FIRST MERCHANTS CORP
Form 10-Q
May 10, 2013

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

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[x] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended March 31, 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 incorporation or organization) | (I.R.S. Employer 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 [X] 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 [X] No [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 [X] 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 [X]

As of April 30, 2013, there were 28,781,559 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

| | March 31, 2013 (Unaudited) | December 31, 2012 |
|---|---|---|
| ASSETS | | |
| Cash and cash equivalents | $51,592 | $101,460 |
| Interest-bearing time deposits | 60,407 | 38,443 |
| Investment securities available for sale | 532,867 | 513,343 |
| Investment securities held to maturity (fair value of $351,439 and $378,174) | 336,696 | 361,020 |
| Mortgage loans held for sale | 26,555 | 22,300 |
| Loans, net of allowance for loan losses of $68,537 and $69,366 | 2,811,005 | 2,832,843 |
| Premises and equipment | 53,762 | 52,749 |
| Federal Reserve and Federal Home Loan Bank stock | 32,777 | 32,785 |
| Interest receivable | 15,346 | 16,367 |
| Core deposit intangibles | 7,767 | 8,154 |
| Goodwill | 141,375 | 141,375 |
| Cash surrender value of life insurance | 126,098 | 125,397 |
| Other real estate owned | 13,130 | 13,263 |
| Tax asset, deferred and receivable | 27,597 | 30,867 |
| Other assets | 15,856 | 14,455 |
| TOTAL ASSETS | $4,252,830 | $4,304,821 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing | $763,965 | $801,597 |
| Interest-bearing | 2,546,843 | 2,544,786 |
| Total Deposits | 3,310,808 | 3,346,383 |
| Borrowings: | | |
| Federal funds purchased | | 18,862 |
| Securities sold under repurchase agreements | 161,813 | 141,828 |
| Federal Home Loan Bank advances | 93,169 | 94,238 |
| Subordinated debentures and term loans | 111,778 | 112,161 |
| Total Borrowings | 366,760 | 367,089 |
| Interest payable | 1,348 | 1,841 |
| Other liabilities | 35,356 | 37,272 |
| Total Liabilities | 3,714,272 | 3,752,585 |
| COMMITMENTS AND CONTINGENT LIABILITIES | | |
| STOCKHOLDERS' EQUITY | | |
| Preferred Stock, no-par value, $1,000 liquidation value: | | |
| Authorized - 500,000 shares | | |
| Senior Non-Cumulative Perpetual Preferred Stock, Series B | | |
| Issued and outstanding - 68,087 and 90,782.94 shares | 68,087 | 90,783 |
| Cumulative Preferred Stock, $1,000 par value, $1,000 liquidation value: | | |
| Authorized - 600 shares | | |
| Issued and outstanding - 125 shares | 125 | 125 |

| | | |
|---|---|---|
| Common Stock, $.125 stated value: | | |
| Authorized - 50,000,000 shares | | |
| Issued and outstanding - 28,780,609 and 28,692,616 shares | 3,598 | 3,587 |
| Additional paid-in capital | 256,966 | 256,843 |
| Retained earnings | 216,530 | 206,397 |
| Accumulated other comprehensive loss | (6,748) | (5,499) |
| Total Stockholders' Equity | 538,558 | 552,236 |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | $4,252,830 | $4,304,821 |

See notes to consolidated condensed financial statements.

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(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF INCOME

(Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| INTEREST INCOME | | |
| Loans receivable: | | |
| Taxable | $37,159 | $35,848 |
| Tax exempt | 117 | 117 |
| Investment securities: | | |
| Taxable | 3,618 | 4,574 |
| Tax exempt | 2,454 | 2,562 |
| Deposits with financial institutions | 19 | 25 |
| Federal Reserve and Federal Home Loan Bank stock | 371 | 343 |
| Total Interest Income | 43,738 | 43,469 |
| INTEREST EXPENSE | | |
| Deposits | 2,891 | 4,110 |
| Federal funds purchased | 11 | 12 |
| Securities sold under repurchase agreements | 194 | 295 |
| Federal Home Loan Bank advances | 459 | 994 |
| Subordinated debentures and term loans | 725 | 1,942 |
| Total Interest Expense | 4,280 | 7,353 |
| NET INTEREST INCOME | 39,458 | 36,116 |
| Provision for loan losses | 2,102 | 4,875 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 37,356 | 31,241 |
| OTHER INCOME | | |
| Service charges on deposit accounts | 2,729 | 2,819 |
| Fiduciary activities | 2,107 | 1,983 |
| Other customer fees | 2,780 | 2,586 |
| Commission income | 2,172 | 1,667 |
| Earnings on cash surrender value of life insurance | 700 | 1,378 |
| Net gains and fees on sales of loans | 2,378 | 1,952 |
| Net realized gains on sales of available for sale securities | 248 | 789 |
| Gain on FDIC modified whole bank transaction | | 9,124 |
| Other income | 763 | 360 |
| Total Other Income | 13,877 | 22,658 |
| OTHER EXPENSES | | |
| Salaries and employee benefits | 20,791 | 19,354 |
| Net occupancy | 2,602 | 2,651 |
| Equipment | 1,774 | 1,805 |
| Marketing | 467 | 442 |
| Outside data processing fees | 1,480 | 1,376 |
| Printing and office supplies | 331 | 267 |
| Core deposit amortization | 387 | 469 |
| FDIC assessments | 744 | 1,117 |

| | | |
|---|---|---|
| Other real estate owned and credit-related expenses | 1,866 | 2,186 |
| Other expenses | 4,258 | 4,361 |
| Total Other Expenses | 34,700 | 34,028 |
| INCOME BEFORE INCOME TAX | 16,533 | 19,871 |
| Income tax expense | 4,668 | 5,500 |
| NET INCOME | 11,865 | 14,371 |
| Preferred stock dividends and discount accretion | (857) | (1,135) |
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS | $11,008 | $13,236 |
| Per Share Data: | | |
| Basic Net Income Available to Common Stockholders | $0.38 | $0.46 |
| Diluted Net Income Available to Common Stockholders | $0.38 | $0.46 |
| Cash Dividends Paid | $0.03 | $0.01 |
| Average Diluted Shares Outstanding (in thousands) | 28,971 | 28,755 |

See notes to consolidated condensed financial statements.

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(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Net income | $11,865 | $14,371 |
| Other comprehensive income net of tax: | | |
| Unrealized holding loss on securities available for sale arising during the period, net of income tax of $1,139 and $11 | (2,115) | (20) |
| 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 $39 and $7 | 72 | (14) |
| Unrealized gain on cash flow hedges arising during the period, net of income tax of $104 and $163 | 193 | 303 |
| Amortization of items previously recorded in accumulated other comprehensive income, net of income tax of $345 and $282 | 640 | 521 |
| Reclassification adjustment for gains included in net income net of income tax expense of $21 and $276 | (39) | (513) |
| | (1,249) | 277 |
| Comprehensive income | $10,616 | $14,648 |

