

FIRST MERCHANTS CORP  
Form 10-Q  
November 08, 2013

FORM 10-Q  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

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

For the quarterly period ended September 30, 2013  
OR  
 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 0-17071

FIRST MERCHANTS CORPORATION  
(Exact name of registrant as specified in its charter)

Indiana 35-1544218  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

200 East Jackson Street, Muncie, IN 47305-2814  
(Address of principal executive offices) (Zip code)

(Registrant's telephone number, including area code): (765) 747-1500

Not Applicable  
(Former name, former address and former fiscal year,  
if changed since last report)

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

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer  Accelerated filer  Non-accelerated filer  (Do not check if smaller reporting company) Smaller reporting company

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

As of October 31, 2013, there were 28,825,706 outstanding common shares of the registrant.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED BALANCE SHEETS

	September 30, 2013 (Unaudited)	December 31, 2012
<b>ASSETS</b>		
Cash and cash equivalents	\$92,341	\$101,460
Interest-bearing time deposits	18,875	38,443
Investment securities available for sale	606,341	513,343
Investment securities held to maturity (fair value of \$314,383 and \$378,174)	307,794	361,020
Mortgage loans held for sale	5,312	22,300
Loans, net of allowance for loan losses of \$66,224 and \$69,366	2,859,233	2,832,843
Premises and equipment	54,386	52,749
Federal Reserve and Federal Home Loan Bank stock	32,790	32,785
Interest receivable	16,171	16,367
Core deposit intangibles	7,001	8,154
Goodwill	141,375	141,375
Cash surrender value of life insurance	127,322	125,397
Other real estate owned	12,052	13,263
Tax asset, deferred and receivable	31,385	30,867
Other assets	13,533	14,455
<b>TOTAL ASSETS</b>	<b>\$4,325,911</b>	<b>\$4,304,821</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$790,174	\$801,597
Interest-bearing	2,465,672	2,544,786
<b>Total Deposits</b>	<b>3,255,846</b>	<b>3,346,383</b>
Borrowings:		
Federal funds purchased	115,938	18,862
Securities sold under repurchase agreements	123,935	141,828
Federal Home Loan Bank advances	172,292	94,238
Subordinated debentures and term loans	111,849	112,161
<b>Total Borrowings</b>	<b>524,014</b>	<b>367,089</b>
Interest payable	1,155	1,841
Other liabilities	31,427	37,272
<b>Total Liabilities</b>	<b>3,812,442</b>	<b>3,752,585</b>
<b>COMMITMENTS AND CONTINGENT LIABILITIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
Preferred Stock, no-par value, \$1,000 liquidation value:		
Authorized - 500,000 shares		
Senior Non-Cumulative Perpetual Preferred Stock, Series B		
Issued and outstanding - 34,043 and 90,782.94 shares	34,043	90,783
Cumulative Preferred Stock, \$1,000 par value, \$1,000 liquidation value:		
Authorized - 600 shares		
Issued and outstanding - 125 shares	125	125

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Common Stock, \$.125 stated value:

Authorized - 50,000,000 shares

Issued and outstanding - 28,825,465 and 28,692,616 shares

Additional paid-in capital

Retained earnings

Accumulated other comprehensive loss

Total Stockholders' Equity

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY

3,603

258,350

233,546

(16,198

513,469

\$4,325,911

3,587

256,843

206,397

) (5,499 )

552,236

\$4,304,821

See notes to consolidated condensed financial statements.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2013	2012	2013	2012
<b>INTEREST INCOME</b>				
Loans receivable:				
Taxable	\$33,548	\$38,160	\$104,725	\$110,660
Tax exempt	85	118	315	358
Investment securities:				
Taxable	3,876	4,176	11,071	13,218
Tax exempt	2,840	2,532	7,809	7,645
Deposits with financial institutions	18	16	99	69
Federal Reserve and Federal Home Loan Bank stock	369	345	1,108	1,035
Total Interest Income	40,736	45,347	125,127	132,985
<b>INTEREST EXPENSE</b>				
Deposits	2,213	3,517	7,703	11,566
Federal funds purchased	72	38	84	62
Securities sold under repurchase agreements	192	211	594	703
Federal Home Loan Bank advances	506	492	1,427	2,123
Subordinated debentures and term loans	731	1,187	2,189	4,460
Total Interest Expense	3,714	5,445	11,997	18,914
NET INTEREST INCOME	37,022	39,902	113,130	114,071
Provision for loan losses	1,533	4,609	5,632	14,029
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	35,489	35,293	107,498	100,042
<b>OTHER INCOME</b>				
Service charges on deposit accounts	3,120	2,913	8,761	8,625
Fiduciary activities	1,986	1,986	6,357	5,907
Other customer fees	2,899	2,740	8,495	8,476
Commission income	1,636	1,618	5,556	4,770
Earnings on cash surrender value of life insurance	611	685	1,921	2,725
Net gains and fees on sales of loans	1,673	2,849	6,508	7,115
Net realized gains on sales of available for sale securities		843	487	2,134
Gain on FDIC modified whole bank transaction				9,124
Other income	(125	) 639	1,651	1,220
Total Other Income	11,800	14,273	39,736	50,096
<b>OTHER EXPENSES</b>				
Salaries and employee benefits	20,616	20,083	61,943	59,078
Net occupancy	2,430	2,568	7,299	7,692
Equipment	1,852	1,798	5,368	5,259
Marketing	559	536	1,561	1,542
Outside data processing fees	1,515	1,413	4,386	4,295
Printing and office supplies	320	287	962	848
Core deposit amortization	383	489	1,153	1,438

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FDIC assessments	677	792	2,095	2,771
Other real estate owned and credit-related expenses	1,648	2,104	4,993	6,412
Other expenses	4,219	4,334	12,901	13,277
Total Other Expenses	34,219	34,404	102,661	102,612
INCOME BEFORE INCOME TAX	13,070	15,162	44,573	47,526
Income tax expense	2,667	3,926	11,490	12,714
NET INCOME	10,403	11,236	33,083	34,812
Preferred stock dividends	(430	) (1,134	) (2,139	) (3,404
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$9,973	\$10,102	\$30,944	\$31,408
Per Share Data:				
Basic Net Income Available to Common Stockholders	\$0.35	\$0.35	\$1.08	\$1.09
Diluted Net Income Available to Common Stockholders	\$0.35	\$0.35	\$1.07	\$1.09
Cash Dividends Paid	\$0.05	\$0.03	\$0.13	\$0.07
Average Diluted Shares Outstanding (in thousands)	29,081	28,888	29,026	28,819

See notes to consolidated condensed financial statements.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2013	2012	2013	2012	
Net income	\$10,403	\$11,236	\$33,083	\$34,812	
Other comprehensive income net of tax:					
Unrealized holding gain (loss) on securities available for sale arising during the period, net of income tax of \$470, \$1,018, \$6,810, and \$1,670	(873	) 1,891	(12,646	) 3,102	
Unrealized gain (loss) on securities available for sale for which a portion of an other than temporary impairment has been recognized in income, net of tax of \$103, \$12, \$48, and \$43	(192	) (22	) 89	(80	)
Unrealized gain (loss) on cash flow hedges arising during the period, net of income tax of \$86, \$131, \$543, and \$535	(162	) (244	) 1,007	(994	)
Amortization of items previously recorded in accumulated other comprehensive income, net of income tax of \$39, \$113, 73 \$423, and \$506		210	786	940	
Reclassification adjustment for gains included in net income net of income tax expense of \$72, \$294, \$35, and \$747	135	(549	) 65	(1,387	)
Comprehensive income	(1,019	) 1,286	(10,699	) 1,581	
	\$9,384	\$12,522	\$22,384	\$36,393	

See notes to consolidated condensed financial statements.



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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

	Preferred		Common Stock		Additional		Accumulated Other Comprehensive		Total
	Shares	Amount	Shares	Amount	Paid in Capital	Retained Earnings	Loss		
Balances, December 31, 2012	90,908	\$90,908	28,692,616	\$3,587	\$256,843	\$206,397	\$ (5,499 )		\$552,236
Comprehensive Income									
Net Income						33,083			33,083
Other Comprehensive Loss, net of tax							(10,699 )		(10,699 )
Cash Dividends on Common Stock (\$.13 per Share)						(3,795 )			(3,795 )
Cash Dividends on Preferred Stock under Small Business Lending Fund						(2,139 )			(2,139 )
Preferred Stock Redeemed under Small Business Lending Fund		(56,740 )							(56,740 )
Share-based Compensation			111,761	14	1,271				1,285
Stock Issued under Employee Benefit Plans			28,158	4	385				389
Stock Issued under Dividend Reinvestment and Stock Purchase Plan			14,213	2	234				236
Stock Options Exercised			11,250	1	96				97
Stock Redeemed			(32,533 )	(5 )	(479 )				(484 )
Balances, September 30, 2013	34,168	\$34,168	28,825,465	\$3,603	\$258,350	\$233,546	\$ (16,198 )		\$513,469

See notes to consolidated condensed financial statements.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	September 30,	
	2013	2012
Cash Flow From Operating Activities:		
Net income	\$33,083	\$34,812
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	5,632	14,029
Depreciation and amortization	3,932	3,432
Change in deferred taxes	12,647	11,239
Share-based compensation	1,285	1,101
Mortgage loans originated for sale	(242,014 )	(314,240 )
Proceeds from sales of mortgage loans	259,002	304,393
Gain on acquisition		(9,124 )
Gains on sales of securities available for sale	(487 )	(2,134 )
Change in interest receivable	196	732
Change in interest payable	(686 )	(1,701 )
Other adjustments	(6,329 )	4,650
Net cash provided by operating activities	\$66,261	\$47,189
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	\$19,568	\$17,527
Purchases of:		
Securities available for sale	(216,731 )	(129,297 )
Securities held to maturity	(9,026 )	(566 )
Proceeds from sales of securities available for sale	25,222	43,147
Proceeds from maturities of:		
Securities available for sale	79,209	77,898
Securities held to maturity	59,642	49,073
Change in Federal Reserve and Federal Home Loan Bank stock	(5 )	207
Net change in loans	(37,528 )	(52,442 )
Net cash received from acquisition		29,113
Proceeds from the sale of other real estate owned	5,574	4,295
Other adjustments	(5,569 )	351
Net cash provided (used) by investing activities	\$(79,644 )	\$39,306
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	\$69,475	\$42,994
Certificates of deposit and other time deposits	(160,012 )	(108,807 )
Proceeds from borrowings	215,923	138,127
Repayment of borrowings	(58,686 )	(169,988 )
Cash dividends on common stock	(3,795 )	(2,031 )
Cash dividends on preferred stock	(2,139 )	(3,404 )
Stock issued under employee benefit plans	389	354
Stock issued under dividend reinvestment and stock purchase plans	236	143

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Stock options exercised	97	67
Stock redeemed	(484	) (235 )
Preferred stock redeemed (SBLF)	(56,740	)
Net cash provided (used) by financing activities	\$4,264	\$(102,780 )
Net Change in Cash and Cash Equivalents	(9,119	) (16,285 )
Cash and Cash Equivalents, January 1	101,460	73,312
Cash and Cash Equivalents, September 30	\$92,341	\$57,027
Additional cash flow information:		
Interest paid	\$12,683	\$20,248
Income tax paid	\$5,378	\$5,988
Loans transferred to other real estate owned	\$5,045	\$4,364
Fixed assets transferred to other real estate owned	\$461	
Non-cash investing activities using trade date accounting	\$713	\$3,043
Liabilities assumed, net of cash		\$166,112

See notes to consolidated condensed financial statements.

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PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 1

GENERAL

Financial Statement Preparation

The significant accounting policies followed by First Merchants Corporation (the “Corporation”) and its wholly owned subsidiaries for interim financial reporting are consistent with the accounting policies followed for annual financial reporting. All adjustments, which are of a normal recurring nature and are in the opinion of management necessary for a fair statement of the results for the periods reported, have been included in the accompanying consolidated condensed financial statements.

The consolidated condensed balance sheet of the Corporation as of December 31, 2012, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation’s annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation’s Form 10-K annual report filed with the Securities and Exchange Commission. The results of operations for the nine months ended September 30, 2013, are not necessarily indicative of the results to be expected for the year.

NOTE 2

PURCHASE AND ASSUMPTION

Effective February 10, 2012, First Merchants Bank, National Association (the “Bank”) assumed substantially all of the deposits and certain other liabilities and acquired certain assets of SCB Bank, a federal savings bank headquartered in Shelbyville, Indiana, from the Federal Deposit Insurance Corporation (“FDIC”), as receiver for SCB Bank (the “Acquisition”), pursuant to the terms of the Purchase and Assumption Agreement – Modified Whole Bank; All Deposits (the “Agreement”), entered into by the Bank, the FDIC as receiver of SCB Bank and the FDIC.

Under the terms of the Agreement, the Bank acquired \$147.7 million in assets, including approximately \$11.9 million of cash and cash equivalents, \$18.9 million of marketable securities, \$1.8 million in Federal Home Loan Bank stock, \$113.0 million in loans and \$2.1 million of premises and other assets. The Bank assumed approximately \$135.7 million of liabilities, including approximately \$125.9 million in customer deposits, \$9.6 million of other borrowed money and \$402,000 in other liabilities. These balances are book balances and do not reflect the fair value adjustments which are shown on the following table. The acquisition did not include any loss sharing agreement with the FDIC.

The bid accepted by the FDIC included no deposit premium. The assets were acquired at a discount of \$29.0 million from book value. The FDIC made a payment of \$17.2 million to the Bank upon the final closing date balance sheet for

SCB Bank that reflected the difference between the purchase price of the assets acquired and the value of the liabilities assumed.

The Bank engaged in this transaction with the expectation that it would be immediately accretive and add a new market area with a demographic profile consistent with many of the current Indiana markets served by the Bank.

The transaction was accounted for under the acquisition method of accounting in accordance with the Business Combination topic of the FASB Accounting Standards Codification (“ASC 310-20 and 310-30”). The statement of net assets and liabilities acquired as of February 10, 2012, are presented below. The assets and liabilities of SCB were recorded at the respective acquisition date provisional fair values, and identifiable intangible assets were recorded at provisional fair value.

Assets		Liabilities	
Cash and due from banks (1)	\$29,113	Deposits:	
Investment securities, available for sale	18,896	Non-interest bearing	\$13,715
Federal Home Loan Bank stock	1,761	NOW accounts	14,746
Loans:		Savings and money market	25,843
Commercial	51,042	Certificate of deposit	71,605
Residential mortgage	11,181	Total Deposits	125,909
Installment	31,570		
Total Loans	93,793	Federal Home Loan Bank advances	10,286
		Other liabilities	804
Premises	1,516	Total Liabilities Assumed	\$136,999
Core deposit intangible	484		
Other assets	560	Net Gain on Acquisition	\$9,124
Total Assets Purchased	\$146,123		

(1) Includes \$17,200,000 cash received from the FDIC.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

In many cases, the fair values of assets acquired and liabilities assumed were determined by estimating cash flows expected to result from those assets and liabilities and discounting them at appropriate market rates. The most significant category of assets for which this procedure was used was acquired loans. The Bank acquired the \$113.0 million loan portfolio at a fair value discount of \$19.2 million. The performing portion of the portfolio, \$86.3 million, had an estimated fair value of \$76.5 million. The excess of expected cash flows above the fair value of the performing portion of loans will be accreted to interest income over the remaining lives of the loans in accordance with ASC 310-20. Discounts or premiums on term loans are accounted for under an effective yield method. Prepayments on term loans are accounted for in the effective yield calculation. Discounts or premiums on lines of credit are treated in a straight line method over the term of the lines of credit.

