and cash equivalents	$34,501
Investment securities	302,195
FHLB/Federal Reserve Bank stock	6,585
Loans held for sale	1,407
Loans	1,593,991
Premises and equipment	33,433
Accrued interest receivable	5,872
Other real estate owned	1,058
Company-owned life insurance	44,490
Other assets	30,036
Deposits	(1,777,588)
Federal funds purchased and interbank borrowings	(45,600)
Securities sold under agreements to repurchase	(22,965)
Other borrowings	(49,257)
Accrued expenses and other liabilities	(25,784)
Net tangible assets acquired	132,374
Definite-lived intangible assets acquired	26,606
Goodwill	173,785
Total consideration	$332,765

Goodwill related to this acquisition will not be deductible for tax purposes.

The estimated fair value of the core deposit intangible was $26.6 million and is being amortized over an estimated useful life of 10 years.

Acquired loan data for Anchor (MN) can be found in the table below:

(in thousands)	Fair Value of Acquired Loans at Acquisition Date	Gross Contractual Cash Flows at Acquisition Date	Best Estimate at Acquisition Date of Contractual Cash Flows Not Expected to be Collected
Acquired receivables subject to ASC 310-30	$ 10,555	$ 16,898	$ 4,787
Acquired receivables not subject to ASC 310-30	$ 1,583,436	$ 1,879,449	$ 87,767

Divestitures

Based on an ongoing assessment of our service and delivery network, Old National consolidated 29 branches during 2017 and 10 branches during the nine months ended September 30, 2018.

Old National has entered into a branch purchase and assumption agreement for the sale of ten Old National branches in Wisconsin to Marine Credit Union of La Crosse, Wisconsin. Assets associated with this divestiture are included in assets held for sale on the balance sheet. The transaction includes the sale of approximately $231 million in deposits and no loans. The sale closed on October 26, 2018 and Old National expects to record a net gain of approximately $14 million in the fourth quarter of 2018.

Pending Acquisition

On June 20, 2018, Old National entered into an agreement to acquire Minnesota-based Klein through a 100% stock merger. Klein is a bank holding company with KleinBank as its wholly-owned subsidiary. Founded in 1907 and headquartered in Chaska, Minnesota with 18 full-service branches, KleinBank is the largest family-owned community bank serving the Twin Cities and its western communities. At June 30, 2018, Klein had total assets of $2.0 billion and $1.7 billion of deposit liabilities. Pursuant to the merger agreement, each holder of Klein common stock will receive 7.92 shares of Old National common stock per share of Klein common stock such holder owns. Based on Old National's September 28, 2018 closing price of $19.30 per share, this represents a total transaction value of approximately $439.5 million. The transaction value is likely to change until closing due to fluctuations in the price of Old National common stock and is also subject to adjustment under certain circumstances as provided in the merger agreement. The transaction has received regulatory and shareholder approval and is anticipated to close effective November 1, 2018, subject to customary closing conditions.

NOTE 5 – NET INCOME PER SHARE

Basic and diluted net income per share are calculated using the two-class method. Net income is divided by the weighted-average number of common shares outstanding during the period. Adjustments to the weighted average number of common shares outstanding are made only when such adjustments will dilute net income per common share. Net income is then divided by the weighted-average number of common shares and common share equivalents during the period.

The following table reconciles basic and diluted net income per share for the three and nine months ended September 30, 2018 and 2017:

(dollars and shares in thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Basic Net Income Per Share				
Net income	$51,348	$39,372	$143,332	$114,218
Weighted average common shares outstanding	151,930	135,120	151,844	135,040
Basic Net Income Per Share	$0.34	$0.30	$0.95	$0.85
Diluted Net Income Per Share				
Net income	$51,348	$39,372	$143,332	$114,218
Weighted average common shares outstanding	151,930	135,120	151,844	135,040
Effect of dilutive securities:				
Restricted stock	790	589	701	558
Stock options (1)	64	87	71	95
Weighted average shares outstanding	152,784	135,796	152,616	135,693
Diluted Net Income Per Share	$0.34	$0.29	$0.94	$0.84

(1) Options to purchase 14 thousand shares and 55 thousand shares outstanding at September 30, 2018 and 2017, respectively, were not included in the computation of net income per diluted share for the three and nine months ended September 30, 2018 and 2017 because the exercise price of these options was greater than the average market price of the common shares and, therefore, the effect would be antidilutive.

NOTE 6 – INVESTMENT SECURITIES

The following table summarizes the amortized cost and fair value of the available-for-sale and held-to-maturity investment securities portfolio at September 30, 2018 and December 31, 2017 and the corresponding amounts of unrealized gains and losses therein:

(dollars in thousands)	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
September 30, 2018				
Available-for-Sale				
U.S. Treasury	$5,322	$ -	$(85)	$5,237
U.S. government-sponsored entities and agencies	631,360	-	(19,664)	611,696
Mortgage-backed securities - Agency	1,571,101	402	(62,811)	1,508,692
States and political subdivisions	794,671	5,200	(7,205)	792,666
Pooled trust preferred securities	13,873	-	(4,801)	9,072
Other securities	352,198	225	(7,330)	345,093
Total available-for-sale securities	$3,368,525	$ 5,827	$(101,896)	$3,272,456
Held-to-Maturity				
U.S. government-sponsored entities and agencies	$73,776	$ -	$(3,144)	$70,632
Mortgage-backed securities - Agency	131,562	45	(4,995)	126,612
States and political subdivisions	306,869	5,691	(4,238)	308,322
Total held-to-maturity securities	$512,207	$ 5,736	$(12,377)	$505,566
December 31, 2017				
Available-for-Sale				
U.S. Treasury	$5,473	$ 83	$(5)	$5,551
U.S. government-sponsored entities and agencies	675,643	3	(11,360)	664,286
Mortgage-backed securities - Agency	1,704,014	1,600	(37,932)	1,667,682
States and political subdivisions	529,835	5,085	(4,727)	530,193
Pooled trust preferred securities	16,605	-	(8,157)	8,448
Other securities	321,016	1,172	(2,141)	320,047
Total available-for-sale securities	$3,252,586	$ 7,943	$(64,322)	$3,196,207
Held-to-Maturity				
Mortgage-backed securities - Agency	$6,903	$ 153	$-	$7,056
States and political subdivisions	677,160	43,495	(8)	720,647
Total held-to-maturity securities	$684,063	$ 43,648	$(8)	$727,703

As previously disclosed in Note 3, upon the early adoption of ASU No. 2017-12 on January 1, 2018, Old National reclassified $447.0 million in state and political subdivision securities from the held-to-maturity portfolio to the available-for-sale portfolio. Separately, on January 1, 2018, U.S. government-sponsored entities and agencies, agency mortgage-backed securities, and state and political subdivision securities with a fair value of $324.0 million were transferred from the available-for-sale portfolio to the held-to-maturity portfolio. The $10.8 million unrealized holding loss, net of tax, at the date of transfer shall continue to be reported as a separate component of shareholders' equity and is being amortized over the remaining life of the securities as an adjustment to yield. The corresponding discount on these securities will offset this adjustment to yield as it is amortized.

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Proceeds from sales or calls of available-for-sale investment securities, the resulting realized gains and realized losses, and other securities gains or losses were as follows for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Proceeds from sales of available-for-sale securities	$5,327	$98,038	$136,648	$284,315
Proceeds from calls of available-for-sale securities	2,938	2,303	31,585	73,423
Total	$8,265	$100,341	$168,233	$357,738
Realized gains on sales of available-for-sale securities	$-	$2,891	$3,259	$7,174
Realized gains on calls of available-for-sale securities	-	13	284	13
Realized losses on sales of available-for-sale securities	(74)	(36)	(1,379)	(79)
Realized losses on calls of available-for-sale securities	(7)	-	(60)	(8)
Other securities gains (losses) (1)	216	104	313	447
Net securities gains (losses)	$135	$2,972	$2,417	$7,547

(1) Other securities gains (losses) includes net realized and unrealized gains or losses associated with trading securities and mutual funds.

Trading securities, which consist of mutual funds held in trusts associated with deferred compensation plans for former directors and executives, are recorded at fair value and totaled $5.8 million at September 30, 2018 and $5.6 million at December 31, 2017.

All the mortgage-backed securities in the investment portfolio are residential mortgage-backed securities. The amortized cost and fair value of the investment securities portfolio are shown by expected maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Weighted average yield is based on amortized cost.