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
(Unaudited)

| | Preferred | | Common Stock | | Additional | | Accumulated Other | |
|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Paid in Capital | Retained Earnings | Comprehensive Loss | Total |
| Balances, December 31, 2012 | 90,908 | $90,908 | 28,692,616 | $3,587 | $256,843 | $206,397 | $ (5,499 ) | $552,236 |
| Comprehensive Income | | | | | | | | |
| Net Income | | | | | | 11,865 | | 11,865 |
| Other Comprehensive Income, net of tax | | | | | | | (1,249 ) | (1,249 ) |
| Cash Dividends on Common Stock ($.03 per Share) | | | | | | (875 ) | | (875 ) |
| Cash Dividends on Preferred Stock under Small Business Lending Fund | | | | | | (857 ) | | (857 ) |
| Preferred Stock redeemed under Small Business Lending Fund | (22,696) | (22,696 ) | | | | | | (22,696 ) |
| Share-based Compensation | | | 101,681 | 13 | 361 | | | 374 |
| Stock Issued Under Employee Benefit Plans | | | 11,997 | 1 | 154 | | | 155 |
| Stock Issued Under Dividend Reinvestment and Stock Purchase Plan | | | 4,052 | 1 | 62 | | | 63 |
| Stock options exercised | | | 2,250 | | 16 | | | 16 |
| Stock Redeemed | | | (31,987 ) | (4 ) | (470 ) | | | (474 ) |
| Balances, March 31, 2013 | 68,212 | $68,212 | 28,780,609 | $3,598 | $256,966 | $216,530 | $ (6,748 ) | $538,558 |

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

| | March 31, 2013 | 2012 |
|---|---|---|
| Cash Flow From Operating Activities: | | |
| Net income | $11,865 | $14,371 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 2,102 | 4,875 |
| Depreciation and amortization | 1,069 | 1,149 |
| Change in deferred taxes | 5,574 | 4,682 |
| Share-based compensation | 374 | 326 |
| Mortgage loans originated for sale | (92,411) | (91,199) |
| Proceeds from sales of mortgage loans | 88,156 | 86,925 |
| Gain on acquisition | | (9,124) |
| Gains on sales of securities available for sale | (248) | (789) |
| Change in interest receivable | 1,021 | 1,521 |
| Change in interest payable | (493) | (1,198) |
| Other adjustments | (5,168) | (1,023) |
| Net cash provided by operating activities | $11,841 | $10,516 |
| Cash Flows from Investing Activities: | | |
| Net change in interest-bearing deposits | $(21,964) | $18,561 |
| Purchases of: | | |
| Securities available for sale | (73,470) | (52,706) |
| Securities held to maturity | | (566) |
| Proceeds from sales of securities available for sale | 21,721 | 21,928 |
| Proceeds from maturities of: | | |
| Securities available for sale | 31,542 | 22,653 |
| Securities held to maturity | 23,628 | 14,949 |
| Change in Federal Reserve and Federal Home Loan Bank stock | 8 | 5 |
| Net change in loans | 16,561 | 6,390 |
| Net cash received from acquisition | | 29,113 |
| Proceeds from the sale of other real estate owned | 2,536 | 1,983 |
| Other adjustments | (2,082) | (719) |
| Net cash provided (used) by investing activities | $(1,520) | $61,591 |
| Cash Flows from Financing Activities: | | |
| Net change in : | | |
| Demand and savings deposits | $3,062 | $22,890 |
| Certificates of deposit and other time deposits | (38,637) | (3,876) |
| Borrowings | 19,985 | 10,936 |
| Repayment of borrowings | (19,931) | (112,878) |
| Cash dividends on common stock | (875) | (289) |
| Cash dividends on preferred stock | (857) | (1,135) |
| Stock issued under employee benefit plans | 155 | 119 |
| Stock issued under dividend reinvestment and stock purchase plans | 63 | 29 |

| | | |
|---|---|---|
| Stock options exercised | 16 | |
| Stock redeemed | (474) | (224) |
| Cumulative preferred stock redeemed (SBLF) | (22,696) | |
| Net cash used in financing activities | $(60,189) | $(84,428) |
| Net Change in Cash and Cash Equivalents | (49,868) | (12,321) |
| Cash and Cash Equivalents, January 1 | 101,460 | 73,312 |
| Cash and Cash Equivalents, March 31 | $51,592 | $60,991 |
| Additional cash flow information: | | |
| Interest paid | $4,773 | $8,184 |
| Income tax paid (refunded) | $104 | $1,000 |
| Loans transferred to other real estate owned | $3,175 | $2,425 |
| Non-cash investing activities using trade date accounting | $4,489 | $2,390 |
| Liabilities assumed, net of cash | | $166,112 |

See notes to consolidated condensed financial statements.

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ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(table dollar amounts in thousands, except share data)

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 three months ended March 31, 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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(table dollar amounts in thousands, except share data)

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 March 31, 2013 | | | | |
| U.S. Government-sponsored agency securities | $4,228 | $159 | | $4,387 |
| State and municipal | 151,379 | 8,615 | $122 | 159,872 |
| U.S. Government-sponsored mortgage-backed securities | 357,307 | 9,444 | 216 | 366,535 |

| | | | | |
|---|---|---|---|---|
| Corporate obligations | 6,173 | | 5,806 | 367 |
| Equity securities | 1,706 | | | 1,706 |
| Total available for sale | 520,793 | 18,218 | 6,144 | 532,867 |
| Held to maturity at March 31, 2013 | | | | |
| State and municipal | 112,390 | 4,120 | 1 | 116,509 |
| U.S. Government-sponsored mortgage-backed securities | 224,306 | 10,687 | 63 | 234,930 |
| Total held to maturity | 336,696 | 14,807 | 64 | 351,439 |
| Total Investment Securities | $857,489 | $33,025 | $6,208 | $884,306 |

| | 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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(table dollar amounts in thousands, except share data)

The amortized cost and fair value of available for sale securities and held to maturity securities at March 31, 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 March 31, 2013: | | | | |
| Due in one year or less | $2,811 | $2,866 | $1,755 | $1,759 |
| Due after one through five years | 15,341 | 16,043 | 4,929 | 5,295 |
| Due after five through ten years | 55,107 | 58,080 | 55,406 | 57,228 |
| Due after ten years | 88,521 | 87,637 | 50,300 | 52,227 |
| | $161,780 | $164,626 | $112,390 | $116,509 |
| U.S. Government-sponsored mortgage-backed securities | 357,307 | 366,535 | 224,306 | 234,930 |
| Equity securities | 1,706 | 1,706 | | |
| Total Investment Securities | $520,793 | $532,867 | $336,696 | $351,439 |

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was $330,238,000 at March 31, 2013, and $335,775,000 at December 31, 2012.

The book value of securities sold under agreements to repurchase amounted to $148,023,000 at March 31, 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 months ended March 31, 2013 and 2012 are shown below.

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Sales and Redemptions of Available for Sale Securities: | | |
| Gross gains | $248 | $789 |
| 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 March 31, 2013, and December 31, 2012:

| | 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 March 31, 2013 | | | | | | |
| State and municipal | $10,702 | $123 | | | $10,702 | $123 |
| U.S. Government-sponsored mortgage-backed securities | 27,183 | 279 | | | 27,183 | 279 |
| Corporate obligations | | | $336 | $5,806 | 336 | 5,806 |
| Total Temporarily Impaired Investment Securities | $37,885 | $402 | $336 | $5,806 | $38,221 | $6,208 |

| | 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.

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Investments reported at less than historical cost: | | |
| Historical cost | $44,428 | $22,999 |
| Fair value | $38,221 | $17,038 |
| Percent of the Corporation's available for sale and held to maturity portfolio | 4.4 % | 1.9 % |

The Corporation’s management has evaluated all securities with unrealized losses for other-than-temporary impairment ("OTTI") as of March 31, 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 $6.1 million and a fair value of $336,000, 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 the 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 March 31, 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 March 31, 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 March 31, 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, March 31 | $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 at March 31, 2013, and December 31, 2012, were $26,555,000 and $22,300,000, respectively.