Certain loans for which specific credit-related deterioration has occurred since origination are recorded at fair value which is derived from calculating the present value of the amounts expected to be collected. Income recognition on these loans is based on reasonable expectation about the timing and amount of cash flows to be collected. Some of the acquired loans deemed impaired and considered collateral dependent, with the timing of a sale of loan collateral indeterminate, remain on non-accrual status and have little to no accretable yield.

In accordance with ASC 310-30 (formerly Statement of Position (“SOP”) 03-3 as of February 10, 2012, loans acquired during 2012 for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

Preliminary estimate of contractually required principal and interest at acquisition	\$31,143
Preliminary estimate of contractual cash flows not expected to be collected (nonaccretable differences)	9,688
Preliminary estimate of expected cash flows at acquisition	21,455
Preliminary estimate of interest component of expected cash flows (accretable discount)	4,152
Preliminary estimate of fair value of acquired loans accounted for under ASC 310-30	\$17,303

Pro-forma statements were determined to be impracticable due to the nature of the transaction as certain assets were not purchased.

## NOTE 3

## INVESTMENT SECURITIES

The amortized cost, gross unrealized gains, gross unrealized losses and approximate fair values of the investment securities at the dates indicated were:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at September 30, 2013				
U.S. Government-sponsored agency securities	\$3,791	\$18	\$9	\$3,800

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State and municipal	200,662	4,983	3,463	202,182
U.S. Government-sponsored mortgage-backed securities	397,687	6,136	5,654	398,169
Corporate obligations	6,335		5,851	484
Equity securities	1,706			1,706
Total available for sale	610,181	11,137	14,977	606,341
Held to maturity at September 30, 2013				
State and municipal	115,796	498	6	116,288
U.S. Government-sponsored mortgage-backed securities	191,998	6,600	503	198,095
Total held to maturity	307,794	7,098	509	314,383
Total Investment Securities	\$917,975	\$18,235	\$15,486	\$920,724

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2012				
U.S. Government-sponsored agency securities	\$4,475	\$165		\$4,640
State and municipal	148,187	10,025	\$18	158,194
U.S. Government-sponsored mortgage-backed securities	337,631	10,994	46	348,579
Corporate obligations	6,105		5,881	224
Equity securities	1,706			1,706
Total available for sale	498,104	21,184	5,945	513,343
Held to maturity at December 31, 2012				
State and municipal	117,227	5,489	1	122,715
U.S. Government-sponsored mortgage-backed securities	243,793	11,681	15	255,459
Total held to maturity	361,020	17,170	16	378,174
Total Investment Securities	\$859,124	\$38,354	\$5,961	\$891,517

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## PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

The amortized cost and fair value of available for sale securities and held to maturity securities at September 30, 2013, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Maturity Distribution at September 30, 2013:				
Due in one year or less	\$8,404	\$8,591	\$1,060	\$1,061
Due after one through five years	11,972	12,481	13,116	13,324
Due after five through ten years	57,708	59,110	59,473	59,634
Due after ten years	132,704	126,284	42,147	42,269
	\$210,788	\$206,466	\$115,796	\$116,288
U.S. Government-sponsored mortgage-backed securities	397,687	398,169	191,998	198,095
Equity securities	1,706	1,706		
Total Investment Securities	\$610,181	\$606,341	\$307,794	\$314,383

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$375,411,000 at September 30, 2013, and \$335,775,000 at December 31, 2012.

The book value of securities sold under agreements to repurchase amounted to \$111,138,000 at September 30, 2013, and \$128,094,000 at December 31, 2012.

Gross gains and losses on the sales and redemptions of available for sale securities, and other-than-temporary impairment (“OTTI”) losses recognized for the three and nine months ended September 30, 2013 and 2012 are shown below.

	Three Months Ended		Nine Months Ended	
	September 30, 2013	September 30, 2012	September 30, 2013	September 30, 2012
Sales and Redemptions of Available for Sale Securities:				
Gross gains	\$—	\$843	\$487	\$2,134
Gross losses	—	—	—	—
Other-than-temporary impairment losses	—	—	—	\$—

The following table shows the Corporation’s investments’ gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2013, and December 31, 2012:

	Less than 12 Months	12 Months or Longer	Total
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	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Investment Securities at September 30, 2013						
U.S. Government-sponsored agency securities	\$1,439	\$9			\$1,439	\$9
State and municipal	76,681	3,467	\$239	\$2	76,920	3,469
U.S. Government-sponsored mortgage-backed securities	204,743	6,157			204,743	6,157
Corporate obligations			453	5,851	453	5,851
Total Temporarily Impaired Investment Securities	\$282,863	\$9,633	\$692	\$5,853	\$283,555	\$15,486

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Investment Securities at December 31, 2012						
State and municipal	\$4,524	\$19			\$4,524	\$19
U.S. Government-sponsored mortgage-backed securities	12,320	61			12,320	61
Corporate obligations			\$194	\$5,881	194	5,881
Total Temporarily Impaired Investment Securities	\$16,844	\$80	\$194	\$5,881	\$17,038	\$5,961

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Certain investments in debt and equity securities are reported in the financial statements at an amount less than their historical cost as indicated in the table below.

	September 30, 2013	December 31, 2012		
Investments reported at less than historical cost:				
Historical cost	\$299,041	\$22,999		
Fair value	\$283,555	\$17,038		
Percent of the Corporation's available for sale and held to maturity portfolio	31.0	% 1.9		%

The Corporation's management has evaluated all securities with unrealized losses for other-than-temporary impairment ("OTTI") as of September 30, 2013. The evaluations are based on the nature of the securities, the extent and duration of the loss and the intent and ability of the Corporation to hold these securities either to maturity or through the expected recovery period.

The current unrealized losses are primarily concentrated within trust preferred securities held by the Corporation. Such investments have an amortized cost of \$6.3 million and a fair value of \$453,000, which is less than 1 percent of the Corporation's entire investment portfolio. On all but one small pool investment, the Corporation utilized Moody's to determine their fair value.

In determining the fair value of the trust preferred securities, the Corporation utilizes a third party for portfolio accounting services, including market value input. The Corporation has obtained an understanding of what inputs are being used by the vendor in pricing the portfolio and how the vendor was classifying these securities based upon these inputs. From these discussions, the Corporation's management is comfortable that the classifications are proper. The Corporation has gained trust in the data for two reasons: (a) independent spot testing of the data is conducted by the Corporation through obtaining market quotes from various brokers on a periodic basis and (b) actual gains or loss resulting from the sale of certain securities has proven the data to be accurate over time.

Discount rates used in the OTTI cash flow analysis on these variable rate securities were those margins in effect at the inception of the security added to the appropriate three-month LIBOR spot rate obtained from the forward LIBOR curve used to project future principal and interest payments. These spreads ranged from .85 percent to 1.57 percent spread over LIBOR.

Management believes the declines in fair value for these securities are temporary. Should any additional impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the OTTI is identified.

## U.S. Government-Sponsored Mortgage-Backed Securities

The unrealized losses on the Corporation's investment in U.S. Government-sponsored mortgage-backed securities were a result of changes in interest rates. The Corporation expects to recover the amortized cost basis over the term of the securities as the decline in market value is attributable to changes in interest rates and not credit quality. The

Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2013.

#### State and Municipal

The unrealized losses on the Corporation's investments in securities of state and political subdivisions were caused by changes in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2013.

#### Corporate Obligations

The Corporation's unrealized losses on Corporate Obligations were due to the decline in value related to the pooled trust preferred securities, and is attributable to temporary illiquidity and the financial crisis affecting these markets, coupled with the potential credit loss resulting from the adverse change in expected cash flows. Due to the illiquidity in the market, it is unlikely that the Corporation would be able to recover its investment in these securities if the Corporation sold the securities at this time. Management has analyzed the cash flow characteristics of the securities and this analysis included utilizing the most recent trustee reports and any other relevant market information, including announcements of deferrals or defaults of trust preferred securities. The Corporation compared expected discounted cash flows, based on performance indicators of the underlying assets in the security, to the carrying value of the investment to determine if OTTI existed. The Corporation does not intend to sell the investment, and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the remainder of the investment securities, which are classified as Level 3 inputs in the fair value hierarchy, to be other-than-temporarily impaired at September 30, 2013.

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## Credit Losses Recognized on Investments

Certain debt securities have experienced fair value deterioration due to credit losses and other market factors. The following table provides information about debt securities for which only a credit loss was recognized in income and other losses were recorded in other comprehensive income.

	Accumulated Credit Losses in 2013	Accumulated Credit Losses in 2012
Credit losses on debt securities held:		
Balance, January 1	\$ 11,355	\$ 11,355
Additions related to other-than-temporary losses not previously recognized		
Balance, September 30	\$ 11,355	\$ 11,355

## NOTE 4

## LOANS AND ALLOWANCE

The Corporation's primary lending focus is small business and middle market commercial, residential real estate, auto and small consumer lending, which results in portfolio diversification. The following tables show the composition in the loan portfolio, loan grades and the allowance for loan losses excluding loans held for sale. Residential real estate loans held for sale as of September 30, 2013, and December 31, 2012, were \$5,312,000 and \$22,300,000, respectively.

The following table shows the composition of the Corporation's loan portfolio by loan class for the periods indicated:

	September 30, 2013	December 31, 2012
Commercial and industrial loans	\$652,356	\$622,579
Agricultural production financing and other loans to farmers	98,489	112,527
Real estate loans:		
Construction	149,875	98,639
Commercial and farmland	1,264,180	1,266,682
Residential	452,277	473,537
Home Equity	206,816	203,406
Individuals' loans for household and other personal expenditures	70,380	75,748
Lease financing receivables, net of unearned income	1,815	2,590
Other loans	29,269	46,501
Loans	2,925,457	2,902,209
Allowance for loan losses	(66,224)	(69,366)
Net Loans	\$2,859,233	\$2,832,843

The Corporation maintains an allowance for loan losses to cover probable credit losses identified in the loan portfolio. The allowance is increased by the provision for loan losses and decreased by charge offs less recoveries. The provision for loan losses is a charge against earnings. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off. The Bank charges off a loan when a determination is made that all or a portion of the loan is not collectible.

The amount provided for loan losses in a given period may be greater than or less than the net loan losses experienced during the period, and is based on management's judgment as to the appropriate level of the allowance for loan losses. The determination of the provision amount in a given period is based on management's ongoing review and evaluation of the loan portfolio, including an internally administered loan "watch" list and an independent loan review process. The allowance evaluation takes into consideration identified credit problems, the possibility of losses inherent in the loan portfolio that are not specifically identified and management's judgment as to the impact of current economic conditions on the portfolio.

Management believes that the allowance for loan losses is adequate to cover probable losses inherent in the loan portfolio as of September 30, 2013. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments, to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examinations, and will increase or decrease as deemed necessary to ensure the allowance remains adequate and directionally consistent. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values.

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The historical loss allocation for loans not deemed impaired according to ASC 310 is the product of the volume of loans within the non-impaired criticized and non-criticized risk grade classifications, each segmented by call code, and the historical loss factor for each respective classification and call code segment. The historical loss factors are based upon actual loss experience within each risk and call code classification. The historical look back period for non-criticized loans looks to the most recent rolling-four-quarter average and aligns with the look back period for non-impaired criticized loans. Each of the rolling four quarter periods used to obtain the average, include all charge offs for the previous twelve-month period, therefore the historical look back period includes seven quarters. The resulting allocation is reflective of current conditions. Criticized loans are grouped based on the risk grade assigned to the loan. Loans with a special mention grade are assigned a loss factor, and loans with a classified grade but not impaired are assigned a separate loss factor. The loss factor computation for this allocation includes a segmented historical loss migration analysis of criticized risk grades to charge off.

In addition to the specific reserves and historical loss components of the allowance, consideration is given to various environmental factors to help ensure that losses inherent in the portfolio are reflected in the allowance for loan losses. The environmental component adjusts the historical loss allocations for commercial and consumer loans to reflect relevant current conditions that, in management's opinion, have an impact on loss recognition. Environmental factors that management reviews in the analysis include: national and local economic trends and conditions; trends in growth in the loan portfolio and growth in higher risk areas; levels of, and trends in, delinquencies and non-accruals; experience and depth of lending management and staff; adequacy of, and adherence to, lending policies and procedures including those for underwriting; industry concentrations of credit; and adequacy of risk identification systems and controls through the internal loan review and internal audit processes.

The risk characteristics of the Corporation's material portfolio segments 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 short-term 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 more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral and risk grade criteria. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans.

## Residential and Consumer

With respect to residential loans that are secured by 1-4 family residences and are generally owner occupied, the Corporation generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. 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 and credit rating 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 property values on residential properties. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

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The following tables summarize changes in the allowance for loan losses by loan segment for the three and nine months ended September 30, 2013, and September 30, 2012:

	Three Months Ended September 30, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, July 1	\$26,563	\$23,605	\$2,885	\$15,113	\$36	\$68,202
Provision for losses	(346	) 1,560	(31	) 333	17	1,533
Recoveries on loans	1,494	258	110	311	3	2,176
Loans charged off	(1,680	) (2,795	) (161	) (1,051	)	(5,687
Balances, September 30, 2013	\$26,031	\$22,628	\$2,803	\$14,706	\$56	\$66,224

	Nine Months Ended September 30, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, January 1	\$25,913	\$26,703	\$2,593	\$14,157		\$69,366
Provision for losses	1,929	132	267	3,236	\$68	5,632
Recoveries on loans	4,050	3,023	426	946	3	8,448
Loans charged off	(5,861	) (7,230	) (483	) (3,633	) (15	) (17,222
Balances, September 30, 2013	\$26,031	\$22,628	\$2,803	\$14,706	\$56	\$66,224

	Three Months Ended September 30, 2012					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, July 1	\$17,791	\$35,133	\$2,431	\$14,788		\$70,143
Provision for losses	5,431	(879	) 147	(90	)	4,609
Recoveries on loans	526	1,598	219	174		2,517
Loans charged off	(1,424	) (4,439	) (168	) (1,745	)	(7,776
Balances, September 30, 2012	\$22,324	\$31,413	\$2,629	\$13,127		\$69,493

	Nine Months Ended September 30, 2012					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, January 1	\$17,731	\$37,919	\$2,902	\$12,343	\$3	\$70,898
Provision for losses	10,333	149	(14	) 3,565	(4	) 14,029
Recoveries on loans	1,193	3,462	595	968	1	6,219



Loans charged off	(6,933	) (10,117	) (854	) (3,749	)	(21,653	)
Balances, September 30, 2012	\$22,324	\$31,413	\$2,629	\$13,127		\$69,493	

The following tables show the Corporation's allowance for credit losses and loan portfolio by loan segment as of the periods indicated:

	September 30, 2013					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
<b>Allowance Balances:</b>						
Individually evaluated for impairment	\$285	\$757		\$6		\$1,048
Collectively evaluated for impairment	25,630	21,560	\$2,803	14,700	\$56	64,749
Loans Acquired with Deteriorated Credit Quality	116	311				427
Total Allowance for Loan Losses	\$26,031	\$22,628	\$2,803	\$14,706	\$56	\$66,224
<b>Loan Balances:</b>						
Individually evaluated for impairment	\$7,946	\$33,912		\$2,839		\$44,697
Collectively evaluated for impairment	771,299	1,370,737	\$70,380	655,842	\$1,815	2,870,073
Loans Acquired with Deteriorated Credit Quality	869	9,406		412		10,687
Loans	\$780,114	\$1,414,055	\$70,380	\$659,093	\$1,815	\$2,925,457

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	December 31, 2012					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance Balances:						
Individually evaluated for impairment	\$1,628	\$2,565		\$50		\$4,243
Collectively evaluated for impairment	24,285	24,138	\$2,593	14,107		65,123
Total Allowance for Loan Losses	\$25,913	\$26,703	\$2,593	\$14,157		\$69,366
Loan Balances:						
Individually evaluated for impairment	\$14,190	\$45,394		\$8,515		\$68,099
Collectively evaluated for impairment	765,707	1,309,912	\$75,748	667,401	\$2,590	2,821,358
Loans Acquired with Deteriorated Credit Quality	1,710	10,015		1,027		12,752
Loans	\$781,607	\$1,365,321	\$75,748	\$676,943	\$2,590	\$2,902,209

Loans are reclassified to a non-accruing status when, in management's judgment, the collateral value and financial condition of the borrower do not justify accruing interest. Interest previously recorded, but not deemed collectible, is reversed and charged against current income. Payments subsequently received on non-accrual loans are applied to principal. A loan is returned to accrual status when principal and interest are no longer past due and collectability is probable, typically after a minimum of six consecutive months of performance. Payments received on impaired accruing or delinquent loans are applied to interest income as accrued.

