

FIRST MID ILLINOIS BANCSHARES INC  
Form 10-Q  
August 07, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2014

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 0-13368

FIRST MID-ILLINOIS BANCSHARES, INC.  
(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

37-1103704  
(I.R.S. employer identification no.)

1421 Charleston Avenue,  
Mattoon, Illinois  
(Address of principal executive offices)

61938  
(Zip code)

(217) 234-7454  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data 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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, 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

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Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of August 7, 2014, 5,883,289 common shares, \$4.00 par value, were outstanding.

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## PART I

## ITEM 1. FINANCIAL STATEMENTS

First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Balance Sheets

(In thousands, except share data)

|  | (Unaudited)      |                      |
|--|------------------|----------------------|
|  | June 30,<br>2014 | December 31,<br>2013 |
| Assets   |                  |                      |
| Cash and due from banks:   |                  |                      |
| Non-interest bearing   | \$35,794         | \$33,453             |
| Interest bearing   | 21,246           | 31,152               |
| Federal funds sold   | 495              | 497                  |
| Cash and cash equivalents  | 57,535           | 65,102               |
| Investment securities:   |                  |                      |
| Available-for-sale, at fair value  | 439,190          | 488,724              |
| Loans held for sale  | 929              | 514                  |
| Loans  | 1,021,322        | 982,290              |
| Less allowance for loan losses   | (13,681)         | (13,249)             |
| Net loans  | 1,007,641        | 969,041              |
| Interest receivable  | 5,988            | 6,614                |
| Other real estate owned  | 397              | 568                  |
| Premises and equipment, net  | 27,868           | 28,578               |
| Goodwill, net  | 25,753           | 25,753               |
| Intangible assets, net   | 2,162            | 2,487                |
| Other assets   | 15,389           | 18,117               |
| Total assets   | \$1,582,852      | \$1,605,498          |
| Liabilities and Stockholders' Equity   |                  |                      |
| Deposits:  |                  |                      |
| Non-interest bearing   | \$226,544        | \$235,448            |
| Interest bearing   | 1,064,353        | 1,052,168            |
| Total deposits   | 1,290,897        | 1,287,616            |
| Securities sold under agreements to repurchase   | 95,159           | 119,187              |
| Interest payable   | 292              | 277                  |
| FHLB borrowings  | 10,000           | 20,000               |
| Junior subordinated debentures   | 20,620           | 20,620               |
| Other liabilities  | 7,260            | 8,417                |
| Total liabilities  | 1,424,228        | 1,456,117            |
| Stockholders' Equity:  |                  |                      |
| Convertible preferred stock, no par value; authorized 1,000,000 shares; issued 10,426 shares in 2014 and 10,427 shares in 2013 | 52,030           | 52,035               |
| Common stock, \$4 par value; authorized 18,000,000 shares; issued 7,851,253 shares in 2014 and 7,797,597 shares in 2013        | 31,405           | 31,190               |
| Additional paid-in capital   | 34,929           | 33,911               |
| Retained earnings  | 90,483           | 86,578               |
| Deferred compensation  | 3,088            | 2,989                |
| Accumulated other comprehensive loss   | (3,298)          | (8,380)              |
| Less treasury stock at cost, 1,954,922 in 2014 and 1,913,817 shares in 2013  | (50,013)         | (48,942)             |
| Total stockholders' equity   | 158,624          | 149,381              |
| Total liabilities and stockholders' equity   | \$1,582,852      | \$1,605,498          |

See accompanying notes to unaudited condensed consolidated financial statements.

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First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Statements of Income (unaudited)

(In thousands, except per share data)

|  | Three months ended June 30, |          | Six months ended June 30, |          |
|--|-----------------------------|----------|---------------------------|----------|
|  | 2014                        | 2013     | 2014                      | 2013     |
| <b>Interest income:</b>                                    |                             |          |                           |          |
| Interest and fees on loans                                 | \$11,039                    | \$10,390 | \$21,851                  | \$20,825 |
| Interest on investment securities                          | 2,545                       | 2,798    | 5,068                     | 5,539    |
| Interest on certificates of deposit investments            | —                           | 5        | —                         | 13       |
| Interest on federal funds sold                             | —                           | 2        | —                         | 6        |
| Interest on deposits with other financial institutions     | 16                          | 11       | 43                        | 25       |
| Total interest income                                      | 13,600                      | 13,206   | 26,962                    | 26,408   |
| <b>Interest expense:</b>                                   |                             |          |                           |          |
| Interest on deposits                                       | 583                         | 664      | 1,192                     | 1,460    |
| Interest on securities sold under agreements to repurchase | 10                          | 10       | 22                        | 25       |
| Interest on FHLB borrowings                                | 65                          | 59       | 133                       | 116      |
| Interest on other borrowings                               | 1                           | 1        | 1                         | 1        |
| Interest on subordinated debentures                        | 129                         | 131      | 255                       | 261      |
| Total interest expense                                     | 788                         | 865      | 1,603                     | 1,863    |
| Net interest income  | 12,812                      | 12,341   | 25,359                    | 24,545   |
| Provision for loan losses                                  | 128                         | 252      | 451                       | 732      |
| Net interest income after provision for loan losses        | 12,684                      | 12,089   | 24,908                    | 23,813   |
| <b>Other income:</b>                                       |                             |          |                           |          |
| Trust revenues   | 848                         | 806      | 1,781                     | 1,699    |
| Brokerage commissions                                      | 233                         | 218      | 483                       | 389      |
| Insurance commissions                                      | 441                         | 410      | 999                       | 896      |
| Service charges  | 1,353                       | 1,215    | 2,497                     | 2,355    |
| Securities gains, net                                      | 543                         | 482      | 734                       | 835      |
| Mortgage banking revenue, net                              | 158                         | 305      | 256                       | 591      |
| ATM / debit card revenue                                   | 1,002                       | 947      | 1,975                     | 1,830    |
| Other  | 412                         | 331      | 746                       | 669      |
| Total other income   | 4,990                       | 4,714    | 9,471                     | 9,264    |
| <b>Other expense:</b>                                      |                             |          |                           |          |
| Salaries and employee benefits                             | 6,054                       | 5,972    | 12,107                    | 11,769   |
| Net occupancy and equipment expense                        | 2,114                       | 2,102    | 4,263                     | 4,145    |
| Net other real estate owned expense (income)               | (39)                        | ) 46     | (18)                      | ) 162    |
| FDIC insurance   | 199                         | 213      | 405                       | 435      |
| Amortization of intangible assets                          | 163                         | 171      | 325                       | 341      |
| Stationery and supplies                                    | 173                         | 121      | 328                       | 262      |
| Legal and professional                                     | 677                         | 614      | 1,239                     | 1,162    |
| Marketing and donations                                    | 245                         | 264      | 509                       | 507      |
| Other  | 1,628                       | 1,415    | 3,016                     | 2,747    |
| Total other expense  | 11,214                      | 10,918   | 22,174                    | 21,530   |
| Income before income taxes                                 | 6,460                       | 5,885    | 12,205                    | 11,547   |
| Income taxes   | 2,431                       | 2,220    | 4,569                     | 4,354    |
| Net income   | 4,029                       | 3,665    | 7,636                     | 7,193    |
| Dividends on preferred shares                              | 1,104                       | 1,105    | 2,208                     | 2,209    |
| Net income available to common stockholders                | \$2,925                     | \$2,560  | \$5,428                   | \$4,984  |



First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Statements of Income (unaudited) (continued)

(In thousands, except per share data)

|  | Three months ended June 30, |      | Six months ended June 30, |      |
|--|-----------------------------|------|---------------------------|------|
|  | 2014                        | 2013 | 2014                      | 2013 |
| Per share data:  |                             |      |                           |      |
| Basic net income per common share available to common stockholders   | 0.49                        | 0.43 | 0.92                      | 0.84 |
| Diluted net income per common share available to common stockholders | 0.48                        | 0.43 | 0.91                      | 0.84 |
| Cash dividends declared per common share                             | 0.26                        | 0.21 | 0.26                      | 0.21 |

See accompanying notes to unaudited condensed consolidated financial statements.