(dollars in thousands)	At September 30, 2018		
Maturity	Amortized Cost	Fair Value	Weighted Average Yield
Available-for-Sale			
Within one year	$78,428	$78,457	2.46 %
One to five years	484,883	476,762	2.29
Five to ten years	444,926	439,284	3.15
Beyond ten years	2,360,288	2,277,953	2.65

Total	$3,368,525	$3,272,456	2.66	%
Held-to-Maturity				
Within one year	$26,046	$26,176	3.70	%
One to five years	32,394	32,869	4.07	
Five to ten years	79,600	81,252	4.39	
Beyond ten years	374,167	365,269	3.58	
Total	$512,207	$505,566	3.74	%

The following table summarizes the available-for-sale investment securities with unrealized losses at September 30, 2018 and December 31, 2017 by aggregated major security type and length of time in a continuous unrealized loss position:

	Less than 12 months		12 months or longer		Total	
(dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2018						
Available-for-Sale						
U.S. Treasury	$5,237	$(85)	$-	$-	$5,237	$(85)
U.S. government-sponsored entities and agencies	202,437	(5,075)	407,060	(14,589)	609,497	(19,664)
Mortgage-backed securities - Agency	606,669	(15,981)	845,276	(46,830)	1,451,945	(62,811)
States and political subdivisions	423,498	(6,703)	12,825	(502)	436,323	(7,205)
Pooled trust preferred securities	-	-	9,072	(4,801)	9,072	(4,801)
Other securities	195,930	(3,782)	112,440	(3,548)	308,370	(7,330)
Total available-for-sale	$1,433,771	$(31,626)	$1,386,673	$(70,270)	$2,820,444	$(101,896)
December 31, 2017						
Available-for-Sale						
U.S. Treasury	$1,480	$(5)	$-	$-	$1,480	$(5)
U.S. government-sponsored entities and agencies	201,773	(1,333)	408,493	(10,027)	610,266	(11,360)
Mortgage-backed securities - Agency	789,804	(8,692)	774,825	(29,240)	1,564,629	(37,932)
States and political subdivisions	196,024	(1,899)	90,637	(2,828)	286,661	(4,727)
Pooled trust preferred securities	-	-	8,448	(8,157)	8,448	(8,157)
Other securities	61,260	(429)	125,517	(1,712)	186,777	(2,141)
Total available-for-sale	$1,250,341	$(12,358)	$1,407,920	$(51,964)	$2,658,261	$(64,322)

The following table summarizes the held-to-maturity investment securities with unrecognized losses at September 30, 2018 and December 31, 2017 by aggregated major security type and length of time in a continuous unrecognized loss position:

	Less than 12 months		12 months or longer		Total	
(dollars in thousands)	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses	Fair Value	Unrecognized Losses
September 30, 2018						
Held-to-Maturity						
U.S. government-sponsored entities and agencies	$-	$ -	$70,632	$ (6,368)	$70,632	$ (6,368)

Mortgage-backed securities - Agency	32,646	(1,227)	92,986	(9,389)	125,632	(10,616)
States and political subdivisions	32,219	(2,192)	70,392	(4,817)	102,611	(7,009)
Total held-to-maturity	$64,865	$ (3,419)	$234,010	$ (20,574)	$298,875	$ (23,993)
December 31, 2017						
Held-to-Maturity						
States and political subdivisions	$2,309	$ (8)	$-	$ -	$2,309	$ (8)
Total held-to-maturity	$2,309	$ (8)	$-	$ -	$2,309	$ (8)

The unrecognized losses on held-to-maturity investment securities presented in the table above include unrecognized losses on securities that were transferred from available-for-sale to held-to-maturity totaling $11.6 million at September 30, 2018. There were no unrecognized losses on securities that were transferred from available-for-sale to held-to-maturity at December 31, 2017.

Management evaluates securities for OTTI at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Investment securities classified as available-for-sale or held-to-maturity are generally evaluated for OTTI under FASB ASC 320, Investments – Debt and Equity Securities. In determining OTTI under FASB ASC 320, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When OTTI occurs, the amount of the OTTI recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the OTTI shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. Otherwise, the OTTI shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total OTTI related to the credit loss is determined based on the present value of cash flows expected to be collected and is recognized in earnings. The amount of the total OTTI related to other factors shall be recognized in other comprehensive income, net of applicable taxes. The previous amortized cost basis less the OTTI recognized in earnings shall become the new amortized cost basis of the investment.

There was no OTTI recorded during the nine months ended September 30, 2018 or 2017.

At September 30, 2018, Old National's securities portfolio consisted of 1,600 securities, 940 of which were in an unrealized loss position. The unrealized losses attributable to our U.S. Treasury, U.S. government-sponsored entities and agencies, agency mortgage-backed securities, states and political subdivisions, and other securities are the result of fluctuations in interest rates. Our pooled trust preferred securities are discussed below. At September 30, 2018, we had no intent to sell any securities that were in an unrealized loss position nor is it expected that we would be required to sell any securities.

Pooled Trust Preferred Securities

At September 30, 2018, our securities portfolio contained two pooled trust preferred securities with a fair value of $9.1 million and unrealized losses of $4.8 million. These securities are not subject to FASB ASC 325-10 and are evaluated using collateral-specific assumptions to estimate the expected future interest and principal cash flows. For the nine months ended September 30, 2018 and 2017, our analysis indicated no OTTI on these securities.

During the first quarter of 2018, Old National sold a pooled trust security that fell within the scope of FASB ASC 325-10 (EITF 99-20). Proceeds from the sale were $1.8 million, which resulted in a loss of $0.9 million. Although Old National typically does not sell securities in an unrealized loss position, this security was sold because the final liquidation value was significantly higher than our assessment of value for this position.

The table below summarizes the relevant characteristics of our pooled trust preferred securities as well as our single issuer trust preferred securities that are included in the "other securities" category in this footnote. Each of the pooled trust preferred securities support a more senior tranche of security holders. Both pooled trust preferred securities have experienced credit defaults. However, these securities have excess subordination and are not other-than-temporarily impaired as a result of their class hierarchy, which provides more loss protection.

Actual	Expected	Excess

Trust preferred securities

September 30, 2018 (dollars in thousands)	Class	Lowest Credit Rating (1)	Amortized Cost	Fair Value	Unrealized Gain/ (Loss)	Realized Losses 2018	# of Issuers Currently Performing/ Remaining	Deferrals and Defaults as a % of Original Collateral	Defaults as a % of Remaining Performing Collateral	Subordination as a % of Current Performing Collateral
Pooled trust preferred securities:										
Pretsl XXVII LTD	B	B	$ 4,365	$ 2,656	$ (1,709)	$ -	35/44	16.7%	4.2%	37.5%
Trapeza Ser 13A	A2A	BBB	9,508	6,416	(3,092)	-	47/52	4.5%	4.6%	53.8%
			13,873	9,072	(4,801)	-				
Single Issuer trust preferred securities:										
JP Morgan Chase Cap XIII		BBB-	4,785	4,538	(247)	-				
Total			$ 18,658	$ 13,610	$ (5,048)	$ -				

(1) Lowest rating for the security provided by any nationally recognized credit rating agency.

NOTE 7 – LOANS HELD FOR SALE

Mortgage loans held for immediate sale in the secondary market were $21.4 million at September 30, 2018, compared to $17.9 million at December 31, 2017. Residential loans that Old National has originated with the intent to sell are recorded at fair value in accordance with FASB ASC 825-10, *Financial Instruments*. Conventional mortgage production is sold on a servicing retained basis. Certain loans, such as government guaranteed mortgage loans are sold on servicing released basis.

NOTE 8 – LOANS AND ALLOWANCE FOR LOAN LOSSES

Old National's loans consist primarily of loans made to consumers and commercial clients in various industries including manufacturing, agribusiness, transportation, mining, wholesaling, and retailing. Most of Old National's lending activity occurs within our principal geographic markets of Indiana, Kentucky, Michigan, Wisconsin, and Minnesota. Old National manages concentrations of credit exposure by industry, product, geography, customer relationship, and loan size. While loans to lessors of both residential and non-residential real estate exceed 10% of total loans, no individual sub-segment category within those broader categories reaches the 10% threshold.

The composition of loans by lending classification was as follows:

(dollars in thousands)	September 30, 2018	December 31, 2017
Commercial (1)	$2,949,277	$2,717,269
Commercial real estate:		
Construction	542,228	374,306
Other	3,939,326	3,980,246
Residential real estate	2,166,203	2,167,053
Consumer credit:		
Home equity	498,325	507,507
Auto	1,058,977	1,148,672
Other	138,323	223,068
Total loans	11,292,659	11,118,121
Allowance for loan losses	(52,713)	(50,381)
Net loans	$11,239,946	$11,067,740

(1) Includes direct finance leases of $22.1 million at September 30, 2018 and $29.5 million at December 31, 2017.

The risk characteristics of each loan portfolio segment are as follows:

Commercial

Commercial loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial Real Estate

These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be adversely affected by conditions in the real estate markets or in the general economy. The properties securing Old National's commercial real estate portfolio are diverse in terms of type and geographic location. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans.

Included with commercial real estate are construction loans, which are underwritten utilizing independent appraisal reviews, sensitivity analysis of absorption and lease rates, financial analysis of the developers and property owners, and feasibility studies, if available. Construction loans are generally based on estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders (including Old National), sales of developed property, or an interim loan commitment from Old National until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions, and the availability of long-term financing.

The acquisition of Anchor (MN) on November 1, 2017 added $864.4 million of commercial real estate loans to our portfolio. At 211%, Old National Bank's commercial real estate loans as a percentage of its risk-based capital remained well below the regulatory guideline limit of 300% at September 30, 2018.

