

FIRST MERCHANTS CORP  
Form 10-Q  
August 09, 2016

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

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

For the quarterly period ended June 30, 2016  
OR  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-17071

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

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

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

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

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

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

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

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

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

As of July 29, 2016, there were 40,774,224 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

|  | June 30,<br>2016<br>(Unaudited) | December 31,<br>2015 |
|--|---------------------------------|----------------------|
| <b>ASSETS</b>  |                                 |                      |
| Cash and cash equivalents  | \$ 120,471                      | \$ 102,170           |
| Interest-bearing time deposits   | 62,533                          | 32,315               |
| Investment securities available for sale                                       | 658,829                         | 658,400              |
| Investment securities held to maturity (fair value of \$665,066 and \$632,380) | 638,972                         | 618,599              |
| Loans held for sale  | 18,854                          | 9,894                |
| Loans, net of allowance for loan losses of \$62,186 and \$62,453               | 4,729,243                       | 4,631,369            |
| Premises and equipment   | 95,170                          | 97,648               |
| Federal Reserve and Federal Home Loan Bank stock                               | 18,096                          | 37,633               |
| Interest receivable  | 23,351                          | 24,415               |
| Core deposit intangibles   | 16,821                          | 16,635               |
| Goodwill   | 244,000                         | 243,129              |
| Cash surrender value of life insurance   | 201,417                         | 200,539              |
| Other real estate owned  | 13,219                          | 17,257               |
| Tax asset, deferred and receivable   | 32,547                          | 46,977               |
| Other assets   | 32,895                          | 24,023               |
| <b>TOTAL ASSETS</b>  | <b>\$6,906,418</b>              | <b>\$6,761,003</b>   |
| <b>LIABILITIES</b>   |                                 |                      |
| Deposits:  |                                 |                      |
| Noninterest-bearing  | \$ 1,253,747                    | \$ 1,266,027         |
| Interest-bearing   | 4,153,807                       | 4,023,620            |
| <b>Total Deposits</b>  | <b>5,407,554</b>                | <b>5,289,647</b>     |
| Borrowings:  |                                 |                      |
| Federal funds purchased  | 20,000                          | 49,721               |
| Securities sold under repurchase agreements                                    | 140,777                         | 155,325              |
| Federal Home Loan Bank advances  | 268,579                         | 235,652              |
| Subordinated debentures and term loans   | 127,678                         | 127,846              |
| <b>Total Borrowings</b>  | <b>557,034</b>                  | <b>568,544</b>       |
| Interest payable   | 3,051                           | 3,092                |
| Other liabilities  | 51,229                          | 49,211               |
| <b>Total Liabilities</b>   | <b>6,018,868</b>                | <b>5,910,494</b>     |
| <b>COMMITMENTS AND CONTINGENT LIABILITIES</b>                                  |                                 |                      |
| <b>STOCKHOLDERS' EQUITY</b>  |                                 |                      |
| 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 - 40,772,896 and 40,664,259 shares                      | 5,097                           | 5,083                |
| Additional paid-in capital   | 505,725                         | 504,530              |

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|   |             |             |
|---|-------------|-------------|
| Retained earnings                             | 369,568     | 342,133     |
| Accumulated other comprehensive income (loss) | 7,035       | (1,362 )    |
| Total Stockholders' Equity                    | 887,550     | 850,509     |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY    | \$6,906,418 | \$6,761,003 |

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENTS OF INCOME

(Unaudited)

|   | Three Months<br>Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|---|-----------------------------------|----------|------------------------------|----------|
|   | 2016                              | 2015     | 2016                         | 2015     |
| <b>INTEREST INCOME</b>  |                                   |          |                              |          |
| Loans receivable:   |                                   |          |                              |          |
| Taxable   | \$52,099                          | \$45,320 | \$102,588                    | \$88,871 |
| Tax exempt  | 1,465                             | 736      | 2,780                        | 984      |
| Investment securities:  |                                   |          |                              |          |
| Taxable   | 4,202                             | 4,425    | 8,530                        | 9,148    |
| Tax exempt  | 4,583                             | 4,231    | 9,092                        | 8,066    |
| Deposits with financial institutions                                  | 122                               | 31       | 228                          | 68       |
| Federal Reserve and Federal Home Loan Bank stock                      | 233                               | 459      | 713                          | 1,009    |
| Total Interest Income   | 62,704                            | 55,202   | 123,931                      | 108,146  |
| <b>INTEREST EXPENSE</b>   |                                   |          |                              |          |
| Deposits  | 4,039                             | 3,686    | 8,102                        | 7,202    |
| Federal funds purchased   | 7                                 | 19       | 35                           | 42       |
| Securities sold under repurchase agreements                           | 92                                | 90       | 192                          | 168      |
| Federal Home Loan Bank advances                                       | 818                               | 706      | 1,614                        | 1,397    |
| Subordinated debentures and term loans                                | 1,786                             | 1,670    | 3,571                        | 3,330    |
| Total Interest Expense  | 6,742                             | 6,171    | 13,514                       | 12,139   |
| NET INTEREST INCOME   | 55,962                            | 49,031   | 110,417                      | 96,007   |
| Provision for loan losses   | 790                               | 417      | 1,340                        | 417      |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES                   | 55,172                            | 48,614   | 109,077                      | 95,590   |
| <b>OTHER INCOME</b>   |                                   |          |                              |          |
| Service charges on deposit accounts                                   | 4,416                             | 4,090    | 8,561                        | 7,638    |
| Fiduciary activities  | 2,376                             | 2,309    | 4,870                        | 4,816    |
| Other customer fees   | 4,695                             | 4,602    | 9,754                        | 8,269    |
| Commission income   |                                   | 1,815    |                              | 4,143    |
| Earnings on cash surrender value of life insurance                    | 1,297                             | 640      | 2,773                        | 1,387    |
| Net gains and fees on sales of loans                                  | 1,717                             | 1,781    | 3,177                        | 3,270    |
| Net realized gains (losses) on sales of available for sale securities | 706                               | (93)     | 1,703                        | 932      |
| Gain on sale of insurance subsidiary                                  |                                   | 8,265    |                              | 8,265    |
| Other income  | 1,178                             | 697      | 1,384                        | 785      |
| Total Other Income  | 16,385                            | 24,106   | 32,222                       | 39,505   |
| <b>OTHER EXPENSES</b>   |                                   |          |                              |          |
| Salaries and employee benefits  | 25,570                            | 26,434   | 52,907                       | 50,975   |
| Net occupancy   | 4,059                             | 3,503    | 8,081                        | 7,293    |
| Equipment   | 3,243                             | 2,840    | 6,481                        | 5,406    |
| Marketing   | 851                               | 951      | 1,588                        | 1,731    |
| Outside data processing fees  | 2,025                             | 1,768    | 4,094                        | 3,485    |

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|   |          |          |          |          |
|---|----------|----------|----------|----------|
| Printing and office supplies                        | 369      | 303      | 733      | 667      |
| Core deposit amortization                           | 977      | 729      | 1,955    | 1,450    |
| FDIC assessments                                    | 1,002    | 895      | 1,952    | 1,758    |
| Other real estate owned and foreclosure expenses    | 915      | 845      | 1,666    | 1,241    |
| Professional and other outside services             | 1,478    | 3,134    | 3,640    | 4,625    |
| Other expenses                                      | 4,346    | 4,494    | 8,213    | 7,634    |
| Total Other Expenses                                | 44,835   | 45,896   | 91,310   | 86,265   |
| INCOME BEFORE INCOME TAX                            | 26,722   | 26,824   | 49,989   | 48,830   |
| Income tax expense                                  | 6,716    | 8,856    | 12,290   | 14,690   |
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS         | \$20,006 | \$17,968 | \$37,699 | \$34,140 |
| Per Share Data:                                     |          |          |          |          |
| Basic Net Income Available to Common Stockholders   | \$0.50   | \$0.47   | \$0.93   | \$0.90   |
| Diluted Net Income Available to Common Stockholders | \$0.49   | \$0.47   | \$0.92   | \$0.90   |
| Cash Dividends Paid                                 | \$0.14   | \$0.11   | \$0.25   | \$0.19   |
| Average Diluted Shares Outstanding (in thousands)   | 40,969   | 38,043   | 40,941   | 38,022   |

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

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## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

|  | Three Months<br>Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|--|-----------------------------------|----------|------------------------------|----------|
|  | 2016                              | 2015     | 2016                         | 2015     |
| Net income   | \$20,006                          | \$17,968 | \$37,699                     | \$34,140 |
| Other comprehensive income net of tax:   |                                   |          |                              |          |
| Unrealized holding gain (loss) on securities available for sale arising during the period, net of tax of \$3,096, \$2,904, \$5,861 and \$2,376 | 5,750                             | (5,393)  | 10,885                       | (4,413)  |
| Unrealized gain (loss) on cash flow hedges arising during the period, net of tax of \$284, \$282, \$969 and \$165                              | (529)                             | 525      | (1,798)                      | (304)    |
| Reclassification adjustment for net losses (gains) included in net income, net of tax of \$136, \$158, \$371 and \$77                          | (252)                             | 293      | (690)                        | (143)    |
|  | 4,969                             | (4,575)  | 8,397                        | (4,860)  |
| Comprehensive income   | \$24,975                          | \$13,393 | \$46,096                     | \$29,280 |

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.



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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

|  | Preferred<br>Shares | Preferred<br>Amount | Common Stock<br>Shares | Common Stock<br>Amount | Additional<br>Paid in<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total      |
|--|---------------------|---------------------|------------------------|------------------------|----------------------------------|----------------------|---|------------|
| Balances, December 31, 2015                                      | 125                 | \$ 125              | 40,664,259             | \$ 5,083               | \$ 504,530                       | \$ 342,133           | \$ (1,362)  | \$ 850,509 |
| Comprehensive income   |                     |                     |                        |                        |                                  |                      |   |            |
| Net income   |                     |                     |                        |                        |                                  | 37,699               |   | 37,699     |
| Other comprehensive income, net of tax                           |                     |                     |                        |                        |                                  |                      | 8,397   | 8,397      |
| Cash dividends on common stock (\$ .25 per share)                |                     |                     |                        |                        |                                  | (10,264)             |   | (10,264)   |
| Share-based compensation   |                     |                     | 106,290                | 13                     | 1,222                            |                      |   | 1,235      |
| Stock issued under employee benefit plans                        |                     |                     | 10,536                 | 1                      | 215                              |                      |   | 216        |
| Stock issued under dividend reinvestment and stock purchase plan |                     |                     | 15,703                 | 2                      | 382                              |                      |   | 384        |
| Stock options exercised  |                     |                     | 13,828                 | 2                      | 212                              |                      |   | 214        |
| Stock redeemed   |                     |                     | (37,720)               | (4)                    | (836)                            |                      |   | (840)      |
| Balances, June 30, 2016  | 125                 | \$ 125              | 40,772,896             | \$ 5,097               | \$ 505,725                       | \$ 369,568           | \$ 7,035  | \$ 887,550 |

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

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## PART I. FINANCIAL INFORMATION

## ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

## CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

|   | Six Months Ended |                  |
|---|------------------|------------------|
|   | June 30,<br>2016 | June 30,<br>2015 |
| Cash Flow From Operating Activities:  |                  |                  |
| Net income  | \$37,699         | \$34,140         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                  |
| Provision for loan losses   | 1,340            | 417              |
| Depreciation and amortization   | 3,604            | 3,123            |
| Change in deferred taxes  | 5,571            | 2,341            |
| Share-based compensation  | 1,235            | 1,130            |
| Tax benefit from stock options exercised  | (3               | ) (35            |
| Loans originated for sale   | (199,281         | ) (176,552       |
| Proceeds from sales of loans  | 190,321          | 175,492          |
| Gain on sale of insurance subsidiary  |                  | (8,265           |
| Gains on sales of securities available for sale                                   | (1,703           | ) (932           |
| Change in interest receivable   | 1,064            | 396              |
| Change in interest payable  | (41              | ) (19            |
| Other adjustments   | (5,237           | ) 5,170          |
| Net cash provided by operating activities   | 34,569           | 36,406           |
| Cash Flows from Investing Activities:   |                  |                  |
| Net change in interest-bearing deposits   | (30,218          | ) 21,773         |
| Purchases of:   |                  |                  |
| Securities available for sale   | (96,873          | ) (101,627       |
| Securities held to maturity   | (76,395          | ) (55,415        |
| Proceeds from sales of securities available for sale                              | 85,081           | 42,117           |
| Proceeds from maturities of:  |                  |                  |
| Securities available for sale   | 32,286           | 31,917           |
| Securities held to maturity   | 54,810           | 44,035           |
| Change in Federal Reserve and Federal Home Loan Bank stock                        | 19,537           | 7,578            |
| Net change in loans   | (102,735         | ) (213,356       |
| Net cash and cash equivalents paid in acquisition                                 |                  | (12,004          |
| Net cash received from sale of insurance subsidiary                               |                  | 15,155           |
| Proceeds from the sale of other real estate owned                                 | 4,633            | 4,444            |
| Other adjustments   | (1,671           | ) 1,464          |
| Net cash used in investing activities   | (111,545         | ) (213,919       |
| Cash Flows from Financing Activities:   |                  |                  |
| Net change in :   |                  |                  |
| Demand and savings deposits   | 173,705          | 51,914           |
| Certificates of deposit and other time deposits                                   | (56,969          | ) (8,357         |
| Borrowings  | 279,518          | 200,467          |
| Repayment of borrowings   | (290,687         | ) (71,916        |
| Cash dividends on common stock  | (10,264          | ) (7,246         |

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|   |           |            |
|---|-----------|------------|
| Stock issued under employee benefit plans                                 | 216       | 231        |
| Stock issued under dividend reinvestment and stock purchase plans         | 384       | 310        |
| Stock options exercised   | 211       | 619        |
| Tax benefit from stock options exercised                                  | 3         | 35         |
| Stock redeemed  | (840)     | (1,232)    |
| Net cash provided by financing activities                                 | 95,277    | 164,825    |
| Net Change in Cash and Cash Equivalents                                   | 18,301    | (12,688)   |
| Cash and Cash Equivalents, January 1                                      | 102,170   | 118,616    |
| Cash and Cash Equivalents, June 30  | \$120,471 | \$105,928  |
| Additional cash flow information:   |           |            |
| Interest paid   | \$13,555  | \$12,129   |
| Income tax paid   | \$3,155   | \$3,000    |
| Loans transferred to other real estate owned                              | \$320     | \$3,360    |
| Fixed assets transferred to other real estate owned                       | \$360     | \$1,003    |
| Non-cash investing activities using trade date accounting                 | \$4,414   | \$1,887    |
| In conjunction with the acquisition, liabilities were assumed as follows: |           |            |
| Fair value of assets acquired   |           | \$141,724  |
| Cash received (paid) in acquisition                                       |           | \$(14,500) |
| Less: Common stock issued   |           |            |
| Liabilities assumed   | \$—       | \$127,224  |

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

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PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 1

GENERAL

Financial Statement Preparation

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

The Consolidated Condensed Balance Sheet of the Corporation as of December 31, 2015, 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 Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2016, are not necessarily indicative of the results to be expected for the year. Reclassifications have been made to prior financial statements to conform to the current financial statement presentation. These reclassifications had no effect on net income.

NOTE 2

ACQUISITIONS AND DIVESTITURES

Acquisition - Ameriana Bancorp, Inc.

On December 31, 2015, the Corporation acquired 100 percent of Ameriana Bancorp, Inc. ("Ameriana"). Ameriana merged with and into the Corporation (the "Ameriana Merger") whereupon the separate corporate existence of Ameriana ceased and the Corporation survived. Immediately following the Ameriana Merger, Ameriana Bank, an Indiana bank and wholly-owned subsidiary of Ameriana, merged with and into First Merchants Bank, National Association, a national bank and wholly-owned subsidiary of the Corporation (the "Bank"), with the Bank continuing as the surviving bank. Ameriana was headquartered in New Castle, Indiana and had 13 banking centers serving central and east central Indiana. Pursuant to the merger agreement, each Ameriana shareholder received 0.9037 shares of the Corporation's common stock for each outstanding share of Ameriana common stock held. The Corporation issued approximately 2.8 million shares of common stock, which was valued at approximately \$70.4 million. The Corporation engaged in this transaction with the expectation that it would be accretive and expand the existing footprint in central and east central Indiana. Goodwill resulted from this transaction due to the expected synergies and economies of scale that are expected.

Under the acquisition method of accounting, the total purchase price is allocated to net tangible and intangible assets based on their current estimated fair values on the date of the acquisition. Based on preliminary valuations of the fair value of tangible and intangible assets acquired and liabilities assumed, which are based on assumptions that are subject to change, the purchase price for the Ameriana acquisition is detailed in the following table. If prior to the end of the one year measurement period for finalizing the purchase price allocation, information becomes available which would indicate adjustments are required to the purchase price allocation, such adjustments will be included in the purchase price allocation retrospectively.

|  | Fair<br>Value |
|--|---------------|
| Cash and cash equivalents              | \$4,068       |
| Interest-bearing time deposits         | 8,790         |
| Investment securities                  | 61,754        |
| Loans                                  | 316,929       |
| Premises and equipment                 | 13,946        |
| Federal Home Loan Bank stock           | 2,693         |
| Other real estate owned                | 5,613         |
| Interest receivable                    | 1,306         |
| Cash surrender value of life insurance | 28,188        |
| Other assets                           | 6,713         |
| Deposits                               | (383,718)     |
| Interest payable                       | (24 )         |
| Federal Home Loan Bank Advances        | (24,884 )     |
| Subordinated debentures                | (5,487 )      |
| Other liabilities                      | (9,451 )      |
| Net tangible assets acquired           | 26,436        |
| Core deposit intangible                | 5,342         |
| Goodwill                               | 38,624        |
| Purchase price                         | \$70,402      |

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## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Of the total purchase price, \$5,342,000 has been allocated to a core deposit intangible that will be amortized over its estimated life of 10 years. The remaining purchase price has been allocated to goodwill, which is not deductible for tax purposes.

## Acquisition - C Financial Corporation

On April 17, 2015, the Corporation acquired 100 percent of C Financial Corporation, ("C Financial"). C Financial merged with and into the Corporation (the "C Financial Merger") whereupon the separate corporate existence of C Financial ceased and the Corporation survived. Immediately following the C Financial Merger, Cooper State Bank, an Ohio state bank and wholly-owned subsidiary of C Financial, merged with and into the Bank, with the Bank continuing as the surviving bank. C Financial was headquartered in Columbus, Ohio and had 6 full service banking centers serving the Columbus, Ohio market. As part of the \$14.5 million C Financial Merger, shareholders of C Financial received \$6.738 in cash for each share of C Financial common stock held.

The Corporation expects the transaction to be accretive to income and expand the existing footprint in Columbus, Ohio. Goodwill resulted from this transaction due to the synergies and economies of scale that were expected. The purchase price of the C Financial acquisition was allocated as follows:

|                                 | Fair<br>Value |
|---------------------------------|---------------|
| Cash and cash equivalents       | \$2,496       |
| Federal Funds sold              | 7,018         |
| Interest-bearing time deposits  | 922           |
| Loans                           | 110,625       |
| Premises and equipment          | 7,290         |
| Federal Home Loan Bank stock    | 855           |
| Interest receivable             | 292           |
| Other assets                    | 119           |
| Deposits                        | (105,326)     |
| Interest payable                | (29 )         |
| Federal Home Loan Bank Advances | (18,958 )     |
| Other liabilities               | (2,911 )      |
| Net tangible assets acquired    | 2,393         |
| Core deposit intangible         | 981           |
| Goodwill                        | 11,126        |
| Purchase price                  | \$14,500      |

Of the total purchase price, \$981,000 has been allocated to a core deposit intangible that will be amortized over its estimated life of 10 years. The remaining purchase price has been allocated to goodwill, which is deductible over a 15 year period for tax purposes as the transaction was considered a taxable exchange.