The following table summarizes the Corporation's non-accrual loans by loan class as of the periods indicated:

	September 30, 2013	December 31, 2012
Commercial and industrial loans	\$6,467	\$12,195
Agriculture Production financing and other loans to farmers	31	
Real Estate Loans:		
Construction	2,643	4,814
Commercial and farmland	16,187	22,612
Residential	8,375	11,476
Home Equity	1,093	1,997
Individuals' loans for household and other personal expenditures	32	
Lease financing receivables, net of unearned income		301
Other Loans	164	4
Total	\$34,992	\$53,399

Commercial impaired loans include all non-accrual loans, loans accounted for under ASC 310-30 and renegotiated loans, as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more. A loan is deemed impaired when, based on current information or events, it is probable that all amounts

due of principal and interest according to the contractual terms of the loan agreement will not be collected.

Allowable methods for determining the amount of impairment include estimating fair value using the fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. The fair value of real estate is generally based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

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The following tables show the composition of the Corporation's commercial impaired loans by loan class for the periods indicated:

	September 30, 2013		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance:			
Commercial and industrial loans	\$21,683	\$7,758	
Agriculture production financing and other loans to farmers	33	31	
Real Estate Loans:			
Construction	6,161	3,789	
Commercial and farmland	46,834	33,085	
Residential	4,671	2,569	
Home equity	3,386	199	
Other loans	457	172	
Total	\$83,225	\$47,603	
Impaired loans with related allowance:			
Commercial and industrial loans	\$1,119	\$853	\$401
Real Estate Loans:			
Construction			
Commercial and farmland	6,520	5,700	1,068
Residential	74	71	6
Other loans			
Total	\$7,713	\$6,624	\$1,475
Total Impaired Loans	\$90,938	\$54,227	\$1,475

	December 31, 2012		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance:			
Commercial and industrial loans	\$28,532	\$11,730	
Real Estate Loans:			
Construction	9,787	5,164	
Commercial and farmland	58,173	43,204	
Residential	8,820	6,215	
Home equity	4,199	1,006	
Other loans	83	14	
Total	\$109,594	\$67,333	
Impaired loans with related allowance:			

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Commercial and industrial loans	\$4,415	\$4,155	\$1,628
Real Estate Loans:			
Construction	1,202	1,058	105
Commercial and farmland	5,579	5,182	2,460
Residential	1,722	1,451	50
Total	\$12,918	\$11,846	\$4,243
Total Impaired Loans	\$122,512	\$79,179	\$4,243

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	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial	\$8,352	\$110	\$9,553	\$184
Agriculture production financing and other loans to farmers	32		33	
Real Estate Loans:				
Construction	4,115	29	4,262	85
Commercial and farmland	34,298	620	35,198	1,642
Residential	2,687	82	3,028	114
Home equity	217		236	
Other loans	174		184	1
Total	\$49,875	\$841	\$52,494	\$2,026
Impaired loans with related allowance:				
Commercial and industrial	\$865		\$889	\$7
Real Estate Loans:				
Construction				
Commercial and farmland	5,742	\$5	5,844	5
Residential	74		78	
Other loans				
Total	\$6,681	\$5	\$6,811	\$12
Total Impaired Loans	\$56,556	\$846	\$59,305	\$2,038
	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial loans	\$9,994	\$26	\$11,615	\$68
Agriculture production financing and other loans to farmers	300		300	
Real Estate Loans:				
Construction	6,658	17	7,665	47
Commercial and farmland	31,081	250	33,459	706

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Residential	6,936	20	7,342	54
Home equity	713	3	727	10
Other loans	17		18	1
Total	\$55,699	\$316	\$61,126	\$886
Impaired loans with related allowance:				
Commercial and industrial loans	\$5,244	\$11	\$5,307	\$32
Real Estate Loans:				
Construction	510		541	
Commercial and farmland	12,326	32	12,371	95
Residential	1,485	19	1,485	56
Total	\$19,565	\$62	\$19,704	\$183
Total Impaired Loans	\$75,264	\$378	\$80,830	\$1,069

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As part of the ongoing monitoring of the credit quality of the Corporation's loan portfolio, management tracks certain credit quality indicators including trends related to: (i) the level of criticized commercial loans, (ii) net charge offs, (iii) non-performing loans and (iv) the general national and local economic conditions.

The Corporation utilizes a risk grading of pass, special mention, substandard, doubtful and loss to assess the overall credit quality of large commercial loans. All large commercial credit grades are reviewed at a minimum of once a year for pass grade loans. Loans with grades below pass are reviewed more frequently depending on the grade. A description of the general characteristics of these grades is as follows:

**Pass** - Loans that are considered to be of acceptable credit quality.

**Special Mention** - Loans which possess some credit deficiency or potential weakness, which deserves close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Corporation's credit position at some future date. Special mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification. The key distinctions of this category's classification are that it is indicative of an unwarranted level of risk; and weaknesses are considered "potential", not "defined", impairments to the primary source of repayment. Examples include businesses that may be suffering from inadequate management, loss of key personnel or significant customer or litigation.

**Substandard** - A substandard loan is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness that jeopardizes the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Other characteristics may include:

- o the likelihood that a loan will be paid from the primary source of repayment is uncertain or financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss,
- o the primary source of repayment is gone, and the Corporation is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees,
- o loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
- o unusual courses of action are needed to maintain a high probability of repayment,
- o the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
- o the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
- o loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
- o the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
- o there is significant deterioration in market conditions to which the borrower is highly vulnerable.

**Doubtful** - Loans that have all of the weaknesses of those classified as Substandard. However, based on currently existing facts, conditions and values, these weaknesses make full collection of principal highly questionable and improbable. Other credit characteristics may include the primary source of repayment is gone or there is considerable doubt as to the quality of the secondary sources of repayment. The possibility of loss is high, but because of certain important pending factors that may strengthen the loan, loss classification is deferred until the exact status of



repayment is known.

Loss – Loans that are considered uncollectible and of such little value that continuing to carry them as an asset is not warranted. Loans will be classified as Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

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The following tables summarize the credit quality of the Corporation's loan portfolio, by loan class as of the periods indicated. Consumer non-performing loans include accruing consumer loans 90 plus days delinquent and consumer non-accrual loans. The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified date.

	September 30, 2013							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$ 603,166	\$ 18,481	\$ 29,155	\$ 1,554				\$ 652,356
Agriculture production financing and other loans to farmers	98,458		31					98,489
Real Estate Loans:								
Construction	142,169	2,752	4,491				\$ 463	149,875
Commercial and farmland	1,163,570	41,954	58,309	112			235	1,264,180
Residential	139,481	1,504	10,803	140		\$ 293,329	7,020	452,277
Home equity	6,633	105	1,126			197,776	1,176	206,816
Individuals' loans for household and other personal expenditures						70,285	95	70,380
Lease financing receivables, net of unearned income	1,688		127					1,815
Other loans	29,063	2	204					29,269
Loans	\$ 2,184,228	\$ 64,798	\$ 104,246	\$ 1,806		\$ 561,390	\$ 8,989	\$ 2,925,457

	December 31, 2012							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$ 559,852	\$ 23,678	\$ 34,460	\$ 4,589				\$ 622,579
Agriculture production financing and other loans to farmers	112,209	224	94					112,527
Real Estate Loans:								
Construction	85,728	1,384	11,356				\$ 171	98,639
Commercial and farmland	1,148,561	38,199	79,078	553			291	1,266,682

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Residential	145,402	5,437	13,880	922	\$ 301,614	6,282	473,537
Home equity	9,092	893	1,657		189,721	2,043	203,406
Individuals' loans for household and other personal expenditures					75,748		75,748
Lease financing receivables, net of unearned income					2,289	301	2,590
Other loans	46,473		28				46,501
Loans	\$2,107,317	\$ 69,815	\$ 140,553	\$ 6,064	\$ 569,372	\$ 9,088	\$ 2,902,209

The following table shows a past due aging of the Corporation's loan portfolio, by loan class as of September 30, 2013, and December 31, 2012:

	September 30, 2013					Non-Accrual	Total Past Due & Non-Accrual	Total
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing				
Commercial and industrial loans	\$645,044	\$845			\$ 6,467	\$ 7,312	\$652,356	
Agriculture production financing and other loans to farmers	98,458				31	31	98,489	
Real Estate Loans:								
Construction	147,157			\$75	2,643	2,718	149,875	
Commercial and farmland	1,246,319	843	\$831		16,187	17,861	1,264,180	
Residential	439,860	2,627	998	417	8,375	12,417	452,277	
Home equity	204,028	1,153	260	282	1,093	2,788	206,816	
Individuals' loans for household and other personal expenditures	69,819	378	88	63	32	561	70,380	
Lease financing receivables, net of unearned income	1,815						1,815	
Other loans	29,105				164	164	29,269	
Loans	\$2,881,605	\$5,846	\$2,177	\$837	\$ 34,992	\$ 43,852	\$2,925,457	

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(Unaudited)

	December 31, 2012						
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total
Commercial and industrial loans	\$607,442	\$2,628	\$144	\$170	\$ 12,195	\$ 15,137	\$622,579
Agriculture production financing and other loans to farmers	112,527						112,527
Real Estate Loans:							
Construction	93,426	399			4,814	5,213	98,639
Commercial and farmland	1,238,907	3,276	1,822	65	22,612	27,775	1,266,682
Residential	453,743	5,734	1,338	1,246	11,476	19,794	473,537
Home equity	199,063	1,467	323	556	1,997	4,343	203,406
Individuals' loans for household and other personal expenditures	74,919	799	30			829	75,748
Lease financing receivables, net of unearned income	2,289				301	301	2,590
Other loans	46,497				4	4	46,501
Loans	\$2,828,813	\$14,303	\$3,657	\$2,037	\$ 53,399	\$ 73,396	\$2,902,209

See the information regarding the analysis of loan loss experience in the "LOAN QUALITY/PROVISION FOR LOAN LOSSES" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as ITEM 2 of this Form 10-Q.

On occasion, borrowers experience declines in income and cash flow. As a result, these borrowers seek to reduce contractual cash outlays including debt payments. Concurrently, in an effort to preserve and protect earning assets, specifically troubled loans, the Corporation works to maintain its relationship with certain customers who are experiencing financial difficulty by contractually modifying the borrower's debt agreement with the Corporation. In certain loan restructuring situations, the Corporation may grant a concession to a debtor experiencing financial difficulty, resulting in a trouble debt restructuring. A concession is deemed to be granted when, as a result of the restructuring, the Corporation does not expect to collect all amounts due, including interest accrued at the original contract rate. If the payment of principal at original maturity is primarily dependent on the value of collateral, the current value of the collateral is considered in determining whether the principal will be paid.

The following tables summarize troubled debt restructurings that occurred during the periods indicated:

	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and industrial loans	\$162	\$ 183	1	\$294	\$ 315	5
Real Estate Loans:						

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Commercial and farmland	1,464	1,469	6	6,449	5,450	10
Residential	190	191	2	658	649	8
Individuals' loans for household and other personal expenditures				44	45	2
Total	\$1,816	\$ 1,843	9	\$7,445	\$ 6,459	25

	Three Months Ended September 30, 2012			Nine Months Ended September 30, 2012		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and industrial loans	\$875	\$ 1,048	3	\$1,155	\$ 1,327	6
Real Estate Loans:						
Construction	303	303	1	794	653	2
Commercial and farmland	875	875	2	2,967	2,828	7
Residential	239	241	4	2,196	2,063	19
Individuals' loans for household and other personal expenditures	90	117	4	90	117	4
Total	\$2,382	\$ 2,584	14	\$7,202	\$ 6,988	38

Commercial and Farmland real estate loans account for 67 percent and 40 percent of the troubled debt restructured loans made in the three and nine months ended September 30, 2013, respectively. Five and twelve troubled debt restructured loans made during the three and nine months ended September 30, 2013, respectively, are in accrual status.

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The following tables show the recorded investment of troubled debt restructurings, by modification type, that occurred during the periods indicated:

	Three Months Ended September 30, 2013			Total Modification
	Term Modification	Rate Modification	Combination	
Commercial and industrial loans	\$175			\$175
Real Estate Loans:				
Commercial and farmland	1,399			1,399
Residential	158	\$34		192
Total	\$1,732	\$34		\$1,766

	Nine Months Ended September 30, 2013			Total Modification
	Term Modification	Rate Modification	Combination	
Commercial and industrial loans	\$228		\$63	\$291
Real Estate Loans:				
Commercial and farmland	1,399		1,950	3,349
Residential	158	\$94	353	605
Individuals' loans for household and other personal expenditures			26	26
Total	\$1,785	\$94	\$2,392	\$4,271

	Three Months Ended September 30, 2012			Total Modification
	Term Modification	Rate Modification	Combination	
Commercial and industrial loans			\$1,048	\$1,048
Real Estate Loans:				
Construction			299	299
Commercial and farmland		\$680	195	875
Residential			167	167
Individuals loans for household and other personal expenditures		7	109	116
Total		\$687	\$1,818	\$2,505

	Nine Months Ended September 30, 2012			Total Modification
	Term Modification	Rate Modification	Combination	
Commercial and industrial loans	\$230		\$1,072	\$1,302
Real Estate Loans:				

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Construction			639	639
Commercial and farmland	1,693	\$680	385	2,758
Residential	528	252	1,100	1,880
Individuals' loans for household and other personal expenditures		7	109	116
Total	\$2,451	\$939	\$3,305	\$6,695

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The following tables summarize troubled debt restructures that occurred during the twelve months ended September 30, 2013, and September 30, 2012, that subsequently defaulted during the period indicated and remained in default at period end. For purposes of this schedule, a loan is considered in default if it is 30 or more days past due.