Residential

With respect to residential loans that are secured by 1-4 family residences and are generally owner occupied, Old National typically establishes a maximum loan-to-value ratio and generally requires private mortgage insurance if that ratio is exceeded. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas such as unemployment levels. Repayment can also be impacted by changes in residential property values. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

Consumer

Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer loans are secured by consumer assets such as automobiles or recreational vehicles. Some consumer loans are unsecured such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas such as unemployment levels. Repayment can also be impacted by changes in residential property or other collateral values. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers. Old National assumed student loans in the acquisition of Anchor (WI) in May 2016. Student loans are guaranteed by the government from 97% to 100% and totaled $68.2 million at December 31, 2017. Old National sold the remaining student loan portfolio totaling $64.9 million during the second quarter of 2018, resulting in a $2.2 million gain that is included in other income on the income statement.

Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed adequate by management to absorb probable losses incurred in the consolidated loan portfolio. Management's evaluation of the adequacy of the allowance is an estimate based on reviews of individual loans, pools of homogeneous loans, assessments of the impact of current and anticipated economic conditions on the portfolio, and historical loss experience. The allowance is increased through a provision charged to operating expense. Loans deemed to be uncollectible are charged to the allowance. Recoveries of loans previously charged-off are added to the allowance.

We utilize a PD and LGD model as a tool to determine the adequacy of the allowance for loan losses for performing commercial and commercial real estate loans. The PD is forecast using a transition matrix to determine the likelihood of a customer's AQR migrating from its current AQR to any other status within the time horizon. Transition rates are measured using Old National's own historical experience. The model assumes that recent historical transition rates will continue into the future. The LGD is defined as credit loss incurred when an obligor of the bank defaults. The sum of all net charge-offs for a particular portfolio segment are divided by all loans that have defaulted over a given period of time. The expected loss derived from the model considers the PD, LGD, and exposure at default. Additionally, qualitative factors, such as changes in lending policies or procedures, and economic business conditions are also considered.

We use historic loss ratios adjusted for economic conditions to determine the appropriate level of allowance for residential real estate and consumer loans.

No allowance was brought forward on any of the acquired loans as any credit deterioration evident in the loans was included in the determination of the fair value of the loans at the acquisition date. An allowance for loan losses will be established for any subsequent credit deterioration or adverse changes in expected cash flows.

Old National's activity in the allowance for loan losses for the three and nine months ended September 30, 2018 and 2017 was as follows:

(dollars in thousands)	Commercial	Commercial Real Estate	Residential	Consumer	Total
Three Months Ended September 30, 2018					
Balance at beginning of period	$ 21,387	$ 22,498	$ 1,867	$ 7,908	$ 53,660
Charge-offs	(1,662)	(241)	(284)	(2,074)	(4,261)
Recoveries	467	944	45	1,108	2,564
Provision	(473)	(309)	292	1,240	750
Balance at end of period	$ 19,719	$ 22,892	$ 1,920	$ 8,182	$ 52,713
Three Months Ended September 30, 2017					
Balance at beginning of period	$ 20,365	$ 20,654	$ 1,811	$ 8,156	$ 50,986
Charge-offs	(70)	(1,148)	(227)	(1,376)	(2,821)
Recoveries	255	339	89	1,010	1,693
Provision	(23)	180	236	(82)	311
Balance at end of period	$ 20,527	$ 20,025	$ 1,909	$ 7,708	$ 50,169
Nine Months Ended September 30, 2018					
Balance at beginning of period	$ 19,246	$ 21,436	$ 1,763	$ 7,936	$ 50,381
Charge-offs	(2,378)	(675)	(941)	(6,006)	(10,000)
Recoveries	1,227	2,011	1,890	3,628	8,756
Provision	1,624	120	(792)	2,624	3,576
Balance at end of period	$ 19,719	$ 22,892	$ 1,920	$ 8,182	$ 52,713
Nine Months Ended September 30, 2017					
Balance at beginning of period	$ 21,481	$ 18,173	$ 1,643	$ 8,511	$ 49,808
Charge-offs	(951)	(2,784)	(954)	(4,751)	(9,440)
Recoveries	1,647	3,086	196	2,859	7,788
Provision	(1,650)	1,550	1,024	1,089	2,013
Balance at end of period	$ 20,527	$ 20,025	$ 1,909	$ 7,708	$ 50,169

The following table provides Old National's recorded investment in loans by portfolio segment at September 30, 2018 and December 31, 2017 and other information regarding the allowance:

(dollars in thousands)	Commercial	Commercial Real Estate	Residential	Consumer	Total
September 30, 2018					
Allowance for loan losses:					
Individually evaluated for impairment	$4,881	$7,270	$-	$-	$12,151
Collectively evaluated for impairment	14,831	15,478	1,919	8,031	40,259
Loans acquired with deteriorated credit quality	7	144	1	151	303
Total allowance for loan losses	$19,719	$22,892	$1,920	$8,182	$52,713
Loans and leases outstanding:					
Individually evaluated for impairment	$35,404	$86,503	$-	$-	$121,907
Collectively evaluated for impairment	2,909,643	4,377,382	2,156,492	1,691,777	11,135,294
Loans acquired with deteriorated credit quality	4,230	17,669	9,711	3,848	35,458
Total loans and leases outstanding	$2,949,277	$4,481,554	$2,166,203	$1,695,625	$11,292,659
December 31, 2017					
Allowance for loan losses:					
Individually evaluated for impairment	$3,424	$6,654	$-	$-	$10,078
Collectively evaluated for impairment	15,790	14,782	1,763	7,802	40,137
Loans acquired with deteriorated credit quality	32	-	-	134	166
Total allowance for loan losses	$19,246	$21,436	$1,763	$7,936	$50,381
Loans and leases outstanding:					
Individually evaluated for impairment	$26,270	$66,061	$-	$-	$92,331
Collectively evaluated for impairment	2,685,847	4,266,665	2,155,750	1,874,002	10,982,264
Loans acquired with deteriorated credit quality	5,152	21,826	11,303	5,245	43,526
Total loans and leases outstanding	$2,717,269	$4,354,552	$2,167,053	$1,879,247	$11,118,121

Credit Quality

Old National's management monitors the credit quality of its loans in an on-going manner. Internally, management assigns an AQR to each non-homogeneous commercial and commercial real estate loan in the portfolio, with the exception of certain FICO-scored small business loans. The primary determinants of the AQR are based upon the reliability of the primary source of repayment and the past, present, and projected financial condition of the borrower. The AQR will also consider current industry conditions. Major factors used in determining the AQR can vary based on the nature of the loan, but commonly include factors such as debt service coverage, internal cash flow, liquidity, leverage, operating performance, debt burden, FICO scores, occupancy, interest rate sensitivity, and expense burden. Old National uses the following definitions for risk ratings:

Criticized. Special mention loans that have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

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

Classified – Nonaccrual. Loans classified as nonaccrual have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection in full, on the basis of currently existing facts, conditions, and values, in doubt.

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

Pass rated loans are those loans that are other than criticized, classified – substandard, classified – nonaccrual, or classified – doubtful.

The risk category of commercial and commercial real estate loans by class of loans at September 30, 2018 and December 31, 2017 was as follows:

(dollars in thousands) Corporate Credit Exposure	Commercial		Commercial Real Estate - Construction		Commercial Real Estate - Other	
Credit Risk Profile by Internally Assigned Grade	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017	September 30, 2018	December 31, 2017
Grade:						
Pass	$2,789,061	$2,577,824	$505,930	$357,438	$3,734,727	$3,762,896
Criticized	79,866	74,876	22,130	14,758	79,170	98,451
Classified - substandard	43,835	37,367	-	-	58,364	58,584
Classified - nonaccrual	28,151	24,798	14,168	2,110	30,624	30,108
Classified - doubtful	8,364	2,404	-	-	36,441	30,207
Total	$2,949,277	$2,717,269	$542,228	$374,306	$3,939,326	$3,980,246

Old National considers the performance of the loan portfolio and its impact on the allowance for loan losses. For residential and consumer loan classes, Old National also evaluates credit quality based on the aging status of the loan and by payment activity. The following table presents the recorded investment in residential and consumer loans based on payment activity at September 30, 2018 and December 31, 2017:

(dollars in thousands)	Residential	Consumer Home Equity	Auto	Other
September 30, 2018				
Performing	$2,142,768	$494,510	$1,056,681	$136,801
Nonperforming	23,435	3,815	2,296	1,522
Total	$2,166,203	$498,325	$1,058,977	$138,323
December 31, 2017				
Performing	$2,144,882	$502,322	$1,145,977	$217,819
Nonperforming	22,171	5,185	2,695	5,249
Total	$2,167,053	$507,507	$1,148,672	$223,068

Impaired Loans

Large commercial credits are subject to individual evaluation for impairment. Retail credits and other small balance credits that are part of a homogeneous group are not tested for individual impairment unless they are modified as a TDR. A loan is considered impaired when it is probable that contractual interest and principal payments will not be collected either for the amounts or by the dates as scheduled in the loan agreement. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported net, at the present value of estimated cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Old National's policy, for all but PCI loans, is to recognize interest income on impaired loans unless the loan is placed on nonaccrual status.

The following table shows Old National's impaired loans at September 30, 2018 and December 31, 2017, respectively. Only purchased loans that have experienced subsequent impairment since the date acquired (excluding loans acquired with deteriorated credit quality) are included in the table below.

(dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
September 30, 2018			
With no related allowance recorded:			
Commercial	$ 20,332	$ 21,083	$ -
Commercial Real Estate - Other	45,740	47,168	-
Residential	2,335	2,355	-
Consumer	1,301	1,425	-
With an allowance recorded:			
Commercial	15,072	15,125	4,881
Commercial Real Estate - Construction	14,168	14,973	2,474
Commercial Real Estate - Other	26,595	26,727	4,796
Residential	792	792	40
Consumer	1,901	1,901	95
Total	$ 128,236	$ 131,549	$ 12,286
December 31, 2017			
With no related allowance recorded:			
Commercial	$ 20,557	$ 21,483	$ -
Commercial Real Estate - Other	38,678	44,564	-
Residential	2,443	2,464	-
Consumer	1,685	2,105	-
With an allowance recorded:			
Commercial	5,713	5,713	3,424
Commercial Real Estate - Construction	905	1,371	401
Commercial Real Estate - Other	26,478	26,902	6,253
Residential	870	870	44
Consumer	2,211	2,228	110
Total	$ 99,540	$ 107,700	$ 10,232

The average balance of impaired loans during the three and nine months ended September 30, 2018 and 2017 are included in the table below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Average Recorded Investment				
With no related allowance recorded:				
Commercial	$ 19,960	$ 24,234	$ 20,445	$ 27,197
Commercial Real Estate - Other	45,302	33,268	42,209	31,258
Residential	2,303	2,482	2,289	2,405

Consumer	1,392	1,755	1,617	1,786
With an allowance recorded:				
Commercial	14,771	7,792	10,393	8,086
Commercial Real Estate - Construction	11,307	-	7,537	-
Commercial Real Estate - Other	24,305	30,846	26,537	28,580
Residential	863	1,011	887	1,059
Consumer	1,909	2,163	2,013	2,136
Total	$122,112	$103,551	$113,927	$102,507

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Old National does not record interest on nonaccrual loans until principal is recovered. Interest income recognized on impaired loans during the three and nine months ended September 30, 2018 and 2017 was immaterial.

For all loan classes, a loan is generally placed on nonaccrual status when principal or interest becomes 90 days past due unless it is well secured and in the process of collection, or earlier when concern exists as to the ultimate collectibility of principal or interest. Interest accrued during the current year on such loans is reversed against earnings. Interest accrued in the prior year, if any, is charged to the allowance for loan losses. Cash interest received on these loans is applied to the principal balance until the principal is recovered or until the loan returns to accrual status. Loans may be returned to accrual status when all the principal and interest amounts contractually due are brought current, remain current for a prescribed period, and future payments are reasonably assured.

Loans accounted for under FASB ASC Topic 310-30 accrue interest, even though they may be contractually past due, as any nonpayment of contractual principal or interest is considered in the periodic re-estimation of expected cash flows and is included in the resulting recognition of current period loan loss provision or prospective yield adjustments.

Old National's past due financing receivables at September 30, 2018 and December 31, 2017 were as follows:

(dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	Past Due 90 Days or More and Accruing	Nonaccrual (1)	Total Past Due	Current
September 30, 2018						
Commercial	$588	$72	$ 1	$ 36,515	$37,176	$2,912,101
Commercial Real Estate:						
Construction	354	-	-	14,168	14,522	527,706
Other	1,858	25	-	67,065	68,948	3,870,378
Residential	23,977	3,352	190	23,435	50,954	2,115,249
Consumer:						
Home equity	1,449	190	271	3,815	5,725	492,600
Auto	5,319	1,224	441	2,296	9,280	1,049,697
Other	663	561	77	1,522	2,823	135,500
Total loans	$34,208	$5,424	$ 980	$ 148,816	$189,428	$11,103,231
December 31, 2017						
Commercial	$986	$360	$ 144	$ 27,202	$28,692	$2,688,577
Commercial Real Estate:						
Construction	-	-	-	2,110	2,110	372,196
Other	2,247	89	-	60,315	62,651	3,917,595
Residential	18,948	3,416	-	22,171	44,535	2,122,518
Consumer:						
Home equity	1,467	230	68	5,185	6,950	500,557
Auto	6,487	1,402	532	2,695	11,116	1,137,556
Other	3,967	1,514	150	5,249	10,880	212,188
Total loans	$34,102	$7,011	$ 894	$ 124,927	$166,934	$10,951,187

(1) Includes purchased credit impaired loans of \$9.9 million at September 30, 2018 and \$12.6 million at December 31, 2017 that are categorized as nonaccrual for credit analysis purposes because the collection of principal or interest is doubtful. However, these loans are accounted for under FASB ASC 310-30 and accordingly treated as performing assets.

Loan Participations

Old National has loan participations, which qualify as participating interests, with other financial institutions. At September 30, 2018, these loans totaled $752.3 million, of which $371.2 million had been sold to other financial institutions and $381.1 million was retained by Old National. The loan participations convey proportionate ownership rights with equal priority to each participating interest holder; involve no recourse (other than ordinary representations and warranties) to, or subordination by, any participating interest holder; all cash flows are divided among the participating interest holders in proportion to each holder's share of ownership; and no holder has the right to pledge the entire financial asset unless all participating interest holders agree.

Troubled Debt Restructurings

Old National may choose to restructure the contractual terms of certain loans. The decision to restructure a loan, versus aggressively enforcing the collection of the loan, may benefit Old National by increasing the ultimate probability of collection.

Any loans that are modified are reviewed by Old National to identify if a TDR has occurred, which is when for economic or legal reasons related to a borrower's financial difficulties, Old National Bank grants a concession to the borrower that it would not otherwise consider. Terms may be modified to fit the ability of the borrower to repay in line with its current financial status. The modification of the terms of such loans include one or a combination of the following: a reduction of the stated interest rate of the loan, an extension of the maturity date at a stated rate of interest lower than the current market rate of new debt with similar risk, or a permanent reduction of the recorded investment of the loan.

Loans modified in a TDR are typically placed on nonaccrual status until we determine the future collection of principal and interest is reasonably assured, which generally requires that the borrower demonstrate a period of performance according to the restructured terms for six months.

If we are unable to resolve a nonperforming loan issue, the credit will be charged off when it is apparent there will be a loss. For large commercial type loans, each relationship is individually analyzed for evidence of apparent loss based on quantitative benchmarks or subjectively based upon certain events or particular circumstances. Generally, Old National charges off small commercial loans scored through our small business credit center with contractual balances under $250,000 that are 90 days or more delinquent and do not have adequate collateral support. For residential and consumer loans, a charge off is recorded at the time foreclosure is initiated or when the loan becomes 120 to 180 days past due, whichever is earlier.

For commercial TDRs, an allocated reserve is established within the allowance for loan losses for the difference between the carrying value of the loan and its computed value. To determine the value of the loan, one of the following methods is selected: (1) the present value of expected cash flows discounted at the loan's original effective interest rate, (2) the loan's observable market price, or (3) the fair value of the collateral value, if the loan is collateral dependent. The allocated reserve is established as the difference between the carrying value of the loan and the collectable value. If there are significant changes in the amount or timing of the loan's expected future cash flows, impairment is recalculated and the valuation allowance is adjusted accordingly.

When a residential or consumer loan is identified as a TDR, the loan is typically written down to its collateral value less selling costs.

The following table presents activity in TDRs for the three and nine months ended September 30, 2018 and 2017:

(dollars in thousands)	Commercial	Commercial Real Estate	Residential	Consumer	Total
Three Months Ended September 30, 2018					
Balance at beginning of period	$ 9,043	$ 34,927	$ 3,771	$ 3,398	$ 51,139
(Charge-offs)/recoveries	(7)	753	-	3	749
(Payments)/disbursements	453	(6,601)	(75)	(200)	(6,423)
Additions	1,954	-	-	-	1,954
Balance at end of period	$ 11,443	$ 29,079	$ 3,696	$ 3,201	$ 47,419
Three Months Ended September 30, 2017					
Balance at beginning of period	$ 20,064	$ 33,059	$ 3,640	$ 3,644	$ 60,407
(Charge-offs)/recoveries	59	6	-	39	104
(Payments)/disbursements	(1,488)	(361)	(294)	(134)	(2,277)
Additions	3,157	-	-	644	3,801
Balance at end of period	$ 21,792	$ 32,704	$ 3,346	$ 4,193	$ 62,035
Nine Months Ended September 30, 2018					
Balance at beginning of period	$ 12,088	$ 34,705	$ 3,315	$ 3,895	$ 54,003
(Charge-offs)/recoveries	(158)	731	23	(19)	577
(Payments)/disbursements	(3,525)	(7,570)	(144)	(1,107)	(12,346)
Additions	3,038	1,213	502	432	5,185
Balance at end of period	$ 11,443	$ 29,079	$ 3,696	$ 3,201	$ 47,419
Nine Months Ended September 30, 2017					
Balance at beginning of period	$ 16,802	$ 18,327	$ 2,985	$ 2,602	$ 40,716
(Charge-offs)/recoveries	(5)	366	-	(58)	303
(Payments)/disbursements	(7,604)	(3,418)	(576)	(919)	(12,517)
Additions	12,599	17,429	937	2,568	33,533
Balance at end of period	$ 21,792	$ 32,704	$ 3,346	$ 4,193	$ 62,035

TDRs included with nonaccrual loans totaled $29.9 million at September 30, 2018 and $34.0 million at December 31, 2017. Old National has allocated specific reserves to customers whose loan terms have been modified in TDRs totaling $3.0 million at September 30, 2018 and $5.7 million at December 31, 2017. At September 30, 2018, Old National had not committed to lend additional funds to customers with outstanding loans that are classified as TDRs.