First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Statements of Comprehensive Income (Loss) (unaudited)

(in thousands)

|  | Three months ended June 30, |          | Six months ended June 30, |          |
|--|-----------------------------|----------|---------------------------|----------|
|  | 2014                        | 2013     | 2014                      | 2013     |
| Net income   | \$4,029                     | \$3,665  | \$7,636                   | \$7,193  |
| Other Comprehensive Income (Loss)  |                             |          |                           |          |
| Unrealized gains (losses) on available-for-sale securities, net of taxes of \$(1,904) and \$6,061 for three months ended June 30, 2014 and 2013, respectively and \$(3,532) and \$6,761 for six months ended June 30 2014 and 2013, respectively.      | 2,981                       | (9,488   | ) 5,530                   | (10,584  |
| Less: reclassification adjustment for realized gains included in net income net of taxes of \$212 and \$188 for three months ended June 30, 2014 and 2013, respectively and \$286 and \$326 for six months ended June 30, 2014 and 2013, respectively. | (331                        | ) (294   | ) (448                    | ) (509   |
| Other comprehensive income (loss), net of taxes  | 2,650                       | (9,782   | ) 5,082                   | (11,093  |
| Comprehensive income (loss)  | \$6,679                     | \$(6,117 | ) \$12,718                | \$(3,900 |

See accompanying notes to unaudited condensed consolidated financial statements.



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First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Statements of Cash Flows (unaudited)  
(In thousands)

Six months ended June 30,  
2014                      2013

Cash flows from operating activities:

|   |          |            |
|---|----------|------------|
| Net income  | \$7,636  | \$7,193    |
| Adjustments to reconcile net income to net cash provided by operating activities: |          |            |
| Provision for loan losses   | 451      | 732        |
| Depreciation, amortization and accretion, net                                     | 2,035    | 2,475      |
| Stock-based compensation expense  | 221      | 168        |
| Gains on investment securities, net   | (734     | ) (835     |
| (Gain) loss on sales of other real property owned, net                            | (38      | ) 59       |
| Loss on write down of fixed assets  | 19       | 24         |
| Gains on sale of loans held for sale, net   | (272     | ) (571     |
| Decrease in accrued interest receivable   | 626      | 789        |
| Increase (decrease) in accrued interest payable                                   | 15       | (70        |
| Origination of loans held for sale  | (19,760  | ) (41,351  |
| Proceeds from sale of loans held for sale   | 19,617   | 40,066     |
| (Increase) decrease in other assets   | (329     | ) 2,589    |
| Decrease in other liabilities   | (1,271   | ) (975     |
| Net cash provided by operating activities   | 8,216    | 10,293     |
| Cash flows from investing activities:   |          |            |
| Proceeds from maturities of certificates of deposit investments                   | —        | 4,673      |
| Proceeds from sales of securities available-for-sale                              | 63,142   | 29,112     |
| Proceeds from maturities of securities available-for-sale                         | 40,270   | 103,833    |
| Purchases of securities available-for-sale  | (45,427  | ) (176,694 |
| Net increase in loans   | (39,293  | ) (3,934   |
| Purchases of premises and equipment   | (496     | ) (679     |
| Proceeds from sales of other real property owned                                  | 451      | 790        |
| Net cash provided by (used in) investing activities                               | 18,647   | (42,899    |
| Cash flows from financing activities:   |          |            |
| Net increase (decrease) in deposits   | 3,281    | (2,931     |
| Decrease in repurchase agreements   | (24,028  | ) (18,790  |
| Proceeds from FHLB advances   | —        | 10,000     |
| Repayment of FHLB advances  | (10,000  | ) (2,500   |
| Repayment of other borrowings   | (1,000   | ) —        |
| Proceeds from other borrowings  | 1,000    | —          |
| Proceeds from issuance of common stock  | 381      | 529        |
| Conversion of preferred stock   | (5       | ) —        |
| Purchase of treasury stock  | (902     | ) (1,593   |
| Dividends paid on preferred stock   | (2,024   | ) (2,026   |
| Dividends paid on common stock  | (1,133   | ) (930     |
| Net cash used in financing activities   | (34,430  | ) (18,241  |
| Decrease in cash and cash equivalents   | (7,567   | ) (50,847  |
| Cash and cash equivalents at beginning of period                                  | 65,102   | 82,712     |
| Cash and cash equivalents at end of period  | \$57,535 | \$31,865   |



| First Mid-Illinois Bancshares, Inc.<br>Condensed Consolidated Statements of Cash Flows (unaudited) (continued)<br>(In thousands) | Six months ended June 30, |         |
|--|---------------------------|---------|
|  | 2014                      | 2013    |
| Supplemental disclosures of cash flow information  |                           |         |
| Cash paid during the period for:   |                           |         |
| Interest   | \$1,588                   | \$1,933 |
| Income taxes   | 4,685                     | 5,407   |
| Supplemental disclosures of noncash investing and financing activities   |                           |         |
| Loans transferred to other real estate owned   | 242                       | 665     |
| Dividends reinvested in common stock   | 576                       | 499     |
| Net tax benefit related to option and deferred compensation plans  | 101                       | 101     |

See accompanying notes to unaudited condensed consolidated financial statements.

Notes to Condensed Consolidated Financial Statements  
(unaudited)

Note 1 -- Basis of Accounting and Consolidation

The unaudited condensed consolidated financial statements include the accounts of First Mid-Illinois Bancshares, Inc. ("Company") and its wholly-owned subsidiaries: First Mid-Illinois Bank & Trust, N.A. ("First Mid Bank"), Mid-Illinois Data Services, Inc. ("MIDS") and The Checkley Agency, Inc. doing business as First Mid Insurance Group ("First Mid Insurance"). All significant intercompany balances and transactions have been eliminated in consolidation. The financial information reflects all adjustments which, in the opinion of management, are necessary for a fair presentation of the results of the interim periods ended June 30, 2014 and 2013, and all such adjustments are of a normal recurring nature. Certain amounts in the prior year's consolidated financial statements have been reclassified to conform to the June 30, 2014 presentation and there was no impact on net income or stockholders' equity. The results of the interim period ended June 30, 2014 are not necessarily indicative of the results expected for the year ending December 31, 2014. The Company operates as a one-segment entity for financial reporting purposes.

The 2013 year-end consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

The unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information required by U.S. generally accepted accounting principles ("GAAP") for complete financial statements and related footnote disclosures although the Company believes that the disclosures made are adequate to make the information not misleading. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2013 Annual Report on Form 10-K.

Website

The Company maintains a website at [www.firstmid.com](http://www.firstmid.com). All periodic and current reports of the Company and amendments to these reports filed with the Securities and Exchange Commission ("SEC") can be accessed, free of charge, through this website as soon as reasonably practicable after these materials are filed with the SEC.

NASDAQ Listing

On May 12, 2014, the Company's common stock began trading on The NASDAQ Stock Market under the ticker "FMBH." Prior to the listing of the Company's common stock on NASDAQ, the common stock was traded on the OTC Bulletin Board.

Stock Plans

At the Annual Meeting of Stockholders held May 23, 2007, the stockholders approved the First Mid-Illinois Bancshares, Inc. 2007 Stock Incentive Plan ("SI Plan"). The SI Plan was implemented to succeed the Company's 1997 Stock Incentive Plan, which had a ten-year term that expired October 21, 2007. The SI Plan is intended to provide a means whereby directors, employees, consultants and advisors of the Company and its subsidiaries may sustain a sense of proprietorship and personal involvement in the continued development and financial success of the Company and its subsidiaries, thereby advancing the interests of the Company and its stockholders. Accordingly, directors and selected employees, consultants and advisors may be provided the opportunity to acquire shares of common stock of the Company on the terms and conditions established in the SI Plan.

On September 27, 2011, the Board of Directors passed a resolution relating to the SI Plan whereby they authorized and approved the Executive Long-Term Incentive Plan ("LTIP"). The LTIP was implemented to provide methodology for granting Stock Awards and Stock Unit Awards to select senior executives of the Company or any Subsidiary.

A maximum of 300,000 shares of common stock may be issued under the SI Plan. As of June 30, 2014, the Company had awarded 59,500 shares as stock options under the SI plan. There were no stock options awarded in 2014 or 2013. The Company awarded 14,770 shares and 14,054 shares during 2014 and 2013, respectively, as 50% Stock Awards and 50% Stock Unit Awards under the SI plan.

## Convertible Preferred Stock

Series B Convertible Preferred Stock. During 2009, the Company sold to certain accredited investors including directors, executive officers, and certain major customers and holders of the Company's common stock, \$24,635,000, in the aggregate, of a newly authorized series of its preferred stock designated as Series B 9% Non-Cumulative Perpetual Convertible Preferred Stock (the "Series B Preferred Stock"). The Series B Preferred Stock had an issue price of \$5,000 per share and no par value per share. The Series B Preferred Stock was issued in a private placement exempt from registration pursuant to Regulation D of the Securities Act of 1933, as amended.

The Series B Preferred Stock pays non-cumulative dividends semiannually in arrears, when, as and if authorized by the Board of Directors of the Company, at a rate of 9% per year. Holders of the Series B Preferred Stock will have no voting rights, except with respect to certain fundamental changes in the terms of the Series B Preferred Stock and certain other matters. In addition, if dividends on the Series B Preferred Stock are not paid in full for four dividend periods, whether consecutive or not, the holders of the Series B Preferred Stock, acting as a class with any other of the Company's securities having similar voting rights, will have the right to elect two directors to the Company's Board of Directors. The terms of office of these directors will end when the Company has paid or set aside for payment full semi-annual dividends for four consecutive dividend periods.