Subsidiary Divestiture - First Merchants Insurance Services, Inc.

On June 12, 2015, the Corporation sold all of its stock in First Merchants Insurance Services, Inc., an Indiana corporation ("FMIG"), to USI Insurance Services LLC, a Delaware limited liability company. The sale price was \$18 million, of which \$16 million was paid at closing with the remaining \$2 million paid through a two-year promissory note. The sale of FMIG generated a gain on sale of \$8.3 million.

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(table dollar amounts in thousands, except share data)

(Unaudited)

## NOTE 3

## INVESTMENT SECURITIES

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

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Available for sale at June 30, 2016                  |                   |                              |                               |               |
| U.S. Government-sponsored agency securities          | \$ 100            | \$ 2                         |                               | \$ 102        |
| State and municipal                                  | 329,042           | 24,438                       |                               | 353,480       |
| U.S. Government-sponsored mortgage-backed securities | 292,822           | 8,469                        | \$ 20                         | 301,271       |
| Corporate obligations                                | 31                |                              |                               | 31            |
| Equity securities                                    | 3,882             | 63                           |                               | 3,945         |
| Total available for sale                             | 625,877           | 32,972                       | 20                            | 658,829       |
| Held to maturity at June 30, 2016                    |                   |                              |                               |               |
| Federal agencies                                     | 28,980            | 34                           | 5                             | 29,009        |
| State and municipal                                  | 207,731           | 11,621                       |                               | 219,352       |
| U.S. Government-sponsored mortgage-backed securities | 402,261           | 14,444                       |                               | 416,705       |
| Total held to maturity                               | 638,972           | 26,099                       | 5                             | 665,066       |
| Total Investment Securities                          | \$ 1,264,849      | \$ 59,071                    | \$ 25                         | \$ 1,323,895  |

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| Available for sale at December 31, 2015              |                   |                              |                               |               |
| U.S. Government-sponsored agency securities          | \$ 100            | \$ 4                         |                               | \$ 104        |
| State and municipal                                  | 291,730           | 14,241                       | \$ 60                         | 305,911       |
| U.S. Government-sponsored mortgage-backed securities | 342,550           | 4,234                        | 518                           | 346,266       |
| Corporate obligations                                | 31                |                              |                               | 31            |
| Equity securities                                    | 3,912             |                              |                               | 3,912         |
| Certificates of deposit                              | 2,176             |                              |                               | 2,176         |
| Total available for sale                             | 640,499           | 18,479                       | 578                           | 658,400       |
| Held to maturity at December 31, 2015                |                   |                              |                               |               |
| State and municipal                                  | 219,767           | 6,982                        | 15                            | 226,734       |
| U.S. Government-sponsored mortgage-backed securities | 398,832           | 7,601                        | 787                           | 405,646       |
| Total held to maturity                               | 618,599           | 14,583                       | 802                           | 632,380       |
| Total Investment Securities                          | \$ 1,259,098      | \$ 33,062                    | \$ 1,380                      | \$ 1,290,780  |



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The amortized cost and fair value of available for sale and held to maturity securities at June 30, 2016 and December 31, 2015, 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<br>Cost  | Fair<br>Value | Amortized<br>Cost | Fair<br>Value |
| Maturity Distribution at June 30, 2016:              |                    |               |                   |               |
| Due in one year or less                              | \$3,065            | \$3,086       | \$2,500           | \$2,532       |
| Due after one through five years                     | 19,909             | 21,060        | 42,528            | 44,205        |
| Due after five through ten years                     | 60,972             | 64,871        | 82,937            | 85,365        |
| Due after ten years                                  | 245,227            | 264,596       | 108,746           | 116,259       |
|  | \$329,173          | \$353,613     | \$236,711         | \$248,361     |
| U.S. Government-sponsored mortgage-backed securities | 292,822            | 301,271       | 402,261           | 416,705       |
| Equity securities                                    | 3,882              | 3,945         |                   |               |
| Total Investment Securities                          | \$625,877          | \$658,829     | \$638,972         | \$665,066     |

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|  | Available for Sale |            | Held to Maturity |            |
|--|--------------------|------------|------------------|------------|
|  | Amortized Cost     | Fair Value | Amortized Cost   | Fair Value |
| Maturity Distribution at December 31, 2015           |                    |            |                  |            |
| Due in one year or less                              | \$4,658            | \$4,704    | \$4,144          | \$4,148    |
| Due after one through five years                     | 13,725             | 14,295     | 28,054           | 29,175     |
| Due after five through ten years                     | 52,878             | 55,375     | 81,483           | 83,646     |
| Due after ten years                                  | 220,600            | 231,672    | 106,086          | 109,765    |
|  | \$291,861          | \$306,046  | \$219,767        | \$226,734  |
| U.S. Government-sponsored mortgage-backed securities | 342,550            | 346,266    | 398,832          | 405,646    |
| Equity securities                                    | 3,912              | 3,912      |                  |            |
| Certificates of deposit                              | 2,176              | 2,176      |                  |            |
| Total Investment Securities                          | \$640,499          | \$658,400  | \$618,599        | \$632,380  |

The carrying value of securities pledged as collateral, to secure borrowings and for other purposes, was \$607,799,000 at June 30, 2016, and \$637,358,000 at December 31, 2015.

The book value of securities sold under agreements to repurchase amounted to \$135,855,000 at June 30, 2016, and \$153,789,000 at December 31, 2015.

Gross gains on the sales and redemptions of available for sale securities for the three and six months ended June 30, 2016 and 2015 are shown below.

|   | Three Months Ended June 30, 2016 |      | Six Months Ended June 30, 2015 |         |
|---|----------------------------------|------|--------------------------------|---------|
|   | 2016                             | 2015 | 2016                           | 2015    |
| Sales and Redemptions of Available for Sale Securities: |                                  |      |                                |         |
| Gross gains   | \$706                            | \$7  | \$1,703                        | \$1,032 |
| Gross losses  |                                  | 100  |                                | 100     |

The following table shows investment securities with unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2016, and December 31, 2015:

|  | Less than 12 Months |                         | 12 Months or Longer |                         | Total      | Gross Unrealized Losses |
|--|---------------------|-------------------------|---------------------|-------------------------|------------|-------------------------|
|  | Fair Value          | Gross Unrealized Losses | Fair Value          | Gross Unrealized Losses |            |                         |
|  |                     |                         |                     |                         | Fair Value | Gross Unrealized Losses |

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Temporarily Impaired Available for Sale Securities at June 30, 2016

|  |       |       |         |      |       |       |
|--|-------|-------|---------|------|-------|-------|
| U.S. Government-sponsored mortgage-backed securities     | 4,007 | \$ 15 | \$1,053 | \$ 5 | 5,060 | \$ 20 |
| Total Temporarily Impaired Available for Sale Securities | 4,007 | 15    | 1,053   | 5    | 5,060 | 20    |

Temporarily Impaired Held to Maturity Securities at June 30, 2016

|  |         |       |         |      |          |       |
|--|---------|-------|---------|------|----------|-------|
| Federal agencies                                       | 4,995   | 5     |         |      | 4,995    | 5     |
| Total Temporarily Impaired Held to Maturity Securities | 4,995   | 5     |         |      | 4,995    | 5     |
| Total Temporarily Impaired Investment Securities       | \$9,002 | \$ 20 | \$1,053 | \$ 5 | \$10,055 | \$ 25 |

|  | Less than<br>12 Months |                               | 12 Months<br>or Longer |                               | Total         |                               |
|--|------------------------|-------------------------------|------------------------|-------------------------------|---------------|-------------------------------|
|  | Fair<br>Value          | Gross<br>Unrealized<br>Losses | Fair<br>Value          | Gross<br>Unrealized<br>Losses | Fair<br>Value | Gross<br>Unrealized<br>Losses |
| Temporarily Impaired Available for Sale Securities at<br>December 31, 2015 |                        |                               |                        |                               |               |                               |
| State and municipal  | \$7,558                | \$ 60                         |                        |                               | \$7,558       | \$ 60                         |
| U.S. Government-sponsored mortgage-backed securities                       | 83,396                 | 445                           | \$2,101                | \$ 73                         | 85,497        | 518                           |
| Total Temporarily Impaired Available for Sale Securities                   | 90,954                 | 505                           | 2,101                  | 73                            | 93,055        | 578                           |
| Temporarily Impaired Held to Maturity Securities at<br>December 31, 2015   |                        |                               |                        |                               |               |                               |
| State and municipal  |                        |                               | 1,982                  | 15                            | 1,982         | 15                            |
| U.S. Government-sponsored mortgage-backed securities                       | 69,641                 | 519                           | 12,906                 | 268                           | 82,547        | 787                           |
| Total Temporarily Impaired Held to Maturity Securities                     | 69,641                 | 519                           | 14,888                 | 283                           | 84,529        | 802                           |
| Total Temporarily Impaired Investment Securities                           | \$160,595              | \$ 1,024                      | \$16,989               | \$ 356                        | \$177,584     | \$ 1,380                      |

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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.

|  | June 30,<br>2016 | December 31,<br>2015 |   |
|--|------------------|----------------------|---|
| Investments reported at less than historical cost:                             |                  |                      |   |
| Historical cost  | \$ 10,081        | \$ 178,964           |   |
| Fair value   | \$ 10,055        | \$ 177,584           |   |
| Percent of the Corporation's available for sale and held to maturity portfolio | 0.8              | % 13.9               | % |

Management believes the decline in fair value for these securities was 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 during the period the other-than-temporary impairment is identified.

The Corporation's management has evaluated all securities with unrealized losses for other-than temporary impairment as of June 30, 2016. 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.

In determining the fair value of the investment securities portfolio, the Corporation utilizes a third party for portfolio accounting services, including market value input, for those securities classified as Level 1 and Level 2 in the fair value hierarchy. 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 losses resulting from the sale of certain securities has proven the data to be accurate over time. The fair value of securities classified as Level 3 in the valuation hierarchy was determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

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

The unrealized losses on the Corporation's investments in securities of U.S. Government-sponsored mortgage-backed securities were caused by changes in interest rates and not credit quality. 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 investments and more likely than not the Corporation won't be required to sell the investments before recovery of its lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at June 30, 2016.

## Credit Losses Recognized on Investments

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

|   | Accumulated<br>Credit<br>Losses in<br>2016 | Accumulated<br>Credit<br>Losses in<br>2015 |
|---|--|--|
| Credit losses on debt securities held:  |  |  |
| Balance, January 1  | \$   | —\$ 500                                    |
| Reductions for previous other-than-temporary losses realized on securities sold during the year | —  | (500 )                                     |
| Balance, June 30  | \$   | —\$ —                                      |

In the first quarter of 2015, the Corporation sold its remaining trust preferred security which had no remaining book value as a result of other than temporary impairment of approximately \$500,000 taken in 2009. The sale of this security resulted in a gain of \$45,000, which is included in the Consolidated Condensed Statement of Income for the six months ended June 30, 2015.

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## NOTE 4

## LOANS AND ALLOWANCE

The Corporation's primary lending focus is small business and middle market commercial, commercial real estate, residential real estate and consumer, which results in portfolio diversification. The following tables show the composition of the loan portfolio, the allowance for loan losses and certain credit quality aspects, all excluding loans held for sale. Loans held for sale as of June 30, 2016, and December 31, 2015, were \$18,854,000 and \$9,894,000, respectively.

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

|  | June 30,<br>2016 | December<br>31, 2015 |
|--|------------------|----------------------|
| Commercial and industrial loans                                  | \$1,084,890      | \$1,057,075          |
| Agricultural production financing and other loans to farmers     | 95,131           | 97,711               |
| Real estate loans:   |                  |                      |
| Construction   | 352,980          | 366,704              |
| Commercial and farmland  | 1,869,703        | 1,802,921            |
| Residential  | 758,870          | 786,105              |
| Home Equity  | 374,159          | 348,613              |
| Individuals' loans for household and other personal expenditures | 75,205           | 74,717               |
| Lease financing receivables, net of unearned income              | 388              | 588                  |
| Other commercial loans   | 180,103          | 159,388              |
| Loans  | \$4,791,429      | \$4,693,822          |
| Allowance for loan losses  | (62,186 )        | (62,453 )            |
| Net Loans  | \$4,729,243      | \$4,631,369          |

## Allowance, Credit Quality and Loan Portfolio

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. Management believes the allowance for loan losses is adequate to cover probable losses inherent in the loan portfolio at June 30, 2016. 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 it 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, portfolio mix and collateral values.

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The allowance is increased by provision expense 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 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 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 the current environment and economic conditions on the portfolio.

The allowance consists of specific impairment reserves as required by ASC 310-10-35, a component for historical losses in accordance with ASC 450 and the consideration of current environmental factors in accordance with ASC 450. 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.

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 risk grades to charge off.

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In addition to the specific reserves and historical loss components of the allowance, consideration is given to various environmental factors to ensure that losses inherent in the portfolio are reflected in the allowance for loan losses. The environmental component adjusts the historical loss allocations for non-impaired 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.

In conformance with ASC 805 and ASC 820, loans purchased after December 31, 2008 are recorded at the acquisition date fair value. Such loans are included in the allowance to the extent a specific impairment is identified that exceeds the fair value adjustment on an impaired loan or the historical loss and environmental factor analysis indicates losses inherent in a purchased portfolio exceeds the fair value adjustment on the portion of the purchased portfolio not deemed impaired.

The following tables summarize changes in the allowance for loan losses by loan segment for the three and six months ended June 30, 2016, and June 30, 2015:

## Three Months Ended June 30, 2016

|                            | Commercial | Commercial<br>Real Estate | Consumer | Residential | Finance<br>Leases | Total    |
|----------------------------|------------|---------------------------|----------|-------------|-------------------|----------|
| Allowance for loan losses: |            |                           |          |             |                   |          |
| Balances, April 1          | \$26,264   | \$22,317                  | \$2,647  | \$10,856    | \$2               | \$62,086 |
| Provision for losses       | 400        | 200                       | 44       | 146         |                   | 790      |
| Recoveries on loans        | 683        | 276                       | 107      | 273         |                   | 1,339    |
| Loans charged off          | (1,026)    | (513)                     | (114)    | (376)       |                   | (2,029)  |
| Balances, June 30, 2016    | \$26,321   | \$22,280                  | \$2,684  | \$10,899    | \$2               | \$62,186 |

## Six Months Ended June 30, 2016

|                            | Commercial | Commercial<br>Real Estate | Consumer | Residential | Finance<br>Leases | Total    |
|----------------------------|------------|---------------------------|----------|-------------|-------------------|----------|
| Allowance for loan losses: |            |                           |          |             |                   |          |
| Balances, January 1        | \$26,478   | \$22,145                  | \$2,689  | \$11,139    | \$2               | \$62,453 |
| Provision for losses       | 539        | 414                       | 77       | 310         |                   | 1,340    |
| Recoveries on loans        | 975        | 1,228                     | 185      | 585         |                   | 2,973    |
| Loans charged off          | (1,671)    | (1,507)                   | (267)    | (1,135)     |                   | (4,580)  |
| Balances, June 30, 2016    | \$26,321   | \$22,280                  | \$2,684  | \$10,899    | \$2               | \$62,186 |

## Three Months Ended June 30, 2015

| Commercial | Consumer | Residential | Total |
|------------|----------|-------------|-------|
|------------|----------|-------------|-------|



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|                            | Commercial<br>Real Estate |           | Finance<br>Leases |           |      |          |
|----------------------------|---------------------------|-----------|-------------------|-----------|------|----------|
| Allowance for loan losses: |                           |           |                   |           |      |          |
| Balances, April 1          | \$30,007                  | \$ 16,383 | \$ 3,138          | \$ 13,269 | \$ 4 | \$62,801 |
| Provision for losses       | 1,190                     | (502 )    | (200 )            | (72 )     | 1    | 417      |
| Recoveries on loans        | 437                       | 147       | 101               | 747       |      | 1,432    |
| Loans charged off          | (155 )                    | (200 )    | (112 )            | (1,633 )  |      | (2,100 ) |
| Balances, June 30, 2015    | \$31,479                  | \$ 15,828 | \$ 2,927          | \$ 12,311 | \$ 5 | \$62,550 |

Six Months Ended June 30, 2015

|                            | Commercial<br>Real Estate | Commercial<br>Real Estate | Consumer | Residential | Finance<br>Leases | Total    |
|----------------------------|---------------------------|---------------------------|----------|-------------|-------------------|----------|
| Allowance for loan losses: |                           |                           |          |             |                   |          |
| Balances, January 1        | \$28,824                  | \$ 19,327                 | \$ 2,658 | \$ 13,152   | \$ 3              | \$63,964 |
| Provision for losses       | 3,024                     | (3,398 )                  | 327      | 462         | 2                 | 417      |
| Recoveries on loans        | 887                       | 559                       | 179      | 879         |                   | 2,504    |
| Loans charged off          | (1,256 )                  | (660 )                    | (237 )   | (2,182 )    |                   | (4,335 ) |
| Balances, June 30, 2015    | \$31,479                  | \$ 15,828                 | \$ 2,927 | \$ 12,311   | \$ 5              | \$62,550 |

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

|   | June 30, 2016 |                           |           |              |                   | Total        |
|---|---------------|---------------------------|-----------|--------------|-------------------|--------------|
|   | Commercial    | Commercial<br>Real Estate | Consumer  | Residential  | Finance<br>Leases |              |
| Allowance Balances:                             |               |                           |           |              |                   |              |
| Individually evaluated for impairment           | \$ 1,573      | \$ 276                    |           | \$ 69        |                   | \$ 1,918     |
| Collectively evaluated for impairment           | 24,748        | 21,824                    | \$ 2,684  | 10,808       | \$ 2              | 60,066       |
| Loans Acquired with Deteriorated Credit Quality |               | 180                       |           | 22           |                   | 202          |
| Total Allowance for Loan Losses                 | \$ 26,321     | \$ 22,280                 | \$ 2,684  | \$ 10,899    | \$ 2              | \$ 62,186    |
| Loan Balances:                                  |               |                           |           |              |                   |              |
| Individually evaluated for impairment           | \$ 7,841      | \$ 21,118                 |           | \$ 3,462     |                   | \$ 32,421    |
| Collectively evaluated for impairment           | 1,345,826     | 2,155,077                 | \$ 75,205 | 1,126,707    | \$ 388            | 4,703,203    |
| Loans Acquired with Deteriorated Credit Quality | 6,457         | 46,488                    |           | 2,860        |                   | 55,805       |
| Loans   | \$ 1,360,124  | \$ 2,222,683              | \$ 75,205 | \$ 1,133,029 | \$ 388            | \$ 4,791,429 |

|   | December 31, 2015 |                           |           |              |                   | Total        |
|---|-------------------|---------------------------|-----------|--------------|-------------------|--------------|
|   | Commercial        | Commercial<br>Real Estate | Consumer  | Residential  | Finance<br>Leases |              |
| Allowance Balances:                             |                   |                           |           |              |                   |              |
| Individually evaluated for impairment           | \$ 1,277          | \$ 243                    |           | \$ 169       |                   | \$ 1,689     |
| Collectively evaluated for impairment           | 25,201            | 21,753                    | \$ 2,689  | 10,966       | \$ 2              | 60,611       |
| Loans Acquired with Deteriorated Credit Quality |                   | 149                       |           | 4            |                   | 153          |
| Total Allowance for Loan Losses                 | \$ 26,478         | \$ 22,145                 | \$ 2,689  | \$ 11,139    | \$ 2              | \$ 62,453    |
| Loan Balances:                                  |                   |                           |           |              |                   |              |
| Individually evaluated for impairment           | \$ 7,877          | \$ 16,670                 |           | \$ 4,020     |                   | \$ 28,567    |
| Collectively evaluated for impairment           | 1,298,988         | 2,096,089                 | \$ 74,717 | 1,125,316    | \$ 588            | 4,595,698    |
| Loans Acquired with Deteriorated Credit Quality | 7,309             | 56,866                    |           | 5,382        |                   | 69,557       |
| Loans   | \$ 1,314,174      | \$ 2,169,625              | \$ 74,717 | \$ 1,134,718 | \$ 588            | \$ 4,693,822 |

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

(Unaudited)

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. Uncollected interest previously recorded, but not deemed collectible, is reversed and charged against current income. Payments subsequently received on non-accrual loans are applied to principal. A loan is returned to accrual status when principal and interest are no longer past due and collectability is probable, typically after a minimum of six consecutive months of performance. Payments received on impaired accruing or delinquent loans are applied to interest income as accrued.