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

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Loans: | | |
| Commercial and industrial loans | $637,952 | $622,579 |
| Agricultural production financing and other loans to farmers | 104,284 | 112,527 |
| Real estate loans: | | |
| Construction | 75,877 | 98,639 |
| Commercial and farmland | 1,280,611 | 1,266,682 |
| Residential | 467,629 | 473,537 |
| Home Equity | 201,767 | 203,406 |
| Individuals' loans for household and other personal expenditures | 73,314 | 75,748 |
| Lease financing receivables, net of unearned income | 2,013 | 2,590 |
| Other loans | 36,095 | 46,501 |
| Loans | 2,879,542 | 2,902,209 |
| Allowance for loan losses | (68,537) | (69,366) |
| Net Loans | $2,811,005 | $2,832,843 |

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. The allowance is increased by the provision for loan losses and decreased by charge offs less recoveries. 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 uncollectible. 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 in a given period may be greater than or less than 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 independent loan reviews. The 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 at March 31, 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. 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.

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 months ended March 31, 2013, and March 31, 2012:

| | Three Months Ended March 31, 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 | 358 | (755) | 73 | 2,406 | $20 | 2,102 |
| Recoveries on loans | 1,873 | 1,376 | 209 | 288 | | 3,746 |
| Loans charged off | (2,773) | (2,346) | (186) | (1,372) | | (6,677) |
| Balances, March 31, 2013 | $25,371 | $24,978 | $2,689 | $15,479 | $20 | $68,537 |

| | Three Months Ended March 31, 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 | 577 | 1,778 | 16 | 2,508 | (4) | 4,875 |
| Recoveries on loans | 148 | 228 | 208 | 313 | 1 | 898 |
| Loans charged off | (2,882) | (2,018) | (321) | (1,081) | | (6,302) |
| Balances, March 31, 2012 | $15,574 | $37,907 | $2,805 | $14,083 | $— | $70,369 |

The following tables show the Corporation’s allowance for credit losses and loan portfolio by loan segment at the periods indicated:

| | March 31, 2013 | | | | | |
|---|---|---|---|---|---|---|
| | Commercial | Commercial Real Estate | Consumer | Residential | Finance Leases | Total |
| Allowance Balances: | | | | | | |
| Individually evaluated for impairment | $838 | $2,373 | | $297 | | $3,508 |
| Collectively evaluated for impairment | 24,533 | 22,508 | $2,689 | 15,165 | $20 | 64,915 |
| Loans Acquired with Deteriorated Credit Quality | | $97 | | $17 | | 114 |
| Total Allowance for Loan Losses | $25,371 | $24,978 | $2,689 | $15,479 | $20 | $68,537 |
| Loan Balances: | | | | | | |
| Individually evaluated for impairment | $11,057 | $39,154 | | $7,776 | | $57,987 |
| Collectively evaluated for impairment | 766,238 | 1,307,663 | $73,314 | 660,897 | $2,013 | 2,810,125 |
| Loans Acquired with Deteriorated Credit Quality | 1,037 | 9,669 | | 724 | | 11,430 |
| Loans | $778,332 | $1,356,486 | $73,314 | $669,397 | $2,013 | $2,879,542 |

| | 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.

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

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Commercial and industrial | $9,462 | $12,195 |
| Agriculture Production financing and other loans to farmers | 86 | |
| Real Estate Loans: | | |
| Construction | 3,786 | 4,814 |
| Commercial and farmland | 19,303 | 22,612 |
| Residential | 11,856 | 11,476 |
| Home Equity | 2,268 | 1,997 |
| Lease financing receivables, net of unearned income | | 301 |
| Other Loans | | 4 |
| Total | $46,761 | $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.

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

| | March 31, 2013 | | |
|---|---|---|---|
| | Unpaid Principal Balance | Recorded Investment | Related Allowance |
| Impaired loans with no related allowance: | | | |
| Commercial and industrial | $20,987 | $7,628 | |
| Agriculture production financing and other loans to farmers | 86 | 86 | |
| Real Estate Loans: | | | |

| | | | |
|---|---|---|---|
| Construction | 6,008 | 3,928 | |
| Commercial and farmland | 52,030 | 37,803 | |
| Residential | 7,039 | 4,650 | |
| Home equity | 4,083 | 896 | |
| Other loans | 57 | 9 | |
| Total | $90,290 | $55,000 | |
| Impaired loans with related allowance: | | | |
| Commercial and industrial | $5,751 | $4,370 | $838 |
| Real Estate Loans: | | | |
| Construction | 1,025 | 911 | 85 |
| Commercial and farmland | 5,875 | 5,406 | 2,385 |
| Residential | 2,725 | 2,390 | 314 |
| Total | $15,376 | $13,077 | $3,622 |
| Total Impaired Loans | $105,666 | $68,077 | $3,622 |

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| | December 31, 2012 | | |
|---|---|---|---|
| | Unpaid Principal Balance | Recorded Investment | Related Allowance |
| Impaired loans with no related allowance: | | | |
| Commercial and industrial | $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: | | | |
| Commercial and industrial | $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 |

| | Three Months Ended March 31, 2013 | |
|---|---|---|
| | Average Recorded Investment | Interest Income Recognized |
| Impaired loans with no related allowance: | | |
| Commercial and industrial | $8,043 | $44 |
| Agriculture production financing and other loans to farmers | 86 | |
| Real Estate Loans: | | |
| Construction | 3,936 | 19 |
| Commercial and farmland | 39,228 | 382 |
| Residential | 4,737 | 22 |
| Home equity | 923 | 3 |
| Other loans | 10 | |
| Total | $56,963 | $470 |
| Impaired loans with related allowance: | | |
| Commercial and industrial | $5,124 | $3 |
| Real Estate Loans: | | |
| Construction | 915 | |
| Commercial and farmland | 5,428 | |
| Residential | 2,390 | |
| Total | $13,857 | $3 |
| Total Impaired Loans | $70,820 | $473 |

| | Three Months Ended March 31, 2012 | |
|---|---|---|
| | Average Recorded Investment | Interest Income Recognized |

| | | |
|---|---|---|
| Impaired loans with no related allowance: | | |
| Commercial and industrial | $13,785 | $37 |
| Real Estate Loans: | | |
| Construction | 8,994 | 14 |
| Commercial and farmland | 50,333 | 289 |
| Residential | 6,562 | 28 |
| Home equity | 305 | 3 |
| Other loans | 20 | |
| Total | $79,999 | $371 |
| Impaired loans with related allowance: | | |
| Commercial and industrial | $7,188 | $11 |
| Real Estate Loans: | | |
| Construction | 2,360 | |
| Commercial and farmland | 5,821 | 36 |
| Residential | 1,312 | |
| Home equity | 215 | |
| Total | $16,896 | $47 |
| Total Impaired Loans | $96,895 | $418 |

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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:
  - 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,
  - 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,
  - loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
  - unusual courses of action are needed to maintain a high probability of repayment,
  - the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
  - the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
  - loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
  - the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
  - 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 not 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 at 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.