Each share of the Series B Preferred Stock may be converted at any time at the option of the holder into shares of the Company's common stock. The number of shares of common stock into which each share of the Series B Preferred Stock is convertible is the \$5,000 liquidation preference per share divided by the Conversion Price initially set at \$21.94. The Conversion Price is subject to adjustment from time to time pursuant to the terms of the Certificate of Designation (the "Series B Certificate of Designation"). If at the time of conversion, there are any authorized, declared and unpaid dividends with respect to a converted share of Series B Preferred Stock, the holder will receive cash in lieu of the dividends, and a holder will receive cash in lieu of fractional shares of common stock following conversion.

After November 16, 2014, the Company may, at its option but subject to the Company's receipt of any required prior approvals from the Board of Governors of the Federal Reserve System or any other regulatory authority, redeem the Series B Preferred Stock. Any redemption will be in exchange for cash in the amount of \$5,000 per share, plus any authorized, declared and unpaid dividends, without accumulation of any undeclared dividends.

The Company also has the right at any time on or after November 16, 2014 to require the conversion of all (but not less than all) of the Series B Preferred Stock into shares of common stock if, on the date notice of mandatory conversion is given to holders, the book value of the Company's common stock equals or exceeds 115% of the book value of the Company's common stock at September 30, 2008. "Book value of the Company's common stock" at any date means the result of dividing the Company's total common stockholders' equity at that date, determined in accordance with U.S. generally accepted accounting principles, by the number of shares of common stock then outstanding, net of any shares held in the treasury. The book value of the Company's common stock at September 30, 2008 was \$13.03, and 115% of this amount is approximately \$14.98. The book value of the Company's common stock at June 30, 2014 was \$18.08.

Pursuant to Section 3(j) of the Series B Certification of Designation, the conversion price for the Series B Preferred Stock, which was initially set at \$21.94, was required to be adjusted if, among other things, the initial conversion price of any subsequently issued series of preferred stock was lower than the then current conversion price of the Series B Preferred Stock. As a result of the Series C Preferred Stock (see below) having an initial conversion price of less than \$21.94, the conversion price of the Series B Preferred Stock was adjusted pursuant to the terms of the Series B Certificate of Designation based on the amount of Series C Preferred Stock sold on February 11, 2011, March 2, 2011, May 13, 2011 and June 28, 2012. The new conversion price of the Series B Preferred Stock, certified by the Company's accountant pursuant to Section 3(j) of the Series B Certificate of Designation, is \$21.62.

Series C Convertible Preferred Stock. On February 11, 2011, the Company accepted from certain accredited investors, including directors, executive officers, and certain major customers and holders of the Company's common stock (collectively, the "Investors"), subscriptions for the purchase of \$27,500,000, in the aggregate, of a newly authorized series of preferred stock designated as Series C 8% Non-Cumulative Perpetual Convertible Preferred Stock (the "Series C Preferred Stock"). As of February 11, 2011, \$11,010,000 of the Series C Preferred Stock had been issued and sold by the Company to certain Investors. On March 2, 2011, three investors subsequently completed the required bank regulatory process and an additional \$2,750,000 of Series C Preferred Stock was issued and sold by the Company to these investors. On May 13, 2011, four additional investors received the required bank regulatory approval and an additional \$5,490,000 of Series C Preferred Stock was issued and sold by the Company to these investors. On June 28, 2012, the final \$8,250,000 of the Company's Series C Preferred Stock was issued and sold by the Company to Investors following their receipt of the required bank regulatory

approval, for a total of \$27,500,000 of outstanding Series C Preferred Stock. All of the Series C Preferred Stock subscribed for by investors has been issued.

The Series C Preferred Stock has an issue price of \$5,000 per share and no par value per share. The Series C Preferred Stock was issued in a private placement exempt from registration pursuant to Regulation D of the Securities Act of 1933, as amended.

The Series C Preferred Stock pays non-cumulative dividends semiannually in arrears, when, as and if authorized by the Board of Directors of the Company, at a rate of 8% per year. Holders of the Series C Preferred Stock will have no voting rights, except with respect to certain fundamental changes in the terms of the Series C Preferred Stock and certain other matters. In addition, if dividends on the Series C Preferred Stock are not paid in full for four dividend periods, whether consecutive or not, the holders of the Series C Preferred Stock, acting as a class with any other of the Company's securities having similar voting rights, including the Company's Series B Preferred Stock, will have the right to elect two directors to the Company's Board of Directors. The terms of office of these directors will end when the Company has paid or set aside for payment full semi-annual dividends for four consecutive dividend periods.

Each share of the Series C Preferred Stock may be converted at any time at the option of the holder into shares of the Company's common stock. The number of shares of common stock into which each share of the Series C Preferred Stock is convertible is the \$5,000 liquidation preference per share divided by the Conversion Price of \$20.29. The Conversion Price is subject to adjustment from time to time pursuant to the terms of the Series C Certificate of Designation. If at the time of conversion, there are any authorized, declared and unpaid dividends with respect to a converted share of Series C Preferred Stock, the holder will receive cash in lieu of the dividends, and a holder will receive cash in lieu of fractional shares of common stock following conversion.

After May 13, 2016 the Company may, at its option but subject to the Company's receipt of any required prior approvals from the Board of Governors of the Federal Reserve System or any other regulatory authority, redeem the Series C Preferred Stock. Any redemption will be in exchange for cash in the amount of \$5,000 per share, plus any authorized, declared and unpaid dividends, without accumulation of any undeclared dividends.

The Company also has the right at any time after May 13, 2016 to require the conversion of all (but not less than all) of the Series C Preferred Stock into shares of common stock if, on the date notice of mandatory conversion is given to holders, (a) the tangible book value per share of the Company's common stock equals or exceeds 115% of the tangible book value per share of the Company's common stock at December 31, 2010, and (b) the NASDAQ Bank Index (denoted by CBNK:IND) equals or exceeds 115% of the NASDAQ Bank Index at December 31, 2010. "Tangible book value per share of our common stock" at any date means the result of dividing the Company's total common stockholders equity at that date, less the amount of goodwill and intangible assets, determined in accordance with U.S. generally accepted accounting principles, by the number of shares of common stock then outstanding, net of any shares held in the treasury. The tangible book value of the Company's common stock at December 31, 2010 was \$9.38, and 115% of this amount is approximately \$10.79. The NASDAQ Bank Index value at December 31, 2010 was 1,847.35 and 115% of this amount is approximately 2,124.45. The tangible book value of the Company's common stock at June 30, 2014 was \$13.34 and the NASDAQ Bank Index value at June 30, 2014 was 2,668.29.



## Accumulated Other Comprehensive Income

The components of accumulated other comprehensive income included in stockholders' equity as of June 30, 2014 and December 31, 2013 are as follows (in thousands):

|  | Unrealized<br>Gain (Loss)<br>on<br>Available for<br>Sale Securities | Securities with<br>Other-Than-Temporary<br>Impairment Losses | Total       |
|--|---|--|-------------|
| June 30, 2014  |   |  |             |
| Net unrealized losses on securities available-for-sale | \$(2,325 )  | \$ —   | \$(2,325 )  |
| Securities with other-than-temporary impairment losses | —   | (3,080 )   | (3,080 )    |
| Tax benefit  | 906   | 1,201  | 2,107       |
| Balance at June 30, 2014                               | \$(1,419 )  | \$(1,879 )   | \$(3,298 )  |
| December 31, 2013                                      |   |  |             |
| Net unrealized gains on securities available-for-sale  | \$(10,272 )   | \$—  | \$(10,272 ) |
| Securities with other-than-temporary impairment losses | —   | (3,461 )   | (3,461 )    |
| Tax benefit  | 4,004   | 1,349  | 5,353       |
| Balance at December 31, 2013                           | \$(6,268 )  | \$(2,112 )   | \$(8,380 )  |

Amounts reclassified from accumulated other comprehensive income and the affected line items in the statements of income during the six months ended June 30, 2014 and 2013, were as follows (in thousands):

|   | Amounts Reclassified from Other<br>Comprehensive Income |        | Affected Line Item in the Statements of<br>Income               |
|---|---|--------|---|
|   | 2014  | 2013   |   |
| Unrealized gains on available-for-sale securities                     | \$734   | 835    | Securities gains, net<br>(Total reclassified amount before tax) |
|   | (286 )  | (326 ) | Tax expense   |
| Total reclassifications out of accumulated other comprehensive income | \$448   | \$509  | Net reclassified amount   |

See "Note 3 – Investment Securities" for more detailed information regarding unrealized losses on available-for-sale securities.