The pre-modification and post-modification outstanding recorded investments of loans modified as TDRs during the nine months ended September 30, 2018 and 2017 are the same except for when the loan modifications involve the forgiveness of principal. The following table presents loans by class modified as TDRs that occurred during the nine months ended September 30, 2018 and 2017:

(dollars in thousands)	Number of Loans	Pre-modification Outstanding Recorded Investment	Post-modification Outstanding Recorded Investment
Nine Months Ended September 30, 2018			
TDR:			
Commercial	5	$ 3,038	$ 3,038
Commercial Real Estate - Other	2	1,213	1,213
Residential	1	502	502
Consumer	1	432	432
Total	9	$ 5,185	$ 5,185
Nine Months Ended September 30, 2017			
TDR:			
Commercial	9	$ 12,599	$ 12,599
Commercial Real Estate - Other	10	17,429	17,429
Residential	6	937	937
Consumer	7	2,568	2,568
Total	32	$ 33,533	$ 33,533

The TDRs that occurred during the nine months ended September 30, 2018 did not have a material impact on the allowance for loan losses and resulted in no charge-offs during the nine months ended September 30, 2018. The TDRs that occurred during the nine months ended September 30, 2017 increased the allowance for loan losses by $3.2 million and resulted in no charge-offs.

A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

TDRs for which there was a payment default within twelve months following the modification were insignificant during the nine months ended September 30, 2018 and 2017.

The terms of certain other loans were modified during 2018 that did not meet the definition of a TDR. It is our process to review all classified and criticized loans that, during the period, have been renewed, have entered into a forbearance agreement, have gone from principal and interest to interest only, or have extended the maturity date. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on its debt in the foreseeable future without the modification. The evaluation is performed under our internal underwriting policy. We also evaluate whether a concession has been granted or if we were adequately compensated through a market interest rate, additional collateral or a bona fide guarantee. We also consider whether the modification was insignificant relative to the other terms of the agreement or the delay in a payment.

PCI loans are not considered impaired until after the point at which there has been a degradation of cash flows below our expected cash flows at acquisition. If a PCI loan is subsequently modified, and meets the definition of a TDR, it will be removed from PCI accounting and accounted for as a TDR only if the PCI loan was being accounted for individually. If the PCI loan is being accounted for as part of a pool, it will not be removed from the pool. As of

September 30, 2018, it has not been necessary to remove any loans from PCI accounting.

In general, once a modified loan is considered a TDR, the loan will always be considered a TDR, and therefore impaired, until it is paid in full, otherwise settled, sold or charged off. However, guidance also permits for loans to be removed from TDR status when subsequently restructured under these circumstances: (1) at the time of the subsequent restructuring, the borrower is not experiencing financial difficulties, and this is documented by a current credit evaluation at the time of the restructuring, (2) under the terms of the subsequent restructuring agreement, the institution has granted no concession to the borrower; and (3) the subsequent restructuring agreement includes market terms that are no less favorable than those that would be offered for a comparable new loan. For loans subsequently restructured that have cumulative principal forgiveness, the loan should continue to be measured in accordance with ASC 310-10, *Receivables – Overall*. However, consistent with ASC 310-40-50-2, *Troubled Debt Restructurings by Creditors, Creditor Disclosure of Troubled Debt Restructurings*, the loan would not be required to be reported in the years following the restructuring if the subsequent restructuring meets both of these criteria: (1) has an interest rate at the time of the subsequent restructuring that is not less than a market interest rate; and (2) is performing in compliance with its modified terms after the subsequent restructuring.

Purchased Credit Impaired Loans

Purchased loans acquired in a business combination are recorded at estimated fair value on their purchase date with no carryover of the related allowance for loan and lease losses. In determining the estimated fair value of purchased loans, management considers a number of factors including, among others, the remaining life of the acquired loans, estimated prepayments, estimated loss ratios, estimated value of the underlying collateral, and net present value of cash flows expected to be received. Purchased loans are accounted for in accordance with guidance for certain loans acquired in a transfer (ASC 310-30), when the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the non-accretable difference. Subsequent decreases to the expected cash flows will generally result in a provision for loan and lease losses. Subsequent increases in expected cash flows will result in a reversal of the provision for loan losses to the extent of prior charges and then an adjustment to accretable yield, which would have a positive impact on interest income prospectively.

Old National has purchased loans for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. For these loans that meet the criteria of ASC 310-30 treatment, the carrying amount was as follows:

(dollars in thousands)	September 30, 2018	December 31, 2017
Commercial	$ 4,230	$ 5,152
Commercial real estate	17,669	21,826
Residential	9,711	11,303
Consumer	3,848	5,245
Carrying amount	35,458	43,526
Allowance for loan losses	(303)	(166)
Carrying amount, net of allowance	$ 35,155	$ 43,360

The outstanding balance of loans accounted for under ASC 310-30, including contractual principal, interest, fees and penalties, was $236.1 million at September 30, 2018 and $235.9 million at December 31, 2017.

The accretable difference on PCI loans is the difference between the expected cash flows and the net present value of expected cash flows with such difference accreted into earnings using the effective yield method over the term of the loans. Accretion recorded as loan interest income totaled $1.9 million during the three months ended September 30, 2018 and $8.9 million during the nine months ended September 30, 2018, compared to $5.4 million during the three months ended September 30, 2017 and $12.8 million during the nine months ended September 30, 2017. Improvement in cash flow expectations has resulted in a reclassification from nonaccretable difference to accretable yield as shown in the table below.

Accretable yield of PCI loans, or income expected to be collected, is as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Balance at beginning of period	$24,249	$27,050	$27,835	$33,603
Accretion of income	(1,854)	(5,445)	(8,927)	(12,775)
Reclassifications from (to) nonaccretable difference	1,599	5,973	5,065	6,567
Disposals/other adjustments	1	94	22	277
Balance at end of period	$23,995	$27,672	$23,995	$27,672

Included in Old National's allowance for loan losses is $0.3 million related to the purchased loans disclosed above at September 30, 2018 and $0.2 million at December 31, 2017.

PCI loans purchased during 2017 for which it was probable at acquisition that all contractually required payments would not be collected were as follows:

(dollars in thousands)	Anchor (MN) (1)
Contractually required payments	$ 16,898
Nonaccretable difference	(4,787)
Cash flows expected to be collected at acquisition	12,111
Accretable yield	(1,556)
Fair value of acquired loans at acquisition	$ 10,555

(1) Old National acquired Anchor (MN) effective November 1, 2017.

Income would not be recognized on certain purchased loans if Old National could not reasonably estimate cash flows to be collected. Old National had no purchased loans for which it could not reasonably estimate cash flows to be collected.

NOTE 9 – OTHER REAL ESTATE OWNED

The following table presents activity in other real estate owned for the three and nine months ended September 30, 2018 and 2017:

Three Months Ended	Nine Months Ended

	September 30,		September 30,	
(dollars in thousands)	2018	2017	2018	2017
Balance at beginning of period	$3,729	$11,071	$8,810	$18,546
Additions	474	1,745	1,649	2,695
Sales	(511)	(2,143)	(6,136)	(8,695)
Impairment	(129)	(414)	(760)	(2,287)
Balance at end of period (1)	$3,563	$10,259	$3,563	$10,259

(1) Includes repossessed personal property of $0.3 million at September 30, 2018 and $0.1 million at September 30, 2017.

At September 30, 2018, foreclosed residential real estate property included in the table above totaled $1.5 million. At September 30, 2018, consumer mortgage loans collateralized by residential real property that were in the process of foreclosure totaled $6.5 million.

NOTE 10 – PREMISES AND EQUIPMENT

The composition of premises and equipment at September 30, 2018 and December 31, 2017 was as follows:

(dollars in thousands)	September 30, 2018	December 31, 2017
Land	$70,628	$73,046
Buildings	340,920	343,833
Furniture, fixtures, and equipment	101,418	94,254
Leasehold improvements	41,831	38,918
Total	554,797	550,051
Accumulated depreciation	(104,544)	(91,977)
Premises and equipment, net	$450,253	$458,074

Depreciation expense was $5.9 million for the three months ended September 30, 2018 and $17.7 million for the nine months ended September 30, 2018, compared to $5.8 million for the three months ended September 30, 2017 and $16.2 million for the nine months ended September 30, 2017.

Operating Leases

Old National rents certain premises and equipment under operating leases, which expire at various dates. Many of these leases require the payment of property taxes, insurance premiums, maintenance, and other costs. In some cases, rentals are subject to increase in relation to a cost-of-living index. The leases have original terms ranging from two years and six months to twenty-five years, and Old National has the right, at its option, to extend the terms of certain leases for four additional successive terms of five years. Old National does not have any material sub-lease agreements. Rent expense was $4.4 million for the three months ended September 30, 2018 and $13.4 million for the nine months ended September 30, 2018, compared to $3.9 million for the three months ended September 30, 2017 and $11.6 million for the nine months ended September 30, 2017. See Note 3 to the consolidated financial statements for details regarding new guidance in Topic 842 that will affect the accounting for these leases effective January 1, 2019.