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Commercial and Industrial loans	1	\$18	1	\$18
Real Estate Loans:				
Commercial and farmland			1	223
Residential	2	166	2	166
Total	3	\$184	4	\$407

	Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Commercial and Industrial loans	3	\$1,415	3	\$1,415
Real Estate Loans:				
Commercial and farmland	1	23	1	23
Residential	7	371	11	2,494
Total	11	\$1,809	15	\$3,932

For potential consumer loan restructures, impairment evaluation occurs prior to modification. Any subsequent impairment is typically addressed through the charge off process, or may be addressed through a specific reserve. Consumer troubled debt restructurings are generally included in the general historical allowance for loan loss at the post modification balance. Consumer non-accrual and delinquent troubled debt restructurings are also considered in the calculation of the non-accrual and delinquency trend environmental allowance allocation. Commercial troubled debt restructured loans risk graded special mention, substandard, doubtful and loss are individually evaluated for impairment under ASC 310. Any resulting specific reserves are included in the allowance for loan losses. Commercial 30 - 89 day delinquent troubled debt restructurings are included in the calculation of the delinquency trend environmental allowance allocation. All commercial non-impaired loans, including non-accrual and 90+ day delinquents, are included in the ASC 450 loss migration analysis.

## NOTE 5

## ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE



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The Bank acquired loans in a purchase during the year ended December 31, 2012. The following table includes the carrying amount of these loans, which are included in the balance sheet amounts of loans receivable at September 30, 2013 and December 31, 2012.

	September 30, 2013	December 31, 2012
Commercial and industrial loans	\$6,265	\$8,542
Agricultural production financing and other loans to farmers	1,382	1,127
Real estate loans:		
Construction	8	58
Commercial and farmland	18,553	24,259
Residential	9,614	12,118
Home Equity	16,529	18,805
Individuals' loans for household and other personal expenditures	336	691
Other Loans	164	
Total	\$52,851	\$65,600

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

	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013
Beginning balance	\$3,959	\$5,142
Accretion	(413	) (1,596
Ending balance, September 30, 2013	\$3,546	\$3,546

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	Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Beginning balance	\$9,048	\$9,774
Accretion	(2,612	) (3,338
Ending balance, September 30, 2012	\$6,436	\$6,436

At acquisition, certain purchased loans evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected.

Certain loans purchased with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be credit impaired. Evidence of credit quality deterioration as of the purchase date may include information such as past-due and non-accrual status, borrower credit scores and recent loan to value percentages. Purchased credit-impaired loans are accounted for under the accounting guidance for loans and debt securities acquired with deteriorated credit quality (ASC 310-30) and initially measured at fair value, which includes estimated future credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for credit losses related to these loans is not carried over and recorded at the acquisition date. Management estimated the cash flows expected to be collected at acquisition, which incorporated the estimate of current key assumptions, such as default rates, severity and prepayment speeds.

## NOTE 6

## DERIVATIVE FINANCIAL INSTRUMENTS

## Risk Management Objective of Using Derivatives

The Corporation is exposed to certain risks arising from both its business operations and economic conditions. The Corporation principally manages its exposures to a wide variety of business and operational risks through management of its core business activities. The Corporation manages economic risks, including interest rate, liquidity, and credit risk, primarily by managing the amount, sources, and duration of its assets and liabilities and through the use of derivative financial instruments. Specifically, the Corporation enters into derivative financial instruments to manage exposures that arise from business activities that result in the receipt or payment of future known and uncertain cash amounts, the value of which are determined by interest rates. The Corporation's derivative financial instruments are used to manage differences in the amount, timing, and duration of the Corporation's known or expected cash payments principally related to certain variable-rate liabilities. The Corporation also has derivatives that are a result of a service the Corporation provides to certain qualifying customers, and, therefore, are not used to manage interest rate risk in the Corporation's assets or liabilities. The Corporation manages a matched book with respect to its derivative instruments offered as a part of this service to its customers in order to minimize its net risk exposure resulting from such transactions.

### Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish these objectives, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. As of September 30, 2013 and 2012, the Corporation had five interest rate swaps with a notional amount of \$56.0 million and one interest rate cap with a notional amount of \$13.0 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2013, \$26.0 million of the interest rate swaps and the \$13.0 million interest rate cap were used to hedge the variable cash outflows (LIBOR-based) associated with existing trust preferred securities when the outflows converted from a fixed rate to variable rate in September of 2012. In addition, the remaining \$30.0 million of interest rate swaps were used to hedge the variable cash outflows (LIBOR-based) associated with three Federal Home Loan Bank advances. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the nine months ended September 30, 2013, and 2012, the Corporation did not recognize any ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation expects to reclassify \$1,355,000 from accumulated other comprehensive income to interest expense.

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## Non-designated Hedges

The Corporation does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Corporation provides to certain customers. The Corporation executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Corporation executes with a third party, such that the Corporation minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of September 30, 2013, the notional amount of customer-facing swaps was approximately \$146,980,000. This amount is offset with third party counterparties, as described above.

## Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Corporation's derivative financial instruments, as well as their classification on the Balance Sheet, as of September 30, 2013, and December 31, 2012.

	Asset Derivatives				Liability Derivatives			
	September 30, 2013		December 31, 2012		September 30, 2013		December 31, 2012	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:								
Interest rate contracts	Other Assets	\$421	Other Assets	\$197	Other Liabilities	\$1,441	Other Liabilities	\$3,332
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	\$3,054	Other Assets	\$6,103	Other Liabilities	\$3,136	Other Liabilities	\$6,434

## Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Corporation's derivative financial instruments on the Income Statement for three and nine months ended September 30, 2013, and 2012.

Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative
		Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013

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Interest rate contracts	Other income	\$(16	) \$249
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Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative	
		Three Months Ended September 30, 2012	Nine Months Ended September 30, 2012
Interest rate contracts	Other income	\$(70	) \$(125 )

The amount of gain (loss) recognized in other comprehensive income is included in the table below for the periods indicated.

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Other Comprehensive Income on Derivative (Effective Portion)			
	Three Months ended September 30, 2013		Nine Months ended September 30, 2012	
Interest Rate Products	\$(248	) \$(376	) \$1,550	\$(1,529 )

The amount of gain (loss) reclassified from other comprehensive income into income is included in the table below for the periods indicated.

Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion)	Amount of Gain (Loss) Reclassified from Other Comprehensive Income into Income (Effective Portion)			
	Three Months ended September 30, 2013		Nine Months ended September 30, 2012	
Interest Expense	\$(207	)	\$(587	)

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The Corporation's exposure to credit risk occurs because of nonperformance by its counterparties. The counterparties approved by the Corporation are usually financial institutions, which are well capitalized and have credit ratings through Moody's and/or Standard & Poor's, at or above investment grade. The Corporation's control of such risk is through quarterly financial reviews, comparing mark-to-mark values with policy limitations, credit ratings and collateral pledging.

Credit-risk-related Contingent Features

The Corporation also has agreements with certain of its derivative counterparties that contain a provision where if the Corporation fails to maintain its status as a well or adequate capitalized institution, then the Corporation could be required to terminate or fully collateralize all outstanding derivative contracts.

The Corporation has agreements with certain of its derivative counterparties that contain a provision where if the Corporation defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, the Corporation could also be declared in default on its derivative obligations.

As of September 30, 2013, the termination value of derivatives in a net liability position related to these agreements was \$4,365,000. As of September 30, 2013, the Corporation had minimum collateral posting thresholds with certain of its derivative counterparties and had posted collateral of \$4,271,000. If the Corporation had breached any of these provisions at September 30, 2013, it could have been required to settle its obligations under the agreements at their termination value.

NOTE 7

DISCLOSURES ABOUT FAIR VALUE OF ASSETS AND LIABILITIES

The Corporation used fair value measurements to record fair value adjustments, to certain assets, and liabilities and to determine fair value disclosures. The accounting guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. ASC 820 applies only when other guidance requires or permits assets or liabilities to be measured at fair value; it does not expand the use of fair value in any new circumstances.

As defined in ASC 820, fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants. It represents an exit price at the measurement date. Market participants are buyers and sellers, who are independent, knowledgeable, and willing and able to transact in the principal (or most advantageous) market for the asset or liability being measured. Current market conditions, including imbalances between supply and demand, are considered in determining fair value. The Corporation values its assets and liabilities in the principal market where it sells the particular asset or transfers the liability with the greatest volume and level of activity. In the absence of a principal market, the valuation is based on the most advantageous market for the asset or liability (i.e., the market where the asset could be sold or the liability transferred at a price that maximizes the amount to be received for the asset or minimizes the amount to be paid to transfer the liability).

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability. Inputs can be observable or unobservable. Observable inputs are those assumptions which market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of the Corporation. Unobservable inputs are assumptions based on the Corporation's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date. All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy which gives the highest ranking to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest ranking to unobservable inputs for which there is little or no market activity (Level 3). Fair values for assets or liabilities classified as Level 2 are based on one or a combination of the following factors: (i) quoted prices for similar assets; (ii) observable inputs for the asset or liability, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation considers an input to be significant if it drives 10 percent or more of the total fair value of a particular asset or liability.

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(table dollar amounts in thousands, except share data)

(Unaudited)

## Recurring Measurements

The following table presents the fair value measurements of assets and liabilities recognized in the Consolidated Condensed Balance Sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2013, and December 31, 2012.

September 30, 2013	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$3,800		\$3,800	
State and municipal	202,182		181,672	\$20,510
U.S. Government-sponsored mortgage-backed securities	398,169		398,169	
Corporate obligations	484			484
Equity securities	1,706		1,702	4
Interest rate swap asset	3,054		3,054	
Interest rate cap	421		421	
Interest rate swap liability	4,577		4,577	
December 31, 2012	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$4,640		\$4,640	
State and municipal	158,194		140,094	\$18,100
U.S. Government-sponsored mortgage-backed securities	348,579		348,579	
Corporate obligations	224			224
Equity securities	1,706		1,702	4
Interest rate swap asset	6,103		6,103	
Interest rate cap	197		197	
Interest rate swap liability	9,766		9,766	



Following is a description of the valuation methodologies and inputs used for instruments measured at fair value on a recurring basis and recognized in the accompanying Consolidated Condensed Balance Sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques as of September 30, 2013.

#### Available for Sale Investment Securities

Where quoted, market prices are available in an active market and securities are classified within Level 1 of the valuation hierarchy. There are no securities classified within Level 1 of the hierarchy. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include agencies, mortgage backs, state and municipal, and equity securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy. Level 3 fair value, including corporate obligations, state and municipal and equity securities, was determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

Third party vendors compile prices from various sources and may apply such techniques as matrix pricing to determine the value of identical or similar investment securities classified within Level 2. Matrix pricing is a mathematical technique widely used in the banking industry to value investment securities without relying exclusively on quoted prices for specific investment securities but rather relying on the investment securities' relationship to other benchmark quoted investment securities. Any investment security not valued based upon the methods above are considered Level 3.

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## Pooled Trust Preferred Securities

Pooled trust preferred securities are classified as Level 3 inputs in the fair value hierarchy. These securities were rated A or better at inception, but at September 30, 2013, Moody's ratings on these securities ranged from Ca to C. The issuers in these securities are primarily banks, but some of the pools do include a limited number of insurance companies. On a quarterly basis, the Corporation uses an other-than-temporary impairment ("OTTI") evaluation process to compare the present value of expected cash flows to determine whether an adverse change in cash flows has occurred. The OTTI evaluation process considers the structure and term of the collateralized debt obligation ("CDO"), interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. Assumptions used in the evaluation process include expected future default rates and prepayments as well as recovery assumptions on defaults and deferrals. In addition, the process is used to "stress" each CDO, or make assumptions more severe than expected activity, to determine the degree to which assumptions could deteriorate before the CDO could no longer fully support repayment of the Corporation's note class. Upon completion of the September 30, 2013 quarterly evaluation process, the conclusion was no OTTI for the three months ending September 30, 2013. No OTTI was recognized for nine months ended September 30, 2013 and 2012.

## Interest Rate Derivative Agreements

See information regarding the Corporation's interest rate derivative products in NOTE 6. DERIVATIVE FINANCIAL INSTRUMENTS, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

The fair value of the interest rate swap and cap instruments were transferred from Level 3 to Level 2 as of March 31, 2012 due to the availability of additional valuation information. These instruments were valued using widely accepted valuation techniques including discounted cash flow analysis using observable inputs such as contractual terms and LIBOR-based rate curves.

## Level 3 Reconciliation

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the Consolidated Condensed Balance Sheets using significant unobservable (Level 3) inputs for three and nine months ended September 30, 2013, and 2012.

	Three Months Ended September 30, 2013				Nine Months Ended September 30, 2013			
	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability
Balance at beginning of the period	\$17,915				\$18,328			

Total realized and unrealized gains and losses:		
Included in net income (loss)		
Included in other comprehensive income	(486 )	(521 )
Purchases, issuances and settlements		
Transfers in/(out) of Level 3	3,905	3,905
Principal payments/additions	(336 )	(714 )
Ending balance at September 30, 2013	\$20,998	\$20,998

	Three Months Ended September 30, 2012				Nine Months Ended September 30, 2012			
	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability
Balance at beginning of the period	\$19,740				\$20,838	\$5,241	\$424	\$(7,797 )
Total realized and unrealized gains and losses:								
Included in net income (loss)						(860 )		863
Included in other comprehensive income	(183 )				(944 )	481	(15 )	
Purchases, issuances and settlements								
Transfers in/(out) of Level 3						(4,862 )	(409 )	6,934
Principal payments	(1,132 )				(1,469 )			
Ending balance at September 30, 2012	\$18,425				\$18,425	\$—	\$—	\$—

There were no gains or losses for the period included in earnings that were attributable to the changes in unrealized gains or losses related to assets or liabilities held at September 30, 2013 or December 31, 2012.

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## Transfers Between Levels

Transfer between Levels 1, 2 and 3 and the reasons for those transfers are as follows:

Three and Nine Months Ended September 30, 2013				Reason for Transfer
Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		
Transfers to/(from) Level:				
Available for sale securities	\$ (3,905	) \$ 3,905		Selected state and municipal securities were transferred from Level 2 to Level 3 due to limited availability of similar securities in active markets.
	\$ (3,905	) \$ 3,905		
Nine Months Ended September 30, 2012				
Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)		Reason for Transfer
Transfers to/(from) Level:				
Interest rate swap asset	\$ 4,862	\$ (4,862	)	The interest rate swap and cap instruments were transferred from Level 3 to Level 2 as of March 31, 2012 due to the availability of additional valuation information. These instruments are valued using widely accepted valuation techniques including discounted cash flow analysis using observable inputs such as contractual terms and LIBOR-based rate curves.
Interest rate cap	409	(409	)	
Interest rate swap liability	6,934	(6,934	)	
	\$ 12,205	\$ (12,205	)	

## Nonrecurring Measurements

The following table presents the fair value measurement of assets and liabilities measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2013, and December 31, 2012.

		Fair Value Measurements Using		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2013				
Impaired loans (collateral dependent)	\$8,874			\$8,874
Other real estate owned	\$8,220			\$8,220
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2012				
Impaired loans (collateral dependent)	\$17,703			\$17,703
Other real estate owned	\$7,684			\$7,684

Following is a description of valuation methodologies used for instruments measured at fair value on a nonrecurring basis and recognized in the Consolidated Condensed Balance Sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy.