| | March 31, 2013 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Commercial Pass | Commercial Special Mention | Commercial Substandard | Commercial Doubtful | Commercial Loss | Consumer Performing | Consumer Non-Performing | Total |
| Commercial and industrial | $588,140 | $ 17,592 | $ 30,027 | $ 2,193 | | | | $637,952 |
| Agriculture production financing and other loans to farmers | 103,894 | 217 | 173 | | | | | 104,284 |
| Real Estate Loans: | | | | | | | | |
| Construction | 64,904 | 1,372 | 9,091 | | | | 510 | 75,877 |
| Commercial and farmland | 1,157,933 | 48,235 | 73,845 | 350 | | | 248 | 1,280,611 |
| Residential | 145,949 | 3,480 | 14,579 | 144 | | 296,613 | 6,864 | 467,629 |
| Home equity | 10,334 | 638 | 1,240 | | | 187,877 | 1,678 | 201,767 |
| Individuals' loans for household and other personal expenditures | | | | | | 73,303 | 11 | 73,314 |
| Lease financing receivables, net of unearned income | 1,866 | | 147 | | | | | 2,013 |
| Other loans | 36,079 | 16 | | | | | | 36,095 |
| Loans | $2,109,099 | $ 71,550 | $ 129,102 | $ 2,687 | | $557,793 | $ 9,311 | $2,879,542 |

| | December 31, 2012 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Commercial Pass | Commercial Special Mention | Commercial Substandard | Commercial Doubtful | Commercial Loss | Consumer Performing | Consumer Non-Performing | Total |
| Commercial and industrial | $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 |
| 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 |
| | | | | | | 75,748 | | 75,748 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Individuals' loans for household and other personal expenditures | | | | | | | | |
| 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 at March 31, 2013, and December 31, 2012:

| | March 31, 2013 | | | | | | |
|---|---|---|---|---|---|---|---|
| | 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 | $625,645 | $2,058 | $596 | $191 | $ 9,462 | $ 12,307 | $637,952 |
| Agriculture production financing and other loans to farmers | 104,198 | | | | 86 | 86 | 104,284 |
| Real Estate Loans: | | | | | | | |
| Construction | 71,682 | 373 | 36 | | 3,786 | 4,195 | 75,877 |
| Commercial and farmland | 1,258,913 | 1,332 | 1,063 | | 19,303 | 21,698 | 1,280,611 |
| Residential | 448,486 | 5,460 | 1,194 | 633 | 11,856 | 19,143 | 467,629 |
| Home equity | 197,003 | 2,054 | 335 | 107 | 2,268 | 4,764 | 201,767 |
| Individuals' loans for household and other personal expenditures | 72,771 | 441 | 91 | 11 | | 543 | 73,314 |
| Lease financing receivables, net of unearned income | 1,886 | 110 | | 17 | | 127 | 2,013 |
| Other loans | 36,095 | | | | | | 36,095 |
| Loans | $2,816,679 | $11,828 | $3,315 | $959 | $ 46,761 | $ 62,863 | $2,879,542 |

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| | 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 | $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.

Due to challenging economic conditions, borrowers of all types have experienced declines in income and cash flow. As a result, borrowers are occasionally seeking to reduce contractual cash outlays including debt payments. Concurrently, in an effort to preserve and protect its earning assets, specifically troubled loans, the Corporation is working 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 March 31, 2013 | | |
|---|---|---|---|
| | Pre-Modification Recorded Balance | Post-Modification Recorded Balance | Number of Loans |
| Commercial and industrial | $96 | $ 96 | 3 |
| Real Estate Loans: | | | |

| | | | |
|---|---|---|---|
| Commercial and farmland | 511 | 431 | 2 |
| Residential | 37 | 38 | 1 |
| Total | $644 | $ 565 | 6 |

| | Three Months Ended March 31, 2012 | | |
|---|---|---|---|
| | Pre-Modification Recorded Balance | Post-Modification Recorded Balance | Number of Loans |
| Commercial and industrial | $238 | $ 238 | 2 |
| Real Estate Loans: | | | |
| Commercial and farmland | 1,774 | 1,635 | 2 |
| Residential | 224 | 224 | 4 |
| Total | $2,236 | $ 2,097 | 8 |

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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 March 31, 2013 | | | |
|---|---|---|---|---|
| | Term Modification | Rate Modification | Combination | Total Modification |
| Commercial and industrial | $31 | | $69 | $100 |
| Real Estate Loans: | | | | |
| Commercial and farmland | | | 415 | 415 |
| Residential | | | 37 | 37 |
| Total | $31 | | $521 | $552 |

| | Three Months Ended March 31, 2012 | | | |
|---|---|---|---|---|
| | Term Modification | Rate Modification | Combination | Total Modification |
| Commercial and industrial | $238 | $22 | | $238 |
| Real Estate Loans: | | | | |
| Commercial and farmland | 1,635 | | | 1,635 |
| Residential | 199 | | $25 | 224 |
| Total | $2,072 | $22 | $25 | $2,097 |

Commercial and Industrial Loans account for 50 percent of the troubled debt restructured loans made in the three months ended March 31, 2013. Five troubled debt restructured loans made during the three months ended March 31, 2013 are in non accrual status.

The following tables summarize troubled debt restructures that occurred during the twelve months ended March 31, 2013, and March 31, 2012, that subsequently defaulted during the period indicated:

| | Three Months Ended March 31, 2013 | |
|---|---|---|
| | Number of Loans | Recorded Balance |
| Commercial and Industrial | 1 | $5 |
| Real Estate Loans: | | |
| Commercial and farmland | 1 | 230 |
| Residential | 1 | 47 |
| Total | 3 | $282 |

| | Three Months Ended March 31, 2012 | |
|---|---|---|
| | Number of Loans | Recorded Balance |

| | | |
|---|---|---|
| Real Estate Loans: | | |
| Commercial and farmland | 1 | $717 |
| Residential | 3 | 217 |
| Total | 4 | $934 |

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.

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NOTE 5

ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE

The Bank acquired loans in a purchase during the year ended December 31, 2012. At acquisition, the purchased loans evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected.

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 nonaccrual 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.

The following table includes the carrying amount of these loans, which are included in the balance sheet amounts of loans receivable at March 31, 2013 and December 31, 2012.

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Commercial and industrial loans | $6,337 | $8,542 |
| Agricultural production financing and other loans to farmers | 245 | 1,127 |
| Real estate loans: | | |
| Construction | 28 | 58 |
| Commercial and farmland | 22,534 | 24,259 |
| Residential | 11,269 | 12,118 |
| Home Equity | 18,016 | 18,805 |
| Individuals' loans for household and other personal expenditures | 570 | 691 |
| Total | $58,999 | $65,600 |

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

| | Three Months Ended March 31, 2013 |
|---|---|
| Beginning balance, Dec 31, 2012 | $5,142 |
| Accretions | (771) |
| Ending balance, March 31, 2013 | $4,371 |

Three Months
Ended

| | March 31, 2012 |
|---|---|
| Beginning balance, February 10, 2012 | $9,774 |
| Accretions | |
| Ending balance, March 31, 2012 | $9,774 |

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 March 31, 2013 and 2012, the Corporation had two interest rate swaps with a notional amount of $26.0 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, such derivatives 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. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the three months ended March 31, 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 $767,000 from accumulated other comprehensive income to interest expense.