Old National had deferred gains remaining associated with prior sale leaseback transactions totaling $6.9 million at September 30, 2018 and $8.2 million at December 31, 2017. Under current GAAP, the gains will be recognized over the remaining term of the leases. The leases had original terms ranging from five to twenty-four years. Topic 842 may change how this gain is recognized beginning in first quarter 2019. See Note 3 to the consolidated financial statements for details regarding new accounting guidance in Topic 842.

Capital Leases

Old National leases two branch buildings and certain equipment under capital leases. See Note 16 to the consolidated financial statements for detail regarding these leases.

NOTE 11 – GOODWILL AND OTHER INTANGIBLE ASSETS

The following table shows the changes in the carrying amount of goodwill for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Balance at beginning of period	$828,804	$655,018	$828,051	$655,018
Acquisition adjustments	-	-	753	-
Balance at end of period	$828,804	$655,018	$828,804	$655,018

Goodwill is reviewed annually for impairment. No events or circumstances since the August 31, 2018 annual impairment test were noted that would indicate it was more likely than not a goodwill impairment exists. During the nine months ended September 30, 2018, Old National recorded a $0.8 million increase to goodwill associated with the acquisition of Anchor (MN).

The gross carrying amount and accumulated amortization of other intangible assets at September 30, 2018 and December 31, 2017 were as follows:

(dollars in thousands)	Gross Carrying Amount	Accumulated Amortization and Impairment	Net Carrying Amount
September 30, 2018			
Core deposit	$90,083	$ (53,765)	$36,318
Customer trust relationships	16,547	(10,731)	5,816
Total intangible assets	$106,630	$ (64,496)	$42,134
December 31, 2017			
Core deposit	$108,923	$ (62,874)	$46,049
Customer trust relationships	16,547	(9,533)	7,014
Customer loan relationships	4,413	(4,380)	33
Total intangible assets	$129,883	$ (76,787)	$53,096

Other intangible assets consist of core deposit intangibles and customer relationship intangibles and are being amortized primarily on an accelerated basis over their estimated useful lives, generally over a period of 5 to 15 years. During the nine months ended September 30, 2018, Old National recorded a $0.7 million decrease to core deposit intangibles related to the updated valuation associated with the acquisition of Anchor (MN).

Old National reviews other intangible assets for possible impairment whenever events or changes in circumstances indicate that carrying amounts may not be recoverable. No impairment charges were recorded during the nine months ended September 30, 2018 or 2017. Total amortization expense associated with intangible assets was $3.3 million for the three months ended September 30, 2018 and $10.3 million for the nine months ended September 30, 2018, compared to $2.6 million for the three months ended September 30, 2017 and $8.4 million for the nine months ended September 30, 2017.

Estimated amortization expense for future years is as follows:

(dollars in thousands)	
2018 remaining	$3,116
2019	11,010
2020	8,672
2021	6,417
2022	4,595
Thereafter	8,324
Total	$42,134

NOTE 12 – LOAN SERVICING RIGHTS

At September 30, 2018, loan servicing rights derived from loans sold with servicing retained totaled $24.3 million, compared to $24.7 million at December 31, 2017. Loans serviced for others are not reported as assets. The principal balance of loans serviced for others was $3.314 billion at September 30, 2018, compared to $3.321 billion at December 31, 2017. Approximately 99.7% of the loans serviced for others at September 30, 2018 were residential mortgage loans. Custodial escrow balances maintained in connection with serviced loans were $43.1 million at September 30, 2018 and $8.9 million at December 31, 2017.

The following table summarizes the carrying values and activity related to loan servicing rights and the related valuation allowance for the three and nine months ended September 30, 2018 and 2017:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Balance at beginning of period	$24,318	$25,098	$24,690	$25,629
Additions	1,147	1,204	3,098	3,180
Amortization	(1,117)	(1,348)	(3,440)	(3,855)
Balance before valuation allowance at end of period	24,348	24,954	24,348	24,954
Valuation allowance:				
Balance at beginning of period	(15)	(75)	(29)	(68)
(Additions)/recoveries	3	21	17	14
Balance at end of period	(12)	(54)	(12)	(54)
Loan servicing rights, net	$24,336	$24,900	$24,336	$24,900

At September 30, 2018, the fair value of servicing rights was $27.4 million, which was determined using a discount rate of 12% and a weighted average prepayment speed of 115% PSA. At December 31, 2017, the fair value of servicing rights was $25.8 million, which was determined using a discount rate of 13% and a weighted average prepayment speed of 140% PSA.

NOTE 13 – QUALIFIED AFFORDABLE HOUSING PROJECTS AND OTHER TAX CREDIT INVESTMENTS

Old National is a limited partner in several tax-advantaged limited partnerships whose purpose is to invest in approved qualified affordable housing, renewable energy, or other renovation or community revitalization projects. As of September 30, 2018, Old National expects to recover its remaining investments using the tax credits that are generated by the investments.

The following table summarizes Old National's investments in qualified affordable housing projects and other tax credit investments at September 30, 2018 and December 31, 2017:

(dollars in thousands)		September 30, 2018		December 31, 2017	
Investment	Accounting Method	Investment	Unfunded Commitment (1)	Investment	Unfunded Commitment
LIHTC	Proportional amortization	$28,991	$ 5,134	$31,183	$ 15,553
FHTC	Equity	2,039	7,760	10,645	12,040
CReED	Equity	17	538	704	1,502
Renewable Energy	Equity	19,252	27,608	22,364	19,771
Total		$50,299	$ 41,040	$64,896	$ 48,866

(1) All commitments will be paid by Old National by 2027.

The following table summarizes the amortization expense and tax benefit recognized for Old National's qualified affordable housing projects and other tax credit investments for the three and nine months ended September 30, 2018 and 2017:

(dollars in thousands)	Amortization Expense (1)	Tax Expense (Benefit) Recognized (2)
Three Months Ended September 30, 2018		
LIHTC	$ 640	$ (832)
FHTC	3,282	(1,258)
CReED (3)	687	-
Renewable Energy	5,265	(3,109)
Total	$ 9,874	$ (5,199)
Three Months Ended September 30, 2017		
LIHTC	$ 940	$ (1,297)
FHTC	-	(1,520)
CReED (3)	-	(303)
Total	$ 940	$ (3,120)
Nine Months Ended September 30, 2018		
LIHTC	$ 1,923	$ (2,494)
FHTC	8,727	(5,154)
CReED (3)	687	-
Renewable Energy	12,393	(9,406)
Total	$ 23,730	$ (17,054)
Nine Months Ended September 30, 2017		
LIHTC	$ 2,822	$ (3,892)
FHTC	-	(4,559)
CReED (3)	-	(909)
Total	$ 2,822	$ (9,360)

(1) The amortization expense for the LIHTC investments is included in our income tax expense. The amortization expense for the FHTC, CReED, and Renewable Energy tax credits is included in noninterest expense.
(2) All of the tax benefits recognized are included in our income tax expense. The tax benefit recognized for the FHTC, CReED, and Renewable Energy investments primarily reflects the tax credits generated from the investments, and excludes the net tax expense (benefit) of the investments' income (loss).
(3) The CReED tax credit investment qualifies for an Indiana state tax credit.

NOTE 14 – SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase are secured borrowings. Old National pledges investment securities to secure these borrowings. The following table presents securities sold under agreements to repurchase and related weighted-average interest rates at or for the nine months ended September 30:

(dollars in thousands)	2018	2017

Outstanding at September 30,	$319,831	$285,409
Average amount outstanding	342,797	325,230
Maximum amount outstanding at any month-end	364,001	351,897
Weighted-average interest rate:		
During the nine months ended September 30,	0.52 %	0.36 %
At September 30,	0.74	0.34

The following table presents the contractual maturity of our secured borrowings and class of collateral pledged:

	At September 30, 2018				
	Remaining Contractual Maturity of the Agreements				
(dollars in thousands)	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 days	Total
Repurchase Agreements:					
U.S. Treasury and agency securities	$319,831	$ -	$ -	$ -	$319,831
Total	$319,831	$ -	$ -	$ -	$319,831

The fair value of securities pledged to secure repurchase agreements may decline. Old National has pledged securities valued at 120% of the gross outstanding balance of repurchase agreements at September 30, 2018 to manage this risk.

NOTE 15 – FEDERAL HOME LOAN BANK ADVANCES

The following table summarizes Old National Bank's FHLB advances at September 30, 2018 and December 31, 2017:

(dollars in thousands)	September 30, 2018	December 31, 2017
FHLB advances (fixed rates 1.50% to 6.08% and variable rates 2.21% to 2.49%) maturing October 2018 to June 2028	$1,556,730	$1,610,531
ASC 815 fair value hedge and other basis adjustments	(2,215)	(952)
Total other borrowings	$1,554,515	$1,609,579

FHLB advances had weighted-average rates of 2.34% at September 30, 2018 and 1.55% at December 31, 2017. Investment securities and residential real estate loans collateralize these borrowings up to 140% of outstanding debt.