## Adoption of New Accounting Guidance

Accounting Standards Update 2014-04 - Receivables--Troubled Debt Restructurings by Creditors (Topic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure ("ASU 2014-04"). In January 2014, the Financial Accounting Standards Board ("FASB") issued ASU 2014-04 to reduce diversity by clarifying when a creditor should be considered to have received physical possession of residential real estate property that collateralizes a consumer mortgage loan so that the loan should be derecognized, and the real estate property recognized, in the financial statements. ASU 2014-04 amends Topic 310-40 to clarify when an in substance repossession of foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan when either: (1) the creditor obtains legal title to the property upon completion of foreclosure or (2) the borrower conveys all interest in the property to the creditor

to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. ASC 2014-04 is effective for annual and interim reporting periods beginning on or after December 15, 2014. The adoption of this guidance is not expected to have a material impact on the Company's financial statements.

Note 2 -- Earnings Per Share

Basic net income per common share available to common stockholders is calculated as net income less preferred stock dividends divided by the weighted average number of common shares outstanding. Diluted net income per common share available to common stockholders is computed using the weighted average number of common shares outstanding, increased by the assumed conversion of the Company's convertible preferred stock and the Company's stock options, unless anti-dilutive.

The components of basic and diluted net income per common share available to common stockholders for the three and six-month period ended June 30, 2014 and 2013 were as follows:

|   | Three months ended June 30, |              | Six months ended June 30, |              |
|---|-----------------------------|--------------|---------------------------|--------------|
|   | 2014                        | 2013         | 2014                      | 2013         |
| Basic Net Income per Common Share                   |                             |              |                           |              |
| Available to Common Stockholders:                   |                             |              |                           |              |
| Net income  | \$4,029,000                 | \$3,665,000  | \$7,636,000               | \$7,193,000  |
| Preferred stock dividends                           | (1,104,000 )                | (1,105,000 ) | (2,208,000 )              | (2,209,000 ) |
| Net income available to common stockholders         | \$2,925,000                 | \$2,560,000  | \$5,428,000               | \$4,984,000  |
| Weighted average common shares outstanding          | 5,880,919                   | 5,951,981    | 5,882,123                 | 5,953,623    |
| Basic earnings per common share                     | \$0.49                      | \$0.43       | \$0.92                    | \$0.84       |
| Diluted Net Income per Common Share                 |                             |              |                           |              |
| Available to Common Stockholders:                   |                             |              |                           |              |
| Net income available to common stockholders         | \$2,925,000                 | \$2,560,000  | \$5,428,000               | \$4,984,000  |
| Effect of assumed preferred stock conversion        | 1,104,000                   | —            | 2,208,000                 | —            |
| Net income applicable to diluted earnings per share | \$4,029,000                 | \$2,560,000  | \$7,636,000               | \$4,984,000  |
| Weighted average common shares outstanding          | 5,880,919                   | 5,951,981    | 5,882,123                 | 5,953,623    |
| Dilutive potential common shares:                   |                             |              |                           |              |
| Assumed conversion of stock options                 | —                           | 1,118        | —                         | 1,124        |
| Restricted stock awarded                            | 9,501                       | 9,027        | 9,051                     | 9,027        |
| Assumed conversion of preferred stock               | 2,494,569                   | —            | 2,494,679                 | —            |
| Dilutive potential common shares                    | 2,504,070                   | 10,145       | 2,503,730                 | 10,151       |
| Diluted weighted average common shares outstanding  | 8,384,989                   | 5,962,126    | 8,386,303                 | 5,963,774    |
| Diluted earnings per common share                   | \$0.48                      | \$0.43       | \$0.91                    | \$0.84       |

The following shares were not considered in computing diluted earnings per share for the three and six-month periods ended June 30, 2014 and 2013 because they were anti-dilutive:

|  | Three months ended June 30, |           | Six months ended June 30, |           |
|--|-----------------------------|-----------|---------------------------|-----------|
|  | 2014                        | 2013      | 2014                      | 2013      |
| Stock options to purchase shares of common stock                                     | 128,750                     | 104,750   | 128,750                   | 104,750   |
| Average dilutive potential common shares associated with convertible preferred stock | —                           | 2,494,801 | —                         | 2,494,801 |



## Note 3 -- Investment Securities

The amortized cost, gross unrealized gains and losses and estimated fair values for available-for-sale and held-to-maturity securities by major security type at June 30, 2014 and December 31, 2013 were as follows (in thousands):

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>(Losses) | Fair Value   |
|---|-------------------|------------------------------|---------------------------------|--------------|
| June 30, 2014   |                   |                              |                                 |              |
| Available-for-sale:   |                   |                              |                                 |              |
| U.S. Treasury securities and obligations of U.S. government corporations & agencies | \$ 163,914        | \$ 155                       | \$(3,833)                       | ) \$ 160,236 |
| Obligations of states and political subdivisions                                    | 67,786            | 2,167                        | (343)                           | ) 69,610     |
| Mortgage-backed securities: GSE residential   | 205,411           | 1,859                        | (2,327)                         | ) 204,943    |
| Trust preferred securities  | 3,449             | —                            | (3,080)                         | ) 369        |
| Other securities  | 4,035             | 30                           | (33)                            | ) 4,032      |
| Total available-for-sale  | \$ 444,595        | \$ 4,211                     | \$(9,616)                       | ) \$ 439,190 |
| December 31, 2013   |                   |                              |                                 |              |
| Available-for-sale:   |                   |                              |                                 |              |
| U.S. Treasury securities and obligations of U.S. government corporations & agencies | \$ 197,805        | \$ 137                       | \$(7,574)                       | ) \$ 190,368 |
| Obligations of states and political subdivisions                                    | 65,304            | 1,031                        | (1,773)                         | ) 64,562     |
| Mortgage-backed securities: GSE residential   | 229,661           | 2,215                        | (4,275)                         | ) 227,601    |
| Trust preferred securities  | 3,652             | —                            | (3,461)                         | ) 191        |
| Other securities  | 6,035             | 34                           | (67)                            | ) 6,002      |
| Total available-for-sale  | \$ 502,457        | \$ 3,417                     | \$(17,150)                      | ) \$ 488,724 |

The trust preferred securities represent one trust preferred pooled security issued by First Tennessee Financial (“FTN”). The unrealized loss of this security, which has a remaining maturity of twenty-three years, is primarily due to its long-term nature, a lack of demand or inactive market for the security, and concerns regarding the underlying financial institutions that have issued the trust preferred security. See the heading “Trust Preferred Securities” for further information regarding this security.

Realized gains and losses resulting from sales of securities were as follows during the six months ended June 30, 2014 and 2013 (in thousands):

|              | June 30,<br>2014 | June 30,<br>2013 |
|--------------|------------------|------------------|
| Gross gains  | \$ 1,435         | \$ 835           |
| Gross losses | (701)            | ) —              |

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The following table indicates the expected maturities of investment securities classified as available-for-sale and held-to-maturity, presented at fair value, at June 30, 2014 and the weighted average yield for each range of maturities (dollars in thousands):

|   | One year or less | After 1 through 5 years | After 5 through 10 years | After ten years | Total      |   |
|---|------------------|-------------------------|--------------------------|-----------------|------------|---|
| Available-for-sale:   |                  |                         |                          |                 |            |   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 120,920       | \$ 34,500               | \$ 4,816                 | \$—             | \$ 160,236 |   |
| Obligations of state and political subdivisions                                       | 3,560            | 32,518                  | 31,499                   | 2,033           | 69,610     |   |
| Mortgage-backed securities: GSE residential   | 2,166            | 120,370                 | 82,407                   | —               | 204,943    |   |
| Trust preferred securities  | —                | —                       | —                        | 369             | 369        |   |
| Other securities  | —                | —                       | 3,972                    | 60              | 4,032      |   |
| Total investments   | \$ 126,646       | \$ 187,388              | \$ 122,694               | \$ 2,462        | \$ 439,190 |   |
| Weighted average yield  | 1.67             | % 2.50                  | % 2.55                   | % 1.64          | % 2.26     | % |
| Full tax-equivalent yield   | 1.75             | % 2.96                  | % 3.17                   | % 2.37          | % 2.66     | % |

The weighted average yields are calculated on the basis of the amortized cost and effective yields weighted for the scheduled maturity of each security. Tax-equivalent yields have been calculated using a 35% tax rate. With the exception of obligations of the U.S. Treasury and other U.S. government agencies and corporations, there were no investment securities of any single issuer, the book value of which exceeded 10% of stockholders' equity at June 30, 2014.

Investment securities carried at approximately \$285 million and \$321 million at June 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits and repurchase agreements and for other purposes as permitted or required by law.