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

|  | June 30, December |           |
|--|-------------------|-----------|
|  | 2016              | 31, 2015  |
| Commercial and industrial loans                                  | \$3,413           | \$ 4,634  |
| Agriculture production financing and other loans to farmers      | 1,471             | 827       |
| Real estate Loans:   |                   |           |
| Construction   | 721               | 736       |
| Commercial and farmland  | 15,541            | 11,277    |
| Residential  | 9,952             | 11,818    |
| Home Equity  | 2,345             | 1,952     |
| Individuals' loans for household and other personal expenditures | 122               | 145       |
| Total  | \$33,565          | \$ 31,389 |

Commercial impaired loans include non-accrual loans, loans accounted for under ASC 310-30, and loans risk graded as substandard, doubtful and loss that were still accruing but deemed impaired according to the guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more and troubled debt restructurings.

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 as of the periods indicated:

| June 30, 2016                  |          |         |
|--------------------------------|----------|---------|
| Unpaid                         | Recorded | Related |
| Principal Investment Allowance |          |         |

|   | Balance    |           |          |
|---|------------|-----------|----------|
| Impaired loans with no related allowance:                   |            |           |          |
| Commercial and industrial loans                             | \$ 19,322  | \$ 10,183 |          |
| Agriculture production financing and other loans to farmers | 709        | 701       |          |
| Real estate Loans:  |            |           |          |
| Construction  | 8,089      | 4,091     |          |
| Commercial and farmland                                     | 83,028     | 61,319    |          |
| Residential   | 8,650      | 5,016     |          |
| Home equity   | 176        | 139       |          |
| Other commercial loans                                      | 16         |           |          |
| Total   | \$ 119,990 | \$ 81,449 |          |
| Impaired loans with related allowance:                      |            |           |          |
| Commercial and industrial loans                             | \$ 2,491   | \$ 2,114  | \$ 1,007 |
| Agriculture production financing and other loans to farmers | 1,331      | 1,301     | 566      |
| Real estate Loans:  |            |           |          |
| Commercial and farmland                                     | 2,145      | 1,978     | 456      |
| Residential   | 877        | 801       | 91       |
| Total   | \$ 6,844   | \$ 6,194  | \$ 2,120 |
| Total Impaired Loans  | \$ 126,834 | \$ 87,643 | \$ 2,120 |

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(table dollar amounts in thousands, except share data)

(Unaudited)

|   | December 31, 2015                   |                                  |                                   |                                  |
|---|-------------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|   | Unpaid<br>Principal<br>Balance      | Recorded<br>Investment           | Related<br>Allowance              |                                  |
| Impaired loans with no related allowance:                   |                                     |                                  |                                   |                                  |
| Commercial and industrial loans                             | \$22,151                            | \$ 11,669                        |                                   |                                  |
| Agriculture production financing and other loans to farmers | 370                                 | 361                              |                                   |                                  |
| Real estate Loans:  |                                     |                                  |                                   |                                  |
| Construction  | 4,551                               | 2,336                            |                                   |                                  |
| Commercial and farmland                                     | 95,930                              | 69,024                           |                                   |                                  |
| Residential   | 11,262                              | 7,338                            |                                   |                                  |
| Home equity   | 297                                 | 247                              |                                   |                                  |
| Other commercial loans                                      | 20                                  |                                  |                                   |                                  |
| Total   | \$134,581                           | \$ 90,975                        |                                   |                                  |
| Impaired loans with related allowance:                      |                                     |                                  |                                   |                                  |
| Commercial and industrial loans                             | \$3,043                             | \$ 2,690                         | \$ 1,247                          |                                  |
| Agriculture production financing and other loans to farmers | 466                                 | 466                              | 30                                |                                  |
| Real estate Loans:  |                                     |                                  |                                   |                                  |
| Commercial and farmland                                     | 2,144                               | 1,933                            | 392                               |                                  |
| Residential   | 2,300                               | 1,463                            | 173                               |                                  |
| Total   | \$7,953                             | \$ 6,552                         | \$ 1,842                          |                                  |
| Total Impaired Loans  | \$142,534                           | \$ 97,527                        | \$ 1,842                          |                                  |
|   |                                     |                                  |                                   |                                  |
|   | Three Months Ended<br>June 30, 2016 |                                  | Six Months Ended<br>June 30, 2016 |                                  |
|   | Average<br>Recorded<br>Investment   | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| Impaired loans with no related allowance:                   |                                     |                                  |                                   |                                  |
| Commercial and industrial loans                             | \$10,372                            | \$ 128                           | \$10,307                          | \$ 231                           |
| Agriculture production financing and other loans to farmers | 834                                 | 2                                | 882                               | 2                                |
| Real estate Loans:  |                                     |                                  |                                   |                                  |
| Construction  | 4,085                               | 74                               | 4,074                             | 147                              |
| Commercial and farmland                                     | 62,173                              | 861                              | 63,136                            | 1,706                            |
| Residential   | 5,069                               | 54                               | 5,390                             | 107                              |
| Home equity   | 138                                 |                                  | 139                               |                                  |
| Total   | \$82,671                            | \$ 1,119                         | \$83,928                          | \$ 2,193                         |
| Impaired loans with related allowance:                      |                                     |                                  |                                   |                                  |
| Commercial and industrial loans                             | \$2,120                             | \$ 9                             | \$2,129                           | \$ 19                            |
| Agriculture production financing and other loans to farmers | 1,321                               |                                  | 1,405                             |                                  |
| Real estate Loans:  |                                     |                                  |                                   |                                  |
| Commercial and farmland                                     | 1,986                               |                                  | 2,008                             |                                  |
| Residential   | 840                                 |                                  | 860                               |                                  |

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|   |                       |          |                       |          |
|---|-----------------------|----------|-----------------------|----------|
| Total   | \$6,267               | \$ 9     | \$6,402               | \$ 19    |
| Total Impaired Loans  | \$88,938              | \$ 1,128 | \$90,330              | \$ 2,212 |
|   | Three Months Ended    |          | Six Months Ended      |          |
|   | June 30, 2015         |          | June 30, 2015         |          |
|   | Average Interest      |          | Average Interest      |          |
|   | Recorded Income       |          | Recorded Income       |          |
|   | Investment Recognized |          | Investment Recognized |          |
| Impaired loans with no related allowance:                   |                       |          |                       |          |
| Commercial and industrial loans                             | \$12,154              | \$ 111   | \$12,942              | \$ 200   |
| Agriculture production financing and other loans to farmers | 1,325                 |          | 1,343                 |          |
| Real estate Loans:  |                       |          |                       |          |
| Construction  | 7,648                 | 95       | 7,898                 | 191      |
| Commercial and farmland                                     | 66,625                | 894      | 66,957                | 1,765    |
| Residential   | 7,114                 | 57       | 7,150                 | 107      |
| Home equity   | 208                   |          | 208                   |          |
| Total   | \$95,074              | \$ 1,157 | \$96,498              | \$ 2,263 |
| Impaired loans with related allowance:                      |                       |          |                       |          |
| Commercial and industrial loans                             | \$3,204               | \$ 10    | \$3,214               | \$ 19    |
| Real estate Loans:  |                       |          |                       |          |
| Commercial and farmland                                     | 2,622                 |          | 2,727                 |          |
| Residential   | 2,600                 |          | 2,603                 |          |
| Total   | \$8,426               | \$ 10    | \$8,544               | \$ 19    |
| Total Impaired Loans  | \$103,500             | \$ 1,167 | \$105,042             | \$ 2,282 |

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(table dollar amounts in thousands, except share data)

(Unaudited)

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

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

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

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

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

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

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



repayment is known.

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

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(Unaudited)

The following tables summarize the credit quality of the Corporation's loan portfolio, by loan class for 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. Loans that evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected are included in the applicable categories below.

|  | June 30, 2016      |                                  |                           |                        |                    |                        |                            |              |
|--|--------------------|----------------------------------|---------------------------|------------------------|--------------------|------------------------|----------------------------|--------------|
|  | Commercial<br>Pass | Commercial<br>Special<br>Mention | Commercial<br>Substandard | Commercial<br>Doubtful | Commercial<br>Loss | Consumer<br>Performing | Consumer<br>Non-Performing | Total        |
| Commercial and industrial loans                                  | \$ 1,022,507       | \$ 29,117                        | \$ 33,266                 |                        |                    |                        |                            | \$ 1,084,890 |
| Agriculture production financing and other loans to farmers      | 37,114             | 32,784                           | 25,233                    |                        |                    |                        |                            | 95,131       |
| Real estate Loans:   |                    |                                  |                           |                        |                    |                        |                            |              |
| Construction   | 328,366            | 5,023                            | 1,606                     |                        |                    | \$ 17,908              | \$ 77                      | 352,980      |
| Commercial and farmland  | 1,733,503          | 51,793                           | 84,407                    |                        |                    |                        |                            | 1,869,703    |
| Residential  | 157,186            | 7,953                            | 6,352                     |                        |                    | 579,403                | 7,976                      | 758,870      |
| Home equity  | 7,377              | 97                               | 743                       |                        |                    | 363,618                | 2,324                      | 374,159      |
| Individuals' loans for household and other personal expenditures |                    |                                  |                           |                        |                    | 75,084                 | 121                        | 75,205       |
| Lease financing receivables, net of unearned income              | 300                |                                  | 88                        |                        |                    |                        |                            | 388          |
| Other commercial loans   | 180,103            |                                  |                           |                        |                    |                        |                            | 180,103      |
| Loans  | \$ 3,466,456       | \$ 126,767                       | \$ 151,695                |                        |                    | \$ 1,036,013           | \$ 10,498                  | \$ 4,791,429 |

|  | December 31, 2015  |                                  |                           |                        |                    |                        |                            |              |
|--|--------------------|----------------------------------|---------------------------|------------------------|--------------------|------------------------|----------------------------|--------------|
|  | Commercial<br>Pass | Commercial<br>Special<br>Mention | Commercial<br>Substandard | Commercial<br>Doubtful | Commercial<br>Loss | Consumer<br>Performing | Consumer<br>Non-Performing | Total        |
| Commercial and industrial loans                  | \$ 962,340         | \$ 48,432                        | \$ 45,984                 | \$ 319                 |                    |                        |                            | \$ 1,057,075 |
| Agriculture production financing and other loans | 77,884             | 6,665                            | 13,162                    |                        |                    |                        |                            | 97,711       |

|  |             |            |            |        |              |          |             |
|--|-------------|------------|------------|--------|--------------|----------|-------------|
| to farmers   |             |            |            |        |              |          |             |
| Real estate Loans:   |             |            |            |        |              |          |             |
| Construction   | 345,449     | 1,271      | 1,790      |        | \$ 18,114    | \$ 80    | 366,704     |
| Commercial and farmland  | 1,679,141   | 46,442     | 77,338     |        |              |          | 1,802,921   |
| Residential  | 171,576     | 3,107      | 10,428     |        | 593,533      | 7,461    | 786,105     |
| Home equity  | 8,218       | 48         | 600        |        | 337,718      | 2,029    | 348,613     |
| Individuals' loans for household and other personal expenditures |             |            |            |        | 74,491       | 226      | 74,717      |
| Lease financing receivables, net of unearned income              | 495         |            | 93         |        |              |          | 588         |
| Other commercial loans   | 159,388     |            |            |        |              |          | 159,388     |
| Loans  | \$3,404,491 | \$ 105,965 | \$ 149,395 | \$ 319 | \$ 1,023,856 | \$ 9,796 | \$4,693,822 |

The tables below show a past due aging of the Corporation's loan portfolio, by loan class, as of June 30, 2016, and December 31, 2015.

|  | June 30, 2016 |                     |                     |                              |             | Total Past Due & Non-Accrual | Total       |
|--|---------------|---------------------|---------------------|------------------------------|-------------|------------------------------|-------------|
|  | Current       | 30-59 Days Past Due | 60-89 Days Past Due | Loans > 90 Days And Accruing | Non-Accrual |                              |             |
| Commercial and industrial loans                                  | \$1,080,184   | \$998               | \$282               | \$ 13                        | \$ 3,413    | \$ 4,706                     | \$1,084,890 |
| Agriculture production financing and other loans to farmers      | 92,979        | 250                 | 431                 |                              | 1,471       | 2,152                        | 95,131      |
| Real estate Loans:   |               |                     |                     |                              |             |                              |             |
| Construction   | 351,147       |                     | 1,112               |                              | 721         | 1,833                        | 352,980     |
| Commercial and farmland  | 1,850,882     | 2,384               | 896                 |                              | 15,541      | 18,821                       | 1,869,703   |
| Residential  | 743,951       | 3,847               | 888                 | 232                          | 9,952       | 14,919                       | 758,870     |
| Home equity  | 370,602       | 628                 | 467                 | 117                          | 2,345       | 3,557                        | 374,159     |
| Individuals' loans for household and other personal expenditures | 74,744        | 297                 | 42                  |                              | 122         | 461                          | 75,205      |
| Lease financing receivables, net of unearned income              | 388           |                     |                     |                              |             |                              | 388         |
| Other commercial loans   | 180,103       |                     |                     |                              |             |                              | 180,103     |
| Loans  | \$4,744,980   | \$8,404             | \$4,118             | \$ 362                       | \$ 33,565   | \$ 46,449                    | \$4,791,429 |

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(table dollar amounts in thousands, except share data)

(Unaudited)

|  | December 31, 2015 |                     |                     |                              |             |           | Total Past Due & Non-Accrual | Total |
|--|-------------------|---------------------|---------------------|------------------------------|-------------|-----------|------------------------------|-------|
|  | Current           | 30-59 Days Past Due | 60-89 Days Past Due | Loans > 90 Days And Accruing | Non-Accrual |           |                              |       |
| Commercial and industrial loans                                  | \$ 1,052,275      | \$ 166              |                     |                              | \$ 4,634    | \$ 4,800  | \$ 1,057,075                 |       |
| Agriculture production financing and other loans to farmers      | 96,884            |                     |                     |                              | 827         | 827       | 97,711                       |       |
| Real estate Loans:   |                   |                     |                     |                              |             |           |                              |       |
| Construction   | 362,084           | 3,884               |                     |                              | 736         | 4,620     | 366,704                      |       |
| Commercial and farmland  | 1,786,092         | 5,552               |                     |                              | 11,277      | 16,829    | 1,802,921                    |       |
| Residential  | 765,634           | 6,090               | \$ 2,061            | \$ 502                       | 11,818      | 20,471    | 786,105                      |       |
| Home equity  | 344,344           | 1,433               | 560                 | 324                          | 1,952       | 4,269     | 348,613                      |       |
| Individuals' loans for household and other personal expenditures | 73,990            | 445                 | 56                  | 81                           | 145         | 727       | 74,717                       |       |
| Lease financing receivables, net of unearned income              | 588               |                     |                     |                              |             |           | 588                          |       |
| Other commercial loans   | 159,324           |                     | 64                  |                              |             | 64        | 159,388                      |       |
| Loans  | \$ 4,641,215      | \$ 17,570           | \$ 2,741            | \$ 907                       | \$ 31,389   | \$ 52,607 | \$ 4,693,822                 |       |

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 Quarterly Report on Form 10-Q.

On occasion, borrowers experience declines in income and cash flow. As a result, these borrowers seek to reduce contractual cash outlays including debt payments. Concurrently, in an effort to preserve and protect its earning assets, specifically troubled loans, the Corporation works to maintain its relationship with certain customers who are experiencing financial difficulty by contractually modifying the borrower's debt agreement with the Corporation. In certain loan restructuring situations, the Corporation may grant a concession to a debtor experiencing financial difficulty, resulting in a trouble debt restructuring. A concession is deemed to be granted when, as a result of the restructuring, the Corporation does not expect to collect all original 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 in the Corporation's loan portfolio that occurred during the periods indicated:

|                                 | Three Months Ended June 30, 2016  |                                    |                 | Six Months Ended June 30, 2016    |                                    |                 |
|---------------------------------|-----------------------------------|------------------------------------|-----------------|-----------------------------------|------------------------------------|-----------------|
|                                 | Pre-Modification Recorded Balance | Post-Modification Recorded Balance | Number of Loans | Pre-Modification Recorded Balance | Post-Modification Recorded Balance | Number of Loans |
| Commercial and industrial loans |                                   |                                    |                 | \$ 260                            | \$ 260                             | 3               |

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|   |         |          |   |         |          |    |
|---|---------|----------|---|---------|----------|----|
| Agriculture production financing and other loans to farmers | \$1,141 | \$ 1,141 | 3 | 1,606   | 1,472    | 5  |
| Real estate Loans:  |         |          |   |         |          |    |
| Commercial and farmland                                     | 3,539   | 3,508    | 5 | 3,891   | 3,860    | 6  |
| Residential   |         |          |   | 113     | 133      | 3  |
| Home Equity   | 174     | 146      | 1 | 174     | 146      | 1  |
| Total   | \$4,854 | \$ 4,795 | 9 | \$6,044 | \$ 5,871 | 18 |

|                                 | Three Months Ended June 30, 2015        |  |                       | Six Months Ended June 30, 2015          |  |                       |
|---------------------------------|---|--|-----------------------|---|--|-----------------------|
|                                 | Pre-Modification<br>Recorded<br>Balance | Post-Modification<br>Recorded<br>Balance | Number<br>of<br>Loans | Pre-Modification<br>Recorded<br>Balance | Post-Modification<br>Recorded<br>Balance | Number<br>of<br>Loans |
| Commercial and industrial loans | \$1,386                                 | \$ 536                                   | 1                     | \$3,748                                 | \$ 1,897                                 | 5                     |
| Real estate Loans:              |   |  |                       |   |  |                       |
| Construction                    |   |  |                       | 79                                      | 80                                       | 1                     |
| Commercial and farmland         | 537                                     | 537                                      | 1                     | 537                                     | 2,280                                    | 2                     |
| Residential                     | 20                                      | 871                                      | 2                     | 44                                      | 895                                      | 3                     |
| Total                           | \$1,943                                 | \$ 1,944                                 | 4                     | \$4,408                                 | \$ 5,152                                 | 11                    |

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(table dollar amounts in thousands, except share data)

(Unaudited)

The following tables summarize the recorded investment of troubled debt restructurings as of June 30, 2016 and 2015, by modification type, that occurred during the periods indicated:

|   | Three Months Ended June 30, 2016 |                      |             | Total<br>Modification |
|---|----------------------------------|----------------------|-------------|-----------------------|
|   | Term<br>Modification             | Rate<br>Modification | Combination |                       |
| Agriculture production financing and other loans to farmers | \$ 1,141                         |                      |             | \$ 1,141              |
| Real estate Loans:  |                                  |                      |             |                       |
| Commercial and farmland                                     | 418                              |                      | \$ 3,086    | 3,504                 |
| Home Equity   |                                  | \$ 143               |             | 143                   |
| Total   | \$ 1,559                         | \$ 143               | \$ 3,086    | \$ 4,788              |

|   | Six Months Ended June 30, 2016 |                      |             | Total<br>Modification |
|---|--------------------------------|----------------------|-------------|-----------------------|
|   | Term<br>Modification           | Rate<br>Modification | Combination |                       |
| Commercial and industrial loans                             |                                |                      | \$ 198      | \$ 198                |
| Agriculture production financing and other loans to farmers | \$ 1,141                       | \$ 49                |             | 1,190                 |
| Real estate Loans:  |                                |                      |             |                       |
| Commercial and farmland                                     | 418                            |                      | 3,433       | 3,851                 |
| Residential   |                                | 112                  |             | 112                   |
| Home Equity   |                                | 143                  |             | 143                   |
| Total   | \$ 1,559                       | \$ 304               | \$ 3,631    | \$ 5,494              |

|                                 | Three Months Ended June 30, 2015 |                      |             | Total<br>Modification |
|---------------------------------|----------------------------------|----------------------|-------------|-----------------------|
|                                 | Term<br>Modification             | Rate<br>Modification | Combination |                       |
| Commercial and industrial loans | \$ 492                           |                      |             | \$ 492                |
| Real estate Loans:              |                                  |                      |             |                       |
| Commercial and farmland         |                                  |                      | \$ 240      | 240                   |
| Residential                     | 850                              | \$ 21                |             | 871                   |
| Total                           | \$ 1,342                         | \$ 21                | \$ 240      | \$ 1,603              |

|                                 | Six Months Ended June 30, 2015 |                      |             | Total<br>Modification |
|---------------------------------|--------------------------------|----------------------|-------------|-----------------------|
|                                 | Term<br>Modification           | Rate<br>Modification | Combination |                       |
| Commercial and industrial loans | \$ 1,234                       |                      | \$ 1,030    | \$ 2,264              |
| Real estate Loans:              |                                |                      |             |                       |
| Construction                    | 199                            |                      |             | 199                   |
| Commercial and farmland         | 1,442                          |                      | 240         | 1,682                 |
| Residential                     | 850                            | \$ 47                |             | 897                   |

Total \$3,725 \$ 47 \$ 1,270 \$ 5,042

Commercial and farmland real estate loans made up 66 percent of the post-modification balance of troubled debt restructured loans made in the six months ended June 30, 2016.