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 March 31, 2013, the notional amount of customer-facing swaps was approximately $159,817,000. 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 March 31, 2013, and December 31, 2012.

| | Asset Derivatives | | | | Liability Derivatives | | | |
|---|---|---|---|---|---|---|---|---|
| | March 31, 2013 | | December 31, 2012 | | March 31, 2013 | | December 31, 2012 | |
| | Balance Sheet | Fair Value | Balance Sheet | Fair Value | Balance Sheet | Fair Value | Balance Sheet | Fair Value |

| | Location | | Location | | Location | | Location | |
|---|---|---|---|---|---|---|---|---|
| Derivatives designated as hedging instruments: | | | | | | | | |
| Interest rate contracts | Other Assets | $233 | Other Assets | $197 | Other Liabilities | $2,888 | Other Liabilities | $3,332 |
| Derivatives not designated as hedging instruments: | | | | | | | | |
| Interest rate contracts | Other Assets | $5,155 | Other Assets | $6,103 | Other Liabilities | $5,419 | 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 the three months ended March 31, 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 March 31, 2013 | Three Months Ended March 31, 2012 |
| Interest rate contracts | Other income | $66 | $3 |

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain Recognized in Other Comprehensive Income on Derivative (Effective Portion) | | Location of Loss Reclassified from Accumulated Other Comprehensive Income (Effective Portion) | Amount of Loss Reclassified from Other Comprehensive Income into Income (Effective Portion) | |
|---|---|---|---|---|---|
| | Three Months ended | | | Three Months ended | |
| | March 31, 2013 | March 31, 2012 | | March 31, 2013 | March 31, 2012 |
| Interest Rate Products | $297 | $467 | Interest Expense | $188 | |

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 March 31, 2013, the termination value of derivatives in a net liability position related to these agreements was $8,510,000. As of March 31, 2013, the Corporation had minimum collateral posting thresholds with certain of its derivative counterparties and had posted collateral of $7,638,000. If the Corporation had breached any of these provisions at March 31, 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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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 March 31, 2013, and December 31, 2012.

| | | Fair Value Measurements Using: | | |
|---|---|---|---|---|
| March 31, 2013 | Fair Value | 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 | $4,387 | | $4,387 | |
| State and municipal | 159,872 | | 142,565 | $17,307 |
| U.S. Government-sponsored mortgage-backed securities | 366,535 | | 366,535 | |
| Corporate obligations | 367 | | | 367 |
| Equity securities | 1,706 | | 1,702 | 4 |
| Interest rate swap asset | 5,155 | | 5,155 | |
| Interest rate cap | 233 | | 233 | |
| Interest rate swap liability | 8,307 | | 8,307 | |

| | | Fair Value Measurements Using: | | |
|---|---|---|---|---|
| December 31, 2012 | Fair Value | 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 during the three months ended March 31, 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 March 31, 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 March 31, 2013 quarterly evaluation process, the conclusion was no OTTI for the three months ending March 31, 2013.

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 the three months ended March 31, 2013, and 2012.

| | Three Months Ended March 31, 2013 | | | |
|---|---|---|---|---|
| | Available for Sale Securities | Interest Rate Swap Asset | Interest Rate Cap | Interest Rate Swap Liability |
| Balance at beginning of the period | $18,328 | | | |
| Total realized and unrealized gains and losses: | | | | |
| Included in net income (loss) | | | | |
| Included in other comprehensive income | (176) | | | |
| Purchases, issuances and settlements | | | | |
| Transfers in/(out) of Level 3 | | | | |
| Principal payments/additions | (474) | | | |

| | | | | |
|---|---|---|---|---|
| Ending balance at March 31, 2013 | $17,678 | | | |

| | Three Months Ended March 31, 2012 | | | |
|---|---|---|---|---|
| | Available for Sale Securities | Interest Rate Swap Asset | Interest Rate Cap | Interest Rate Swap Liability |
| Balance at beginning of the period | $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 | (523) | 481 | (15) | |
| Purchases, issuances and settlements | | | | |
| Transfers in/(out) of Level 3 | | (4,862) | (409) | 6,934 |
| Principal payments | (437) | | | |
| Ending balance at March 31, 2012 | $19,878 | | | |

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 March 31, 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 Months Ended March 31, 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 March 31, 2013, and December 31, 2012.

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| March 31, 2013 | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Impaired loans (collateral dependent) | $11,096 | | | $11,096 |
| Other real estate owned | $4,411 | | | $4,411 |

| | | Fair Value Measurements Using | | |
|---|---|---|---|---|
| December 31, 2012 | Fair Value | Quoted Prices in Active Markets for | Significant Other Observable | Significant Unobservable |

| | | Identical Assets (Level 1) | Inputs (Level 2) | Inputs (Level 3) |
|---|---|---|---|---|
| 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.

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.

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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 March 31, 2013.

| | Fair Value | Valuation Technique | Unobservable Inputs | Range |
|---|---|---|---|---|
| State and municipal securities | $17,307 | Discounted cash flow | Maturity/Call date | 1 month to 11 yrs |
| | | | Blend of US Muni BQ curve | A- to BBB- |
| | | | Discount rate | 1% - 4% |
| Corporate obligations/Equity securities | $371 | Discounted cash flow | Risk free rate | 3 month LIBOR |
| | | | plus Premium for illiquidity | plus 200bps |
| Impaired loans (collateral dependent) | $11,096 | Collateral based | Discount to reflect current market | 0% - 50% |
| | | measurements | conditions and ultimate collectability | |
| Other real estate owned | $4,411 | 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.
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 March 31, 2013, and December 31, 2012.

| | | March 31, 2013 (unaudited) | | |
|---|---|---|---|---|
| | Carrying Amount | 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 | $51,592 | $51,592 | | |
| Interest-bearing time deposits | 60,407 | 60,407 | | |
| Investment securities available for sale | 532,867 | | $515,189 | $17,678 |
| Investment securities held to maturity | 336,696 | | 344,948 | 6,491 |
| Mortgage loans held for sale | 26,555 | | 26,555 | |
| Loans | 2,811,005 | | | 2,824,164 |
| Federal Reserve Bank and Federal Home Loan Bank stock | 32,777 | | 32,777 | |
| Interest rate swap asset | 5,388 | | 5,388 | |
| Interest receivable | 15,346 | | 15,346 | |
| Liabilities: | | | | |
| Deposits | $3,310,808 | $2,481,769 | $825,841 | |
| Borrowings: | | | | |
| Federal funds purchased | | | | |
| Securities sold under repurchase agreements | 161,813 | | 162,234 | |
| Federal Home Loan Bank advances | 93,169 | | 96,211 | |
| Subordinated debentures and term loans | 111,778 | | 62,596 | |
| Interest rate swap liability | 8,307 | | 8,307 | |
| Interest payable | 1,348 | | 1,348 | |

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| | Carrying Amount | December 31, 2012<br>Quoted Prices in Active Markets for Identical Assets<br>(Level 1) | Significant Other Observable Inputs<br>(Level 2) | Significant Unobservable Inputs<br>(Level 3) |
|---|---|---|---|---|
| Assets: | | | | |
| Cash and due from banks | $101,460 | $101,460 | | |
| Interest-bearing time deposits | 38,443 | 38,443 | | |
| 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 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 | |

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.

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.