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## Impaired Loans (collateral dependent)

Loans for which it is probable that the Corporation will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. During 2013, certain impaired loans were partially charged off or re-evaluated. Impaired loans that are collateral dependent are classified within Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

## Other Real Estate Owned

The fair value for impaired loans and other real estate owned is measured based on the value of the collateral securing those loans or real estate and is determined using several methods. The fair value of real estate is generally determined based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and/or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

## Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements, other than goodwill, at September 30, 2013.

	Fair Value	Valuation Technique	Unobservable Inputs	Range
State and municipal securities	\$20,510	Discounted cash flow	Maturity/Call date Blend of US Muni BQ curve Discount rate	1 month to 10 yrs A- to BBB- 1% - 5%
Corporate obligations/Equity securities	\$488	Discounted cash flow	Risk free rate plus Premium for illiquidity	3 month LIBOR plus 200bps
Impaired loans (collateral dependent)	\$8,874			0% - 50%

		Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	
Other real estate owned	\$8,220	Appraisals	Discount to reflect current market conditions	0% - 20%

#### Sensitivity of Significant Unobservable Inputs

The following is a discussion of the sensitivity of significant unobservable inputs, the interrelationships between those inputs and other unobservable inputs used in recurring fair value measurement and of how those inputs might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

#### State and Municipal Securities

The significant unobservable inputs used in the fair value measurement of the Corporation's state and municipal securities are premiums for unrated securities and marketability discounts. Significant increases or decreases in either of those inputs in isolation would result in a significantly lower or higher fair value measurement. Generally, changes in either of those inputs will not affect the other input.

#### Corporate Obligations/Equity Securities

The significant unobservable inputs used in the fair value measurement of the Corporation's corporate obligations/equity securities are premiums for unrated securities and marketability discounts. Significant increases or decreases in either of those inputs in isolation would result in a significantly lower or higher fair value measurement. Generally, changes in either of those inputs will not affect the other input.

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## Fair Value of Financial Instruments

The following table presents estimated fair values of the Corporation's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2013, and December 31, 2012.

	Carrying Amount	September 30, 2013 (unaudited)		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and due from banks	\$92,341	\$92,341		
Interest-bearing time deposits	18,875	18,875		
Investment securities available for sale	606,341		\$585,343	\$20,998
Investment securities held to maturity	307,794		303,371	11,012
Mortgage loans held for sale	5,312		5,312	
Loans	2,859,233			2,822,465
Federal Reserve Bank and Federal Home Loan Bank stock	32,790		32,790	
Interest rate swap and cap asset	3,475		3,475	
Interest receivable	16,171		16,171	
Liabilities:				
Deposits	\$3,255,846	\$2,548,183	\$700,168	
Borrowings:				
Federal funds purchased	115,938		115,938	
Securities sold under repurchase agreements	123,935		124,195	
Federal Home Loan Bank advances	172,292		173,449	
Subordinated debentures and term loans	111,849		63,391	
Interest rate swap liability	4,577		4,577	
Interest payable	1,155		1,155	
	Carrying Amount	December 31, 2012		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and due from banks	\$101,460	\$101,460		
Interest-bearing time deposits	38,443	38,443		



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Investment securities available for sale	513,343		\$495,015	\$18,328
Investment securities held to maturity	361,020		366,590	11,584
Mortgage loans held for sale	22,300		22,300	
Loans	2,832,843			2,852,614
Federal Reserve Bank and Federal Home Loan Bank stock	32,785		32,785	
Interest rate swap and cap asset	6,300		6,300	
Interest receivable	16,367		16,367	
Liabilities:				
Deposits	\$3,346,383	\$2,478,706	\$865,793	
Borrowings:				
Federal funds purchased	18,862		18,862	
Securities sold under repurchase agreements	141,828		142,318	
Federal Home Loan Bank advances	94,238		97,357	
Subordinated debentures and term loans	112,161		62,133	
Interest rate swap liability	9,766		9,766	
Interest payable	1,841		1,841	

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The following methods were used to estimate the fair value of all other financial instruments recognized in the Consolidated Condensed Balance Sheets at amounts other than fair value.

Cash and due from banks: The fair value of cash and cash equivalents approximates carrying value.

Interest-bearing time deposits: The fair value of interest-bearing time deposits approximates carrying value.

Investment securities: Fair value is based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The fair value of certain Level III securities is estimated using discounted cash flow analysis, using interest rates currently being offered on investments with similar maturities and investment quality.

Mortgage Loans Held For Sale: The carrying amount approximates fair value due to the short duration between origination and date of sale.

Loans: The fair value for loans is estimated using discounted cash flow analysis, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. See Impaired Loans above.

Federal Reserve and Federal Home Loan Bank stock: The fair value of Federal Reserve Bank and Federal Home Loan Bank stock is based on the price which it may be resold to the Federal Reserve and Federal Home Loan Bank.

Derivative instruments: The fair value of the interest rate swaps reflects the estimated amounts that would have been received to terminate these contracts at the reporting date based upon pricing or valuation models applied to current market information. Interest rate caps are valued using the market standard methodology of discounting the future expected cash receipts that would occur if variable interest rates rose above the strike rate of the caps. The projected cash receipts on the caps are based on an expectation of future interest rates derived from observed market interest rate curves and volatilities.

Interest Receivable and Interest Payable: The fair value of interest receivables/payable approximates the carrying amount.

Deposits: The fair values of noninterest-bearing and interest-bearing demand accounts and savings deposits are equal to the amount payable on demand at the balance sheet date. The carrying amounts for variable rate, fixed-term certificates of deposit approximate their fair values at the balance sheet date. Fair values for fixed-rate certificates of deposit and other time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered to a schedule of aggregated expected monthly maturities on such time deposits.

Federal funds purchased: The fair value of Federal Funds purchased approximates the carrying amount.

Borrowings: The fair value of borrowings is estimated using a discounted cash flow calculation, based on current rates for similar debt.

## NOTE 8

## ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the changes in the balances of each component of accumulated other comprehensive income (loss), net of tax, as of September 30, 2013 and 2012:

	Accumulated Other Comprehensive Income					Total
	Unrealized Gains (Losses) on Securities Available for Sale	Unrealized Gains (Losses) on Securities Available for Sale for which a Portion of Other-Than-Temporary Impairment has been Recognized in Income	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans		
Balance at December 31, 2012	\$17,904	\$ (3,272 )	\$(2,652 )	\$(17,479 )		\$(5,499 )
Other comprehensive income before reclassifications	(12,646 )	89	1,007			(11,550 )
Amounts reclassified from accumulated other comprehensive income	(317 )		382	786		851
Period change	(12,963 )	89	1,389	786		(10,699 )
Balance at September 30, 2013	\$4,941	\$ (3,183 )	\$(1,263 )	\$(16,693 )		\$(16,198 )
Balance at December 31, 2011	\$18,244	\$ (3,168 )	\$(1,841 )	\$(16,837 )		\$(3,602 )
Other comprehensive income before reclassifications	3,102	(80 )	(994 )			2,028
Amounts reclassified from accumulated other comprehensive income	(1,387 )			940		(447 )
Period change	1,715	(80 )	(994 )	940		1,581
Balance at September 30, 2012	\$19,959	\$ (3,248 )	\$(2,835 )	\$(15,897 )		\$(2,021 )

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The following table presents the reclassification adjustments out of accumulated other comprehensive income (loss) that were included in net income in the Consolidated Condensed Statements of Income for the three and nine months ended September 30, 2013 and 2012:

Details about Accumulated Other Comprehensive Income Components	Amount Reclassified from Accumulated Other Comprehensive Income For the Three Months Ended September 30,		Affected Line Item in the Statements of Income
	2013	2012	
Unrealized gains (losses) on available for sale securities <sup>(1)</sup>			
Realized securities gains reclassified into income		\$843	Other income - net realized gains on sales of available for sale securities
Related income tax expense		(294 )	Income tax expense
		\$549	
Unrealized gains (losses) on cash flow hedges <sup>(2)</sup>			
Interest rate contracts	\$(207 )		Interest expense - subordinated debentures and term loans
Related income tax benefit	72		Income tax expense
	\$(135 )		
Unrealized gains (losses) on defined benefit plans			
Amortization of net loss and prior service costs	\$(112 )	\$(323 )	Other expenses - salaries and employee benefits
Related income tax benefit	39	113	Income tax expense
	\$(73 )	\$(210 )	
Total reclassifications for the period, net of tax	\$(208 )	\$339	

Amount Reclassified from Accumulated Other Comprehensive Income For the Nine Months Ended

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Details about Accumulated Other Comprehensive Income Components	September 30,		Affected Line Item in the Statements of Income
	2013	2012	
Unrealized gains (losses) on available for sale securities (1)			
Realized securities gains reclassified into income	\$487	\$2,134	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(170 )	(747 )	Income tax expense
	\$317	\$1,387	
Unrealized gains (losses) on cash flow hedges (2)			
Interest rate contracts	\$(587 )		Interest expense - subordinated debentures and term loans
Related income tax benefit	205		Income tax expense
	\$(382 )		
Unrealized gains (losses) on defined benefit plans			
Amortization of net loss and prior service costs	\$(1,209 )	\$(1,446 )	Other expenses - salaries and employee benefits
Related income tax benefit	423	506	Income tax expense
	\$(786 )	\$(940 )	
Total reclassifications for the period, net of tax	\$(851 )	447	

(1) For additional detail related to unrealized gains (losses) on available for sale securities and related amounts reclassified from accumulated other comprehensive income see NOTE 3. INVESTMENT SECURITIES.

(2) For additional detail related to unrealized gains (losses) on cash flow hedges and related amounts reclassified from accumulated other comprehensive income see NOTE 6. DERIVATIVE FINANCIAL INSTRUMENTS.

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## NOTE 9

## SHARE-BASED COMPENSATION

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten year life, become 100 percent vested ranging from six months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. RSAs for employees retired from the Corporation continue to vest after retirement. Deferred stock units ("DSUs") can be credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of September 30, 2013, there were no outstanding DSUs.

The Corporation's 2009 Employee Stock Purchase Plan ("ESPP") provides eligible employees of the Corporation and its subsidiaries an opportunity to purchase shares of common stock of the Corporation through quarterly offerings financed by payroll deductions. The price of the stock to be paid by the employees shall be equal to 85 percent of the average of the closing price of the Corporation's common stock on each trading day during the offering period. However, in no event shall such purchase price be less than the lesser of an amount equal to 85 percent of the market price of the Corporation's stock on the offering date or an amount equal to 85 percent of the market value on the date of purchase. Common stock purchases are made quarterly and are paid through advance payroll deductions up to a calendar year maximum of \$25,000.

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three and nine months ended September 30, 2013 was \$475,000 and \$1,285,000, respectively compared to \$415,000 and \$1,101,000 for the three and nine months ended September 30, 2012. Share-based compensation has been recognized as a component of salaries and benefits expense in the accompanying CONSOLIDATED CONDENSED STATEMENTS OF INCOME.

The estimated fair value of the stock options granted during 2013 and in prior year was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2013 Black Scholes model:

Risk-free interest rate	1.25	%
Expected price volatility	45.68	%
Dividend yield	2.96	%
Forfeiture rate	4.73	%
Weighted-average expected life, until exercise	7.3	years

The Black Scholes model incorporates assumptions to value share-based awards. The risk-free rate of interest, for periods equal to the expected life of the option, is based on a U.S. government instrument over a similar contractual term of the equity instrument. Expected price volatility is based on historical volatility of the Corporation's common stock. In addition, the Corporation generally uses historical information to determine the dividend yield and weighted-average expected life of the options until exercise. Separate groups of employees that have similar historical exercise behavior with regard to option exercise timing and forfeiture rates are considered separately for valuation and attribution purposes.

Share-based compensation expense recognized in the CONSOLIDATED CONDENSED STATEMENTS OF INCOME is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately five percent for the nine months ended September 30, 2013, based on historical experience.

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The following table summarizes the components of the Corporation's share-based compensation awards recorded as expense:

	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2013	2012	2013	2012	
Stock and ESPP Options					
Pre-tax compensation expense	\$89	\$71	\$177	\$197	
Income tax expense (benefit)	(17	) (11	) 1	(13	)
Stock and ESPP option expense, net of income taxes	\$72	\$60	\$178	\$184	
Restricted Stock Awards					
Pre-tax compensation expense	\$386	\$344	\$1,108	\$904	
Income tax benefit	(135	) (104	) (387	) (322	)
Restricted stock awards expense, net of income taxes	\$251	\$240	\$721	\$582	
Total Share-Based Compensation					
Pre-tax compensation expense	\$475	\$415	\$1,285	\$1,101	
Income tax benefit	(152	) (115	) (386	) (335	)
Total share-based compensation expense, net of income taxes	\$323	\$300	\$899	\$766	

As of September 30, 2013, unrecognized compensation expense related to stock options and RSAs totaling \$96,000 and \$2,523,000, respectively, is expected to be recognized over weighted-average periods of .54 and 1.44 years, respectively.

Stock option activity under the Corporation's stock option plans as of September 30, 2013 and changes during the nine months ended September 30, 2013, were as follows:

	Number of	Weighted-Average	Weighted Average	Aggregate
	Shares	Exercise Price	Remaining Contractual Term (in Years)	Intrinsic Value
Outstanding at January 1, 2013	906,636	\$ 21.58		
Granted	22,500	\$ 16.50		
Exercised	(11,250	) \$ 7.90		
Canceled	(104,012	) \$ 23.52		
Outstanding September 30, 2013	813,874	\$ 21.46	3.86	1,464,190
Vested and Expected to Vest at September 30, 2013	813,874	\$ 21.46	3.9	1,464,190
Exercisable at September 30, 2013	763,074	\$ 21.98	3.52	1,277,175

The weighted-average grant date fair value was \$5.73 and \$3.97 for stock options granted during the nine months ended September 30, 2013 and 2012, respectively.



The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of the first nine months of 2013 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their stock options on September 30, 2013. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock. The aggregate intrinsic value of stock options exercised during the nine months ended September 30, 2013 and 2012 was \$106,000 and \$46,000, respectively. Cash receipts of stock options exercised during this same period were \$97,000 and \$67,000, respectively.

The following table summarizes information on unvested RSAs outstanding as of September 30, 2013:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2013	401,375	\$9.29
Granted	118,954	\$15.47
Vested	(111,770)	) \$6.15
Forfeited	(1,700)	) \$11.95
Unvested RSAs at September 30, 2013	406,859	\$11.94

The grant date fair value of ESPP options was estimated at the beginning of the April 1, 2013 quarterly offering period of approximately \$29,000. The ESPP options vested during the three months ending September 30, 2013, leaving no unrecognized compensation expense related to unvested ESPP options at September 30, 2013.

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## NOTE 10

## Income Tax

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Income Tax Expense :				
Currently Payable:				
Federal	\$ (1,897	) \$ 139	\$ (1,157	) \$ 1,475
State				
Deferred:				
Federal	4,564	3,787	12,647	11,239
State				
Total Income Tax Expense	\$ 2,667	\$ 3,926	\$ 11,490	\$ 12,714
Reconciliation of Federal Statutory to Actual Tax Expense:				
Federal statutory income tax at 35%	\$ 4,575	\$ 5,307	\$ 15,601	\$ 16,634
Tax-exempt interest income	(1,024	) (927	) (2,842	) (2,788
Stock compensation	14	14	40	56
Earnings on life insurance	(213	) (240	) (672	) (954
Tax credits	(375	) (19	) (411	) (55
Other	(310	) (209	) (226	) (179
Actual Tax Expense	\$ 2,667	\$ 3,926	\$ 11,490	\$ 12,714

## NOTE 11

## Net Income Per Share

Basic net income per share is computed by dividing net income by the weighted-average shares outstanding during the reporting period. Diluted net income per share is computed by dividing net income by the combination of all dilutive common share equivalents, comprised of shares issuable under the Corporation's share-based compensation plans, and the weighted-average shares outstanding during the reporting period.