The following tables summarize troubled debt restructures that occurred during the three and six months ended June 30, 2016, that subsequently defaulted during the period indicated and remained in default at period end. There were no troubled debt restructures that occurred during the three and six months ended June 30, 2015 that subsequently defaulted during this period. For purposes of this discussion, a loan is considered in default if it is 30 or more days past due.

|                                 | Three<br>Months<br>Ended June<br>30, 2016    | Six Months<br>Ended June<br>30, 2016         |
|---------------------------------|--|--|
|                                 | Number<br>Recorded<br>of<br>Balance<br>Loans | Number<br>Recorded<br>of<br>Balance<br>Loans |
| Commercial and industrial loans | 1 \$ 72                                      | 4 \$ 269                                     |
| Real estate Loans:              |  |  |
| Residential                     | 1 55   | 1 55   |
| Total                           | 2 \$ 127                                     | 5 \$ 324                                     |

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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. Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process totaled \$2,735,000 and \$1,391,000 at June 30, 2016 and December 31, 2015, respectively.

Commercial troubled debt restructured loans risk graded special mention, substandard, doubtful and loss are individually evaluated for impairment under ASC 310. Any resulting specific reserves are included in the allowance for loan losses. Commercial 30 - 89 day delinquent troubled debt restructurings are included in the calculation of the delinquency trend environmental allowance allocation. All commercial non-impaired loans, including non-accrual and 90+ day delinquents, are included in the ASC 450 loss migration analysis.

## NOTE 5

## ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE

The acquired loans detailed in the tables below are included in NOTE 4. LOANS AND ALLOWANCE, in the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q. As described in NOTE 4, loans purchased after December 31, 2008 are recorded at the acquisition date fair value, which could result in a fair value discount or premium. Purchased loans with evidence of credit deterioration since origination and for which it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments are accounted for under ASC 310-30, Loans Acquired with Deteriorated Credit Quality. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the nonaccretable portion of the fair value discount or premium. The accretable portion of the fair value discount or premium is the difference between the expected cash flows and the net present value of expected cash flows, with such difference accreted into earnings over the term of the loans. All other loans not accounted for under ASC 310-30 are accounted for under ASC 310-20.

The Corporation's recent acquisitions are detailed in NOTE 2, ACQUISITIONS AND DIVESTITURES, in the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q. In addition, the Corporation acquired Community Bancshares, Inc. ("Community") in November 2014 and CFS Bancorp, Inc. ("CFS") in November 2013. The Corporation also acquired certain loans from SCB Bank ("SCB") in February 2012. The following table includes the outstanding balance and carrying amount of all acquired loans which were included in the Corporation's balance sheet at June 30, 2016, and December 31, 2015.

|                                 | June 30, 2016 |                |           |          |         |          |
|---------------------------------|---------------|----------------|-----------|----------|---------|----------|
|                                 | Ameriana      | C<br>Financial | Community | CFS      | SCB     | Total    |
| Commercial and industrial loans | \$21,544      | \$95           | \$5,613   | \$49,079 | \$4,408 | \$80,739 |



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|  |           |          |          |           |          |           |
|--|-----------|----------|----------|-----------|----------|-----------|
| Agricultural production financing and other loans to farmers     |           |          | 2,802    | 25        | 1,047    | 3,874     |
| Real estate loans:   |           |          |          |           |          |           |
| Construction   | 32,597    | 5,034    | 8,923    | 624       |          | 47,178    |
| Commercial and farmland  | 120,330   | 25,024   | 45,281   | 164,742   | 11,265   | 366,642   |
| Residential  | 112,520   | 48,782   | 12,159   | 107,895   | 5,467    | 286,823   |
| Home Equity  | 13,029    | 8,646    | 7,724    | 29,464    | 12,480   | 71,343    |
| Individuals' loans for household and other personal expenditures | 1,101     | 5        | 238      | 295       | 38       | 1,677     |
| Other commercial loans   | 1,840     |          |          | 69        |          | 1,909     |
| Total  | \$302,961 | \$87,586 | \$82,740 | \$352,193 | \$34,705 | \$860,185 |
| Carrying Amount  | \$290,946 | \$85,505 | \$77,933 | \$336,031 | \$30,743 | \$821,158 |
| Allowance  |           | 180      | 22       |           |          | 202       |
| Carrying Amount Net of Allowance                                 | \$290,946 | \$85,325 | \$77,911 | \$336,031 | \$30,743 | \$820,956 |

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|  | December 31, 2015 |           |           |           |          |           |
|--|-------------------|-----------|-----------|-----------|----------|-----------|
|  | Ameriana          | C         | Community | CFS       | SCB      | Total     |
|  | Financial         |           |           |           |          |           |
| Commercial and industrial loans                                  | \$21,888          | \$ 104    | \$ 6,769  | \$52,060  | \$4,620  | \$85,441  |
| Agricultural production financing and other loans to farmers     |                   |           | 1,761     |           | 1,288    | 3,049     |
| Real estate loans:   |                   |           |           |           |          |           |
| Construction   | 23,365            | 6,214     | 10,436    | 976       |          | 40,991    |
| Commercial and farmland  | 144,514           | 27,838    | 49,997    | 189,372   | 13,293   | 425,014   |
| Residential  | 123,231           | 55,856    | 21,886    | 118,105   | 6,063    | 325,141   |
| Home Equity  | 14,261            | 9,144     | 8,231     | 31,986    | 13,431   | 77,053    |
| Individuals' loans for household and other personal expenditures | 1,731             | 10        | 461       | 443       | 48       | 2,693     |
| Other commercial loans   | 1,928             |           |           | 72        |          | 2,000     |
| Total  | \$330,918         | \$ 99,166 | \$ 99,541 | \$393,014 | \$38,743 | \$961,382 |
| Carrying Amount  | \$319,664         | \$96,829  | \$ 93,355 | \$373,649 | \$34,092 | \$917,589 |
| Allowance  |                   |           | 4         | 149       |          | 153       |
| Carrying Amount Net of Allowance                                 | \$319,664         | \$96,829  | \$ 93,351 | \$373,500 | \$34,092 | \$917,436 |

The outstanding balance and related carrying amount of loans acquired and accounted for under ASC 310-30 as of June 30, 2016 were \$76.6 million and \$55.8 million, respectively. Additionally, the outstanding balance and related carrying amount of those loans as of December 31, 2015 were \$95.8 million and \$69.6 million, respectively.

As customer cash flow expectations improve, nonaccretable yield can be reclassified to accretable yield. The accretable yield, or income expected to be collected, and reclassifications from nonaccretable yield, are identified in the table below. The table reflects only purchased loans accounted for under ASC 310-30 and not the entire portfolio of purchased loans.

|                                     | Three Months Ended June 30, 2016 |        |           |         |        |          |
|-------------------------------------|----------------------------------|--------|-----------|---------|--------|----------|
|                                     | Ameriana                         | C      | Community | CFS     | SCB    | Total    |
|                                     | Financial                        |        |           |         |        |          |
| Beginning balance                   | \$2,120                          | \$ 100 | \$ 1,456  | \$1,033 | \$590  | \$5,299  |
| Additions                           |                                  |        |           |         |        |          |
| Accretion                           | (47 )                            | (71 )  | (849 )    | (855 )  | (293 ) | (2,115 ) |
| Reclassification from nonaccretable | 5                                | 52     | 738       | 737     | 154    | 1,686    |
| Disposals                           | (232 )                           |        |           | (11 )   |        | (243 )   |
| Ending balance                      | \$1,846                          | \$ 81  | \$ 1,345  | \$904   | \$451  | \$4,627  |

|                   | Six Months Ended June 30, 2016 |        |           |         |       |         |
|-------------------|--------------------------------|--------|-----------|---------|-------|---------|
|                   | Ameriana                       | C      | Community | CFS     | SCB   | Total   |
|                   | Financial                      |        |           |         |       |         |
| Beginning balance | \$2,160                        | \$ 114 | \$ 1,508  | \$1,188 | \$642 | \$5,612 |
| Additions         |                                |        |           |         |       |         |

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|                                     |         |       |          |          |        |          |
|-------------------------------------|---------|-------|----------|----------|--------|----------|
| Accretion                           | (87 )   | (86 ) | (912 )   | (2,145 ) | (381 ) | (3,611 ) |
| Reclassification from nonaccretable | 5       | 53    | 749      | 1,872    | 190    | 2,869    |
| Disposals                           | (232 )  |       |          | (11 )    |        | (243 )   |
| Ending balance                      | \$1,846 | \$ 81 | \$ 1,345 | \$904    | \$451  | \$4,627  |

Three Months Ended June 30, 2015

|                                     | C<br>Financial | .Community | CFS     | SCB    | Total    |
|-------------------------------------|----------------|------------|---------|--------|----------|
| Beginning balance                   |                | \$ 1,990   | \$2,009 | \$818  | \$4,817  |
| Additions                           | \$145          |            |         |        | 145      |
| Accretion                           | (12 )          | (353 )     | (578 )  | (304 ) | (1,247 ) |
| Reclassification from nonaccretable |                | 181        | 309     | 244    | 734      |
| Disposals                           |                |            | (8 )    |        | (8 )     |
| Ending balance                      | \$133          | \$ 1,818   | \$1,732 | \$758  | \$4,441  |

Six Months Ended June 30, 2015

|                                     | C<br>Financial | .Community | CFS      | SCB    | Total    |
|-------------------------------------|----------------|------------|----------|--------|----------|
| Beginning balance                   |                | \$ 2,122   | \$2,400  | \$868  | \$5,390  |
| Additions                           | \$145          |            |          |        | \$145    |
| Accretion                           | (12 )          | (532 )     | (1,919 ) | (489 ) | (2,952 ) |
| Reclassification from nonaccretable |                | 228        | 1,259    | 379    | 1,866    |
| Disposals                           |                |            | (8 )     |        | (8 )     |
| Ending balance                      | \$133          | \$ 1,818   | \$1,732  | \$758  | \$4,441  |

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## NOTE 6

## GOODWILL

Goodwill is recorded on the acquisition date of an entity. During the measurement period, the Corporation may record subsequent adjustments to goodwill for provisional amounts recorded at the acquisition date. The Ameriana acquisition on December 31, 2015 resulted in \$38,624,000 of goodwill, of which, \$871,000 was recorded during the first quarter of 2016 as a measurement period adjustment. The C Financial acquisition on April 17, 2015 resulted in goodwill of \$11,126,000. On June 12, 2015, the sale of FMIG resulted in a goodwill reduction of \$8,474,000. Details regarding the acquisitions and sale are discussed in NOTE 2. ACQUISITIONS AND DIVESTITURES, in the Notes to Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

|                               | 2016      |
|-------------------------------|-----------|
| Balance, January 1            | \$243,129 |
| Measurement period adjustment | 871       |
| Balance, June 30              | \$244,000 |

|                      | 2015      |
|----------------------|-----------|
| Balance, January 1   | \$202,724 |
| Goodwill acquired    | 48,879    |
| Goodwill reduction   | (8,474 )  |
| Balance, December 31 | \$243,129 |

## NOTE 7

## CORE DEPOSIT AND OTHER INTANGIBLES

Core deposit and other intangibles are recorded on the acquisition date of an entity. During the measurement period, the Corporation may record subsequent adjustments to core deposit and other intangibles for provisional amounts recorded at the acquisition date. The Ameriana acquisition on December 31, 2015 resulted in a core deposit intangible of \$5,342,000, of which, \$2,142,000 was recorded as a measurement period adjustment in the first quarter of 2016. The C Financial acquisition on April 17, 2015 resulted in a core deposit intangible of \$981,000. On June 12, 2015, the sale of FMIG resulted in an other intangible reduction of \$742,000. Details regarding the acquisitions and sale are discussed in NOTE 2. ACQUISITIONS AND DIVESTITURES, in the Notes to Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

The carrying basis and accumulated amortization of recognized core deposit and other intangibles are noted below.

|   | June 30, | December 31, |
|---|----------|--------------|
|   | 2016     | 2015         |
| Gross carrying amount                       | \$61,798 | \$ 58,360    |
| Core deposit and other intangibles acquired |          | 4,181        |

|  |           |           |
|--|-----------|-----------|
| Accumulated amortization                     | (47,119 ) | (45,164 ) |
| Measurement period adjustment                | 2,142     |           |
| Core deposit and other intangibles reduction | (742 )    |           |
| Core deposit and other intangibles           | \$16,821  | \$ 16,635 |

Estimated future amortization expense is summarized as follows:

|            | Amortization<br>Expense |
|------------|-------------------------|
| 2016       | \$ 1,955                |
| 2017       | 3,614                   |
| 2018       | 2,299                   |
| 2019       | 1,914                   |
| 2020       | 1,733                   |
| After 2020 | 5,306                   |
|            | \$ 16,821               |

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NOTE 8

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 June 30, 2016 and December 31, 2015, the Corporation had five interest rate swaps with a notional amount of \$56.0 million and one interest rate cap with a notional amount of \$13.0 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation expects to reclassify \$1,274,000 from accumulated other comprehensive income to interest expense.

During 2016, \$26.0 million of the interest rate swaps and the \$13.0 million interest rate cap were used to hedge the LIBOR-based variable cash outflows associated with existing trust preferred securities when the outflows converted from a fixed rate to variable rate in September of 2012. In addition, the remaining \$30.0 million of interest rate swaps were used to hedge the LIBOR-based variable cash outflows associated with three Federal Home Loan Bank advances. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

During the six months ended June 30, 2016, and 2015, the Corporation did not recognize any ineffectiveness.

#### 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 June 30, 2016, the notional amount of customer-facing swaps was approximately \$205,884,000. This amount is offset with third party counterparties, as described above.

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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 June 30, 2016, and December 31, 2015.

|  | Asset Derivatives      |            |                        |            | Liability Derivatives  |            |                        |            |
|--|------------------------|------------|------------------------|------------|------------------------|------------|------------------------|------------|
|  | June 30, 2016          |            | December 31, 2015      |            | June 30, 2016          |            | December 31, 2015      |            |
|  | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments:     |                        |            |                        |            |                        |            |                        |            |
| Interest rate contracts                            | Other Assets           | \$5        | Other Assets           | \$36       | Other Liabilities      | \$5,092    | Other Liabilities      | \$2,921    |
| Derivatives not designated as hedging instruments: |                        |            |                        |            |                        |            |                        |            |
| Interest rate contracts                            | Other Assets           | \$11,971   | Other Assets           | \$4,938    | Other Liabilities      | \$12,669   | Other Liabilities      | \$5,149    |

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

| Derivatives in Cash Flow Hedging Relationships | Amount of Gain (Loss) Recognized in Other Comprehensive Income on Derivative (Effective Portion) |                                |                                  |                                |
|--|--|--------------------------------|----------------------------------|--------------------------------|
|  | Three Months Ended June 30, 2016   | Six Months Ended June 30, 2015 | Three Months Ended June 30, 2016 | Six Months Ended June 30, 2015 |
| Interest Rate Products                         | \$(813)  | \$ 807                         | \$(2,767)                        | \$(469 )                       |

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 and six months ended June 30, 2016, and 2015.

| Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10 | Location of Gain (Loss) Recognized in Income on Derivative | Amount of Gain (Loss) Recognized in Income on |                                |
|---|--|---|--------------------------------|
|   |  | Three Months Ended June 30, 2016              | Six Months Ended June 30, 2015 |
|   |  |   |                                |



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|                         |              | Derivative<br>Three<br>Months<br>Ended<br>June<br>30,<br>2016 | Three<br>Months<br>Ended<br>June 30,<br>2015 |
|-------------------------|--------------|---|--|
| Interest rate contracts | Other income | \$(242)   | \$ 156                                       |

|   |   | Amount of Gain<br>(Loss)<br>Recognized in<br>Income on | Derivative                                 |
|---|---|--|--|
| Derivatives Not Designated as<br>Hedging Instruments under<br>FASB ASC 815-10 | Location of Gain (Loss)<br>Recognized Income on<br>Derivative | Six<br>Months<br>Ended<br>June<br>30,<br>2016          | Six<br>Months<br>Ended<br>June 30,<br>2015 |
| Interest rate contracts   | Other income  | \$(488 )   | \$ 55                                      |

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

|   |   | Amount of Gain<br>(Loss)<br>Reclassified from<br>Other<br>Comprehensive<br>Income into | Income                                       |
|---|---|--|--|
| Derivatives Designated as<br>Hedging Instruments under<br>FASB ASC 815-10 | Location of Gain (Loss)<br>Recognized Income on<br>Derivative | (Effective<br>Portion)   |  |
|   |   | Three<br>Months<br>Ended<br>June<br>30,<br>2016  | Three<br>Months<br>Ended<br>June 30,<br>2015 |
| Interest rate contracts   | Interest Expense  | (318 )   | (358 )                                       |

|   |   | Amount of Gain<br>(Loss)<br>Reclassified from<br>Other<br>Comprehensive<br>Income into | Income |
|---|---|--|--------|
| Derivatives Designated as<br>Hedging Instruments under<br>FASB ASC 815-10 | Location of Gain (Loss)<br>Recognized Income on<br>Derivative |  |        |

|                         |                  | (Effective<br>Portion)                        |  |
|-------------------------|------------------|---|--|
|                         |                  | Six<br>Months<br>Ended<br>June<br>30,<br>2016 | Six<br>Months<br>Ended<br>June 30,<br>2015 |
| Interest rate contracts | Interest Expense | \$ (642 )                                     | \$ (712 )                                  |

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 level of risk is monitored by performing quarterly financial reviews, comparing mark-to-mark values with policy limitations, monitoring credit ratings and pledging of collateral.

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Credit-risk-related Contingent Features

The Corporation 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 adequately capitalized institution, then the Corporation could be required to terminate or fully collateralize all outstanding derivative contracts.

The Corporation also 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 June 30, 2016, the termination value of derivatives in a net liability position related to these agreements was \$18,063,000. As of June 30, 2016, the Corporation had minimum collateral posting thresholds with certain of its derivative counterparties and had posted collateral of \$18,011,000. If the Corporation had breached any of these provisions at June 30, 2016, it could have been required to settle its obligations under the agreements at their termination value.