The following table presents the aging of gross unrealized losses and fair value by investment category as of June 30, 2014 and December 31, 2013 (in thousands):

|   | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| June 30, 2014   |                     |                   |                   |                   |            |                   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 4,926            | \$(74 )           | \$ 137,393        | \$(3,759 )        | \$ 142,319 | \$(3,833 )        |
| Obligations of states and political subdivisions                                      | 6,440               | (41 )             | 11,289            | (302 )            | 17,729     | (343 )            |
| Mortgage-backed securities: GSE residential   | 29,223              | (204 )            | 83,470            | (2,123 )          | 112,693    | (2,327 )          |
| Trust preferred securities  | —                   | —                 | 369               | (3,080 )          | 369        | (3,080 )          |
| Other securities  | —                   | —                 | 1,967             | (33 )             | 1,967      | (33 )             |
| Total   | \$ 40,589           | \$(319 )          | \$ 234,488        | \$(9,297 )        | \$ 275,077 | \$(9,616 )        |
| December 31, 2013   |                     |                   |                   |                   |            |                   |
| U.S. Treasury securities and obligations of U.S. government corporations and          | \$ 183,074          | \$(7,574 )        | \$—               | \$—               | \$ 183,074 | \$(7,574 )        |

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|  |           |             |         |            |           |             |
|--|-----------|-------------|---------|------------|-----------|-------------|
| agencies   |           |             |         |            |           |             |
| Obligations of states and political subdivisions | 29,986    | (1,708 )    | 808     | (65 )      | 30,794    | (1,773 )    |
| Mortgage-backed securities: GSE residential      | 131,125   | (4,275 )    | 13      | —          | 131,138   | (4,275 )    |
| Trust preferred securities                       | —         | —           | 191     | (3,461 )   | 191       | (3,461 )    |
| Other securities                                 | 3,933     | (67 )       | —       | —          | 3,933     | (67 )       |
| Total  | \$348,118 | \$(13,624 ) | \$1,012 | \$(3,526 ) | \$349,130 | \$(17,150 ) |

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U.S. Treasury Securities and Obligations of U.S. Government Corporations and Agencies. At June 30, 2014, there were thirty U.S. Treasury securities and obligations of U.S. government corporations and agencies with a fair value of \$137,393,000 and unrealized losses of \$3,759,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2013 there were no obligations of U.S. government corporations and agencies in a continuous unrealized loss position for twelve months or more. The increase in unrealized losses is due to the rise in interest rates over the past year.

Obligations of states and political subdivisions. At June 30, 2014 there were twenty-five obligations of states and political subdivisions with a fair value of \$11,289,000 and unrealized losses of \$302,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2013, there were two obligations of states and political subdivisions with a fair value of \$808,000 and unrealized losses of \$65,000 in a continuous unrealized loss position for twelve months or more. The increase in unrealized losses is due to the rise in interest rates over the past year.

Mortgage-backed Securities: GSE Residential. At June 30, 2014 there were twenty-nine mortgage-backed securities with a fair value of \$83,470,000 and unrealized losses of \$2,123,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2013, there was one mortgage-backed security with a fair value of \$13,000 and unrealized losses of \$109 in a continuous unrealized loss position for twelve months or more. The increase in unrealized losses is due to the rise in interest rates over the past year.

Trust Preferred Securities. At June 30, 2014, there was one trust preferred security with a fair value of \$369,000 and unrealized losses of \$3,080,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2013, there were one trust preferred securities with a fair value of \$191,000 and unrealized losses of \$3,461,000 in a continuous unrealized loss position for twelve months or more. The unrealized loss was primarily due to the long-term nature of the trust preferred security, a lack of demand or inactive market for the security, the impending change to the regulatory treatment of these securities, and concerns regarding the underlying financial institutions that have issued the trust preferred securities.

The Company recorded no other-than-temporary impairment (OTTI) for these securities during 2014 or 2013. Because it is not more-likely-than-not that the Company will be required to sell the remaining security before recovery of its new, lower amortized cost basis, which may be maturity, the Company does not consider the remainder of the investment to be other-than-temporarily impaired at June 30, 2014. However, future downgrades or additional deferrals and defaults in this security, could result in additional OTTI and consequently, have a material impact on future earnings.

Following are the details for the currently impaired trust preferred security (in thousands):

|               | Book Value | Market Value | Unrealized Gains (Losses) | Other-than-temporary Impairment Recorded To-date |
|---------------|------------|--------------|---------------------------|--|
| PreTSL XXVIII | 3,449      | 369          | (3,080)                   | (1,111)  |

Other securities. At June 30, 2014, there was one corporate bond with a fair value of \$1,967,000 and unrealized losses of \$33,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2013, there were no corporate bonds in a continuous unrealized loss position for twelve months or more.



The Company does not believe any other individual unrealized loss as of June 30, 2014 represents OTTI. However, given the continued disruption in the financial markets, the Company may be required to recognize OTTI losses in future periods with respect to its available for sale investment securities portfolio. The amount and timing of any additional OTTI will depend on the decline in the underlying cash flows of the securities. 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 the period the other-than-temporary impairment is identified.

Other-than-temporary Impairment. Upon acquisition of a security, the Company determines whether it is within the scope of the accounting guidance for investments in debt and equity securities or whether it must be evaluated for impairment under the accounting guidance for beneficial interests in securitized financial assets

The Company conducts periodic reviews to evaluate its investment securities to determine whether OTTI has occurred. While all securities are considered, the securities primarily impacted by OTTI evaluation are pooled trust preferred securities. For the

pooled trust preferred security currently in the investment portfolio, an extensive review is conducted to determine if any additional OTTI has occurred. The Company utilizes an independent third-party to perform the OTTI evaluation. The Company's management reviews the assumption inputs and methodology with the third-party to obtain an understanding of them and determine if they are appropriate for the evaluation. Economic models are used to project future cash flows for the security based on current assumptions for discount rate, prepayments, default and deferral rates and recoveries. These assumptions are determined based on the structure of the issuance, the specific collateral underlying the security, historical performance of trust preferred securities and general state of the economy. The OTTI test compares the present value of the cash flows from quarter to quarter to determine if there has been an adverse change which could indicate additional OTTI.

The discount rate assumption used in the cash flow model is equal to the current yield used to accrete the beneficial interest. The Company's current trust preferred security investment has a floating rate coupon of 3-month LIBOR plus 90 basis points. Since the estimate of 3-month LIBOR is based on the forward curve on the measurement date, and is therefore variable, the discount assumption for this security is a range of projected coupons over the expected life of the security.

The Company considers the likelihood that issuers will prepay their securities which changes the amount of expected cash flows. Factors such as the coupon rates of collateral, economic conditions and regulatory changes, such as the Dodd-Frank Act and Basel III, are considered.

The trust preferred security includes collateral issued by financial institutions and insurance companies. To identify bank issuers with a high risk of near term default or deferral, a credit model developed by the third-party is utilized that scores each bank issuer based on 29 different ratios covering capital adequacy, asset quality, earnings, liquidity, the Texas Ratio, and sensitivity to interest rates. To account for longer term bank default risk not captured by the credit model, it is assumed that banks will default at a rate of 2% annually for the first two years of the cash flow projection, and 36 basis points in each year thereafter. To project defaults for insurance issuers, each issuer's credit rating is mapped to its idealized default rate, which is AM Best's estimate of the historical default rate for insurance companies with that rating.

Lastly, it is assumed that trust preferred securities issued by banks that have already failed will have no recoveries, and that banks projected to default will have recoveries of 10%. Additionally, the 10% recovery assumption, incorporates the potential for cures by banks that are currently in deferral.

If the Company determines that a given pooled trust preferred security position will be subject to a write-down or loss, the Company records the expected credit loss as a charge to earnings.

**Credit Losses Recognized on Investments.** As described above, some of the Company's investments in trust preferred securities have experienced fair value deterioration due to credit losses but are not otherwise other-than-temporarily impaired. The following table provides information about those trust preferred securities for which only a credit loss was recognized in income and other losses are recorded in other comprehensive income (loss) for the six months ended June 30, 2014 and 2013 (in thousands).

|   | Accumulated Credit Losses |               |
|---|---------------------------|---------------|
|   | June 30, 2014             | June 30, 2013 |
| Credit losses on trust preferred securities held                    |                           |               |
| Beginning of period   | \$1,111                   | \$3,989       |
| Additions related to OTTI losses not previously recognized          | —                         | —             |
| Reductions due to sales / (recoveries)                              | —                         | —             |
| Reductions due to change in intent or likelihood of sale            | —                         | —             |
| Additions related to increases in previously recognized OTTI losses | —                         | —             |

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|  |         |         |
|--|---------|---------|
| Reductions due to increases in expected cash flows | —       | —       |
| End of period                                      | \$1,111 | \$3,989 |

On July 22, 2013, the Company sold two of its trust preferred securities (PreTSL I and PreTSL II). This sale resulted in recovery of all of the book value of these securities. The net proceeds exceeded the aggregate book value of these securities by approximately \$1.4 million and this amount was recorded as a security gain during the third quarter of 2013.