Dilutive common share equivalents include the dilutive effect of in-the-money share-based awards, which are calculated based on the average share price for each period using the treasury stock method. Under the treasury stock method, the exercise price of share-based awards, the amount of compensation expense, if any, for future service that the Corporation has not yet recognized, and the amount of estimated tax benefits that would be recorded in additional paid-in capital when share-based awards are exercised, are assumed to be used to repurchase common stock in the current period.

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The following table reconciles basic and diluted net income per share for the three months ended September 30, 2013 and 2012.

	Three Months Ended September 30,			2012		
	2013 Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	\$10,403			\$11,236		
Less: Preferred Stock dividends and discount accretion	(430 )			(1,134 )		
Net income available to common stockholders	9,973	28,806,809	\$0.35	10,102	28,649,996	\$0.35
Effect of dilutive stock options and warrants		274,663			238,080	
Diluted net income per share:						
Net income available to common stockholders	\$9,973	29,081,472	\$0.35	\$10,102	28,888,076	\$0.35

The following table reconciles basic and diluted net income per share for the nine months ended September 30, 2013 and 2012 .

	Nine Months Ended September 30,			2012		
	2013 Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	\$33,083			\$34,812		
Less: Preferred Stock dividends and discount accretion	(2,139 )			(3,404 )		
Net income available to common stockholders	30,944	28,769,206	\$1.08	31,408	28,619,186	\$1.09
Effect of dilutive stock options and warrants		257,260			200,097	
Diluted net income per share:						
Net income available to common stockholders	\$30,944	29,026,466	\$1.07	\$31,408	28,819,283	\$1.09

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(table dollar amounts in thousands, except share data)

(Unaudited)

Stock options to purchase 615,151 and 770,001 shares for the three months ended September 30, 2013, and 2012, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price. Stock options to purchase 667,382 and 846,499 shares for the nine months ended September 30, 2013, and 2012, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

NOTE 12

IMPACT OF ACCOUNTING CHANGES

ASU 2011-11 - Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. The ASU amends Topic 210 by requiring additional improved information to be disclosed regarding financial instruments and derivative instruments that are offset in accordance with the conditions under ASC 210-20-45 or ASC 810-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The amendments did not have a material impact on the Corporation's Condensed Consolidated Financial Statements.

ASU 2013-01- Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The ASU amends Update 2011-11 to clarify that the scope applies to derivatives, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to master netting or similar arrangements. Other types of financial assets and liabilities subject to master netting or similar arrangements are not subject to the disclosure requirements in Update 2011-11. The amendments are effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The amendments did not have a material impact on the Corporation's Condensed Consolidated Financial Statements.

ASU 2013-02- Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The ASU requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. The amendments are effective prospectively for reporting periods beginning after December 15, 2012. The disclosures required by the amendment were applied retrospectively for all comparative periods presented. See NOTE 8.

ACCUMULATED OTHER COMPREHENSIVE INCOME, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

Accounting Standards Update No. 2013-04 - Liabilities (Topic 405). On February 28, 2013, FASB issued ASU 2013-04. The amendments in this Update provide guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this Update is fixed at the reporting date, except for obligations addressed within existing guidance in U.S. GAAP. The guidance requires an entity to measure those obligations as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. The guidance in this Update also requires an entity to disclose the

nature and amount of the obligation as well as other information about those obligations. This Accounting Standards Update is the final version of Proposed Accounting Standards Update EITF12D - Liabilities (Topic 405) which has been deleted. The amendments in this Update are effective for fiscal years beginning after December 31, 2013. Early adoption is permitted. The Corporation will adopt the methodologies prescribed by this ASU by the date required, and does not anticipate that the ASU will have a material effect on its financial position or results of operations.

NOTE 13

BUSINESS COMBINATIONS

On May 13, 2013, First Merchants Corporation ("First Merchants") and CFS Bancorp, Inc. ("Citizens") entered into an Agreement of Reorganization and Merger (the "Merger Agreement"), pursuant to which, Citizens will, subject to the terms and conditions of the Merger Agreement, merge with and into First Merchants (the "Merger"), whereupon the separate corporate existence of Citizens will cease and First Merchants will survive. Immediately following the Merger, Citizens Financial Bank, a federal savings bank and wholly-owned subsidiary of Citizens, will be merged with and into First Merchants Bank, National Association, a national bank and wholly-owned subsidiary of First Merchants, with First Merchants Bank, National Association as the surviving bank.

Based on the closing price of First Merchants' common stock on October 31, 2013 of \$18.80 per share, the transaction value is estimated at approximately \$134 million. The transaction is expected to be a tax-free stock exchange for those Citizens shareholders receiving First Merchants' common stock pursuant to the Merger. Subject to customary closing conditions, the parties anticipate completing the Merger in mid-November 2013. The Boards of Directors and shareholders of both First Merchants and Citizens have approved the Merger Agreement.

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(table dollar amounts in thousands, except share data)

(Unaudited)

Subject to the terms and conditions of the Merger Agreement, upon the completion of the Merger, each share of outstanding Citizens common stock, \$0.01 par value per share, will be converted into 0.65 shares (the "Exchange Ratio") of First Merchants common stock, \$0.125 stated value per share. The Exchange Ratio is subject to adjustments for stock splits, stock dividends, recapitalization, or similar transactions, or as otherwise described in the Merger Agreement. Immediately prior to the Merger, each outstanding share of Citizens restricted stock will automatically vest and, upon the Merger, will also be converted into First Merchants common stock pursuant to the Exchange Ratio. First Merchants will pay cash in lieu of any fractional shares of First Merchants common stock resulting from exchange of shares of Citizens common stock or restricted stock, all at a price and as adjusted pursuant to the Merger Agreement. Immediately prior to the Merger, Citizens stock options will fully vest, and, upon the Merger, all Citizens stock options will automatically convert into stock options to purchase First Merchants common stock on the same terms and conditions as were applicable under the terms of the Citizens option plan under which such Citizens options were granted and the applicable award agreements thereunder. In such a case, the number of shares of First Merchants common stock subject to such converted option will equal the product of (i) the number of shares of Citizens' common stock purchasable upon exercise of the original Citizens option and (ii) the Exchange Ratio, and rounded down to the next whole share. The price per share to exercise such converted option will equal (i) the exercise price per share of Citizens common stock under the original Citizens option divided by (ii) the Exchange Ratio, and rounded up to the nearest cent.

NOTE 14

CONTINGENT LIABILITIES

On April 16, 2013, First Merchants was named in a class action lawsuit in Delaware County Circuit Court challenging First Merchant's checking account practices associated with the assessment of overdraft fees. The plaintiff sought damages and other relief, including restitution and injunctive relief. First Merchants removed the case from state court to federal district court. First Merchants then filed a motion to stay the federal action pending arbitration. The motion was recently granted by the court and the action was stayed. To the extent the plaintiff desires to further pursue the matter, the plaintiff must do so through a separate arbitration proceeding. If arbitration is pursued, First Merchants believes it has meritorious defenses to the claims brought by the plaintiff.

On July 30, 2013, a purported shareholder of CFS Bancorp, Inc. filed a putative class action lawsuit captioned Jay Orlando v. CFS Bancorp, Inc., et al., No. 2:13-CV-00261 in U.S. District Court in the Northern District of Indiana against CFS Bancorp, Inc., its board of directors and First Merchants. The complaint generally alleged various claims of federal securities law violations and that the directors of CFS Bancorp, Inc. breached their fiduciary duties by providing materially inadequate disclosures and material disclosure omissions with respect to the proposed merger of CFS Bancorp, Inc. into First Merchants. The plaintiff seeks (1) class certification, (2) to enjoin the merger or, in the event the merger is completed before entry of a final judgment, to rescind the merger or be awarded an unspecified amount of rescissory damages, (3) compensatory damages in an unspecified amount, and (4) costs and expenses, including attorneys' fees. At this early stage of the litigation, it is not possible to assess the probability of a material adverse outcome or reasonably estimate any potential financial impact of the lawsuit on First Merchants. The defendants believe the claims against them are without merit and intend to contest the matter vigorously. On October 15, 2013, the plaintiff dismissed First Merchants as a defendant in the action without prejudice.

NOTE 15

SUBSEQUENT EVENTS

On November 1, 2013, the Corporation privately placed \$65 million of 6.75 percent fixed-to-floating rate subordinated notes due in 2028 and \$5 million of 5 percent fixed-to-floating rate senior unsecured notes due in 2028 through U.S. Bancorp Investments, Inc. The funds were used to refinance the Corporation's \$55.0 million credit facility with Bank of America, N.A., which consisted of a \$50.0 million subordinated debenture and a \$5.0 million term loan, both of which were scheduled to mature in February 2015.

The Corporation intends to apply the remaining funds from the placement to the redemption of the remaining 34,043 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock") held by the U.S. Department of the Treasury (the "Treasury") at an aggregate redemption price of \$34,043,000, plus accrued but unpaid dividends. The Series B Preferred Stock was issued to the Treasury in September of 2011 as part of the Corporation's participation in the Small Business Lending Fund Program.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

From time to time, we include forward-looking statements in our oral and written communication. We may include forward-looking statements in filings with the Securities and Exchange Commission, such as this Form 10-Q, in other written materials and in oral statements made by senior management to analysts, investors, representatives of the media and others. We intend these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of these safe harbor provisions. Forward-looking statements can often be identified by the use of words like "believe", "continue", "pattern", "estimate", "project", "intend", "anticipate", "expect" and similar expressions, future or conditional verbs such as "will", "would", "should", "could", "might", "can", "may", or similar expressions. These forward-looking statements include:

- statements of our goals, intentions and expectations;
- statements regarding our business plan and growth strategies;
- statements regarding the asset quality of our loan and investment portfolios; and
- estimates of our risks and future costs and benefits.

These forward-looking statements are subject to significant risks, assumptions and uncertainties, including, among other things, the following important factors which could affect the actual outcome of future events:

- fluctuations in market rates of interest and loan and deposit pricing, which could negatively affect our net interest margin, asset valuations and expense expectations;
- adverse changes in the economy, which might affect our business prospects and could cause credit-related losses and expenses;
- adverse developments in our loan and investment portfolios;
- competitive factors in the banking industry, such as the trend towards consolidation in our market;
- changes in the banking legislation or the regulatory requirements of federal and state agencies applicable to bank holding companies and banks like our affiliate banks;
- acquisitions of other businesses by us and integration of such acquired businesses;
- changes in market, economic, operational, liquidity, credit and interest rate risks associated with our business; and
- the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends.

Because of these and other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements. In addition, our past results of operations do not necessarily indicate our anticipated future results.

CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles are complex and require us to apply significant judgments to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply those principles where actual measurement is not possible or practical. For a complete discussion of our significant accounting policies, see "Notes to the Consolidated Financial Statements" in our Annual Report on Form 10-K for the year ended December 31,



2012. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

We believe there have been no significant changes during the nine months ended September 30, 2013, to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2012.

## BUSINESS SUMMARY

First Merchants Corporation (the "Corporation") is a financial holding company headquartered in Muncie, Indiana and was organized in September 1982. The Corporation's Common Stock is traded on NASDAQ's Global Select Market System under the symbol FRME. The Corporation has one full-service bank charter, First Merchants Bank, National Association (the "Bank"), which opened for business in Muncie, Indiana, in March 1893. The Bank also operates Lafayette Bank and Trust, Commerce National Bank and First Merchants Trust Company as divisions of First Merchants Bank, National Association. The Bank includes seventy-five banking locations in twenty-four Indiana and two Ohio counties. In addition to its branch network, the Corporation's delivery channels include ATMs, check cards, remote deposit capture, interactive voice response systems and internet technology. The Corporation's business activities are currently limited to one significant business segment, which is community banking.

Through the Bank, the Corporation offers a broad range of financial services, including accepting time deposits, savings and demand deposits; making consumer, commercial, agri-business and real estate mortgage loans; renting safe deposit facilities; providing personal and corporate trust services; providing full-service brokerage; and providing other corporate services, letters of credit and repurchase agreements.

The Corporation also operates First Merchants Insurance Services, Inc., operating as First Merchants Insurance Group, a full-service property, casualty, personal lines, and employee benefit insurance agency headquartered in Muncie, Indiana.

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RECENT DEVELOPMENTS

The Board of Directors and shareholders of the Corporation and CFS Bancorp, Inc. have agreed to merge CFS Bancorp, Inc. with and into the Corporation. See NOTE 13. BUSINESS COMBINATIONS in the Notes to Consolidated Condensed Financial Statements in this Form 10-Q for additional discussion of this transaction.

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported net income available to common stockholders of \$10.0 million, or \$0.35 per fully diluted common share for the quarter ended September 30, 2013, a slight decrease of \$129,000, compared to net income available to common stockholders of \$10.1 million, or \$0.35 per common share for quarter ended September 30, 2012.

Net income available to common stockholders for the nine months ended September 30, 2013 was \$30.9 million, or \$1.07 per fully diluted common share, compared to net income available to common stockholders of \$31.4 million, or \$1.09 per fully diluted common share for the nine months ended September 30, 2012. On February 10, 2012, the Bank assumed substantially all the deposits and certain other liabilities and acquired certain assets of SCB Bank, from the FDIC as the receiver of SCB Bank. This transaction generated a pre-tax gain of \$9.1 million, or \$0.21 per common share after tax. Details of this transaction are included in NOTE 2. PURCHASE AND ASSUMPTION, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

As of September 30, 2013, total assets equaled \$4.3 billion, an increase of \$21.1 million from December 31, 2012. Total loans of \$2.9 billion increased \$6.3 million and investment securities increased \$39.8 million from December 31, 2012. Additional details of the changes in the Corporation's loans and other earning assets are discussed within NOTE 4. LOANS AND ALLOWANCE, included within the Notes to Consolidated Condensed Financial Statements, and the "EARNING ASSETS" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

The Corporation's allowance for loan losses totaled \$66.2 million as of September 30, 2013. The allowance provides 189.3 percent coverage of all non-accrual loans and 2.26 percent of total loans. Provision expense totaled \$1.5 million for third quarter of 2013, compared to \$4.6 million in the third quarter of 2012. Net charge-offs totaled \$3.5 million for the third quarter of 2013, down from \$5.3 million for the third quarter of 2012. Provision expense totaled \$5.6 million for nine months ended September 30, 2013, compared to \$14.0 million in nine months ended September 30, 2012. Net charge-offs totaled \$8.8 million for nine months ended September 30, 2013, compared to \$15.4 million for nine months ended September 30, 2012. Additional details are discussed within the "LOAN QUALITY/PROVISION FOR LOAN LOSSES" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

Total Deposits of \$3.3 billion decreased from December 31, 2012 by \$90.5 million. The largest declines were in maturity deposits, which declined \$160.0 million. These declines were offset by an increase in non-maturity deposits of \$69.5 million compared to December 31, 2012. Total Borrowings increased \$156.9 million from December 31, 2012 as Federal Funds Purchased and Federal Home Loan Bank advances increased \$97.1 million and \$78.1 million, respectively, to offset the decline in total deposits and fund the increase in investment securities.