NOTE 9

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.

#### Recurring Measurements

The following is a description of the valuation methodologies and inputs used for instruments measured at fair value on a recurring basis and recognized in the accompanying Consolidated Condensed Balance Sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques as of June 30, 2016.

#### 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 a discounted cash flow model. Level 2 securities include agencies, mortgage-backed, 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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## Interest Rate Derivative Agreements

See information regarding the Corporation's interest rate derivative products in NOTE 8. DERIVATIVE FINANCIAL INSTRUMENTS, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

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 June 30, 2016, and December 31, 2015.

| June 30, 2016  | Fair Value | Fair Value Measurements Using:                                 |   |   |
|--|------------|--|---|---|
|  |            | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available for sale securities:                       |            |  |   |   |
| U.S. Government-sponsored agency securities          | \$ 102     |  | \$ 102  |   |
| State and municipal                                  | 353,480    |  | 347,951                                       | \$ 5,529                                  |
| U.S. Government-sponsored mortgage-backed securities | 301,271    |  | 301,271                                       |   |
| Corporate obligations                                | 31         |  |   | 31  |
| Equity securities                                    | 3,945      |  | 3,941   | 4   |
| Interest rate swap asset                             | 11,971     |  | 11,971  |   |
| Interest rate cap                                    | 5          |  | 5   |   |
| Interest rate swap liability                         | 17,761     |  | 17,761  |   |

| December 31, 2015                                    | Fair Value | Fair Value Measurements Using:                                 |   |   |
|--|------------|--|---|---|
|  |            | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available for sale securities:                       |            |  |   |   |
| U.S. Government-sponsored agency securities          | \$ 104     |  | \$ 104  |   |
| State and municipal                                  | 305,911    |  | 300,014                                       | \$ 5,897                                  |
| U.S. Government-sponsored mortgage-backed securities | 346,266    |  | 346,266                                       |   |
| Certificates of deposit                              | 2,176      |  | 2,176   |   |
| Corporate obligations                                | 31         |  |   | 31  |
| Equity securities                                    | 3,912      |  | 3,908   | 4   |
| Interest rate swap asset                             | 4,938      |  | 4,938   |   |

|                              |       |       |
|------------------------------|-------|-------|
| Interest rate cap            | 36    | 36    |
| Interest rate swap liability | 8,070 | 8,070 |

## 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 and six months ended June 30, 2016 and 2015.

|   | Available for Sale Securities                   |  |  |  |
|---|---|--|--|--|
|   | Three<br>Months<br>Ended<br>June<br>30,<br>2016 | Three<br>Months<br>Ended<br>June 30,<br>2015 | Six<br>Months<br>Ended<br>June 30,<br>2016 | Six<br>Months<br>Ended<br>June 30,<br>2015 |
| Balance at beginning of the period              | \$5,504   | \$6,198                                      | \$5,932                                    | \$6,646                                    |
| Total realized and unrealized gains and losses: |   |  |  |  |
| Included in net income                          |   |  |  |  |
| Included in other comprehensive income          | 59  | 50   | 96   | 141  |
| Purchases, issuances and settlements            |   |  |  |  |
| Transfers in/(out) of Level 3                   |   |  |  |  |
| Principal payments                              | 1   | (220)  | (464)                                      | (759)                                      |
| Ending balance                                  | \$5,564   | \$6,028                                      | \$5,564                                    | \$6,028                                    |

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 June 30, 2016 or December 31, 2015.

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## Transfers Between Levels

There were no transfers in or out of Level 3 for the three and six months ended June 30, 2016 and 2015.

## 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 June 30, 2016, and December 31, 2015.

|                                       | Fair Value | Fair Value Measurements Using                                  |   |   |
|---------------------------------------|------------|--|---|---|
|                                       |            | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
| June 30, 2016                         |            |  |   |   |
| Impaired loans (collateral dependent) | \$11,013   |  |   | \$ 11,013                                       |
| Other real estate owned               | 2,256      |  |   | 2,256   |

|                                       | Fair Value | Fair Value Measurements Using                                  |   |   |
|---------------------------------------|------------|--|---|---|
|                                       |            | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Observable Inputs (Level 2) | Significant Other Unobservable Inputs (Level 3) |
| December 31, 2015                     |            |  |   |   |
| Impaired loans (collateral dependent) | \$7,066    |  |   | \$ 7,066  |
| Other real estate owned               | 5,529      |  |   | 5,529   |

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 2016, 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 June 30, 2016 and December 31, 2015.

| June 30, 2016                               | Fair Value | Valuation Technique           | Unobservable Inputs   | Range (Weighted-Average)                     |
|---|------------|-------------------------------|---|--|
| State and municipal securities              | \$5,529    | Discounted cash flow          | Maturity/Call date<br>Blend of US Muni BQ curve<br>Discount rate          | 1 month to 20 yrs<br>A- to BBB-<br>.69% - 5% |
| Corporate obligations and Equity securities | \$35       | Discounted cash flow          | Risk free rate<br>plus premium for illiquidity                            | 3 month LIBOR<br>plus 200bps                 |
| Impaired loans (collateral dependent)       | \$11,013   | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 10% (1%)                                |
| Other real estate owned                     | \$2,256    | Appraisals                    | Discount to reflect current market conditions                             | 0% - 10% (4%)                                |
| December 31, 2015                           | Fair Value | Valuation Technique           | Unobservable Inputs   | Range (Weighted-Average)                     |
| State and municipal securities              | \$5,897    | Discounted cash flow          | Maturity/Call date<br>Blend of US Muni BQ curve<br>Discount rate          | 1 month to 15 yrs<br>A- to BBB-<br>.80% - 5% |
| Corporate obligations and Equity securities | \$35       | Discounted cash flow          | Risk free rate<br>plus premium for illiquidity                            | 3 month LIBOR<br>plus 200bps                 |
| Impaired loans (collateral dependent)       | \$7,066    | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 50% (2%)                                |
| Other real estate owned                     | \$5,529    | Appraisals                    | Discount to reflect current market conditions                             | 0% - 20% (2%)                                |

## 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 how those inputs might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

State and Municipal Securities, Corporate Obligations and Equity Securities

The significant unobservable inputs used in the fair value measurement of the Corporation's state and municipal securities, corporate obligations and 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.

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## Fair Value of Financial Instruments

The following table presents estimated fair values of the Corporation's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at June 30, 2016, and December 31, 2015.

|   | Carrying Amount | June 30, 2016  |   |   |
|---|-----------------|--|---|---|
|   |                 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets:   |                 |  |   |   |
| Cash and cash equivalents                             | \$ 120,471      | \$ 120,471   |   |   |
| Interest-bearing time deposits                        | 62,533          | 62,533   |   |   |
| Investment securities available for sale              | 658,829         |  | \$ 653,265                                    | \$ 5,564                                  |
| Investment securities held to maturity                | 638,972         |  | 648,705                                       | 16,361                                    |
| Loans held for sale                                   | 18,854          |  | 18,854  |   |
| Loans   | 4,729,243       |  |   | 4,710,073                                 |
| Federal Reserve Bank and Federal Home Loan Bank stock | 18,096          |  | 18,096  |   |
| Interest rate swap and cap asset                      | 11,976          |  | 11,976  |   |
| Interest receivable                                   | 23,351          |  | 23,351  |   |
| Liabilities:  |                 |  |   |   |
| Deposits  | \$ 5,407,554    | \$ 4,268,709   | \$ 1,129,241                                  |   |
| Borrowings:   |                 |  |   |   |
| Federal funds purchased                               | 20,000          |  | 20,000  |   |
| Securities sold under repurchase agreements           | 140,777         |  | 140,763                                       |   |
| Federal Home Loan Bank advances                       | 268,579         |  | 268,150                                       |   |
| Subordinated debentures and term loans                | 127,678         |  | 103,155                                       |   |
| Interest rate swap liability                          | 17,761          |  | 17,761  |   |
| Interest payable                                      | 3,051           |  | 3,051   |   |

| Carrying Amount | December 31, 2015                                    |                                     |                                 |
|-----------------|--|-------------------------------------|---------------------------------|
|                 | Quoted Prices in Active Markets for Identical Assets | Significant Other Observable Inputs | Significant Unobservable Inputs |

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|   |             | (Level 1)   | (Level 2)   | (Level 3) |
|---|-------------|-------------|-------------|-----------|
| Assets:   |             |             |             |           |
| Cash and cash equivalents                             | \$102,170   | \$102,170   |             |           |
| Interest-bearing time deposits                        | 32,315      | 32,315      |             |           |
| Investment securities available for sale              | 658,400     |             | \$652,468   | \$ 5,932  |
| Investment securities held to maturity                | 618,599     |             | 598,082     | 34,298    |
| Loans held for sale                                   | 9,894       |             | 9,894       |           |
| Loans   | 4,631,369   |             |             | 4,539,940 |
| Federal Reserve Bank and Federal Home Loan Bank stock | 37,633      |             | 37,633      |           |
| Interest rate swap and cap asset                      | 4,974       |             | 4,974       |           |
| Interest receivable                                   | 24,415      |             | 24,415      |           |
| Liabilities:  |             |             |             |           |
| Deposits  | \$5,289,647 | \$4,095,004 | \$1,177,142 |           |
| Borrowings:   |             |             |             |           |
| Federal funds purchased                               | 49,721      |             | 49,721      |           |
| Securities sold under repurchase agreements           | 155,325     |             | 155,325     |           |
| Federal Home Loan Bank advances                       | 235,652     |             | 236,375     |           |
| Subordinated debentures and term loans                | 127,846     |             | 103,643     |           |
| Interest rate swap liability                          | 8,070       |             | 8,070       |           |
| Interest payable                                      | 3,092       |             | 3,092       |           |

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 10

TRANSFERS ACCOUNTED FOR AS SECURED BORROWINGS

The collateral pledged for all repurchase agreements that are accounted for as secured borrowings as of June 30, 2016 and December 31, 2015 were:

|  | June 30, 2016                                    |          |          |                 |            |
|--|--|----------|----------|-----------------|------------|
|  | Remaining Contractual Maturity of the Agreements |          |          |                 |            |
|  | Overnight  | Up to 30 | 30-90    | Greater Than 90 | Total      |
|  | and  | Days     | Days     | Days            |            |
|  | Continuo   | Days     | Days     | Days            |            |
| U.S. Government-sponsored mortgage-backed securities | \$ 119,935                                       | \$ 1,335 | \$ 2,672 | \$ 16,835       | \$ 140,777 |

|  | December 31, 2015                                |          |          |                 |            |
|--|--|----------|----------|-----------------|------------|
|  | Remaining Contractual Maturity of the Agreements |          |          |                 |            |
|  | Overnight  | Up to 30 | 30-90    | Greater Than 90 | Total      |
|  | and  | Days     | Days     | Days            |            |
|  | Continuo   | Days     | Days     | Days            |            |
| U.S. Government-sponsored mortgage-backed securities | \$ 131,537                                       | \$ 5,680 | \$ 8,892 | \$ 9,216        | \$ 155,325 |

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## NOTE 11

## ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table summarizes the changes in the balances of each component of accumulated other comprehensive income (loss), net of tax, as of June 30, 2016 and 2015:

|  | Accumulated Other Comprehensive<br>Income (Loss)                             |  |  | Total       |
|--|--|--|--|-------------|
|  | Unrealized<br>Gains<br>(Losses)<br>on<br>Securities<br>Available<br>for Sale | Unrealized<br>Gains<br>(Losses)<br>on Cash<br>Flow<br>Hedges | Unrealized<br>Gains<br>(Losses)<br>on<br>Defined<br>Benefit<br>Plans |             |
| Balance at December 31, 2015                                     | \$12,325   | \$ (2,347 )  | \$ (11,340 )   | \$ (1,362 ) |
| Other comprehensive income before reclassifications              | 10,885   | (1,798 )   |  | 9,087       |
| Amounts reclassified from accumulated other comprehensive income | (1,107 )   | 417  |  | (690 )      |
| Period change  | 9,778  | (1,381 )   | —  | 8,397       |
| Balance at June 30, 2016   | \$22,103   | \$ (3,728 )  | \$ (11,340 )   | \$7,035     |
| Balance at December 31, 2014                                     | \$14,098   | \$ (2,182 )  | \$ (13,546 )   | \$ (1,630 ) |
| Other comprehensive income before reclassifications              | (4,413 )   | (304 )   |  | (4,717 )    |
| Amounts reclassified from accumulated other comprehensive income | (606 )   | 463  |  | (143 )      |
| Period change  | (5,019 )   | 159  | —  | (4,860 )    |
| Balance at June 30, 2015   | \$9,079  | \$ (2,023 )  | \$ (13,546 )   | \$ (6,490 ) |

The following table presents the reclassification adjustments out of accumulated other comprehensive income (loss) that were included in net income in the Consolidated Condensed Statements of Income for the three and six months ended June 30, 2016 and 2015:

|      |      | Amount<br>Reclassified<br>from<br>Accumulated<br>Other<br>Comprehensive<br>Income (Loss)<br>For the Three<br>Months Ended<br>June 30, | Affected Line Item in the Statements of Income |
|------|------|---|--|
| 2016 | 2015 |   |  |
|      |      |   |  |

Details about Accumulated Other Comprehensive  
Income (Loss) Components

Unrealized gains (losses) on available for sale  
securities <sup>(1)</sup>

|   |        |          |   |
|---|--------|----------|---|
| Realized securities gains (losses) reclassified into income | \$ 706 | \$ (93 ) | Other income - net realized gains on sales of available for sale securities |
| Related income tax expense                                  | (247 ) | 33       | Income tax expense  |
|   | \$ 459 | \$ (60 ) |   |

Unrealized gains (losses) on cash flow hedges <sup>(2)</sup>

|                            |           |           |   |
|----------------------------|-----------|-----------|---|
| Interest rate contracts    | \$ (318 ) | \$ (358 ) | Interest expense - subordinated debentures and term loans |
| Related income tax benefit | 111       | 125       | Income tax expense  |
|                            | \$ (207 ) | \$ (233 ) |   |

Total reclassifications for the period, net of tax

\$ 252    \$ (293 )

Amount  
Reclassified  
from  
Accumulated  
Other  
Comprehensive  
Income (Loss)  
For the Six  
Months Ended  
June 30,

Details about Accumulated Other Comprehensive  
Income (Loss) Components

Unrealized gains (losses) on available for sale  
securities <sup>(1)</sup>

|  |          |        |   |
|--|----------|--------|---|
| Realized securities gains reclassified into income | 2016     | 2015   | Affected Line Item in the Statements of Income                              |
| Realized securities gains reclassified into income | \$ 1,703 | \$ 932 | Other income - net realized gains on sales of available for sale securities |
| Related income tax expense                         | (596 )   | (326 ) | Income tax expense  |
|  | \$ 1,107 | \$ 606 |   |

Unrealized gains (losses) on cash flow hedges <sup>(2)</sup>

|                            |           |           |   |
|----------------------------|-----------|-----------|---|
| Interest rate contracts    | \$ (642 ) | \$ (712 ) | Interest expense - subordinated debentures and term loans |
| Related income tax benefit | 225       | 249       | Income tax expense  |
|                            | \$ (417 ) | \$ (463 ) |   |

Total reclassifications for the period, net of tax

\$ 690    \$ 143

<sup>(1)</sup> 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.

<sup>(2)</sup> For additional detail related to unrealized gains (losses) on cash flow hedges and related amounts reclassified from accumulated other comprehensive income see NOTE 8. DERIVATIVE FINANCIAL INSTRUMENTS.



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NOTE 12

SHARE-BASED COMPENSATION

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten year life, become 100 percent vested ranging from six months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs issued to employees and non-employee directors 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. For non-employee directors, the RSAs vest only if the non-employee director remains as an active board member on the vesting date and, therefore, any unvested shares are forfeited. RSAs for employees and non-employee directors retired from the Corporation are either immediately vested at retirement or continue to vest after retirement, depending on the plan under which the shares were granted. 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 June 30, 2016, there were no outstanding DSUs.

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

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three and six months ended June 30, 2016 was \$641,000 and \$1,235,000, respectively, compared to \$614,000 and \$1,130,000, respectively, for the three and six months ended June 30, 2015. 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 2014 and in prior years was calculated using a Black Scholes option pricing model. There have been no stock options granted since 2014.

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 3.8 percent for the six months ended June 30, 2016, based on historical experience.

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

|   | Three<br>Months<br>Ended<br>June 30, |        | Six Months<br>Ended<br>June 30, |         |
|---|--------------------------------------|--------|---------------------------------|---------|
|   | 2016                                 | 2015   | 2016                            | 2015    |
| Stock and ESPP Options                                      |                                      |        |                                 |         |
| Pre-tax compensation expense                                | \$21                                 | \$28   | \$36                            | \$54    |
| Income tax expense (benefit)                                | 10                                   |        | 10                              | (1 )    |
| Stock and ESPP option expense, net of income taxes          | \$31                                 | \$28   | \$46                            | \$53    |
| Restricted Stock Awards                                     |                                      |        |                                 |         |
| Pre-tax compensation expense                                | \$620                                | \$586  | \$1,199                         | \$1,076 |
| Income tax benefit  | (217 )                               | (198 ) | (420 )                          | (366 )  |
| Restricted stock awards expense, net of income taxes        | \$403                                | \$388  | \$779                           | \$710   |
| Total Share-Based Compensation                              |                                      |        |                                 |         |
| Pre-tax compensation expense                                | \$641                                | \$614  | \$1,235                         | \$1,130 |
| Income tax benefit  | (207 )                               | (198 ) | (410 )                          | (367 )  |
| Total share-based compensation expense, net of income taxes | \$434                                | \$416  | \$825                           | \$763   |

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(table dollar amounts in thousands, except share data)

(Unaudited)

As of June 30, 2016, unrecognized compensation expense related to RSAs was \$4,688,000 and is expected to be recognized over a weighted-average period of 1.72 years. The Corporation did not have any unrecognized compensation expense related to stock options as of June 30, 2016.

Stock option activity under the Corporation's stock option plans as of June 30, 2016 and changes during the six months ended June 30, 2016, were as follows:

|  | Number<br>of<br>Shares | Weighted-Average<br>Exercise Price | Weighted Average<br>Contractual Term<br>(in Years) | Remaining<br>Aggregate<br>Intrinsic<br>Value |
|--|------------------------|------------------------------------|--|--|
| Outstanding at January 1, 2016               | 442,012                | \$ 19.99                           |  |  |
| Granted                                      | —                      |                                    |  |  |
| Exercised                                    | (13,828 )              | \$ 15.94                           |  |  |
| Canceled                                     | (49,482 )              | \$ 25.14                           |  |  |
| Outstanding June 30, 2016                    | 378,702                | \$ 19.47                           | 3.05   | 2,313,252                                    |
| Vested and Expected to Vest at June 30, 2016 | 378,702                | \$ 19.47                           | 3.02   | 2,313,252                                    |
| Exercisable at June 30, 2016                 | 378,702                | \$ 19.47                           | 3.05   | 2,313,252                                    |

There were no options granted during the six months ended June 30, 2016 and June 30, 2015.

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 six months of 2016 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 June 30, 2016. 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 six months ended June 30, 2016 and 2015 was \$116,000 and \$356,000, respectively. Cash receipts of stock options exercised during this same period were \$211,000 and \$619,000, respectively.

The following table summarizes information on unvested RSAs outstanding as of June 30, 2016:

|                                  | Number<br>of Shares | Weighted-Average<br>Grant Date Fair<br>Value |
|----------------------------------|---------------------|--|
| Unvested RSAs at January 1, 2016 | 354,504             | \$ 19.65                                     |
| Granted                          | 116,133             | \$ 23.48                                     |
| Vested                           | (106,290)           | \$ 15.39                                     |
| Forfeited                        | (4,943 )            | \$ 22.28                                     |
| Unvested RSAs at June 30, 2016   | 359,404             | \$ 22.42                                     |

The grant date fair value of ESPP options was estimated at the beginning of the April 1, 2016 quarterly offering period of approximately \$21,000. The ESPP options vested during the three months ending June 30, 2016, leaving no unrecognized compensation expense related to unvested ESPP options at June 30, 2016.