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NOTE 8

ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the activity in accumulated other comprehensive income (loss), net of tax, for the three months ended March 31, 2013 and 2012:

| | Accumulated Other Comprehensive Income | | | | |
|---|---|---|---|---|---|
| | 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 | Total |
| Balance at December 31, 2012 | $17,904 | $ (3,272) | $(2,652) | $(17,479) | $(5,499) |
| Other comprehensive income before reclassifications | (2,115) | 72 | 193 | | (1,850) |
| Amounts reclassified from accumulated other comprehensive income | (161) | | 122 | 640 | 601 |
| Period change | (2,276) | 72 | 315 | 640 | (1,249) |
| Balance at March 31, 2013 | $15,628 | $ (3,200) | $(2,337) | $(16,839) | $(6,748) |
| | | | | | |
| Balance at December 31, 2011 | $18,244 | $ (3,168) | $(1,841) | $(16,837) | $(3,602) |
| Other comprehensive income before reclassifications | (20) | (14) | 304 | | 270 |
| Amounts reclassified from accumulated other comprehensive income | (513) | | | 520 | 7 |
| Period change | (533) | (14) | 304 | 520 | 277 |
| Balance at March 31, 2012 | $17,711 | $ (3,182) | $(1,537) | $(16,317) | $(3,325) |

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 months ended March 31, 2013 and 2012:

| Details about Accumulated Other Comprehensive Income Components | Amount Reclassified from Accumulated Other Comprehensive Income For the Three Months Ended March 31, 2013 | 2012 | Affected Line Item in the Statements of Income |
|---|---|---|---|

| | | | |
|---|---|---|---|
| Unrealized gains (losses) on available for sale securities [1] | | | |
| Realized securities gains reclassified into income | $248 | $789 | Other income - net realized gains on sales of available for sale securities |
| Related income tax expense | (87 ) | (276 ) | Income tax expense |
| | $161 | $513 | |
| | | | |
| Unrealized gains (losses) on cash flow hedges [2] | | | |
| Interest rate contracts | $(188 ) | | Interest expense - subordinated debentures and term loans |
| Related income tax benefit | 66 | | Income tax expense |
| | $(122 ) | | |
| | | | |
| Unrealized gains (losses) on defined benefit plans | | | |
| Amortization of net loss and prior service costs | $(985 ) | $(802 ) | Other expenses - salaries and employee benefits |
| Related income tax benefit | 345 | 282 | Income tax expense |
| | $(640 ) | $(520 ) | |
| | | | |
| Total reclassifications for the period, net of tax | $(601 ) | $(7 ) | |

[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 10-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 March 31, 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 months ended March 31, 2013 and 2012 were $374,000 and $326,000 respectively. 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 years 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 three months ended March 31, 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 March 31, 2013 | 2012 |
|---|---|---|
| Stock and ESPP Options | | |
| Pre-tax compensation expense | $38 | $46 |
| Income tax benefit | (2) | |
| Stock and ESPP option expense, net of income taxes | $36 | $46 |
| Restricted Stock Awards | | |
| Pre-tax compensation expense | $336 | $280 |
| Income tax benefit | (117) | (106) |
| Restricted stock awards expense, net of income taxes | $219 | $174 |
| Total Share-Based Compensation: | | |
| Pre-tax compensation expense | $374 | $326 |
| Income tax benefit | (119) | (106) |
| Total share-based compensation expense, net of income taxes | $255 | $220 |

As of March 31, 2013, unrecognized compensation expense related to stock options and RSAs totaling $94,000 and $3,071,000, respectively, is expected to be recognized over weighted-average periods of 1.14 and 1.86 years, respectively.

Stock option activity under the Corporation's stock option plans as of March 31, 2013 and changes during the three months ended March 31, 2013, were as follows:

| | Number of Shares | Weighted-Average Exercise Price | Weighted Average Remaining Contractual Term (in Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2013 | 906,636 | $ 21.58 | | |
| Granted | 9,000 | $ 15.32 | | |
| Exercised | (2,250) | $ 6.99 | | |
| Canceled | (8,471) | $ 24.69 | | |
| Outstanding March 31, 2013 | 904,915 | $ 21.60 | 3.87 | 1,140,887 |
| Vested and Expected to Vest at March 31, 2013 | 904,915 | $ 21.60 | 3.87 | 1,140,887 |
| Exercisable at March 31, 2013 | 867,615 | $ 22.00 | 3.64 | 1,023,790 |

The weighted-average grant date fair value was $5.32 and $3.86 for stock options granted during the three months ended March 31, 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 three 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 March 31, 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 first three months of 2013 was $18,000. Cash receipts of stock options exercised during this same period were $16,000. There were no stock options exercised during the first three months of 2013.

The following table summarizes information on unvested RSAs outstanding as of March 31, 2013:

| | Number of Shares | | Weighted-Average Grant Date Fair Value |
|---|---|---|---|
| Unvested RSAs at January 1, 2013 | 401,375 | | $9.29 |
| Granted | 109,118 | | $14.74 |
| Vested | (100,123 | ) | $5.95 |
| Forfeited | (200 | ) | $11.38 |
| Unvested RSAs at March 31, 2013 | 410,170 | | $11.55 |

The grant date fair value of ESPP options was estimated at the beginning of the January 1, 2013 quarterly offering period of approximately $17,000. The ESPP options vested during the three months ending March 31, 2013, leaving no unrecognized compensation expense related to unvested ESPP options at March 31, 2013.

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NOTE 10

Income Tax

| | Three Months Ended March 31, | |
|---|---|---|
| | 2013 | 2012 |
| Income Tax Expense : | | |
| Currently Payable: | | |
| Federal | $(906) | $818 |
| State | | |
| Deferred: | | |
| Federal | 5,574 | 4,682 |
| State | | |
| Total Income Tax Expense | $4,668 | $5,500 |
| Reconciliation of Federal Statutory to Actual Tax Expense: | | |
| Federal statutory income tax at 35% | $5,787 | $6,955 |
| Tax-exempt interest income | (897) | (931) |
| Stock compensation | 11 | 16 |
| Earnings on life insurance | (245) | (483) |
| Tax credits | (18) | (18) |
| Other | 30 | (39) |
| Actual Tax Expense | $4,668 | $5,500 |

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.

The following table reconciles basic and diluted net income per share for the three months ended March 31, 2013 and 2012.

| Three Months Ended March 31, | |
|---|---|
| 2013 | 2012 |

| | Net Income | Weighted-Average Shares | Per Share Amount | Net Income | Weighted-Average Shares | Per Share Amount |
|---|---|---|---|---|---|---|
| Basic net income per share: | $11,865 | | | $14,371 | | |
| Less: Preferred Stock dividends and discount accretion | (857 ) | | | (1,135 ) | | |
| Net income available to common stockholders | 11,008 | 28,716,987 | $0.38 | 13,236 | 28,582,616 | $0.46 |
| Effect of dilutive stock options and warrants | | 254,251 | | | 172,097 | |
| Diluted net income per share: | | | | | | |
| Net income available to common stockholders | $11,008 | 28,971,238 | $0.38 | $13,236 | 28,754,713 | $0.46 |

Stock options to purchase 698,718 and 967,987 shares for the three months ended March 31, 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 disclosures required by the amendments were applied retrospectively for all comparative periods presented. 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).

## NOTE 13

## 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 seeks damages and other relief, including restitution and injunctive relief. First Merchants believes it has meritorious defenses to the claims brought by the plaintiff. At this phase of the litigation, it is not possible for management of First Merchants to determine the probability of a material adverse outcome or reasonably estimate the amount of any loss. No class has yet been certified and discovery is still ongoing.

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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 expressio 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 three months ended March 31, 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-six 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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RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported net income available to common stockholders of $11.0 million, or $0.38 per fully diluted common share for the quarter ended March 31, 2013. Net income available to common stockholders for the quarter ended March 31, 2012 was $13.2 million, or $0.46 per fully diluted common share. 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 March 31, 2013, total assets equaled $4.3 billion, a decrease of $52.0 million from December 31, 2012. Total loans of $2.9 billion decreased slightly from December 31, 2012 by $18.4 million. Additional details of the changes in the Corporation's loans and other earning assets are discussed within 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 $68.5 million as of March 31, 2013. The allowance provides 146.6 percent coverage of all non-accrual loans and 2.36 percent of total loans. Provision expense totaled $2.1 million for first quarter of 2013, compared to $4.9 million in the first quarter of 2012. Net charge-offs totaled $2.9 million for the first quarter of 2013, down from $5.4 million for the first quarter of 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.