The Corporation was able to maintain all regulatory capital ratios in excess of the regulatory definition of “well-capitalized” as discussed in the “CAPITAL” section of Management’s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

Net interest income totaled \$37.0 million for the quarter, as net interest margin during the quarter totaled 3.97 percent as yields on earning assets totaled 4.35 percent and the cost of supporting liabilities totaled 0.38 percent. Net interest income totaled \$113.1 million for nine months ended September 30, 2013, as net interest margin during the nine months ended September 30, 2013 totaled 4.03 percent as yields on earning assets totaled 4.44 percent and the cost of supporting liabilities totaled 0.41 percent. Additional details of the Corporation's net interest income are discussed within the "NET INTEREST INCOME" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

#### NET INTEREST INCOME

Net interest income is the primary source of the Corporation’s earnings. Net interest margin is a function of net interest income and the level of average earning assets. Net interest income and net interest margin are presented in the following table on a fully taxable equivalent basis (“FTE”), which adjusts tax-exempt or nontaxable interest income to an amount that would be comparable to interest subject to income taxes using the federal statutory tax rate of 35 percent in effect for all periods. Net interest margin decreased 35 basis points from 4.32 percent in the third quarter of 2012 to 3.97 percent in the third quarter of 2013, while earning assets increased by \$59.5 million.

During the nine months ended September 30, 2013, net interest income decreased 10 basis points compared to the same period in 2012. The yield on interest earning assets decreased 35 basis points, while the cost of interest bearing liabilities decreased 25 basis points during the nine months ended September 30, 2013. The decrease in the net interest margin compared to prior periods, for both the three and nine months ended September 30, 2013, is primarily due to the yield on average earning assets decreasing faster than the cost of interest-bearing liabilities.

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The following table presents the Corporation's interest income, interest expense, and net interest income as a percent of average earning assets for the three and nine months ended September 30, 2013, and 2012.

(Dollars in Thousands)	Three Months Ended		Nine Months Ended		
	September 30,		September 30,		
	2013	2012	2013	2012	
Annualized net interest income	\$148,088	\$159,611	\$150,840	\$152,095	
Annualized FTE adjustment	\$6,298	\$5,707	\$5,832	\$5,746	
Annualized net interest income on a fully taxable equivalent basis	\$154,386	\$165,318	\$156,672	\$157,841	
Average earning assets	\$3,888,646	\$3,829,127	\$3,885,061	\$3,818,805	
Interest income (FTE) as a percent of average earning assets	4.35	% 4.89	% 4.44	% 4.79	%
Interest expense as a percent of average earning assets	0.38	% 0.57	% 0.41	% 0.66	%
Net interest income (FTE) as a percent of average earning assets	3.97	% 4.32	% 4.03	% 4.13	%

Average earning assets include the average balance of securities classified as available for sale, computed based on the average of the historical amortized cost balances without the effects of the fair value adjustment. Annualized amounts are computed utilizing a 30/360 day basis.

## NON-INTEREST INCOME

Non-interest income decreased \$2.5 million or 17.3 percent in the third quarter of 2013, compared to the third quarter of 2012. The largest increases realized during the third quarter of 2013 when compared to the same quarter of 2012 were gains on sale of other real estate owned and service charges on deposit accounts totaling \$237,000 and \$207,000, respectively. The largest decreases realized during the third quarter of 2013 when compared to the same quarter of 2012 were gains on the sale of mortgage loans, security transactions gains, loan level hedge income, and tax credit fund income of \$1.2 million, \$843,000, \$589,000 and \$554,000, respectively.

During the first nine months of 2013, non-interest income decreased \$10.4 million or 20.7 percent from the same period in 2012. The largest item contributing to the decrease was a gross purchase gain of \$9.1 million recognized from the purchase of certain assets and assumption of certain liabilities of SCB Bank in Shelby County Indiana. See NOTE 2. PURCHASE AND ASSUMPTION in the Notes to Consolidated Condensed Financial Statements included in this Form 10-Q for additional discussion of this transaction.

Additionally, earnings on cash surrender value of life insurance decreased by \$804,000 compared to the first nine months of 2012. This decrease was primarily driven by a death benefit of \$576,000 received from Bank Owned Life Insurance during 2012. Finally, gains on the sale of investment securities and gains on the sale of mortgage loans declined by \$1.6 million and \$607,000, respectively, in the first nine months of 2013 when compared to the first nine months of 2012.

Offsetting these declines were increased insurance commissions and fiduciary activities of \$786,000 and \$450,000, respectively, from the same period of 2012.

## NON-INTEREST EXPENSE

Non-interest expenses decreased \$185,000 or 0.5 percent in the third quarter of 2013, compared to the third quarter of 2012. Salaries and employee benefits increased \$533,000 or 2.7 percent over the same quarter last year. This was primarily driven by employee benefits increasing \$441,000 over the same quarter last year. This increase was offset by declines in other real estate owned and credit related expenses and outside services of \$456,000 and \$334,000, respectively, from the third quarter of 2012 to the third quarter of 2013.

During the first nine months of 2013, non-interest expense increased \$49,000 or 0.1 percent when compared to the first nine months of 2012. Salaries and employee benefits increased by \$2.9 million over the same period in 2012. Base salaries were up \$2.0 million while commissions and incentives increased \$139,000. Additionally, retirement plan expenses, employee insurance, and payroll taxes increased \$314,000, \$249,000 and \$221,000, respectively, over the same period in 2012. The increase in salaries and employee benefits was offset by declines in other real estate owned and credit related expenses of \$1.4 million, FDIC assessment expense of \$676,000 and net occupancy expenses of \$393,000, from the first nine months of 2012 to the first nine months of 2013.

## INCOME TAX EXPENSE

The income tax expense for the nine months ended September 30, 2013, was \$11,490,000 on pre-tax net income of \$44,573,000. For the same period in 2012, the income tax expense was \$12,714,000 on pre-tax net income of \$47,526,000. Additional details are discussed within the "RESULTS OF OPERATIONS" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

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## CAPITAL

Capital adequacy is an important indicator of financial stability and performance. The Corporation maintained a strong capital position as tangible common equity to tangible assets was 7.97% percent at September 30, 2013, and 7.55% percent at December 31, 2012.

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk-based capital, Tier 1 capital, and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios. At September 30, 2013, the management of the Corporation believes that it meets all capital adequacy requirements to which it is subject. The most recent notifications from the regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

There are five capital categories defined in the regulations, ranging from well capitalized to critically undercapitalized. Classification of a bank in any of the undercapitalized categories can result in actions by regulators that could have a material effect on a bank's operations.

To be considered well capitalized, a bank must have a total risk-based capital ratio of at least 10 percent, a Tier I capital ratio of at least 6 percent, a Tier 1 leverage ratio of at least 5 percent, and must not be subject to any order or directive requiring the bank to improve its capital level. An adequately capitalized bank has a total risk-based capital ratio of at least 8 percent, a Tier I capital ratio of at least 4 percent and a Tier 1 leverage ratio of at least 4 percent. Banks with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual levels. The appropriate federal regulatory agency may also downgrade a bank to the next lower capital category upon a determination that the bank is in an unsafe or unsound practice. Banks are required to monitor closely their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category.

As of September 30, 2013, the Corporation, on a consolidated basis, as well as the Bank, exceeded the minimum capital levels of the well capitalized category.

(Dollars in Thousands)	September 30, 2013		December 31, 2012		
	Amount	Ratio	Amount	Ratio	
Consolidated					
Total risk-based capital (to risk-weighted assets)	\$498,122	14.96	% \$526,792	16.34	%
Tier 1 capital (to risk-weighted assets)	436,186	13.10	% 456,132	14.15	%
Tier 1 capital (to average assets)	436,186	10.54	% 456,132	11.03	%
First Merchants Bank					
Total risk-based capital (to risk-weighted assets)	\$522,463	15.70	% \$515,337	16.01	%
Tier 1 capital (to risk-weighted assets)	480,590	14.44	% 474,782	14.75	%
Tier 1 capital (to average assets)	480,590	11.62	% 474,782	11.50	%

Tier I regulatory capital consists primarily of total stockholders' equity and subordinated debentures issued to business trusts categorized as qualifying borrowings, less non-qualifying intangible assets and unrealized net securities gains or

losses.

On January 3, 2013, the Corporation redeemed 22,695.94 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock") held by the U.S. Department of the Treasury (the "Treasury") at an aggregate redemption price of \$22,695,940, plus accrued but unpaid dividends. The Series B Preferred Stock was issued to the Treasury in September of 2011 as part of the Corporation's participation in the Small Business Lending Fund Program. Following this redemption, the Treasury held 68,087 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$68 million.

On July 2, 2013, the Corporation redeemed an additional 34,044 shares of the Series B Preferred Stock at an aggregate redemption price of \$34,044,000, plus accrued but unpaid dividends. Following this redemption, the Treasury holds 34,043 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$34 million. See NOTE 15. SUBSEQUENT EVENTS in the Notes to Consolidated Condensed Financial Statements in this Form 10-Q for discussion regarding the Corporation's intent to redeem the remaining shares.

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Management believes that all of the above capital ratios are meaningful measurements for evaluating the safety and soundness of the Corporation. Additionally, management believes the following table is also meaningful when considering performance measures of the Corporation. The table details and reconciles tangible earnings per share, return on tangible capital and tangible assets to traditional GAAP measures for the three and nine months ended September 30, 2013 and 2012.

(Dollars in Thousands, Except Per Share Amounts)	Three Months Ended September 30,		Nine Months Ended September 30,		
	2013	2012	2013	2012	
Average goodwill	\$ 141,374	\$ 141,358	\$ 141,374	\$ 141,357	
Average core deposit intangible (CDI)	7,197	8,725	7,579	8,826	
Average deferred tax on CDI	(2,286 )	(2,177 )	(2,264 )	(2,200 )	
Intangible adjustment	\$ 146,285	\$ 147,906	\$ 146,689	\$ 147,983	
Average stockholders' equity (GAAP capital)	\$ 508,034	\$ 540,988	\$ 528,156	\$ 530,153	
Average cumulative preferred stock	(125 )	(125 )	(125 )	(125 )	
Average non-cumulative preferred stock issued under the Small Business Lending Fund Program	(34,413 )	(90,783 )	(56,905 )	(90,783 )	
Intangible adjustment	(146,285 )	(147,906 )	(146,689 )	(147,983 )	
Average tangible capital	\$ 327,211	\$ 302,174	\$ 324,437	\$ 291,262	
Average assets	\$ 4,286,982	\$ 4,237,590	\$ 4,288,645	\$ 4,230,186	
Intangible adjustment	(146,285 )	(147,906 )	(146,689 )	(147,983 )	
Average tangible assets	\$ 4,140,697	\$ 4,089,684	\$ 4,141,956	\$ 4,082,203	
Net income available to common stockholders	\$ 9,973	\$ 10,102	\$ 30,944	\$ 31,408	
CDI amortization, net of tax	205	272	617	809	
Tangible net income available to common stockholders	\$ 10,178	\$ 10,374	\$ 31,561	\$ 32,217	
Per Share Data:					
Diluted net income available to common stockholders	\$ 0.35	\$ 0.35	\$ 1.07	\$ 1.09	
Diluted tangible net income available to common stockholders	\$ 0.35	\$ 0.36	\$ 1.09	\$ 1.12	
Ratios:					
Return on average GAAP capital (ROE)	7.85	% 7.47	% 7.81	% 7.90	%
Return on average tangible capital	12.44	% 13.73	% 12.97	% 14.75	%
Return on average assets (ROA)	0.93	% 0.95	% 0.96	% 0.99	%
Return on average tangible assets	0.98	% 1.01	% 1.02	% 1.05	%

Return on average tangible capital is tangible net income available to common stockholders (annualized) expressed as a percentage of average tangible capital. Return on average tangible assets is tangible net income available to common stockholders (annualized) expressed as a percentage of average tangible assets.



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## PART I: FINANCIAL INFORMATION

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## LOAN QUALITY/PROVISION FOR LOAN LOSSES

The Corporation's primary business focus is small business and middle market commercial, residential real estate, auto and small consumer lending, which results in portfolio diversification. Commercial loans are individually underwritten and judgmentally risk rated. They are periodically monitored and prompt corrective actions are taken on deteriorating loans. Retail loans are typically underwritten with statistical decision-making tools and are managed throughout their life cycle on a portfolio basis.

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The amount provided for loan losses and the determination of the adequacy of the allowance are based on a continuous review of the loan portfolio, including an internally administered loan "watch" list and an ongoing loan review. The evaluation takes into consideration identified credit problems, as well as the possibility of losses inherent in the loan portfolio that are not specifically identified.

Non-performing loan balances will change as a result of routine problem loan recognition and resolution through collections, sales or charge offs. The performance of any loan can be affected by external factors such as economic conditions, or factors particular to a borrower, such as actions of a borrower's management.

Non-accrual loans decreased by \$18,407,000 during the nine months ended September 30, 2013, from \$53,399,000 at December 31, 2012 to the September 30, 2013, balance of \$34,992,000. In addition, other real estate owned declined \$1,211,000 during the same period. For other real estate owned, current appraisals are obtained to determine value as management continues to aggressively market these real estate assets. Accruing loans delinquent 90 or more days at September 30, 2013 decreased \$1,200,000, or 58.9 percent from December 31, 2012, and was comprised of loans secured by residential real estate.

Commercial impaired loans include all non-accrual loans, loans accounted for under SOP-03-3 and renegotiated loans as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more.

A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected substantially within the contractual terms of the note. At September 30, 2013, commercial impaired loans totaled \$54,227,000, a decrease of \$8,762,000 from the June 30, 2013, balance of \$62,989,000, and were down 31.5 percent from December 31, 2012. At September 30, 2013, an allowance for losses was not deemed necessary for commercial impaired loans totaling \$47,604,000 as there was no identified loss on these credits. An allowance of \$1,475,000 was recorded for the remaining balance of these impaired loans totaling \$6,623,000 and is included in the corporation's allowance for loan losses.

The following table details the Corporation's non-performing assets plus loans 90-days or more delinquent, and notes total commercial impaired loans for the periods indicated.

(Dollars in Thousands)	September 30, 2013	December 31, 2012
Non-Performing Assets:		
Non-accrual loans	\$ 34,992	\$ 53,399

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Renegotiated loans	3,269	12,681
Non-performing loans (NPL)	38,261	66,080
Other real estate owned	12,052	13,263
Non-performing assets (NPA)	50,313	79,343
90+ days delinquent and still accruing	837	2,037
Non-performing assets plus 90+ days delinquent	51,150	81,380
Impaired Loans	\$54,227	\$79,179

The composition of non-performing assets plus loans 90-days or more delinquent is reflected in the following table.

(Dollars in Thousands)	September 30, 2013	December 31, 2012
Non-Performing Assets and 90+ Days Delinquent:		
Commercial and industrial loans	\$6,772	\$13,690
Agricultural production financing and other loans to farmers	31	
Real estate loans:		
Construction	8,626	12,378
Commercial and farmland	21,963	34,999
Residential	11,955	16,620
Home Equity	1,509	3,198
Individuals' loans for household and other personal expenditures	130	190
Lease financing receivables, net of unearned income		301
Other loans	164	4
Non-performing assets plus 90+ days delinquent	\$51,150	\$81,380

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## PART I: FINANCIAL INFORMATION

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

At September 30, 2013, the allowance for loan losses was \$66,224,000, a decrease of \$3,142,000 from December 31, 2012. As a percent of loans, the allowance was 2.26 percent at September 30, 2013, 2.32 percent at June 30, 2013, 2.36 percent at March 31, 2013 and 2.37 percent at December 31, 2012. The provision for loan losses for the nine months ended September 30, 2013 was \$5,632,000, a decrease of \$8,397,000 from \$14,029,000 for the same period in 2012. The continued improvement in credit quality, primarily the declines in loans graded substandard, doubtful and loss, contributed to the decrease in provision expense. Specific reserves, on impaired loans decreased \$2,768,000 from \$4,243,000 at December 31, 2012, to \$1,475,000 at September 30, 2013.