Contractual maturities of FHLB advances at September 30, 2018 were as follows:

(dollars in thousands)	
Due in 2018	$426,567
Due in 2019	201,494
Due in 2020	100,000
Due in 2021	20,000
Due in 2022	58,500
Thereafter	750,169

ASC 815 fair value hedge and other basis adjustments	(2,215)
Total	$1,554,515

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NOTE 16 – OTHER BORROWINGS

The following table summarizes Old National's other borrowings at September 30, 2018 and December 31, 2017:

(dollars in thousands)	September 30, 2018	December 31, 2017
Old National Bancorp:		
Senior unsecured notes (fixed rate 4.125%) maturing August 2024	$175,000	$175,000
Unamortized debt issuance costs related to senior unsecured notes	(910)	(1,026)
Junior subordinated debentures (variable rates of 3.74% to 6.22%) maturing April 2032 to June 2037	60,310	60,310
Other basis adjustments	(3,182)	(3,585)
Old National Bank:		
Capital lease obligations	5,294	5,389
Subordinated debentures (fixed rate 5.75%)	12,000	12,000
Other	3,150	694
Total other borrowings	$251,662	$248,782

Contractual maturities of other borrowings at September 30, 2018 were as follows:

(dollars in thousands)	
Due in 2018	$2,554
Due in 2019	137
Due in 2020	147
Due in 2021	160
Due in 2022	172
Thereafter	251,956
Unamortized debt issuance costs and other basis adjustments	(3,464)
Total	$251,662

Senior Notes

In August 2014, Old National issued $175.0 million of senior unsecured notes with a 4.125% interest rate. These notes pay interest on February 15 and August 15. The notes mature on August 15, 2024.

Junior Subordinated Debentures

Junior subordinated debentures related to trust preferred securities are classified in "other borrowings." With the addition of Anchor (MN) assets, these securities now qualify as Tier 2 capital for regulatory purposes, subject to certain limitations. Prior to the fourth quarter of 2017, these securities qualified as Tier 1 capital for regulatory purposes.

Through various acquisitions, Old National assumed junior subordinated debenture obligations related to various trusts that issued trust preferred securities. Old National guarantees the payment of distributions on the trust preferred securities issued by the trusts. Proceeds from the issuance of each of these securities were used to purchase junior subordinated debentures with the same financial terms as the securities issued by the trusts.

Old National, at any time, may redeem the junior subordinated debentures at par and, thereby cause a redemption of the trust preferred securities in whole or in part.

The following table summarizes the terms of our outstanding junior subordinated debentures at September 30, 2018:

(dollars in thousands) Name of Trust	Issuance Date	Issuance Amount	Rate	Rate at September 30, 2018	Maturity Date
VFSC Capital Trust I	April 2002	$3,093	3-month LIBOR plus 3.70%	6.22%	April 22, 2032
VFSC Capital Trust II	October 2002	4,124	3-month LIBOR plus 3.45%	5.79%	November 7, 2032
VFSC Capital Trust III	April 2004	3,093	3-month LIBOR plus 2.80%	5.13%	September 8, 2034
St. Joseph Capital Trust II	March 2005	5,000	3-month LIBOR plus 1.75%	4.08%	March 20, 2035
Anchor Capital Trust III	August 2005	5,000	3-month LIBOR plus 1.55%	3.95%	September 30, 2035
Tower Capital Trust 2	December 2005	8,000	3-month LIBOR plus 1.34%	3.74%	December 30, 2035
Home Federal Statutory Trust I	September 2006	15,000	3-month LIBOR plus 1.65%	3.98%	September 15, 2036
Monroe Bancorp Capital Trust I	July 2006	3,000	3-month LIBOR plus 1.60%	3.94%	October 7, 2036
Tower Capital Trust 3	December 2006	9,000	3-month LIBOR plus 1.69%	4.01%	March 1, 2037
Monroe Bancorp Statutory Trust II	March 2007	5,000	3-month LIBOR plus 1.60%	3.93%	June 15, 2037
Total		$60,310			

Subordinated Debentures

On November 1, 2017, Old National assumed $12.0 million of subordinated fixed-to-floating notes related to the acquisition of Anchor (MN). The subordinated debentures have a 5.75% fixed rate of interest through October 29, 2020. From October 30, 2020 to the October 30, 2025 maturity date, the debentures have a floating rate of interest equal to the three-month LIBOR rate plus 4.356%.

Capital Lease Obligations

On January 1, 2004, Old National entered into a long-term capital lease obligation for a branch office building in Owensboro, Kentucky, which extends for 25 years with one renewal option for 10 years. The economic substance of this lease is that Old National is financing the acquisition of the building through the lease and accordingly, the building is recorded as an asset and the lease is recorded as a liability. The fair value of the capital lease obligation was estimated using a discounted cash flow analysis based on Old National's current incremental borrowing rate for similar types of borrowing arrangements.

On November 1, 2017, Old National assumed a capital lease obligation for a banking center in Arden Hills, Minnesota related to the acquisition of Anchor (MN). The remaining base term of the lease is five years with one renewal option of ten years. For purposes of measuring the lease obligation, we determined that we would be "reasonably assured" to exercise the renewal option. The fair value of the capital lease obligation was estimated using a discounted cash flow analysis based on a market rate for similar types of borrowing arrangements. Based on the above assumptions, Old National measured the capital lease obligation at $1.5 million as of the date of acquisition.

At September 30, 2018, the future minimum lease payments under the capital lease arrangements were as follows:

(dollars in thousands)	
2018	$142
2019	589
2020	589
2021	589
2022	589
Thereafter	9,275
Total minimum lease payments	11,773
Less amounts representing interest	(6,479)
Present value of net minimum lease payments	$5,294

See Note 3 to the consolidated financial statements for details regarding new guidance in Topic 842 that will affect the accounting for these leases effective January 1, 2019.

NOTE 17 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table summarizes the changes within each classification of AOCI, net of tax, for the three and nine months ended September 30, 2018 and 2017:

(dollars in thousands)	Unrealized Gains and Losses on Available-for-Sale Debt Securities	Unrealized Gains and Losses on Held-to-Maturity Securities	Gains and Losses on Cash Flow Hedges	Defined Benefit Pension Plans	Total
Three Months Ended September 30, 2018					
Balance at beginning of period	$ (59,356)	$ (9,335)	$ 2,277	$ (289)	$ (66,703)
Other comprehensive income (loss) before reclassifications	(13,989)	-	548	-	(13,441)
Amounts reclassified from AOCI to income (1)	(117)	482	(171)	20	214
Balance at end of period	$ (73,462)	$ (8,853)	$ 2,654	$ (269)	$ (79,930)
Three Months Ended September 30, 2017					
Balance at beginning of period	$ (12,457)	$ (12,717)	$ (5,645)	$ (301)	$ (31,120)
Other comprehensive income (loss) before reclassifications	(2,531)	-	134	-	(2,397)
Amounts reclassified from AOCI to income (1)	(1,883)	300	887	16	(680)
Balance at end of period	$ (16,871)	$ (12,417)	$ (4,624)	$ (285)	$ (34,197)
Nine Months Ended September 30, 2018					
Balance at beginning of period	$ (35,557)	$ (12,107)	$ (2,337)	$ (271)	$ (50,272)
Other comprehensive income (loss) before reclassifications	(28,475)	4,514	5,135	-	(18,826)
Amounts reclassified from AOCI to income (1)	(1,847)	1,340	417	61	(29)
Amount reclassified from AOCI to retained earnings for cumulative effect of change in accounting principle (2)	-	-	(52)	-	(52)
Amounts reclassified from AOCI to retained earnings related to the Tax Cuts and Jobs Act of 2017 (3)	(7,583)	(2,600)	(509)	(59)	(10,751)
Balance at end of period	$ (73,462)	$ (8,853)	$ 2,654	$ (269)	$ (79,930)

Nine Months Ended September 30, 2017					
Balance at beginning of period	$ (39,012)	$ (13,310)	$ (6,715)	$ (335)	$ (59,372)
Other comprehensive income (loss) before reclassifications	26,928	-	(986)	-	25,942
Amounts reclassified from AOCI to income (1)	(4,787)	893	3,077	50	(767)
Balance at end of period	$ (16,871)	$ (12,417)	$ (4,624)	$ (285)	$ (34,197)

(1) See table below for details about reclassifications to income.

(2) See Note 3 for details about reclassification from AOCI to beginning retained earnings resulting from the adoption of ASU 2017-12.

(3) See Note 3 for details about reclassification from AOCI to beginning retained earnings resulting from the adoption of ASU 2018-02.