## NOTE 13

## INCOME TAX

The following table summarizes the major components creating differences between income taxes at the federal statutory and the effective tax rate recorded in the consolidated statements of income for the three and six months ended June 30, 2016 and 2015:

|  | Three Months<br>Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |   |
|--|-----------------------------------|----------|------------------------------|----------|---|
|  | 2016                              | 2015     | 2016                         | 2015     |   |
| Reconciliation of Federal Statutory to Actual Tax Expense: |                                   |          |                              |          |   |
| Federal statutory income tax at 35%                        | \$9,353                           | \$9,389  | \$17,496                     | \$17,091 |   |
| Tax-exempt interest income                                 | (2,104 )                          | (1,738 ) | (4,130 )                     | (3,167 ) |   |
| Basis difference on sale of insurance subsidiary           |                                   | 2,252    |                              | 2,252    |   |
| Stock compensation   | 8                                 | 10       | 13                           | 18       |   |
| Earnings on life insurance                                 | (453 )                            | (223 )   | (970 )                       | (485 )   |   |
| Tax credits  | (129 )                            | (148 )   | (258 )                       | (292 )   |   |
| Other  | 41                                | (686 )   | 139                          | (727 )   |   |
| Actual Tax Expense   | \$6,716                           | \$8,856  | \$12,290                     | \$14,690 |   |
| Effective Tax Rate   | 25.1                              | %33.0    | % 24.6                       | %30.1    | % |

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(table dollar amounts in thousands, except share data)

(Unaudited)

## NOTE 14

## 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 and six months ended June 30, 2016 and 2015.

|   | Three Months Ended June 30,<br>2016 |                            |                        | 2015          |                            |                        |
|---|-------------------------------------|----------------------------|------------------------|---------------|----------------------------|------------------------|
|   | Net<br>Income                       | Weighted-Average<br>Shares | Per<br>Share<br>Amount | Net<br>Income | Weighted-Average<br>Shares | Per<br>Share<br>Amount |
| Net income available to common stockholders   | 20,006                              | 40,751,720                 | \$ 0.50                | 17,968        | 37,793,448                 | \$ 0.47                |
| Effect of dilutive stock options and warrants |                                     | 217,391                    |                        |               | 249,911                    |                        |
| Diluted net income per share                  | \$20,006                            | 40,969,111                 | \$ 0.49                | \$17,968      | 38,043,359                 | \$ 0.47                |

|   | Six Months Ended June 30,<br>2016 |                            |                        | 2015          |                            |                        |
|---|-----------------------------------|----------------------------|------------------------|---------------|----------------------------|------------------------|
|   | Net<br>Income                     | Weighted-Average<br>Shares | Per<br>Share<br>Amount | Net<br>Income | Weighted-Average<br>Shares | Per<br>Share<br>Amount |
| Net income available to common stockholders   | 37,699                            | 40,721,147                 | \$ 0.93                | 34,140        | 37,751,896                 | \$ 0.90                |
| Effect of dilutive stock options and warrants |                                   | 220,338                    |                        |               | 270,036                    |                        |
| Diluted net income per share                  | \$37,699                          | 40,941,485                 | \$ 0.92                | \$34,140      | 38,021,932                 | \$ 0.90                |

Stock options to purchase 111,750 and 367,525 shares for the three months ended June 30, 2016 and 2015, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average

market price.

Stock options to purchase 142,259 and 367,550 shares for the six months ended June 30, 2016 and 2015, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

#### NOTE 15

##### IMPACT OF ACCOUNTING CHANGES

The Corporation continually monitors potential accounting changes and pronouncements. The following pronouncements have been deemed to have the most applicability to the Corporation's financial statements:

FASB Accounting Standards Update No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments

Summary - The FASB has issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations.

The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates.

Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances.

The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements.

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In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration.

The ASU is effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). For public companies that are not SEC filers, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For all other organizations, the ASU on credit losses will take effect for fiscal years beginning after December 15, 2020, and for interim periods within fiscal years beginning after December 15, 2021.

Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Corporation is evaluating the effects of this ASU on its consolidated financial statements.

FASB Accounting Standards Update No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

Summary - The amendments in ASU 2016-09 simplify several aspects of accounting for employee share-based payments including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Some areas of the simplification apply only to nonpublic entities. The new guidance will require all income tax effects of awards to be recognized as income tax expense or benefit in the income statement when the awards vest or are settled and additional paid in capital pools will be eliminated. The guidance requires companies to present excess tax benefits as an operating activity on the statement of cash flows rather than as a financing activity. Companies will be required to account for forfeitures of share-based payments by recognizing forfeitures of awards as they occur or estimating the number of awards expected to be forfeited and adjusting the estimate when it is likely to change, as currently required, through an accounting policy election. The guidance will increase the amount an employer can withhold to cover income taxes on awards and still qualify for the exception to liability classification for shares used to satisfy the employer's income tax withholding obligation. The guidance requires an employer to classify the cash paid to a tax authority when shares are withheld to satisfy its statutory income tax withholding obligation as a financing activity on the statement of cash flows. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption will be permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance, however all of the guidance must be adopted in the same period. If early adoption is elected in an interim period, any adjustments should be reflected as of the beginning of the annual period that includes that interim period. Adoption of this ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

The amendments clarify what steps are required when assessing whether the economic characteristics and risks of call (put) options are clearly and closely related to the economic characteristics and risks of their debt hosts, which is one of the criteria for bifurcating an embedded derivative. Consequently, when a call (put) option is contingently exercisable, an entity does not have to assess whether the event that triggers the ability to exercise a call (put) option is related to interest rates or credit risks.

Public business entities must apply the new requirements for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. If an entity early adopts the new requirements in an interim period, it must

reflect any adjustments as of the beginning of the fiscal year that includes that interim period. The Corporation is evaluating the effects of this ASU on its consolidated financial statements.

FASB Accounting Standards Update No. 2016-02 - Leases (Topic 842)

Summary - The FASB has issued its new lease accounting guidance in Accounting Standards Update (ASU) No. 2016-02, Leases (Topic 842). Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date:

- A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and
- A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers.

The new lease guidance simplified the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees will no longer be provided with a source of off-balance sheet financing.

Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (i.e., January 1, 2019, for a calendar year entity). Early application is permitted for all public business entities and all nonpublic business entities upon issuance.

Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Corporation is evaluating the effect of this ASU on its consolidated financial statements.



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FASB Accounting Standards Update No. 2014-09 - Revenue from Contracts with Customers (Topic 606)

Summary - The FASB issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers, which implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. ASU 2014-09 is effective on January 1, 2018. The Corporation is evaluating the effects of this ASU on its consolidated financial statements.

NOTE 16

GENERAL LITIGATION AND REGULATORY EXAMINATIONS

The Corporation is subject to claims and lawsuits that arise primarily in the ordinary course of business. Additionally, the Corporation is subject to periodic examinations by various regulatory agencies. It is the opinion of management that the disposition or ultimate resolution of such claims, lawsuits, and examinations will not have a material adverse effect on the consolidated financial position, results of operations and cash flow of the Corporation.

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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 Quarterly Report on 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 expressions or 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 bank;
- 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,

2015. 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 six months ended June 30, 2016, 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, 2015.

## 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 (the "Bank"), which opened for business in Muncie, Indiana, in March 1893. The Bank also operates Lafayette Bank and Trust and First Merchants Private Wealth Advisors as divisions of First Merchants Bank. The Bank includes 107 banking locations in twenty-seven Indiana, two Illinois 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 private wealth management; and providing letters of credit, repurchase agreements and other corporate services.

The Corporation operated First Merchants Insurance Services, Inc., operating as First Merchants Insurance Group ("FMIG"), a full-service property, casualty, personal lines, and employee benefit insurance agency headquartered in Muncie, Indiana. On June 12, 2015, the Corporation sold all of its stock in FMIG to USI Insurance Services, LLC for \$18,000,000. Additional details of the transaction are included in NOTE 2. ACQUISITIONS AND DIVESTITURES, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

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On April 1, 2016, the Board of Directors of the Bank adopted final resolutions approving the conversion of the Bank's banking charter from a national association to an Indiana state-chartered bank. The initial application to convert was filed with the Indiana Department of Financial Institutions (the "Indiana DFI") on February 9, 2016. Between the date of initial application and adoption of the final resolutions by the Bank's Board, the Indiana DFI and the Federal Deposit Insurance Corporation (the "FDIC") conducted a joint exam of the Bank and its banking activities. Final regulatory approval of the application was obtained at the meeting of the Members of the Indiana DFI on April 14, 2016. The Bank filed official conversion documents effective April 15, 2016.

Along with economic benefits, the Board and management of the Bank feel the state charter is more consistent with the community banking philosophy embraced by the Bank. As a result of the conversion, the Indiana DFI became the Bank's primary regulator and the FDIC became the Bank's primary federal regulator. Upon conversion, the Bank's official name changed from "First Merchants Bank, National Association" to "First Merchants Bank." The Bank intends to continue operating under the following trade names in certain geographic markets: Lafayette Bank and Trust and First Merchants Private Wealth Advisors (each as a division of First Merchants Bank). The conversion is not expected to affect the Bank's operations or customers in any way, and Bank customers will continue to receive identical protection on deposits through the FDIC's deposit insurance program.

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported second quarter 2016 net income of \$20.0 million, compared to \$18.0 million during the second quarter of 2015. Diluted earnings per share for the period totaled \$.49 per share, an increase of \$.02 per share, or 4.3 percent, over the same period in 2015. Year-to-date net income totaled \$37.7 million, compared to \$34.1 million during the same period in 2015. Diluted earnings per share for the six months ended June 30, 2016 totaled \$.92 per share, an increase of \$.02 per share, over same period in 2015.

On April 17, 2015, the Corporation acquired C Financial and on December 31, 2015, the Corporation acquired Ameriana. Additionally, on June 12, 2015, the Corporation sold all of its stock in FMIG, resulting in a gain of \$8.3 million. Details of these transactions are included in NOTE 2. ACQUISITIONS AND DIVESTITURES, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

As of June 30, 2016, total assets equaled \$6.9 billion, an increase of \$145.4 million, or 2.2 percent, from December 31, 2015. The Corporation's loan portfolio increased \$106.6 million, with the largest increase in real estate commercial and farmland. Additional details of the changes in the Corporation's loans and other earning assets are discussed within NOTE 4. LOANS AND ALLOWANCE, included within the Notes to Consolidated Condensed Financial Statements, and the "EARNING ASSETS" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

The Corporation's allowance for loan losses totaled \$62.2 million as of June 30, 2016. The allowance provided 185.3 percent coverage of all non-accrual loans and 1.29 percent of total loans. The Corporation's provision expense totaled \$790,000 and \$1.3 million during the three and six months ended 2016, as net charge-offs totaled \$690,000 and \$1.6 million, for the same periods respectively. The Corporation had \$417,000 of provision expense for both the three and six months ended June 30, 2015, with net charge offs during the same periods of \$668,000 and \$1.8 million, respectively. 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 Quarterly Report on Form 10-Q.

As of June 30, 2016, total deposits equaled \$5.4 billion, an increase of \$117.9 million from December 31, 2015. The largest increases were in demand deposits and savings deposits, which accounted for \$141.2 million and \$32.5 million of the overall increase, respectively. This increase was offset by decreases in other certificates and time deposits and certificates and other time deposits of \$100,000 or more of \$38.8 million and \$22.0 million, respectively, compared to December 31, 2015.

Total borrowings decreased \$11.5 million as of June 30, 2016 compared to December 31, 2015 as Federal Funds purchased decreased \$29.7 million, which was offset by an increase in Federal Home Loan Bank Advances of \$32.9 million.

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 Quarterly Report on Form 10-Q.

#### NET INTEREST INCOME

Net interest income is the most significant component of our earnings, comprising 77 percent of revenues for the three and six months ended June 30, 2016. Net interest income and margin are influenced by many factors, primarily the volume and mix of earnings assets, funding sources, and interest rate fluctuations. Other factors include the level of accretion income on purchased loans, prepayment risk on mortgage and investment-related assets, and the composition and maturity of earning assets and interest-bearing liabilities. Loans typically generate more interest income than investment securities with similar maturities. Funding from client deposits generally costs less than wholesale funding sources. Factors such as general economic activity, Federal Reserve Board monetary policy, and price volatility of competing alternative investments, can also exert significant influence on our ability to optimize the mix of assets and funding and the net interest income and margin.

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Net interest income is the excess of interest received from earning assets over interest paid on interest-bearing liabilities. For analytical purposes, net interest income is also presented in the table that follows, adjusted to a fully taxable equivalent basis ("FTE"), to reflect what our tax-exempt assets would need to yield in order to achieve the same after-tax yield as a taxable asset. We used the federal statutory rate in effect of 35 percent for all periods adjusted for the TEFRA interest disallowance applicable to certain tax-exempt obligations. This analysis portrays the income tax benefits associated in tax-exempt assets and helps to facilitate a comparison between taxable and tax-exempt assets. Management believes that it is a standard practice in the banking industry to present net interest margin and net interest income on a fully taxable equivalent basis. Therefore, management believes these measures provide useful information for both management and investors by allowing them to make peer comparisons.

For the periods presented, the increases in net interest income was primarily driven by the increase in earning assets attributable to acquisitions of C Financial in April 2015 and Ameriana in December 2015, and core organic loan growth.

Net interest margin for the second quarter of 2016 increased to 3.86 percent compared to the second quarter of 2015 at 3.81 percent, as earning assets increased by \$699,000. Asset yields increased 4 basis points FTE and interest costs decreased 1 basis point, resulting in a 5 basis point FTE increase in net interest income as compared to the same period in 2015. As a result of the acquisitions, the Corporation recognized fair value accretion income on purchased loans, which is included in interest income, of \$3,192,000 and \$2,158,000, respectively, for the three months ended June 30, 2016 and 2015.

Net interest margin for the six months ended June 30, 2016 increased to 3.85 percent compared to the six months ended June 30, 2015 at 3.79 percent, as earning assets increased by \$757,000. Asset yields increased 4 basis points FTE and interest costs decreased 2 basis points, resulting in a 6 basis point FTE increase in net interest income as compared to the same period in 2015. As a result of the acquisitions, the Corporation recognized fair value accretion income on purchased loans, which is included in interest income, of \$5,702,000 and \$4,328,000, respectively, for the six months ended June 30, 2016 and 2015.

Additional details of the Corporation's acquisitions, remaining loan fair value discount, accretable and nonaccretable yield can be found in NOTE 2. ACQUISITIONS AND DIVESTITURES and NOTE 5. ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

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The following table presents the Corporation's average balance sheet, interest income/interest expense, and the average rate as a percent of average earning assets/liabilities for the three months ended June 30, 2016, and 2015.

(Dollars in Thousands)

|  | Three Months Ended |                                    |                 | June 30, 2015 |                                    |                 |
|--|--------------------|------------------------------------|-----------------|---------------|------------------------------------|-----------------|
|  | June 30, 2016      | Interest<br>Income<br>/<br>Expense | Average<br>Rate | June 30, 2015 | Interest<br>Income<br>/<br>Expense | Average<br>Rate |
| <b>Assets:</b>                                       |                    |                                    |                 |               |                                    |                 |
| Interest-bearing time deposits                       | \$99,735           | \$122                              | 0.49 %          | \$59,979      | \$31                               | 0.21 %          |
| Federal Reserve and Federal Home Loan Bank stock     | 23,442             | 233                                | 3.98            | 39,195        | 459                                | 4.68            |
| <b>Investment Securities: <sup>(1)</sup></b>         |                    |                                    |                 |               |                                    |                 |
| Taxable  | 730,179            | 4,202                              | 2.30            | 696,505       | 4,425                              | 2.54            |
| Tax-Exempt <sup>(2)</sup>                            | 539,004            | 7,050                              | 5.23            | 484,541       | 6,510                              | 5.37            |
| Total Investment Securities                          | 1,269,183          | 11,252                             | 3.55            | 1,181,046     | 10,935                             | 3.70            |
| Loans held for sale                                  | 3,664              | 96                                 | 10.48           | 6,033         | 146                                | 9.68            |
| <b>Loans: <sup>(3)</sup></b>                         |                    |                                    |                 |               |                                    |                 |
| Commercial   | 3,501,919          | 40,501                             | 4.63            | 3,193,314     | 35,660                             | 4.47            |
| Real Estate Mortgage                                 | 568,746            | 6,116                              | 4.30            | 455,470       | 4,962                              | 4.36            |
| Installment  | 470,254            | 5,386                              | 4.58            | 396,378       | 4,552                              | 4.59            |
| Tax-Exempt <sup>(2)</sup>                            | 194,496            | 2,254                              | 4.64            | 100,665       | 1,132                              | 4.49            |
| Total Loans  | 4,739,079          | 54,353                             | 4.59            | 4,151,860     | 46,452                             | 4.48            |
| Total Earning Assets                                 | 6,131,439          | 65,960                             | 4.30            | 5,432,080     | 57,877                             | 4.26            |
| Net unrealized gain on securities available for sale | 10,924             |                                    |                 | 12,575        |                                    |                 |
| Allowance for loan losses                            | (62,235 )          |                                    |                 | (62,881 )     |                                    |                 |
| Cash and cash equivalents                            | 104,372            |                                    |                 | 97,738        |                                    |                 |
| Premises and equipment                               | 96,620             |                                    |                 | 84,359        |                                    |                 |
| Other assets   | 576,719            |                                    |                 | 496,606       |                                    |                 |
| Total Assets   | \$6,857,839        |                                    |                 | \$6,060,477   |                                    |                 |
| <b>Liabilities:</b>                                  |                    |                                    |                 |               |                                    |                 |
| <b>Interest-bearing deposits:</b>                    |                    |                                    |                 |               |                                    |                 |
| Interest-bearing NOW deposits                        | \$1,429,191        | \$637                              | 0.18 %          | \$1,088,896   | \$283                              | 0.10 %          |
| Money market deposits                                | 849,270            | 502                                | 0.24            | 853,776       | 446                                | 0.21            |
| Savings deposits                                     | 717,044            | 149                                | 0.08            | 612,920       | 166                                | 0.11            |
| Certificates and other time deposits                 | 1,159,247          | 2,751                              | 0.95            | 1,148,463     | 2,791                              | 0.97            |
| Total Interest-bearing Deposits                      | 4,154,752          | 4,039                              | 0.39            | 3,704,055     | 3,686                              | 0.40            |
| Borrowings   | 476,852            | 2,703                              | 2.27            | 471,467       | 2,485                              | 2.11            |
| Total Interest-bearing Liabilities                   | 4,631,604          | 6,742                              | 0.58            | 4,175,522     | 6,171                              | 0.59            |
| Noninterest-bearing deposits                         | 1,285,396          |                                    |                 | 1,093,031     |                                    |                 |
| Other liabilities                                    | 64,723             |                                    |                 | 45,743        |                                    |                 |
| Total Liabilities                                    | 5,981,723          |                                    |                 | 5,314,296     |                                    |                 |
| Stockholders' Equity                                 | 876,116            |                                    |                 | 746,181       |                                    |                 |
| Total Liabilities and Stockholders' Equity           | \$6,857,839        | 6,742                              | 0.44            | \$6,060,477   | 6,171                              | 0.45            |
| Net Interest Income                                  |                    | \$59,218                           |                 |               | \$51,706                           |                 |
| Net Interest Margin                                  |                    |                                    | 3.86 %          |               |                                    | 3.81 %          |

- (1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments. Annualized amounts are computed utilizing a 30/360 day basis.
- (2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2016 and 2015. The fully taxable equivalent adjustments equal \$3,256 and \$2,675 for the three months ended June 30, 2016 and 2015, respectively.
- (3) Non-accruing loans have been included in the average balances.