Net charge offs for the nine months ended September 30, 2013, were \$8,774,000, a decrease of \$6,660,000 from the same period in 2012. Of this amount, seven charge offs, totaling 84.0 percent of net charge offs, were greater than \$500,000. The distribution of the net charge offs for the three and nine months ended September 30, 2013 and September 30, 2012 is reflected in the following table:

(Dollars in Thousands)	Three Months Ended		Nine Months Ended	
	September 30, 2013	2012	September 30, 2013	2012
Net Charge Offs (Recoveries):				
Commercial and industrial loans	\$494	\$923	\$2,179	\$5,266
Agricultural production financing and other loans to farmers	(284	) (3	) (306	) (23
Real estate loans:				
Construction	242	433	99	105
Commercial and farmland	2,295	2,408	4,108	6,550
Residential	576	1,204	1,322	1,895
Home Equity	164	367	1,365	886
Individuals' loans for household and other personal expenditures	51	(51	) 57	259
Lease financing receivables, net of unearned income	(3	)	12	(1
Other Loans	(24	) (22	) (62	) 497
Total Net Charge Offs	\$3,511	\$5,259	\$8,774	\$15,434

Management continually evaluates commercial borrowers by including consideration of specific borrower cash flow analysis and estimated collateral values, types and amounts on non-performing loans, past and anticipated loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans outstanding. The determination of the provision for loan losses in any period is based on management's continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio.

## LIQUIDITY

Liquidity management is the process by which we ensure that adequate liquid funds are available for the holding company and its subsidiaries. These funds are necessary in order to meet financial commitments on a timely basis. These commitments include withdrawals by depositors, funding credit obligations to borrowers, paying dividends to stockholders, paying operating expenses, funding capital expenditures, and maintaining deposit reserve requirements. Liquidity is monitored and closely managed by the asset/liability committee.

The Corporation's liquidity is dependent upon our receipt of dividends from the Bank, which is subject to certain regulatory limitations and access to other funding sources. Liquidity of the Bank is derived primarily from core deposit growth, principal payments received on loans, the sale and maturity of investment securities, net cash provided by operating activities, and access to other funding sources.

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. In addition, Federal Home Loan Bank ("FHLB") advances are utilized as funding sources. At September 30, 2013, total borrowings from the FHLB were \$172,292,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at September 30, 2013, was \$188,870,000.

On March 30, 2012, the Bank completed repayment of \$79,000,000 of Senior Notes (the "Notes") that had matured. The Notes, which were originally issued by the Bank on March 31, 2009, were guaranteed by the FDIC under its Temporary Liquidity Guarantee Program ("TLGP").

On August 22, 2012, the Corporation exercised its option to redeem the \$4,124,000 subordinated debenture associated with the CNBC Statutory Trust I. The redemption price premium was 104.59. The debenture had carried a fixed interest rate of 10.2 percent.

The principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$606,341,000 at September 30, 2013, an increase of \$92,998,000, or 18.1 percent, from December 31, 2012. Securities classified as held to maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held to maturity that are maturing in one year or less, totaled \$1,060,000 at September 30, 2013. In addition, other types of assets such as cash and due from banks, federal funds sold, and securities purchased under agreements to resell, loans and interest-bearing deposits with other banks maturing within one year are sources of liquidity.

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## PART I: FINANCIAL INFORMATION

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The Corporation currently has a \$55 million credit facility with Bank of America, N.A., comprised of (a) a term loan in the principal amount of \$5 million (the "Term Loan") and (b) a subordinated debenture in the principal amount of \$50.0 million (the "Subordinated Debt"). Pursuant to the terms of the underlying Loan Agreement (the "Loan Agreement"), the Term Loan and the Subordinated Debt each mature on February 15, 2015. The Term Loan is secured by a pledge of all of the issued and outstanding shares of the Bank. The Loan Agreement contains certain customary representations and warranties and financial and negative covenants. A breach of any of these covenants could result in a default under the Loan Agreement. As of September 30, 2013, the Corporation was in compliance with these financial covenants.

On November 1, 2013, the Corporation refinanced the \$50.0 million Subordinated Debt and \$5.0 million Term Loan with Bank of America, N.A. with a \$65 million subordinated notes and a \$5 million senior unsecured notes through U.S Bancorp Investments, Inc. See Note 15. SUBSEQUENT EVENTS in the Notes to Consolidated Condensed Financial Statements in this Form 10-Q for additional discussion of this transaction.

In the normal course of business, the Bank is a party to a number of other off-balance sheet activities that contain credit, market and operational risk that are not reflected in whole or in part in our consolidated financial statements. Such activities include traditional off-balance sheet credit-related financial instruments, commitments under operating leases and long-term debt.

The Bank provides customers with off-balance sheet credit support through loan commitments and standby and commercial letters of credit. Summarized credit-related financial instruments at September 30, 2013, are as follows:

(Dollars in Thousands)	September 30, 2013
Amounts of commitments:	
Loan commitments to extend credit	\$1,062,826
Standby and commercial letters of credit	22,245
	\$1,085,071

Since many of the commitments are expected to expire unused or be only partially used, the total amount of unused commitments in the preceding table does not necessarily represent future cash requirements.

In addition to owned banking facilities, the Corporation has entered into a number of long-term leasing arrangements to support ongoing activities. The required payments under such commitments and borrowings at September 30, 2013, are as follows:

(Dollars in Thousands)	Remaining 2013	2014	2015	2016	2017	2018	2019 and after	Total
Operating leases	\$587	\$2,260	\$2,086	\$1,666	\$1,024	\$335	\$1,046	\$9,004
Federal funds purchased	115,938							115,938
Securities sold under repurchase agreements	113,935	10,000						123,935
Federal Home Loan Bank advances	50,043	26,437	30,893	28,933	2,630	13,252	20,104	172,292
	147		55,000				56,702	111,849

Subordinated debentures  
and term loans

Total	\$280,650	\$38,697	\$87,979	\$30,599	\$3,654	\$13,587	\$77,852	\$533,018
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INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK

Asset/Liability Management has been an important factor in the Corporation's ability to record consistent earnings growth through periods of interest rate volatility and product deregulation. Management and the Board of Directors monitor the Corporation's liquidity and interest sensitivity positions at regular meetings to review how changes in interest rates may affect earnings. Decisions regarding investment and the pricing of loan and deposit products are made after analysis of reports designed to measure liquidity, rate sensitivity, the Corporation's exposure to changes in net interest income given various rate scenarios and the economic and competitive environments.

It is the objective of the Corporation to monitor and manage risk exposure to net interest income caused by changes in interest rates. It is the goal of the Corporation's Asset/Liability function to provide optimum and stable net interest income. To accomplish this, management uses two asset liability tools. GAP/Interest Rate Sensitivity Reports and Net Interest Income Simulation Modeling are constructed, presented and monitored quarterly.

Net interest income simulation modeling, or earnings-at-risk, measures the sensitivity of net interest income to various interest rate movements. The Corporation's asset liability process monitors simulated net interest income under three separate interest rate scenarios; base, rising and falling. Estimated net interest income for each scenario is calculated over a 12-month horizon. The immediate and parallel changes to the base case scenario used in the model are presented below. The interest rate scenarios are used for analytical purposes and do not necessarily represent management's view of future market movements. Rather, these are intended to provide a measure of the degree of volatility interest rate movements may introduce into the earnings of the Corporation.

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## PART I: FINANCIAL INFORMATION

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The base scenario is highly dependent on numerous assumptions embedded in the model, including assumptions related to future interest rates. While the base sensitivity analysis incorporates management's best estimate of interest rate and balance sheet dynamics under various market rate movements, the actual behavior and resulting earnings impact will likely differ from that projected. For certain assets, the base simulation model captures the expected prepayment behavior under changing interest rate environments. Assumptions and methodologies regarding the interest rate or balance behavior of indeterminate maturity products, such as savings, money market, NOW and demand deposits, reflect management's best estimate of expected future behavior.

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of September 30, 2013, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In the current rate environment, many driver rates are at or near historical lows, thus total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management have the following results:

Driver Rates	September 30, 2013	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	—
Federal funds	200	—
One-year CMT	200	(2 )
Three-year CMT	200	(40 )
Five-year CMT	200	(92 )
CD's	200	(22 )
FHLB advances	200	(49 )

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at September 30, 2013. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	September 30, 2013		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$ 146,246	\$ 150,903	\$ 143,111
Variance from base		\$ 4,657	\$(3,135 )
Percent of change from base		3.18	% (2.14 )%

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2012, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management in the base simulation are as follows:

December 31, 2012	
RISING	FALLING

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Driver Rates	(200 Basis Points)	(100 Basis Points)
Prime	200	—
Federal funds	200	—
One-year CMT	200	(8 )
Three-year CMT	200	(3 )
Five-year CMT	200	(10 )
CD's	200	(25 )
FHLB advances	200	(5 )

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	December 31, 2012		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$145,846	\$153,621	\$144,122
Variance from base		\$7,775	\$(1,724 )
Percent of change from base		5.33	% (1.18 )%



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## PART I: FINANCIAL INFORMATION

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## EARNING ASSETS

The following table presents the earning asset mix as of September 30, 2013, and December 31, 2012. Earning assets increased by \$26,469,000 in the nine months ended September 30, 2013. Interest-bearing time deposits decreased \$19,568,000, while investments increased by approximately \$39,772,000. Loans and loans held for sale increased by \$6,260,000. Two loan classes experiencing the largest increases from December 31, 2012, were construction and commercial and industrial loans. These increases were offset primarily by decreases in three loan classes, which were real estate residential, other loans and agriculture production financing and other loans to farmers.

(Dollars in Thousands)	September 30, 2013	December 31, 2012
Interest-bearing time deposits	\$18,875	\$38,443
Investment securities available for sale	606,341	513,343
Investment securities held to maturity	307,794	361,020
Mortgage loans held for sale	5,312	22,300
Loans	2,925,457	2,902,209
Federal Reserve and Federal Home Loan Bank stock	32,790	32,785
Total	\$3,896,569	\$3,870,100

## OTHER

The Securities and Exchange Commission maintains a Web site that contains reports, proxy and information statements and other information regarding registrants that file electronically with the Commission, including the Corporation, and that address is (<http://www.sec.gov>).

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PART I: FINANCIAL INFORMATION

ITEM 3. QUANTITATIVE AND QUALITATIVE  
DISCLOSURES ABOUT MARKET RISK

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required under this item is included as part of Management's Discussion and Analysis of Financial Condition and Results of Operations, under the headings "LIQUIDITY" and "INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK".

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PART I: FINANCIAL INFORMATION

ITEM 4. CONTROLS AND PROCEDURES

ITEM 4. CONTROLS AND PROCEDURES

At the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

There have been no changes in the Corporation's internal control over financial reporting identified in connection with the evaluation discussed above that occurred during the Corporation's last fiscal quarter that have materially affected, or are reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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## PART II: OTHER INFORMATION

## ITEM 1., ITEM 1A., ITEM 2., ITEM 3., ITEM 4. AND ITEM 5.

(table dollar amounts in thousands, except share data)

## ITEM 1. LEGAL PROCEEDINGS

On April 16, 2013, First Merchants was named in a class action lawsuit in Delaware County Circuit Court challenging First Merchant's checking account practices associated with the assessment of overdraft fees. The plaintiff sought damages and other relief, including restitution and injunctive relief. First Merchants removed the case from state court to federal district court. First Merchants then filed a motion to stay the federal action pending arbitration. The motion was recently granted by the court and the action was stayed. To the extent the plaintiff desires to further pursue the matter, the plaintiff must do so through a separate arbitration proceeding. If arbitration is pursued, First Merchants believes it has meritorious defenses to the claims brought by the plaintiff. This proceeding was reported in First Merchants' Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2013.

On July 30, 2013, a purported shareholder of CFS Bancorp, Inc. filed a putative class action lawsuit captioned Jay Orlando v. CFS Bancorp, Inc., et al., No. 2:13-CV-00261 in U.S. District Court in the Northern District of Indiana against CFS Bancorp, Inc., its board of directors and First Merchants. The complaint generally alleged various claims of federal securities law violations and that the directors of CFS Bancorp, Inc. breached their fiduciary duties by providing materially inadequate disclosures and material disclosure omissions with respect to the proposed merger of CFS Bancorp, Inc. into First Merchants. The plaintiff seeks (1) class certification, (2) to enjoin the merger or, in the event the merger is completed before entry of a final judgment, to rescind the merger or be awarded an unspecified amount of rescissory damages, (3) compensatory damages in an unspecified amount, and (4) costs and expenses, including attorneys' fees. At this early stage of the litigation, it is not possible to assess the probability of a material adverse outcome or reasonably estimate any potential financial impact of the lawsuit on First Merchants. The defendants believe the claims against them are without merit and intend to contest the matter vigorously. This proceeding was reported in First Merchants' Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2013. On October 15, 2013, the plaintiff dismissed First Merchants as a defendant in the action without prejudice.

## ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors previously disclosed in the Corporation's December 31, 2012, Annual Report on Form 10-K.

## ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

a. None

b. None

c. Issuer Purchases of Equity Securities

The following table presents information relating to our purchases of equity securities during three months ended September 30, 2013, as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as part of Publicly announced Plans or Programs	Maximum Number of Shares that may yet be Purchased Under the Plans or
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July, 2013		
August, 2013	182	\$18.15
September, 2013		

The shares were purchased in connection with the exercise of certain outstanding stock options or restricted stock.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

ITEM 5. OTHER INFORMATION

a. None

b. None

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PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

ITEM 6. EXHIBITS

Exhibit No: Description of Exhibits:

2.1	Agreement of Reorganization and Merger between First Merchants Corporation and CFS Bancorp, Inc. dated May 13, 2013 (Incorporated by reference to Registrant's Form 8-K filed May 13, 2013). Upon request, the Registrant agrees to furnish supplementally to the Commission a copy of the Disclosure Letters referenced in the Agreement of Reorganization and Merger.
3.1	First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2011)
3.2	Bylaws of First Merchants Corporation dated October 28, 2009 (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2009)
4.1	First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.2	Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.3	Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.4	Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.5	First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009)
10.1	Voting Agreement dated May 13, 2013 by and among First Merchants Corporation and certain shareholders of CFS Bancorp, Inc. (Incorporated by reference to Registrant's Form 8-K filed May 13, 2013).
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)
101.INS	XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkebase Document (2)

(1) Filed herewith.

(2) Furnished herewith.



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PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

SIGNATURES

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

First Merchants Corporation  
(Registrant)

Date: November 8, 2013

by /s/ Michael C. Rechin  
Michael C. Rechin  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: November 8, 2013

by /s/ Mark K. Hardwick  
Mark K. Hardwick  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)



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PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

INDEX TO EXHIBITS

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(2) Furnished herewith.