## Note 4 – Loans and Allowance for Loan Losses

Loans are stated at the principal amount outstanding net of unearned discounts, unearned income and allowance for loan losses. Unearned income includes deferred loan origination fees reduced by loan origination costs and is amortized to interest income over the life of the related loan using methods that approximated the effective interest rate method. Interest on substantially all loans is credited to income based on the principal amount outstanding. A summary of loans at June 30, 2014 and December 31, 2013 follows (in thousands):

|  | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| Construction and land development              | \$18,945         | \$25,321             |
| Agricultural real estate                       | 109,577          | 109,376              |
| 1-4 Family residential properties              | 181,778          | 184,158              |
| Multifamily residential properties             | 53,295           | 50,174               |
| Commercial real estate                         | 379,245          | 357,726              |
| Loans secured by real estate                   | 742,840          | 726,755              |
| Agricultural loans                             | 55,578           | 64,055               |
| Commercial and industrial loans                | 200,077          | 168,227              |
| Consumer loans                                 | 14,052           | 14,579               |
| All other loans                                | 9,052            | 9,094                |
| Gross loans                                    | 1,021,599        | 982,710              |
| Less:  |                  |                      |
| Net deferred loan fees, premiums and discounts | 277              | 420                  |
| Allowance for loan losses                      | 13,681           | 13,249               |
| Net loans                                      | \$1,007,641      | \$969,041            |

Loans expected to be sold are classified as held for sale in the consolidated financial statements and are recorded at the lower of aggregate cost or market value, taking into consideration future commitments to sell the loans. These loans are primarily for 1-4 family residential properties. The balance of loans held for sale, excluded from the balances above, were \$929,000 and \$514,000 at June 30, 2014 and December 31, 2013, respectively.

Most of the Company's business activities are with customers located within central Illinois. At June 30, 2014, the Company's loan portfolio included \$165.2 million of loans to borrowers whose businesses are directly related to agriculture. Of this amount, \$136.6 million was concentrated in other grain farming. Total loans to borrowers whose businesses are directly related to agriculture decreased \$8.2 million from \$173.4 million at December 31, 2013 while loans concentrated in other grain farming decreased \$10.5 million from \$147.1 million at December 31, 2013 due to seasonal paydowns based upon timing of cash flow requirements. While the Company adheres to sound underwriting practices, including collateralization of loans, any extended period of low commodity prices, drought conditions, significantly reduced yields on crops and/or reduced levels of government assistance to the agricultural industry could result in an increase in the level of problem agriculture loans and potentially result in loan losses within the agricultural portfolio.

In addition, the Company has \$51.2 million of loans to motels and hotels. The performance of these loans is dependent on borrower specific issues as well as the general level of business and personal travel within the region. While the Company adheres to sound underwriting standards, a prolonged period of reduced business or personal travel could result in an increase in nonperforming loans to this business segment and potentially in loan losses. The Company also has \$104.9 million of loans to lessors of non-residential buildings and \$64.0 million of loans to lessors of residential buildings and dwellings.

The structure of the Company's loan approval process is based on progressively larger lending authorities granted to individual loan officers, loan committees, and ultimately the Board of Directors. Outstanding balances to one borrower or affiliated borrowers are limited by federal regulation; however, limits well below the regulatory thresholds are generally observed. The vast majority of the Company's loans are to businesses located in the geographic market areas served by the Company's branch bank system. Additionally, a significant portion of the collateral securing the loans in the portfolio is located within the Company's primary geographic footprint. In general, the Company adheres to loan underwriting standards consistent with industry guidelines for all loan segments.

The Company's lending can be summarized into the following primary areas:

**Commercial Real Estate Loans.** Commercial real estate loans are generally comprised of loans to small business entities to purchase or expand structures in which the business operations are housed, loans to owners of real estate who lease space to non-related commercial entities, loans for construction and land development, loans to hotel operators, and loans to owners of multi-family residential structures, such as apartment buildings. Commercial real estate loans are underwritten based on historical and projected cash flows of the borrower and secondarily on the underlying real estate pledged as collateral on the debt. For the various types of commercial real estate loans, minimum criteria have been established within the Company's loan policy regarding debt service coverage while maximum limits on loan-to-value and amortization periods have been defined. Maximum loan-to-value ratios range from 65% to 80% depending upon the type of real estate collateral, while the desired minimum debt coverage ratio is 1.20x. Amortization periods for commercial real estate loans are generally limited to twenty years. The Company's commercial real estate portfolio is well below the thresholds that would designate a concentration in commercial real estate lending, as established by the federal banking regulators.

**Commercial and Industrial Loans.** Commercial and industrial loans are primarily comprised of working capital loans used to purchase inventory and fund accounts receivable that are secured by business assets other than real estate. These loans are generally written for one year or less. Also, equipment financing is provided to businesses with these loans generally limited to 80% of the value of the collateral and amortization periods limited to seven years. Commercial loans are often accompanied by a personal guaranty of the principal owners of a business. Like commercial real estate loans, the underlying cash flow of the business is the primary consideration in the underwriting process. The financial condition of commercial borrowers is monitored at least annually with the type of financial information required determined by the size of the relationship. Measures employed by the Company for businesses with higher risk profiles include the use of government-assisted lending programs through the Small Business Administration and U.S. Department of Agriculture.

**Agricultural and Agricultural Real Estate Loans.** Agricultural loans are generally comprised of seasonal operating lines to cash grain farmers to plant and harvest corn and soybeans and term loans to fund the purchase of equipment. Agricultural real estate loans are primarily comprised of loans for the purchase of farmland. Specific underwriting standards have been established for agricultural-related loans including the establishment of projections for each operating year based on industry developed estimates of farm input costs and expected commodity yields and prices. Operating lines are typically written for one year and secured by the crop. Loan-to-value ratios on loans secured by farmland generally do not exceed 65% and have amortization periods limited to twenty five years. Federal government-assistance lending programs through the Farm Service Agency are used to mitigate the level of credit risk when deemed appropriate.

**Residential Real Estate Loans.** Residential real estate loans generally include loans for the purchase or refinance of residential real estate properties consisting of one-to-four units and home equity loans and lines of credit. The Company sells the vast majority of its long-term fixed rate residential real estate loans to secondary market investors. The Company also releases the servicing of these loans upon sale. The Company retains all residential real estate loans with balloon payment features. Balloon periods are limited to five years. Residential real estate loans are typically underwritten to conform to industry standards including criteria for maximum debt-to-income and loan-to-value ratios as well as minimum credit scores. Loans secured by first liens on residential real estate held in the portfolio typically do not exceed 80% of the value of the collateral and have amortization periods of twenty five years or less. The Company does not originate subprime mortgage loans.

**Consumer Loans.** Consumer loans are primarily comprised of loans to individuals for personal and household purposes such as the purchase of an automobile or other living expenses. Minimum underwriting criteria have been established that consider credit score, debt-to-income ratio, employment history, and collateral coverage. Typically,

consumer loans are set up on monthly payments with amortization periods based on the type and age of the collateral.

Other Loans. Other loans consist primarily of loans to municipalities to support community projects such as infrastructure improvements or equipment purchases. Underwriting guidelines for these loans are consistent with those established for commercial loans with the additional repayment source of the taxing authority of the municipality.

#### Allowance for Loan Losses

The allowance for loan losses represents the Company's best estimate of the reserve necessary to adequately account for probable losses existing in the current portfolio. The provision for loan losses is the charge against current earnings that is determined by the Company as the amount needed to maintain an adequate allowance for loan losses.

In determining the adequacy of the allowance for loan losses, and therefore the provision to be charged to current earnings, the Company relies predominantly on a disciplined credit review and approval process that extends to the full range of the Company's credit exposure. The review process is directed by the overall lending policy and is intended to identify, at the earliest possible stage, borrowers who might be facing financial difficulty. Once identified, the magnitude of exposure to individual borrowers is quantified in the form of specific allocations of the allowance for loan losses. The Company considers collateral values and guarantees in the determination of such specific allocations. Additional factors considered by the Company in evaluating the overall adequacy of the allowance include historical net loan losses, the level and composition of nonaccrual, past due and troubled debt restructurings, trends in volumes and terms of loans, effects of changes in risk selection and underwriting standards or lending practices, lending staff changes, concentrations of credit, industry conditions and the current economic conditions in the region where the Company operates.