Taxes, both current and deferred, decreased in the first quarter of 2013 by $3.3 million, mainly due to the receipt of a $3.6 million tax refund associated with amendment of prior year tax returns.

Total Deposits of $3.3 billion decreased slightly from December 31, 2012 by $35.6 million, or 1.1%. Non-maturity deposits remained steady at $2.5 billion, while maturity deposits declined slightly as the Bank focuses on low cost deposits and pricing discipline.

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 $39.5 million for the quarter, as net interest margin remained strong during the quarter totaling 4.25 percent as yields on earning assets totaled 4.70 percent and the cost of supporting liabilities totaled .45 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 increased 29 basis points from 3.96 percent in the first quarter of 2012 to 4.25 percent in the first quarter of 2013, while earning assets increased by $54.3 million.

The increased net interest income during the three months ended March 31, 2013 compared with the same period in 2012 was driven by three primary factors. The first factor is a result of the February 10, 2012 assumption of substantially all the deposits, certain other liabilities and acquisition of certain assets of SCB Bank. Due to this transaction, the Bank had a higher level of earning assets and interest income resulting from the assumption of SCB loans and related fair value accretion recognized in interest income. Additional details can be found in NOTE 2. PURCHASE AND ASSUMPTION, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q. The second factor contributing to the improvement in the net interest margin, expressed as a percentage of earning assets, was a $2.5 million interest income recovery on a previously charged-off loan. Lastly, the improvement in net interest income was also a result of the Corporation's ability to lower its cost of funds and in particular its cost of deposits, due to the growth of the Corporation's non-interest bearing demand deposits and interest-bearing non-maturity deposits.

During the three months ended March 31, 2013, asset yields decreased 4 basis points FTE and interest costs decreased 33 basis points, resulting in a 29 basis point FTE increase in net interest income as compared to the same period in 2012. 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 months ended March 31, 2013, and 2012.

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | 2013 | | 2012 | |
| Annualized net interest income | $157,830 | | $144,465 | |
| Annualized FTE adjustment | $5,537 | | $5,771 | |
| Annualized net interest income on a fully taxable equivalent basis | $163,367 | | $150,236 | |
| Average earning assets | $3,843,741 | | $3,789,437 | |
| Interest income (FTE) as a percent of average earning assets | 4.70 | % | 4.74 | % |
| Interest expense as a percent of average earning assets | 0.45 | % | 0.78 | % |
| Net interest income (FTE) as a percent of average earning assets | 4.25 | % | 3.96 | % |

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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 $8.8 million or 38.8 percent in the first quarter of 2013, compared to the first quarter of 2012. During the first quarter of 2012, a gross purchase gain of $9.1 million was 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 of this Form 10-Q for additional discussion of this transaction.

Additionally, earnings on cash surrender value of life insurance decreased by $678,000 compared to the first quarter of 2012. This decrease was primarily driven by a death benefit of $576,000 received from Bank Owned Life Insurance during the first quarter of 2012. Finally, $541,000 less gains on the sale of investment securities was realized in the first quarter of 2013 than in the first quarter of 2012.

Offsetting these declines were increased insurance commissions and gains on the sale of mortgage loans of $505,000 and $426,000, respectively, from the same period of 2012.

NON-INTEREST EXPENSE

Non-interest expenses increased $672,000 or 2.0 percent in the first quarter of 2013, compared to the first quarter of 2012. Salaries and employee benefits increased $1.4 million or 7.4 percent over the same quarter last year. Base salaries were up $237,000 or 1.9 percent, while commissions and incentives increased $605,000 over the same quarter last year. Retirement plan and employee insurance expenses increased $179,000 and $165,000, respectively, when compared to the first quarter of 2012.

The increases mentioned above were partially offset by declines in FDIC assessment expense of $373,000 and other real estate owned and credit related expenses of $320,000, from the first quarter of 2012 to the first quarter of 2013.

INCOME TAX EXPENSE

The income tax expense for the three months ended March 31, 2013, was $4,668,000 on pre-tax net income of $16,533,000. For the same period in 2012, the income tax expense was $5,500,000 on pre-tax net income of $19,871,000. 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.

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 7.88 percent at March 31, 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 March 31, 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 a 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.

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As of March 31, 2013, the Corporation, on a consolidated basis, as well as the Bank, exceeded the minimum capital levels of the well capitalized category.

| | March 31, 2013 | | | December 31, 2012 | | |
|---|---|---|---|---|---|---|
| (Dollars in Thousands) | Amount | Ratio | | Amount | Ratio | |
| Consolidated | | | | | | |
| Total risk-based capital (to risk-weighted assets) | $511,597 | 15.91 | % | $526,792 | 16.34 | % |
| Tier 1 capital (to risk-weighted assets) | 451,059 | 14.03 | % | 456,132 | 14.15 | % |
| Tier 1 capital (to average assets) | 451,059 | 11.00 | % | 456,132 | 11.03 | % |
| First Merchants Bank | | | | | | |
| Total risk-based capital (to risk-weighted assets) | $521,316 | 16.22 | % | $515,337 | 16.01 | % |
| Tier 1 capital (to risk-weighted assets) | 480,825 | 14.96 | % | 474,782 | 14.75 | % |
| Tier 1 capital (to average assets) | 480,825 | 11.75 | % | 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 the redemption, the Treasury holds 68,087 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately $68 million.

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 months ended March 31, 2013 and 2012.

| | Three Months Ended March 31, | | | |
|---|---|---|---|---|
| (Dollars in Thousands, Except Per Share Amounts) | 2013 | | 2012 | |
| Average goodwill | $141,374 | | $141,357 | |
| Average core deposit intangible (CDI) | 7,966 | | 8,871 | |
| Average deferred tax on CDI | (2,242 | ) | (2,200 | ) |
| Intangible adjustment | $147,098 | | $148,028 | |
| Average stockholders' equity (GAAP capital) | $533,797 | | $517,774 | |
| Average cumulative preferred stock | (125 | ) | (125 | ) |
| Average non-cumulative preferred stock issued under the Small Business Lending Fund Program | (68,591 | ) | (90,782 | ) |
| Intangible adjustment | (147,098 | ) | (148,028 | ) |
| Average tangible capital | $317,983 | | $278,839 | |
| Average assets | $4,248,955 | | $4,202,955 | |
| Intangible adjustment | (147,098 | ) | (148,028 | ) |

| | | |
|---|---|---|
| Average tangible assets | $4,101,857 | $4,054,927 |
| Net income available to common stockholders | $11,008 | $13,236 |
| CDI amortization, net of tax | 207 | 266 |
| Tangible net income available to common stockholders | $11,215 | $13,502 |
| Per Share Data: | | |
| Diluted net income available to common stockholders | $0.38 | $0.46 |
| Diluted tangible net income available to common stockholders | $0.39 | $0.47 |
| Ratios: | | |
| Return on average GAAP capital (ROE) | 8.25 % | 10.23 % |
| Return on average tangible capital | 14.11 % | 19.37 % |
| Return on average assets (ROA) | 1.04 % | 1.26 % |
| Return on average tangible assets | 1.09 % | 1.33 % |

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.

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 $6,638,000 during the three months ended March 31, 2013, from $53,399,000 at December 31, 2012 to the March 31, 2013, balance of $46,761,000. In addition, other real estate owned declined $133,000 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 were $959,000 at March 31, 2013, down from $2,037,000 at December 31, 2012.