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The following table summarizes the significant amounts reclassified out of each component of AOCI for the three months ended September 30, 2018 and 2017:

Details about AOCI Components	Amount Reclassified from AOCI Three Months Ended September 30,		Affected Line Item in the Statement of Income
(dollars in thousands)	2018	2017	
Unrealized gains and losses on			
available-for-sale debt securities	$135	$2,972	Net securities gains
	(18)	(1,089)	Income tax (expense) benefit
	$117	$1,883	Net income
Unrealized gains and losses on			
held-to-maturity securities	$(628)	$(456)	Interest income (expense)
	146	156	Income tax (expense) benefit
	$(482)	$(300)	Net income
Gains and losses on cash flow hedges			
Interest rate contracts	$226	$(1,429)	Interest income (expense)
	(55)	542	Income tax (expense) benefit
	$171	$(887)	Net income
Amortization of defined benefit			
pension items Actuarial gains (losses)	$(27)	$(27)	Salaries and employee benefits
	7	11	Income tax (expense) benefit
	$(20)	$(16)	Net income
Total reclassifications for the period	$(214)	$680	Net income

The following table summarizes the significant amounts reclassified out of each component of AOCI for the nine months ended September 30, 2018 and 2017:

Details about AOCI Components	Amount Reclassified from AOCI Nine Months Ended September 30,		Affected Line Item in the Statement of Income
(dollars in thousands)	2018	2017	
Unrealized gains and losses on			
available-for-sale debt securities	$2,417	$7,547	Net securities gains
	(570)	(2,760)	Income tax (expense) benefit

	$1,847	$4,787	Net income
Unrealized gains and losses on			
held-to-maturity securities	$(1,740)	$(1,358)	Interest income/(expense)
	400	465	Income tax (expense) benefit
	$(1,340)	$(893)	Net income
Gains and losses on cash flow hedges			
Interest rate contracts	$(553)	$(4,962)	Interest income/(expense)
	136	1,885	Income tax (expense) benefit
	$(417)	$(3,077)	Net income
Amortization of defined benefit			
pension items Actuarial gains/(losses)	$(81)	$(81)	Salaries and employee benefits
	20	31	Income tax (expense) benefit
	$(61)	$(50)	Net income
Total reclassifications for the period	$29	$767	Net income

NOTE 18 – EMPLOYEE BENEFIT PLANS

Retirement Plan

Old National had a funded noncontributory defined benefit plan (the "Retirement Plan") that had been frozen since December 31, 2005. During the first quarter of 2016, we notified plan participants of our intent to terminate the Retirement Plan effective May 15, 2016. During October 2016, the Retirement Plan settled plan liabilities through either lump sum distributions to plan participants or annuity contracts purchased from a third-party insurance company that provided for the payment of vested benefits to those participants that did not elect the lump sum option. At September 30, 2018, there were no remaining plan assets.

Employee Stock Ownership Plan

The Employee Stock Ownership and Savings Plan (the "401(k) Plan") permits employees to participate the first month following one month of service. During the second quarter of 2018, Old National increased its match to 75% of employee compensation deferral contributions of the first 4% of compensation, and 50% of the next 4% of compensation. The change was retroactive for all of 2018. For 2017, we matched 50% of employee compensation deferral contributions, up to 6% of compensation. Contribution expense under the 401(k) Plan was $1.9 million in the three months ended September 30, 2018 and $6.5 million in the nine months ended September 30, 2018, compared to $1.1 million in the three months ended September 30, 2017 and $3.5 million in the nine months ended September 30, 2017.

NOTE 19 – SHARE-BASED COMPENSATION

At September 30, 2018, Old National had 4.4 million shares remaining available for issuance under the Company's Amended and Restated 2008 Incentive Compensation Plan. The granting of awards to key employees is typically in the form of restricted stock awards or units.

Restricted Stock Awards

Old National granted 212 thousand time-based restricted stock awards to certain key officers during the nine months ended September 30, 2018, with shares vesting generally over a thirty-six month period. Compensation expense is recognized on a straight-line basis over the vesting period. Shares are subject to certain restrictions and risk of forfeiture by the participants. At September 30, 2018, unrecognized compensation expense was estimated to be $5.2 million for unvested restricted stock awards. The cost is expected to be recognized over a weighted-average period of 2.1 years.

Old National recorded share-based compensation expense, net of tax, related to restricted stock awards of $0.6 million, net of tax, during the three months ended September 30, 2018 and $1.7 million, net of tax, during the nine months ended September 30, 2018, compared to $0.4 million, net of tax, during the three months ended September 30, 2017 and $1.4 million, net of tax, during the nine months ended September 30, 2017.

Restricted Stock Units

Old National granted 288 thousand shares of performance based restricted stock units to certain key officers during the nine months ended September 30, 2018, with shares vesting at the end of a thirty-six month period based on the achievement of certain targets. For certain awards, the level of performance could increase or decrease the percentage of shares earned. Compensation expense is recognized on a straight-line basis over the vesting period. Shares are subject to certain restrictions and risk of forfeiture by the participants. At September 30, 2018, unrecognized compensation expense was estimated to be $4.9 million. The cost is expected to be recognized over a weighted-average period of 1.8 years.

Old National recorded share-based compensation expense, net of tax, related to restricted stock units of $0.9 million, net of tax, during the three months ended September 30, 2018 and $2.5 million during the nine months ended September 30, 2018, compared to $0.5 million, net of tax, during the three months ended September 30, 2017 and $1.5 million, net of tax, during the nine months ended September 30, 2017.

Stock Options

Old National has not granted stock options since 2009. However, Old National did acquire stock options through prior year acquisitions. Old National did not record any share-based compensation expense related to these stock options during the nine months ended September 30, 2018 or 2017.

Stock Appreciation Rights

Old National has never granted stock appreciation rights. However, Old National did acquire stock appreciation rights through a prior year acquisition. Old National did not record any incremental expense associated with the conversion of these stock appreciation rights during the nine months ended September 30, 2018 or 2017. At September 30, 2018, 62 thousand stock appreciation rights remained outstanding.

NOTE 20 – INCOME TAXES

Following is a summary of the major items comprising the differences in taxes from continuing operations computed at the federal statutory rate and as recorded in the consolidated statements of income:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands)	2018	2017	2018	2017
Provision at statutory rate (1)	$11,901	$17,791	$33,171	$51,363
Tax-exempt income:				
Tax-exempt interest	(2,179)	(3,658)	(6,607)	(11,032)
Section 291/265 interest disallowance	84	76	220	197
Company-owned life insurance income	(621)	(708)	(1,679)	(2,201)
Tax-exempt income	(2,716)	(4,290)	(8,066)	(13,036)
State income taxes	2,091	506	4,307	1,553
Interim period effective rate adjustment	(81)	(861)	944	(1,602)
Tax credit investments - federal	(5,483)	(1,684)	(16,224)	(5,431)
Other, net	(387)	(3)	495	(313)
Income tax expense	$5,325	$11,459	$14,627	$32,534
Effective tax rate	9.4 %	22.5 %	9.3 %	22.2 %

(1) The statutory rate was 21% for the three and nine months ended September 30, 2018, compared to 35% for the three and nine months ended September 30, 2017.

In accordance with ASC 740-270, *Accounting for Interim Reporting*, the provision for income taxes was recorded at September 30, 2018 and 2017 based on the current estimate of the effective annual rate.

The lower effective tax rate during the three and nine months ended September 30, 2018 when compared to the three and nine months ended September 30, 2017 is primarily the result of the lowering of the federal corporate tax rate to 21% in 2018 and an increase in federal tax credits available. On December 22, 2017, the Tax Cuts and Jobs Act ("H.R. 1") was enacted into legislation. Under ASC 740, the effects of changes in tax rates and laws are recognized in the period in which the new legislation is enacted. Accordingly, Old National recorded an estimated $39.3 million expense for the revaluation of Old National's deferred tax assets in December 2017.

Shortly after the enactment date, the SEC issued SAB 118, which addresses the situations where the accounting for changes in tax laws is complete, incomplete but can be reasonably estimated, and incomplete and cannot be reasonably estimated. SAB 118 also permits a measurement period of up to one year from the date of enactment to refine the provisional accounting. Old National completed its analysis of H.R. 1 during the second quarter of 2018. During the six months ended June 30, 2018, immaterial adjustments made to the preliminary valuation of assets acquired and liabilities assumed in the acquisition of Anchor (MN) impacted the estimated revaluation of Old National's deferred tax assets.

Unrecognized Tax Benefits

Old National and its subsidiaries file a consolidated U.S. federal income tax return, as well as filing various state returns. Unrecognized state income tax benefits are reported net of their related deferred federal income tax benefit.

A reconciliation of the beginning and ending amounts of unrecognized tax benefits was as follows:

	Nine Months Ended September 30,	
(dollars in thousands)	2018	2017
Balance at beginning of period	$874	$777
Additions based on tax positions related to the current year	-	109
Reductions due to statute of limitations expiring	(301)	(174)
Reductions based on tax positions related to prior years	(78)	-
Balance at end of period	$495	$712

If recognized, approximately $0.5 million of unrecognized tax benefits, net of interest, would favorably affect the effective income tax rate in future periods. Old National expects the total amount of unrecognized tax benefits to decrease by approximately $0.3 million in the next twelve months.

Net Deferred Tax Assets

Significant components of net deferred tax assets (liabilities) were as follows at September 30, 2018 and December 31, 2017:

(dollars in thousands)	September 30, 2018	December 31, 2017
Deferred Tax Assets		
Allowance for loan losses, net of recapture	$ 13,489	$ 12,958
Benefit plan accruals	14,094	11,080
Alternative minimum tax credit	2,545	25,084
Unrealized losses on benefit plans	88	108
Net operating loss carryforwards		