The Company estimates the appropriate level of allowance for loan losses by separately evaluating large impaired loans, large adversely classified loans and nonimpaired loans.

#### Impaired loans

The Company individually evaluates certain loans for impairment. In general, these loans have been internally identified via the Company's loan grading system as credits requiring management's attention due to underlying problems in the borrower's business or collateral concerns. This evaluation considers expected future cash flows, the value of collateral and also other factors that may impact the borrower's ability to make payments when due. For loans greater than \$100,000 in the commercial, commercial real estate, agricultural, agricultural real estate segments, impairment is individually measured each quarter using one of three alternatives: (1) the present value of expected future cash flows discounted at the loan's effective interest rate; (2) the loan's observable market price, if available; or (3) the fair value of the collateral less costs to sell for collateral dependent loans and loans for which foreclosure is deemed to be probable. A specific allowance is assigned when expected cash flows or collateral do not justify the carrying amount of the loan. The carrying value of the loan reflects reductions from prior charge-offs.

#### Adversely classified loans

A detailed analysis is also performed on each adversely classified (substandard or doubtful rated) borrower with an aggregate, outstanding balance of \$100,000 or more. This analysis includes commercial, commercial real estate, agricultural, and agricultural real estate borrowers who are not currently identified as impaired but pose sufficient risk to warrant in-depth review. Estimated collateral shortfalls are then calculated with allocations for each loan segment based on the five-year historical average of collateral shortfalls adjusted for environmental factors including changes in economic conditions, changes in credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets. Because the economic and business climate in any given industry or market, and its impact on any given borrower, can change rapidly, the risk profile of the loan portfolio is periodically assessed and adjusted when appropriate. Consumer loans are evaluated for adverse classification based primarily on the Uniform Retail Credit Classification and Account Management Policy established by the federal banking regulators. Classification standards are generally based on delinquency status, collateral coverage, bankruptcy and the presence of fraud.

#### Non-classified and Watch loans



For loans, in all segments of the portfolio, that are considered to possess levels of risk commensurate with a pass rating, management establishes base loss estimations which are derived from historical loss experience. Use of a five-year historical loss period eliminates the effect of any significant losses that can be attributed to a single event or borrower during a given reporting period. The base loss estimations for each loan segment are adjusted after consideration of several environmental factors influencing the level of credit risk in the portfolio. In addition, loans rated as watch are further segregated in the commercial / commercial real estate and agricultural / agricultural real estate segments. These loans possess potential weaknesses that, if unchecked, may result in deterioration to the point of becoming a problem asset. Due to the elevated risk inherent in these loans, an allocation of twice the adjusted base loss estimation of the applicable loan segment is determined appropriate.

Due to weakened economic conditions during recent years, the Company established allocations for each of the loan segments at levels above the base loss estimations. Some of the economic factors included the potential for reduced cash flow for commercial operating loans from reduction in sales or increased operating costs, decreased occupancy rates for commercial buildings, reduced levels of home sales for commercial land developments, the uncertainty regarding grain prices and increased operating costs for farmers, and increased levels of unemployment and bankruptcy impacting consumer's ability to pay. Each of these economic uncertainties was taken into consideration in developing the level of the reserve. The Company has not materially changed any aspect of its overall approach in the determination of the allowance for loan losses. However, on an on-going basis the Company continues to refine the methods used in determining management's best estimate of the allowance for loan losses.



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The following tables present the balance in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method for the three and six-months ended June 30, 2014 and 2013 and for the year ended December 31, 2013 (in thousands):

|                                       | Commercial/<br>Commercial<br>Real Estate | Agricultural/<br>Agricultural<br>Real Estate | Residential<br>Real Estate | Consumer | Unallocated | Total       |
|---------------------------------------|--|--|----------------------------|----------|-------------|-------------|
| Three months ended June 30, 2014      |  |  |                            |          |             |             |
| Allowance for loan losses:            |  |  |                            |          |             |             |
| Balance, beginning of period          | \$10,581                                 | \$503  | \$760                      | \$372    | \$1,387     | \$13,603    |
| Provision charged to expense          | 200                                      | 21   | 6                          | 27       | (126)       | 128         |
| Losses charged off                    | (28)                                     | —  | (14)                       | (60)     | —           | (102)       |
| Recoveries                            | 18                                       | —  | 5                          | 29       | —           | 52          |
| Balance, end of period                | \$10,771                                 | \$524  | \$757                      | \$368    | \$1,261     | \$13,681    |
| Ending balance:                       |  |  |                            |          |             |             |
| Individually evaluated for impairment | \$322                                    | \$—  | \$—                        | \$—      | \$—         | \$322       |
| Collectively evaluated for impairment | \$10,449                                 | \$524  | \$757                      | \$368    | \$1,261     | \$13,359    |
| Three months ended June 30, 2013      |  |  |                            |          |             |             |
| Allowance for loan losses:            |  |  |                            |          |             |             |
| Balance, beginning of period          | \$9,341                                  | \$417  | \$719                      | \$422    | \$1,085     | \$11,984    |
| Provision charged to expense          | 40                                       | (3)  | 92                         | (15)     | 138         | 252         |
| Losses charged off                    | (98)                                     | —  | (19)                       | (51)     | —           | (168)       |
| Recoveries                            | 21                                       | —  | 1                          | 41       | —           | 63          |
| Balance, end of period                | \$9,304                                  | \$414  | \$793                      | \$397    | \$1,223     | \$12,131    |
| Ending balance:                       |  |  |                            |          |             |             |
| Individually evaluated for impairment | \$439                                    | \$—  | \$—                        | \$—      | \$—         | \$439       |
| Collectively evaluated for impairment | \$8,865                                  | \$414  | \$793                      | \$397    | \$1,223     | \$11,692    |
| Six months ended June 30, 2014        |  |  |                            |          |             |             |
| Allowance for loan losses:            |  |  |                            |          |             |             |
| Balance, beginning of year            | \$10,646                                 | \$533  | \$771                      | \$377    | \$922       | \$13,249    |
| Provision charged to expense          | 75                                       | (10)   | 11                         | 36       | 339         | 451         |
| Losses charged off                    | (32)                                     | —  | (45)                       | (105)    | —           | (182)       |
| Recoveries                            | 82                                       | 1  | 20                         | 60       | —           | 163         |
| Balance, end of period                | \$10,771                                 | \$524  | \$757                      | \$368    | \$1,261     | \$13,681    |
| Ending balance:                       |  |  |                            |          |             |             |
| Individually evaluated for impairment | \$322                                    | \$—  | \$—                        | \$—      | \$—         | \$322       |
| Collectively evaluated for impairment | \$10,449                                 | \$524  | \$757                      | \$368    | \$1,261     | \$13,359    |
| Loans:                                |  |  |                            |          |             |             |
| Ending balance                        | \$657,352                                | \$164,841                                    | \$185,754                  | \$14,304 | \$—         | \$1,022,251 |
| Ending balance:                       |  |  |                            |          |             |             |
| Individually evaluated for impairment | \$3,648                                  | \$—  | \$—                        | \$—      | \$—         | \$3,648     |
| Collectively evaluated for impairment | \$653,704                                | \$164,841                                    | \$185,754                  | \$14,304 | \$—         | \$1,018,603 |