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 March 31, 2013, commercial impaired loans totaled $68,077,000, a decrease of $11,102,000 from the December 31, 2012, balance of $79,179,000, and down from the September 30, 2012 balance of $79,965,000. At March 31, 2013, an allowance for losses was not deemed necessary for commercial impaired loans totaling $55,000,000 as there was no identified loss on these credits. An allowance of $3,622,000 was recorded for the remaining balance of these impaired loans totaling $13,077,000 and is included in the corporation’s allowance for loan losses.

| (Dollars in Thousands) | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Non-Performing Assets: | | |
| Non-accrual loans | $46,761 | $53,399 |
| Renegotiated loans | 5,445 | 12,681 |
| Non-performing loans (NPL) | 52,206 | 66,080 |
| Other real estate owned | 13,130 | 13,263 |
| Non-performing assets (NPA) | 65,336 | 79,343 |

| | | |
|---|---|---|
| 90+ days delinquent and still accruing | 959 | 2,037 |
| Non-performing assets plus 90+ days delinquent | 66,295 | 81,380 |
| Impaired Loans | $68,077 | $79,179 |

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

| (Dollars in Thousands) | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Non-Performing Assets and 90+ Days Delinquent: | | |
| Commercial and industrial loans | $9,713 | $13,690 |
| Agricultural production financing and other loans to farmers | 86 | |
| Real estate loans: | | |
| Construction | 10,738 | 12,378 |
| Commercial and farmland | 29,752 | 34,999 |
| Residential | 13,446 | 16,620 |
| Home Equity | 2,452 | 3,198 |
| Individuals' loans for household and other personal expenditures | 91 | 190 |
| Lease financing receivables, net of unearned income | 17 | 301 |
| Other loans | | 4 |
| Non-performing assets plus 90+ days delinquent | $66,295 | $81,380 |

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At March 31, 2013, the allowance for loan losses was $68,537,000, a decrease of $829,000 from December 31, 2012. As a percent of loans, the allowance was 2.36 percent at March 31, 2013, 2.37 percent at December 31, 2012, 2.43 percent at September 30, 2012 and 2.49 percent at June 30, 2012. The provision for loan losses for the three months ended March 31, 2013 was $2,102,000, a decrease of $2,773,000 from $4,875,000 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 $621,000 from $4,243,000 at December 31, 2012, to $3,622,000 at March 31, 2013.

Net charge offs for the three months ended March 31, 2013, were $2,931,000, a decrease of $2,473,000 from the same period in 2012. Of this amount, two charge offs, totaling 70.9 percent of net charge offs, was greater than $500,000. The distribution of the net charge offs for the three months ended March 31, 2013 and March 31, 2012 is reflected in the following table:

| | Three Months Ended March 31, | |
|---|---|---|
| (Dollars in Thousands) | 2013 | 2012 |
| Net Charge Offs (Recoveries): | | |
| Commercial and industrial loans | $930 | $2,206 |
| Agricultural production financing and other loans to farmers | (18) | (14) |
| Real estate loans: | | |
| Construction | (258) | 143 |
| Commercial and farmland | 1,228 | 1,647 |
| Residential | 746 | 768 |
| Home Equity | 338 | |
| Individuals' loans for household and other personal expenditures | (23) | 113 |
| Lease financing receivables, net of unearned income | | (1) |
| Other Loans | (12) | 542 |
| Total Net Charge Offs | $2,931 | $5,404 |

The declines in the value of commercial and residential real estate in our market over the last several years has had a negative impact on the underlying collateral value in our commercial, residential, land development and construction loans. 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 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 March 31, 2013, total borrowings from the FHLB were $93,169,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at March 31, 2013, was $206,263,000.

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 $532,867,000 at March 31, 2013, an increase of $19,524,000, or 3.8 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 $1,755,000 at March 31, 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.

The Corporation currently has a $55.0 million credit facility with Bank of America, N.A., comprised of (a) a term loan in the principal amount of $5.0 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.

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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 March 31, 2013, the Corporation was in compliance with these financial covenants.

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 March 31, 2013, are as follows:

| (Dollars in Thousands) | March 31, 2013 |
|---|---|
| Amounts of commitments: | |
| Loan commitments to extend credit | $898,083 |
| Standby and commercial letters of credit | 18,339 |
| | $916,422 |

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 March 31, 2013, are as follows:

| (Dollars in Thousands) | Remaining 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 and after | Total |
|---|---|---|---|---|---|---|---|---|
| Operating leases | $1,726 | $2,257 | $2,086 | $1,666 | $1,023 | $324 | $1,041 | $10,123 |
| Securities sold under repurchase agreements | 151,813 | 10,000 | | | | | | 161,813 |
| Federal Home Loan Bank advances | 559 | 26,506 | 30,979 | 28,933 | 2,729 | 3,360 | 103 | 93,169 |
| Subordinated debentures and term loans | 76 | | 55,000 | | | | 56,702 | 111,778 |
| Total | $154,174 | $38,763 | $88,065 | $30,599 | $3,752 | $3,684 | $57,846 | $376,883 |

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.

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.

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The comparative rising 200 basis points and falling 100 basis points scenarios below, as of March 31, 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:

| | March 31, 2013 | |
|---|---|---|
| | RISING | FALLING |
| Driver Rates | (200 Basis Points) | (100 Basis Points) |
| Prime | 200 | — |
| Federal funds | 200 | — |
| One-year CMT | 200 | (6) |
| Three-year CMT | 200 | (3) |
| Five-year CMT | 200 | (15) |
| CD's | 200 | (24) |
| FHLB advances | 200 | (8) |

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 March 31, 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.

| | | March 31, 2013 | |
|---|---|---|---|
| | | RISING | FALLING |
| (Dollars in Thousands) | Base | (200 Basis Points) | (100 Basis Points) |
| Net interest income | $144,546 | $152,514 | $142,738 |
| Variance from base | | $7,968 | $(1,808) |
| Percent of change from base | | 5.51 % | (1.25)% |

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 |
| 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.

| | | December 31, 2012 | |
|---|---|---|---|
| | | RISING | FALLING |
| (Dollars in Thousands) | Base | (200 Basis Points) | (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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EARNING ASSETS

The following table presents the earning asset mix as of March 31, 2013, and December 31, 2012. Earning assets decreased by $1,256,000 in the three months ended March 31, 2013. Interest-bearing time deposits increased $21,964,000, while investments decreased by approximately $4,800,000. Loans and loans held for sale decreased by $18,412,000. The three loan classes that experienced the largest decreases from December 31, 2012 were construction, other loans and agricultural production financing and other loans to farmers.

| (Dollars in Thousands) | March 31, 2013 | December 31, 2012 |
|---|---|---|
| Interest-bearing time deposits | $60,407 | $38,443 |
| Investment securities available for sale | 532,867 | 513,343 |
| Investment securities held to maturity | 336,696 | 361,020 |
| Mortgage loans held for sale | 26,555 | 22,300 |
| Loans | 2,879,542 | 2,902,209 |
| Federal Reserve and Federal Home Loan Bank stock | 32,777 | 32,785 |
| Total | $3,868,844 | $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).

## 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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## 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 seeks damages and other relief, including restitution and injunctive relief. First Merchants believes it has meritorious defenses to the claims brought by the plaintiff. At this phase of the litigation, it is not possible for management of First Merchants to determine the probability of a material adverse outcome or reasonably estimate the amount of any loss. No class has yet been certified and discovery is still ongoing.

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 the quarter ended March 31, 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 Programs |
|---|---|---|---|---|
| January, 2013 | | | — | — |
| February, 2013 | 31,805 | $14.81 | — | — |
| March, 2013 | 182 | $14.83 | — | — |

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: |
|---|---|
| 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) |
| 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: May 10, 2013

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

Date: May 10, 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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