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| (Dollars in Thousands)                               | Six Months Ended |                           |              | June 30, 2015   |                           |              |
|--|------------------|---------------------------|--------------|-----------------|---------------------------|--------------|
|  | Average Balance  | Interest Income / Expense | Average Rate | Average Balance | Interest Income / Expense | Average Rate |
| Assets:  |                  |                           |              |                 |                           |              |
| Federal Funds Sold                                   |                  |                           |              |                 |                           |              |
| Interest-bearing time deposits                       | \$87,722         | \$228                     | 0.52 %       | \$58,452        | \$68                      | 0.23 %       |
| Federal Reserve and Federal Home Loan Bank stock     | 30,537           | 713                       | 4.67         | 40,267          | 1,009                     | 5.01         |
| Investment Securities: <sup>(1)</sup>                |                  |                           |              |                 |                           |              |
| Taxable  | 723,333          | 8,530                     | 2.36         | 716,331         | 9,148                     | 2.55         |
| Tax-Exempt <sup>(2)</sup>                            | 529,963          | 13,987                    | 5.28         | 459,177         | 12,409                    | 5.40         |
| Total Investment Securities                          | 1,253,296        | 22,517                    | 3.59         | 1,175,508       | 21,557                    | 3.67         |
| Loans held for sale                                  | 4,956            | 218                       | 8.80         | 5,483           | 256                       | 9.34         |
| Loans: <sup>(3)</sup>                                |                  |                           |              |                 |                           |              |
| Commercial   | 3,475,684        | 79,365                    | 4.57         | 3,117,698       | 69,830                    | 4.48         |
| Real Estate Mortgage                                 | 572,006          | 12,510                    | 4.37         | 457,620         | 9,811                     | 4.29         |
| Installment  | 463,454          | 10,495                    | 4.53         | 395,227         | 8,975                     | 4.54         |
| Tax-Exempt <sup>(2)</sup>                            | 188,223          | 4,277                     | 4.54         | 68,903          | 1,513                     | 4.39         |
| Total Loans  | 4,704,323        | 106,865                   | 4.54         | 4,044,931       | 90,385                    | 4.47         |
| Total Earning Assets                                 | 6,075,878        | 130,323                   | 4.29 %       | 5,319,158       | 113,019                   | 4.25 %       |
| Net unrealized gain on securities available for sale | 10,464           |                           |              | 13,522          |                           |              |
| Allowance for loan losses                            | (62,724 )        |                           |              | (63,154 )       |                           |              |
| Cash and cash equivalents                            | 103,143          |                           |              | 98,262          |                           |              |
| Premises and equipment                               | 96,659           |                           |              | 81,052          |                           |              |
| Other assets   | 577,157          |                           |              | 492,597         |                           |              |
| Total Assets   | \$6,800,577      |                           |              | \$5,941,437     |                           |              |
| Liabilities:   |                  |                           |              |                 |                           |              |
| Interest-bearing deposits:                           |                  |                           |              |                 |                           |              |
| Interest-bearing NOW deposits                        | \$1,364,729      | \$1,181                   | 0.17 %       | \$1,059,826     | \$534                     | 0.10 %       |
| Money market deposits                                | 857,601          | 993                       | 0.23         | 838,852         | 858                       | 0.20         |
| Savings deposits                                     | 703,174          | 284                       | 0.08         | 592,449         | 326                       | 0.11         |
| Certificates and other time deposits                 | 1,172,852        | 5,644                     | 0.96         | 1,137,342       | 5,484                     | 0.96         |
| Total Interest-bearing Deposits                      | 4,098,356        | 8,102                     | 0.40         | 3,628,469       | 7,202                     | 0.40         |
| Borrowings   | 498,470          | 5,412                     | 2.17         | 454,758         | 4,937                     | 2.17         |
| Total Interest-bearing Liabilities                   | 4,596,826        | 13,514                    | 0.59         | 4,083,227       | 12,139                    | 0.59         |
| Noninterest-bearing deposits                         | 1,270,363        |                           |              | 1,073,173       |                           |              |
| Other liabilities                                    | 64,504           |                           |              | 44,659          |                           |              |
| Total Liabilities                                    | 5,931,693        |                           |              | 5,201,059       |                           |              |
| Stockholders' Equity                                 | 868,884          |                           |              | 740,378         |                           |              |
| Total Liabilities and Stockholders' Equity           | \$6,800,577      | 13,514                    | 0.44         | \$5,941,437     | 12,139                    | 0.46         |
| Net Interest Income                                  |                  | \$116,809                 |              |                 | \$100,880                 |              |
| Net Interest Margin                                  |                  |                           | 3.85 %       |                 |                           | 3.79 %       |

- (1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments. Annualized amounts are computed utilizing a 30/360 day basis.
- (2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2016 and 2015. The fully taxable equivalent adjustments equal \$6,392 and \$4,873 for the six months ended June 30, 2016 and 2015, respectively.
- (3) Non-accruing loans have been included in the average balances.

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NON-INTEREST INCOME

Non-interest income decreased \$7.7 million, or 32.0 percent, in the second quarter of 2016, compared to the second quarter of 2015. In June 2015, the Corporation sold all of its stock in FMIG, which resulted in a gain on the sale of \$8.3 million. This transaction also accounted for a \$1.8 million decline in insurance commission income compared to the second quarter of 2015. In December 2015, the Corporation acquired Ameriana. This acquisition contributed to a larger customer base, which resulted in an increase in service charge income of \$326,000 in the second quarter of 2016 when compared to the same period in 2015. Additional details of the divestiture and acquisitions can be found in NOTE 2. ACQUISITIONS AND DIVESTITURES, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

The sale of investment securities generated net gains of \$706,000, an increase of \$799,000, when compared to net losses of \$93,000 during the second quarter of 2015. Additionally, second quarter 2016 earnings on cash surrender value of life insurance increased by \$657,000 from the same quarter of 2015. The increase was due to death benefits from Bank Owned Life Insurance of \$424,000. Also, the Ameriana acquisition included a \$28.2 million Bank Owned Life Insurance portfolio that contributed to the increase in earnings.

During the first six months of 2016, non-interest income decreased \$7.3 million, or 18.4 percent, over the same period in 2015. In June 2015, the sale of FMIG resulted in a gain on the sale of \$8.3 million, and also accounted for a \$4.1 million decline in insurance commission income compared to the first six months of 2015. The larger customer base from the C Financial and Ameriana acquisitions contributed to increases in other customer fees and service charge income of \$1.5 million and \$923,000, respectively.

The sale of investment securities generated net gains of \$1.7 million, an increase of \$771,000, when compared to the \$932,000 in net gains during the six months ended June 30, 2015. Additionally, the first six months of 2016 earnings on cash surrender value of life insurance increased by \$1.4 million from the same period in 2015. The increase was primarily due to death benefits from Bank Owned Life Insurance of \$895,000. Also, the Ameriana acquisition included a \$28.2 million Bank Owned Life Insurance portfolio that contributed to the increase in earnings.

NON-INTEREST EXPENSE

Non-interest expense decreased \$1.1 million, or 2.3 percent, in the second quarter of 2016, compared to the second quarter of 2015. The sale of FMIG resulted in \$1.6 million less in expense than the second quarter of 2015, of which \$1.3 million was salaries and employee benefits. The Corporation's core business, primarily through bank acquisitions, did see an increase over prior year for net occupancy, salaries and employee benefits and equipment expenses of \$556,000, \$418,000 and \$403,000, respectively. In the second quarter of 2015, contract termination expenses related to the C Financial acquisition of \$719,000 and legal and investment banker fees associated with acquisition and divestiture activities of \$898,000, contributed to the decline in professional and other outside services from the same period in 2015.

During the first six months of 2016, non-interest expense increased \$5.0 million, or 5.8 percent, when compared to the first six months of 2015. The sale of FMIG resulted in \$3.2 million less in expense compared to the first six months of 2015, of which \$2.5 million was salaries and employee benefits. This decrease in salaries and employee benefits was offset by a \$4.5 million increase primarily due to the addition of personnel from C Financial and Ameriana. Additionally, investments in the Corporation's core business, primarily through bank acquisitions, drove the remaining

increase over prior year. As a result of the larger franchise size from the acquisitions, the Corporation experienced increases in equipment, net occupancy and data processing expenses of \$1.1 million, \$788,000 and \$609,000, respectively.

#### INCOME TAXES

Income tax expense for the second quarter of 2016 was \$6,716,000 on pre-tax net income of \$26,722,000. For the same period in 2015, income tax expense was \$8,856,000 on pre-tax net income of \$26,824,000. The effective income tax rates for the second quarter of 2016 and 2015 were 25.1 percent and 33.0 percent, respectively.

Income tax expense for the six months ended June 30, 2016 was \$12,290,000 on pre-tax net income of \$49,989,000. For the same period in 2015, income tax expense was \$14,690,000 on pre-tax net income of \$48,830,000. The effective income tax rates for the six months ended June 30, 2016 and 2015 were 24.6 percent and 30.1 percent, respectively.

The lower effective income tax rates during the three and six months ended June 30, 2016 when compared to the same periods in 2015 were the result of increases in tax-exempt interest income and earnings on life insurance in addition to a permanent book-to-tax difference associated with the gain on sale of FMIG in 2015.

The detailed reconciliation of federal statutory to actual tax expense is shown in NOTE 13. INCOME TAX, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

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## CAPITAL

Capital adequacy is an important indicator of financial stability and performance. 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 four ratios that are calculated according to the regulations: total risk-based capital, tier 1 risk-based capital, common equity 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.

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. Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of total and tier 1 capital to risk-weighted assets, and of tier 1 capital to average assets, or leverage ratio, all of which are calculated as defined in the regulations. 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.

Basel III was effective for the Corporation on January 1, 2015. Basel III requires the Corporation and the Bank to maintain minimum amounts and ratio of common equity tier 1 capital to risk weighted assets, as defined in the regulation. Under the new Basel III rules, in order to avoid limitations on capital distributions, including dividends, the Corporation must hold a capital conservation buffer above the adequately capitalized common equity tier 1 capital to risk-weighted assets ratio. The capital conservation buffer is being phased in from zero percent to 2.50 percent by 2019. As of January 1, 2016, the Corporation is required to hold a capital conservation buffer of 0.625 percent, increasing by that amount each successive year until 2019. Under Basel III, the Corporation and Bank elected to opt-out of including accumulated other comprehensive income in regulatory capital.

As of June 30, 2016, the Bank met all capital adequacy requirements to be considered well capitalized. There is no threshold for well capitalized status for bank holding companies. The Corporation's and Bank's actual and required capital ratios as of June 30, 2016 and December 31, 2015 were as follows:

|  | Prompt Corrective Action<br>Thresholds |         |                           |        |                  |         |
|--|--|---------|---------------------------|--------|------------------|---------|
|  | Actual                                 |         | Adequately<br>Capitalized |        | Well Capitalized |         |
| June 30, 2016  | Amount                                 | Ratio   | Amount                    | Ratio  | Amount           | Ratio   |
| Total risk-based capital to risk-weighted assets     |  |         |                           |        |                  |         |
| First Merchants Corporation                          | \$ 808,369                             | 14.67 % | \$ 440,925                | 8.00 % | N/A              | N/A     |
| First Merchants Bank                                 | 766,409                                | 13.80   | 444,337                   | 8.00   | \$ 555,422       | 10.00 % |
| Tier 1 capital to risk-weighted assets               |  |         |                           |        |                  |         |
| First Merchants Corporation                          | \$ 681,183                             | 12.36 % | \$ 330,693                | 6.00 % | N/A              | N/A     |
| First Merchants Bank                                 | 704,223                                | 12.68   | 333,253                   | 6.00   | \$ 444,337       | 8.00 %  |
| Common equity tier 1 capital to risk-weighted assets |  |         |                           |        |                  |         |

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|                                  |           |        |           |       |           |        |
|----------------------------------|-----------|--------|-----------|-------|-----------|--------|
| First Merchants Corporation      | \$627,715 | 11.39% | \$248,020 | 4.50% | N/A       | N/A    |
| First Merchants Bank             | 704,223   | 12.68  | 249,940   | 4.50  | \$361,024 | 6.50 % |
| Tier 1 capital to average assets |           |        |           |       |           |        |
| First Merchants Corporation      | \$681,183 | 10.41% | \$261,843 | 4.00% | N/A       | N/A    |
| First Merchants Bank             | 704,223   | 10.66  | 264,191   | 4.00  | \$330,239 | 5.00 % |

|  | Prompt Corrective Action<br>Thresholds |        |                           |       |                  |        |
|--|--|--------|---------------------------|-------|------------------|--------|
|  | Actual                                 |        | Adequately<br>Capitalized |       | Well Capitalized |        |
| December 31, 2015                                    | Amount                                 | Ratio  | Amount                    | Ratio | Amount           | Ratio  |
| Total risk-based capital to risk-weighted assets     |  |        |                           |       |                  |        |
| First Merchants Corporation                          | \$783,776                              | 14.94% | \$419,809                 | 8.00% | N/A              | N/A    |
| First Merchants Bank                                 | 739,793                                | 13.98  | 423,242                   | 8.00  | \$529,052        | 10.00% |
| Tier 1 capital to risk weighted assets               |  |        |                           |       |                  |        |
| First Merchants Corporation                          | \$656,323                              | 12.51% | \$314,857                 | 6.00% | N/A              | N/A    |
| First Merchants Bank                                 | 677,340                                | 12.80  | 317,431                   | 6.00  | \$423,242        | 8.00 % |
| Common equity tier 1 capital to risk-weighted assets |  |        |                           |       |                  |        |
| First Merchants Corporation                          | \$603,063                              | 11.49% | \$236,143                 | 4.50% | N/A              | N/A    |
| First Merchants Bank                                 | 677,340                                | 12.80  | 238,074                   | 4.50  | 343,884          | 6.50 % |
| Tier 1 capital to average assets                     |  |        |                           |       |                  |        |
| First Merchants Corporation                          | \$656,323                              | 10.85% | \$242,001                 | 4.00% | N/A              | N/A    |
| First Merchants Bank                                 | 677,340                                | 11.22  | 241,423                   | 4.00  | \$301,779        | 5.00 % |

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Management believes that all of the above capital ratios are meaningful measurements for evaluating the safety and soundness of the Corporation. Traditionally, the banking regulators have assessed bank and bank holding company capital adequacy based on both the amount and the composition of capital, the calculation of which is prescribed in federal banking regulations. The Federal Reserve focuses its assessment of capital adequacy on a component of Tier 1 capital known as Common Equity Tier 1. Because the Federal Reserve has long indicated that voting common shareholders' equity (essentially Tier 1 risk-based capital less preferred stock and noncontrolling interest in subsidiaries) generally should be the dominant element in Tier 1 risk-based capital, this focus on common Equity Tier 1 is consistent with existing capital adequacy categories. 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.

Additionally, management believes the following tables are also meaningful when considering performance measures of the Corporation. Non-GAAP financial measures such as tangible book value per common share, tangible common equity to tangible assets, return on average tangible capital and return on average tangible assets are important measures of the strength of the Corporation's capital and ability to generate earnings on tangible common equity invested by our shareholders. These non-GAAP measures provide useful supplemental information and may assist investors in analyzing the Corporation's capital position without regard to the effects of intangible assets and preferred stock. Disclosure of these measures also allows analysts and banking regulators to assess our capital adequacy on these same bases.

Because these measures are not defined in Generally Accepted Accounting Principles ("GAAP") or federal banking regulations, they are considered non-GAAP financial measures. Non-GAAP financial measures have inherent limitations, are not required to be uniformly applied, and are not audited. Although these non-GAAP financial measures are frequently used by investors to evaluate a company, they have limitations as analytical tools, and should not be considered in isolation, or as a substitute for analyses of results as reported under GAAP.

|   | June 30, 2016 |            | December 31, 2015 |            |
|---|---------------|------------|-------------------|------------|
|   | First         | First      | First             | First      |
|   | Merchants     | Merchants  | Merchants         | Merchants  |
|   | Corporation   | Bank       | Corporation       | Bank       |
| Total Risk-Based Capital  |               |            |                   |            |
| Total Stockholders' Equity (GAAP)                                       | 887,550       | 966,974    | 850,509           | 927,649    |
| Adjust for Accumulated Other Comprehensive (Income) Loss <sup>(1)</sup> | (7,035 )      | (9,699 )   | 1,362             | (579 )     |
| Less: Preferred Stock   | (125 )        |            | (125 )            |            |
| Add: Qualifying Capital Securities                                      | 55,296        |            | 55,776            |            |
| Less: Tier 1 Capital Deductions   | (1,828 )      | (1,427 )   | (2,516 )          | (1,903 )   |
| Less: Disallowed Goodwill and Intangible Assets                         | (249,932 )    | (249,484 ) | (247,006 )        | (246,558 ) |
| Less: Disallowed Servicing Assets                                       |               |            |                   |            |
| Less: Disallowed Deferred Tax Assets                                    | (2,743 )      | (2,141 )   | (1,677 )          | (1,269 )   |
| Total Tier 1 Capital (Regulatory)                                       | 681,183       | 704,223    | 656,323           | 677,340    |
| Qualifying Subordinated Debentures                                      | 65,000        |            | 65,000            |            |
| Allowance for Loan Losses Includible in Tier 2 Capital                  | 62,186        | 62,186     | 62,453            | 62,453     |
| Total Risk-Based Capital (Regulatory)                                   | 808,369       | 766,409    | 783,776           | 739,793    |
| Net Risk-Weighted Assets (Regulatory)                                   | 5,511,557     | 5,554,218  | 5,247,617         | 5,290,524  |
| Average Assets  | 6,546,074     | 6,604,787  | 6,050,023         | 6,035,575  |

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|   |           |           |           |           |   |
|---|-----------|-----------|-----------|-----------|---|
| Total Risk-Based Capital Ratio (Regulatory)     | 14.67     | % 13.80   | % 14.94   | % 13.98   | % |
| Tier 1 Capital to Risk-Weighted Assets          | 12.36     | % 12.68   | % 12.51   | % 12.80   | % |
| Tier 1 Capital to Average Assets                | 10.41     | % 10.66   | % 10.85   | % 11.22   | % |
| Common Equity Tier 1 Capital Ratio              |           |           |           |           |   |
| Total Tier 1 Capital (Regulatory)               | 681,183   | 704,223   | 656,323   | 677,340   |   |
| Less: Qualified Capital Securities              | (55,296 ) |           | (55,776 ) |           |   |
| Add: Additional Tier 1 Capital Deductions       | 1,828     |           | 2,516     |           |   |
| Common Equity Tier 1 Capital (Regulatory)       | 627,715   | 704,223   | 603,063   | 677,340   |   |
| Net Risk-Weighted Assets (Regulatory)           | 5,511,557 | 5,554,218 | 5,247,617 | 5,290,524 |   |
| Common Equity Tier 1 Capital Ratio (Regulatory) | 11.39     | % 12.68   | % 11.49   | % 12.80   | % |



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The Corporation had a strong capital position as evidenced by the tangible common equity to tangible assets ratio of 9.52 percent at June 30, 2016, and 9.17 percent at December 31, 2015.

| (Dollars in Thousands, Except Per Share Amounts)     | Tangible Common Equity to<br>Tangible Assets<br>(non-GAAP) |                      |
|--|--|----------------------|
|  | June 30, 2016  | December 31,<br>2015 |
| Total Stockholders' Equity (GAAP)                    | \$887,550  | \$850,509            |
| Less: Cumulative preferred stock (GAAP)              | (125 )   | (125 )               |
| Less: Intangible assets, net of tax (GAAP)           | (254,368 )   | (253,486 )           |
| Tangible common equity (non-GAAP)                    | \$633,057  | \$596,898            |
| Total assets (GAAP)                                  | \$6,906,418  | \$6,761,003          |
| Less: Intangible assets, net of tax (GAAP)           | (254,368 )   | (253,486 )           |
| Tangible assets (non-GAAP)                           | \$6,652,050  | 6,507,517            |
| Tangible common equity to tangible assets (non-GAAP) | 9.52 %   | 9.17 %               |

The following table details and reconciles tangible earnings per share, return on tangible capital and tangible assets to traditional GAAP measures for the three and six months ended June 30, 2016 and 2015.

| (Dollars in Thousands, Except Per Share Amounts)                        | Three Months Ended June<br>30, |             | Six Months Ended June 30, |             |   |
|---|--------------------------------|-------------|---------------------------|-------------|---|
|   | 2016                           | 2015        | 2016                      | 2015        |   |
| Average goodwill (GAAP)   | \$244,000                      | \$210,217   | \$244,000                 | \$206,491   |   |
| Average core deposit intangible (GAAP)                                  | 17,273                         | 15,584      | 17,816                    | 15,615      |   |
| Average deferred tax on CDI (GAAP)                                      | (6,606 )                       | (5,724 )    | (6,751 )                  | (5,840 )    |   |
| Intangible adjustment (non-GAAP)  | \$254,667                      | \$220,077   | \$255,065                 | \$216,266   |   |
| Average stockholders' equity (GAAP)                                     | \$876,116                      | \$746,181   | \$868,884                 | \$740,378   |   |
| Average cumulative preferred stock (GAAP)                               | (125 )                         | (125 )      | (125 )                    | (125 )      |   |
| Intangible adjustment (non-GAAP)  | (254,666 )                     | (220,077 )  | (255,065 )                | (216,266 )  |   |
| Average tangible capital (non-GAAP)                                     | \$621,325                      | \$525,979   | \$613,694                 | \$523,987   |   |
| Average assets (GAAP)   | \$6,857,839                    | \$6,060,477 | \$6,800,577               | \$5,941,437 |   |
| Intangible adjustment (non-GAAP)  | (254,666 )                     | (220,077 )  | (255,065 )                | (216,266 )  |   |
| Average tangible assets (non-GAAP)                                      | \$6,603,173                    | \$5,840,400 | \$6,545,512               | \$5,725,171 |   |
| Net income available to common stockholders (GAAP)                      | \$20,006                       | \$17,968    | \$37,699                  | \$34,140    |   |
| CDI amortization, net of tax (GAAP)                                     | 635                            | 430         | 1,271                     | 848         |   |
| Tangible net income available to common stockholders (non-GAAP)         | \$20,641                       | \$18,398    | \$38,970                  | \$34,988    |   |
| Per Share Data:   |                                |             |                           |             |   |
| Diluted net income available to common stockholders (GAAP)              | \$0.49                         | \$0.47      | \$0.92                    | \$0.90      |   |
| Diluted tangible net income available to common stockholders (non-GAAP) | \$0.50                         | \$0.48      | \$0.95                    | \$0.92      |   |
| Ratios:   |                                |             |                           |             |   |
| Return on average GAAP capital (ROE)                                    | 9.13                           | % 9.63      | % 8.68                    | % 9.22      | % |
| Return on average tangible capital                                      | 13.29                          | % 13.99     | % 12.70                   | % 13.35     | % |

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|                                   |      |        |        |        |   |
|-----------------------------------|------|--------|--------|--------|---|
| Return on average assets (ROA)    | 1.17 | % 1.19 | % 1.11 | % 1.15 | % |
| Return on average tangible assets | 1.25 | % 1.26 | % 1.19 | % 1.22 | % |

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 lending focus is small business and middle market commercial, commercial real estate, residential real estate 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.

#### Loan Quality

The quality of the loan portfolio and the amount of non-performing loans may increase or decrease as a result of acquisitions, organic portfolio growth, 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 internal factors specific to a particular borrower, such as the actions of a customer's management.

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## PART I: FINANCIAL INFORMATION

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

At June 30, 2016, non performing loans totaled \$37,864,000, an increase of \$4,552,000 from the December 31, 2015 balance of \$33,312,000. Non-accrual loans decreased \$3,154,000 to \$33,565,000 from the March 31, 2016 balance of \$36,719,000, but remained above the \$31,389,000 balance at December 31, 2015. The Corporation's coverage ratio of allowance for loan losses to non-accrual loans increased from 169.1 percent at March 31, 2016 to 185.3 percent at June 30, 2016. This non-accrual coverage ratio at December 31, 2015 was 199.0 percent. See additional information regarding the allowance for loan losses in the "Provision for Loan Losses" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as ITEM 2 of this Quarterly Report on Form 10-Q.

Other real estate owned, totaling \$13,219,000 at June 30, 2016, declined \$4,038,000 from the December 31, 2015 balance of \$17,257,000. For other real estate owned, current appraisals are obtained to determine fair value as management continues to aggressively market these real estate assets.

Accruing loans delinquent 90 or more days of \$362,000 at June 30, 2016 decreased \$545,000 from the December 31, 2015 balance of \$907,000. Residential real estate loans accounted for 64.0 percent of the total at June 30, 2016.

Commercial impaired loans include non-accrual loans, loans accounted for under ASC 310-30, and loans risk graded as substandard, doubtful and loss that were still accruing but deemed impaired according to the guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more and troubled debt restructurings.

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 June 30, 2016, commercial impaired loans totaled \$87,643,000 a decrease of \$9,884,000 from the December 31, 2015 balance of \$97,527,000. At June 30, 2016, a specific allowance for losses was not deemed necessary for commercial impaired loans totaling \$81,449,000 as there was no identified loss on these credits. A specific allowance of \$2,120,000 was recorded for the remaining balance of these impaired loans totaling \$6,194,000 and is included in the Corporation's allowance for loan losses.

At June 30, 2016, non-performing assets, which includes non-accrual loans, renegotiated loans, and other real estate owned, plus loans 90-days delinquent, totaled \$51,445,000; a decrease of \$31,000 from December 31, 2015 as noted in the table below.

| (Dollars in Thousands)                         | June 30, December |          |
|--|-------------------|----------|
|  | 2016              | 31, 2015 |
| Non-Performing Assets:                         |                   |          |
| Non-accrual loans                              | \$33,565          | \$31,389 |
| Renegotiated loans                             | 4,299             | 1,923    |
| Non-performing loans (NPL)                     | 37,864            | 33,312   |
| Other real estate owned                        | 13,219            | 17,257   |
| Non-performing assets (NPA)                    | 51,083            | 50,569   |
| 90+ days delinquent                            | 362               | 907      |
| Non-performing assets plus 90+ days delinquent | \$51,445          | \$51,476 |
| Impaired Loans                                 | \$87,643          | \$97,527 |

The non-accrual balances in the table above include troubled debt restructurings totaling \$6,285,000 and \$5,339,000 as of June 30, 2016 and December 31, 2015, respectively.

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

| (Dollars in Thousands)   | June 30, December 31, |           |
|--|-----------------------|-----------|
|  | 2016                  | 2015      |
| Non-Performing Assets plus loans 90+ Days Delinquent:            |                       |           |
| Commercial and industrial loans                                  | \$3,426               | \$ 5,544  |
| Agricultural production financing and other loans to farmers     | 2,000                 | 827       |
| Real estate loans:   |                       |           |
| Construction   | 9,110                 | 9,345     |
| Commercial and farmland  | 22,143                | 18,243    |
| Residential  | 12,173                | 14,528    |
| Home Equity  | 2,462                 | 2,665     |
| Individuals' loans for household and other personal expenditures | 131                   | 324       |
| Non-performing assets plus 90+ days delinquent                   | \$51,445              | \$ 51,476 |

Although the Corporation believes its underwriting and loan review procedures are appropriate for the various kinds of loans it makes, its results of operations and financial condition could be adversely affected in the event the quality of its loan portfolio declines. Deterioration in the economic environment including residential and commercial real estate values may result in increased levels of loan delinquencies and credit losses.

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## PART I: FINANCIAL INFORMATION

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

## Provision for Loan Losses

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The amount actually provided for loan losses in any period may be greater than or less than net loan losses, based on management's judgment as to the appropriate level of the allowance for loan losses. 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.

In conformance with ASC 805 and ASC 820, loans purchased after December 31, 2008, are recorded at the acquisition date fair value. Such loans are only included in the allowance when deemed impaired in accordance with ASC 310-30.

At June 30, 2016, the allowance for loan losses was \$62,186,000, a decrease of \$267,000 from December 31, 2015. As a percent of loans, the allowance was 1.29 percent at June 30, 2016, compared to 1.33 percent at December 31, 2015. The provision for loan losses for the six months ended June 30, 2016 was \$1,340,000. Comparatively, the provision for loan losses for the six months ended June 30, 2015 was \$417,000. Specific reserves on impaired loans increased \$278,000 from \$1,842,000 at December 31, 2015, to \$2,120,000 at June 30, 2016.

Net charge offs for the six months ended June 30, 2016, were \$1,607,000. Comparatively, the same period in 2015 had net charge offs of \$1,831,000. For the three months ended June 30, 2016, there were no charge offs or recoveries greater than \$500,000. The distribution of the net charge offs or recoveries for the three months ended June 30, 2016 and 2015 are reflected in the following table:

|  | Three      |         | Six Months     |         |
|--|------------|---------|----------------|---------|
|  | Months     |         | Months         |         |
|  | Ended June |         | Ended June 30, |         |
|  | 30,        |         | 30,            |         |
| (Dollars in Thousands)   | 2016       | 2015    | 2016           | 2015    |
| Net Charge Offs (Recoveries):                                    |            |         |                |         |
| Commercial and industrial loans                                  | \$313      | \$(307) | \$644          | \$(383) |
| Agricultural production financing and other loans to farmers     | 30         | 29      | 53             | 760     |
| Real estate loans:   |            |         |                |         |
| Construction   | 21         | 35      | 18             | 39      |
| Commercial and farmland  | 216        | 18      | 261            | 62      |
| Residential  | 35         | 575     | 422            | 789     |
| Home Equity  | 68         | 311     | 128            | 514     |
| Individuals' loans for household and other personal expenditures | 7          | 11      | 82             | 58      |
| Other commercial loans   |            | (4)     | (1)            | (8)     |
| Total Net Charge Offs  | \$690      | \$668   | \$1,607        | \$1,831 |

Management continually evaluates the commercial loan portfolio by including consideration of specific borrower cash flow analysis and estimated collateral values, types and amounts on non-performing loans, past and anticipated loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans

outstanding. The determination of the provision for loan losses in any period is based on management's continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio.

## LIQUIDITY

Liquidity management is the process by which the Corporation ensures 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 the 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 principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$658,829,000 at June 30, 2016, an increase of \$429,000, or 0.07 percent, from December 31, 2015. 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 and that are maturing in one year or less totaled \$2,500,000 at June 30, 2016. In addition, other types of assets such as cash and interest-bearing deposits with other banks, federal funds sold and loans maturing within one year are sources of liquidity.

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. Federal funds purchased and securities sold under agreements to repurchase are also considered a source of liquidity. In addition, Federal Home Loan Bank ("FHLB") advances are utilized as funding sources. At June 30, 2016, total borrowings from the FHLB were \$268,579,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at June 30, 2016 was \$343,943,000.

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## PART I: FINANCIAL INFORMATION

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

On April 11, 2014, the Corporation entered into a line of credit agreement with U.S. Bank, N.A. with a maximum borrowing capacity of \$20 million. The line of credit matured on April 8, 2016 and the agreement was not renewed. Interest was payable quarterly based on one-month LIBOR plus 2.00 percent. The line of credit had a quarterly facility fee of 0.25 percent on the unused balance. The line of credit agreement contained certain customary representations and warranties and financial and negative 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 June 30, 2016 are as follows:

| (Dollars in Thousands)                   | June 30,<br>2016 |
|--|------------------|
| Amounts of commitments:                  |                  |
| Loan commitments to extend credit        | \$1,863,978      |
| Standby and commercial letters of credit | 46,205           |
|  | \$1,910,183      |

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 June 30, 2016, are as follows:

| (Dollars in Thousands)                         | Remaining<br>2016 | 2017     | 2018     | 2019     | 2020     | 2021     | 2022 and<br>after | ASC 805<br>fair value<br>adjustments<br>at<br>acquisition | Total     |
|--|-------------------|----------|----------|----------|----------|----------|-------------------|---|-----------|
| Operating leases                               | \$ 1,636          | \$2,643  | \$1,650  | \$1,453  | \$1,291  | \$970    | \$6,007           |   | \$15,650  |
| Federal funds purchased                        | 20,000            |          |          |          |          |          |                   |   | 20,000    |
| Securities sold under<br>repurchase agreements | 140,777           |          |          |          |          |          |                   |   | 140,777   |
| Federal Home Loan Bank<br>advances             | 99,405            | 37,185   | 26,851   | 13,828   | 31,310   | 25,000   | 35,000            |   | 268,579   |
| Subordinated debentures<br>and term loans      | 370               |          |          |          |          |          | 132,012           | (4,704)   | 127,678   |
| Total  | \$262,188         | \$39,828 | \$28,501 | \$15,281 | \$32,601 | \$25,970 | \$173,019         | \$ (4,704)  | \$572,684 |

## 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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## PART I: FINANCIAL INFORMATION

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

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of June 30, 2016, 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:

|                | June 30, 2016      |                    |
|----------------|--------------------|--------------------|
|                | RISING             | FALLING            |
| Driver Rates   | (200 Basis Points) | (100 Basis Points) |
| Prime          | 200                | (25 )              |
| Federal funds  | 200                | (25 )              |
| One-year CMT   | 200                | (38 )              |
| Three-year CMT | 200                | (46 )              |
| Five-year CMT  | 200                | (47 )              |
| CD's           | 200                | (21 )              |
| FHLB advances  | 200                | (36 )              |

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 June 30, 2016. 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.

|                             | June 30, 2016 |                    |                    |
|-----------------------------|---------------|--------------------|--------------------|
|                             |               | RISING             | FALLING            |
| (Dollars in Thousands)      | Base          | (200 Basis Points) | (100 Basis Points) |
| Net interest income         | \$211,909     | \$231,545          | \$203,522          |
| Variance from base          |               | \$19,636           | \$(8,387 )         |
| Percent of change from base |               | 9.27               | %(3.96 )%          |

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2015, 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, 2015  |                    |
|----------------|--------------------|--------------------|
|                | RISING             | FALLING            |
| Driver Rates   | (200 Basis Points) | (100 Basis Points) |
| Prime          | 200                | (25 )              |
| Federal funds  | 200                | (25 )              |
| One-year CMT   | 200                | (56 )              |
| Three-year CMT | 200                | (100 )             |
| Five-year CMT  | 200                | (100 )             |
| CD's           | 200                | (21 )              |

FHLB advances 200 (83 )

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, 2015               |                                  |
|-----------------------------|-----------|---------------------------------|----------------------------------|
| (Dollars in Thousands)      | Base      | RISING<br>(200 Basis<br>Points) | FALLING<br>(100 Basis<br>Points) |
| Net interest income         | \$198,711 | \$213,758                       | \$188,921                        |
| Variance from base          |           | \$15,047                        | \$(9,790 )                       |
| Percent of change from base |           | 7.57                            | %(4.93 )%                        |

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## PART I: FINANCIAL INFORMATION

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

## EARNING ASSETS

The following table presents the earning asset mix as of June 30, 2016, and December 31, 2015. Earning assets increased by \$138,050,000 during the six months ended June 30, 2016. Interest-bearing time deposits and investment securities increased \$30,218,000 and \$20,802,000, respectively. Loans and loans held for sale increased by \$106,567,000. The four loan classes experiencing the largest increase from December 31, 2015, were real estate commercial and farmland, commercial and industrial loans, real estate home equity and other commercial loans. These increases were primarily offset by decreases in real estate residential and real estate construction. Additionally, the decrease in Federal Reserve and Federal Home Loan Bank stock of \$19,537,000 was due to the sale of the Corporation's Federal Reserve Bank stock after the conversion to an Indiana state-chartered bank.

| (Dollars in Thousands)                           | June 30,<br>2016 | December<br>31, 2015 |
|--|------------------|----------------------|
| Interest-bearing time deposits                   | \$62,533         | \$32,315             |
| Investment securities available for sale         | 658,829          | 658,400              |
| Investment securities held to maturity           | 638,972          | 618,599              |
| Mortgage loans held for sale                     | 18,854           | 9,894                |
| Loans  | 4,791,429        | 4,693,822            |
| Federal Reserve and Federal Home Loan Bank stock | 18,096           | 37,633               |
| Total  | \$6,188,713      | \$6,050,663          |

## OTHER

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

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PART I: FINANCIAL INFORMATION

ITEM 3. QUANTITATIVE AND QUALITATIVE  
DISCLOSURES ABOUT MARKET RISK

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

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PART I: FINANCIAL INFORMATION

ITEM 4. CONTROLS AND PROCEDURES

ITEM 4. CONTROLS AND PROCEDURES

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

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

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PART II: OTHER INFORMATION

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

(table dollar amounts in thousands, except share data)

ITEM 1. LEGAL PROCEEDINGS

There are no pending legal proceedings, other than litigation incidental to the ordinary business of the Corporation or its subsidiaries, of a material nature to which the Corporation or its subsidiaries is a party or of which any of their properties are subject. Further, there are no material legal proceedings in which any director, officer, principal shareholder, or affiliate of the Corporation, or any associate of any such director, officer or principal shareholder, is a party, or has a material interest, adverse to the Corporation or any of its subsidiaries.

None of the routine legal proceedings, individually or in the aggregate, in which the Corporation or its affiliates are involved are expected to have a material adverse impact on the financial position or the results of operations of the Corporation.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015,

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 three months ended June 30, 2016.

| 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 |
|-------------|----------------------------------|------------------------------|--|--|
| April, 2016 |                                  |                              |  |  |
| May, 2016   | 112                              | \$24.62                      |  |  |
| June, 2016  | 1,043                            | \$24.80                      |  |  |

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<br>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) (SEC No. 000-17071)   |
| 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) (SEC No. 000-17071)  |
| 3.3            | First Merchants Corporation Articles of Amendment of the Articles of Incorporation for the Series B Preferred Stock (Incorporated by reference to registrant's Form 8-K filed on September 23, 2011) (SEC No. 000-17071)  |
| 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) (SEC No. 000-17071)   |
| 4.2            | Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)   |
| 4.3            | Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)   |
| 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) (SEC No. 000-17071)   |
| 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) (SEC No. 033-45393)   |
| 4.6            | Upon request, the registrant agrees to furnish supplementally to the Commission a copy of the instruments defining the rights of holders of its (a) 5.00% Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million and (b) 6.75% Fixed-to-Floating Rate Subordinated Notes due 2028 in aggregate principal amount of \$65 million. |
| 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: August 9, 2016 by /s/ Michael C. Rechin  
Michael C. Rechin  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 9, 2016 by /s/ Mark K. Hardwick  
Mark K. Hardwick  
Executive Vice President,  
Chief Financial Officer and Chief Operating Officer  
(Principal Financial and Accounting Officer)

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PART II: OTHER INFORMATION  
ITEM 6. EXHIBITS

INDEX TO EXHIBITS

| Exhibit<br>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) (SEC No. 000-17071)   |
| 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) (SEC No. 000-17071)  |
| 3.3            | First Merchants Corporation Articles of Amendment of the Articles of Incorporation for the Series B Preferred Stock (Incorporated by reference to registrant's Form 8-K filed on September 23, 2011) (SEC No. 000-17071)  |
| 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) (SEC No. 000-17071)   |
| 4.2            | Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)   |
| 4.3            | Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)   |
| 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) (SEC No. 000-17071)   |
| 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) (SEC No. 033-45393)   |
| 4.6            | Upon request, the registrant agrees to furnish supplementally to the Commission a copy of the instruments defining the rights of holders of its (a) 5.00% Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million and (b) 6.75% Fixed-to-Floating Rate Subordinated Notes due 2028 in aggregate principal amount of \$65 million. |
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