|                                       | Commercial/<br>Commercial<br>Real Estate | Agricultural/<br>Agricultural<br>Real Estate | Residential<br>Real Estate | Consumer | Unallocated | Total     |
|---------------------------------------|--|--|----------------------------|----------|-------------|-----------|
| Six months ended June 30, 2013        |  |  |                            |          |             |           |
| Allowance for loan losses:            |  |  |                            |          |             |           |
| Balance, beginning of year            | \$9,301                                  | \$558  | \$726                      | \$403    | \$788       | \$11,776  |
| Provision charged to expense          | 284                                      | (145 )                                       | 144                        | 14       | 435         | 732       |
| Losses charged off                    | (367 )                                   | —  | (86 )                      | (97 )    | —           | (550 )    |
| Recoveries                            | 86                                       | 1  | 9                          | 77       | —           | 173       |
| Balance, end of period                | \$9,304                                  | \$414  | \$793                      | \$397    | \$1,223     | \$12,131  |
| Ending balance:                       |  |  |                            |          |             |           |
| Individually evaluated for impairment | \$439                                    | \$—  | \$—                        | \$—      | \$—         | \$439     |
| Collectively evaluated for impairment | \$8,865                                  | \$414  | \$793                      | \$397    | \$1,223     | \$11,692  |
| Loans:                                |  |  |                            |          |             |           |
| Ending balance                        | \$564,526                                | \$147,218                                    | \$188,255                  | \$15,814 | \$—         | \$915,813 |
| Ending balance:                       |  |  |                            |          |             |           |
| Individually evaluated for impairment | \$5,232                                  | \$312  | \$—                        | \$—      | \$—         | \$5,544   |
| Collectively evaluated for impairment | \$559,294                                | \$146,906                                    | \$188,255                  | \$15,814 | \$—         | \$910,269 |
| Year ended December 31, 2013          |  |  |                            |          |             |           |
| Allowance for loan losses:            |  |  |                            |          |             |           |
| Balance, beginning of year            | \$9,301                                  | \$558  | \$726                      | \$403    | \$788       | \$11,776  |
| Provision charged to expense          | 1,861                                    | (30 )  | 171                        | 57       | 134         | 2,193     |
| Losses charged off                    | (764 )                                   | —  | (141 )                     | (223 )   | —           | (1,128 )  |
| Recoveries                            | 248                                      | 5  | 15                         | 140      | —           | 408       |
| Balance, end of year                  | \$10,646                                 | \$533  | \$771                      | \$377    | \$922       | \$13,249  |
| Ending balance:                       |  |  |                            |          |             |           |
| Individually evaluated for impairment | \$604                                    | \$—  | \$—                        | \$—      | \$—         | \$604     |
| Collectively evaluated for impairment | \$10,042                                 | \$533  | \$771                      | \$377    | \$922       | \$12,645  |
| Loans:                                |  |  |                            |          |             |           |
| Ending balance                        | \$607,062                                | \$172,979                                    | \$187,796                  | \$14,967 | \$—         | \$982,804 |
| Ending balance:                       |  |  |                            |          |             |           |
| Individually evaluated for impairment | \$5,145                                  | \$—  | \$—                        | \$—      | \$—         | \$5,145   |
| Collectively evaluated for impairment | \$601,917                                | \$172,979                                    | \$187,796                  | \$14,967 | \$—         | \$977,659 |

Consistent with regulatory guidance, charge-offs on all loan segments are taken when specific loans, or portions thereof, are considered uncollectible. The Company's policy is to promptly charge these loans off in the period the uncollectible loss is reasonably determined.

For all loan portfolio segments except 1-4 family residential properties and consumer, the Company promptly charges-off loans, or portions thereof, when available information confirms that specific loans are uncollectible based on information that includes, but is not limited to, (1) the deteriorating financial condition of the borrower, (2) declining collateral values, and/or (3) legal action, including bankruptcy, that impairs the borrower's ability to adequately meet its obligations. For impaired loans that are considered to be solely collateral dependent, a partial charge-off is recorded when a loss has been confirmed by an updated appraisal or other appropriate valuation of the collateral.

The Company charges-off 1-4 family residential and consumer loans, or portions thereof, when the Company reasonably determines the amount of the loss. The Company adheres to timeframes established by applicable regulatory guidance which provides for the charge-down of 1-4 family first and junior lien mortgages to the net realizable value less costs to sell when the loan is 180 days past due, charge-off of unsecured open-end loans when the loan is 180 days past due, and charge down to the net realizable value when other secured loans are 120 days past due. Loans at these respective delinquency thresholds for which the Company can clearly document that the loan is both well-secured and in the process of collection, such that collection will occur regardless of delinquency status, need not be charged off.

#### Credit Quality

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, collateral support, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis includes loans with an outstanding balance greater than \$100,000 and non-homogeneous loans, such as commercial and commercial real estate loans. This analysis is performed on a continuous basis. The Company uses the following definitions for risk ratings:

**Watch.** Loans classified as watch have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

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

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing factors, conditions and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered pass rated loans.

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The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of June 30, 2014 and December 31, 2013 (in thousands):

|             | Construction & Land Development |          | Agricultural Real Estate |           | 1-4 Family Residential Properties |           | Multifamily Residential Properties |          |
|-------------|---------------------------------|----------|--------------------------|-----------|-----------------------------------|-----------|------------------------------------|----------|
|             | 2014                            | 2013     | 2014                     | 2013      | 2014                              | 2013      | 2014                               | 2013     |
| Pass        | \$18,101                        | \$23,839 | \$107,840                | \$108,262 | \$180,594                         | \$182,593 | \$53,295                           | \$50,174 |
| Watch       | —                               | —        | 294                      | 231       | 718                               | 637       | —                                  | —        |
| Substandard | 844                             | 1,482    | 1,476                    | 912       | 1,483                             | 1,531     | —                                  | —        |
| Doubtful    | —                               | —        | —                        | —         | —                                 | —         | —                                  | —        |
| Total       | \$18,945                        | \$25,321 | \$109,610                | \$109,405 | \$182,795                         | \$184,761 | \$53,295                           | \$50,174 |

|             | Commercial Real Estate (Nonfarm/Nonresidential) |           | Agricultural Loans |          | Commercial & Industrial Loans |           | Consumer Loans |          |
|-------------|---|-----------|--------------------|----------|-------------------------------|-----------|----------------|----------|
|             | 2014  | 2013      | 2014               | 2013     | 2014                          | 2013      | 2014           | 2013     |
| Pass        | \$359,723                                       | \$335,284 | \$54,539           | \$62,439 | \$192,603                     | \$158,107 | \$14,034       | \$14,558 |
| Watch       | 16,095  | 17,998    | —                  | 193      | 3,071                         | 3,515     | 11             | —        |
| Substandard | 2,813   | 3,717     | 1,121              | 1,496    | 4,545                         | 6,731     | 7              | 21       |
| Doubtful    | —   | —         | —                  | —        | —                             | —         | —              | —        |
| Total       | \$378,631                                       | \$356,999 | \$55,660           | \$64,128 | \$200,219                     | \$168,353 | \$14,052       | \$14,579 |

|             | All Other Loans |         | Total Loans |           |
|-------------|-----------------|---------|-------------|-----------|
|             | 2014            | 2013    | 2014        | 2013      |
| Pass        | \$9,044         | \$9,084 | \$989,773   | \$944,340 |
| Watch       | —               | —       | 20,189      | 22,574    |
| Substandard | —               | —       | 12,289      | 15,890    |
| Doubtful    | —               | —       | —           | —         |
| Total       | \$9,044         | \$9,084 | \$1,022,251 | \$982,804 |



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The following table presents the Company's loan portfolio aging analysis at June 30, 2014 and December 31, 2013 (in thousands):

|                                    | 30-59<br>days Past<br>Due | 60-89<br>days Past<br>Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Current     | Total Loans<br>Receivable | Total<br>Loans > 90<br>days &<br>Accruing |
|------------------------------------|---------------------------|---------------------------|--------------------------------|-------------------|-------------|---------------------------|---|
| June 30, 2014                      |                           |                           |                                |                   |             |                           |   |
| Construction and land development  | \$371                     | \$—                       | \$—                            | \$371             | \$18,574    | \$18,945                  | \$—                                       |
| Agricultural real estate           | 32                        | 122                       | —                              | 154               | 109,456     | 109,610                   | —   |
| 1-4 Family residential properties  | 650                       | 97                        | 236                            | 983               | 181,812     | 182,795                   | —   |
| Multifamily residential properties | 289                       | —                         | —                              | 289               | 53,006      | 53,295                    | —   |
| Commercial real estate             | 598                       | 465                       | —                              | 1,063             | 377,568     | 378,631                   | —   |
| Loans secured by real estate       | 1,940                     | 684                       | 236                            | 2,860             | 740,416     | 743,276                   | —   |
| Agricultural loans                 | 181                       | 8                         | —                              | 189               | 55,471      | 55,660                    | —   |
| Commercial and industrial loans    | 259                       | 5                         | 75                             | 339               | 199,880     | 200,219                   | —   |
| Consumer loans                     | 93                        | 49                        | 8                              | 150               | 13,902      | 14,052                    | —   |
| All other loans                    | —                         | —                         | —                              | —                 | 9,044       | 9,044                     | —   |
| Total loans                        | \$2,473                   | \$746                     | \$319                          | \$3,538           | \$1,018,713 | \$1,022,251               | \$—                                       |
| December 31, 2013                  |                           |                           |                                |                   |             |                           |   |
| Construction and land development  | \$—                       | \$—                       | \$—                            | \$—               | \$25,321    | \$25,321                  | \$—                                       |
| Agricultural real estate           | 299                       | —                         | —                              | 299               | 109,106     | 109,405                   | —   |
| 1-4 Family residential properties  | 326                       | 146                       | 371                            | 843               | 183,918     | 184,761                   | —   |
| Multifamily residential properties | —                         | —                         | —                              | —                 | 50,174      | 50,174                    | —   |
| Commercial real estate             | 568                       | 1,030                     | 145                            | 1,743             | 355,256     | 356,999                   | —   |
| Loans secured by real estate       | 1,193                     | 1,176                     | 516                            | 2,885             | 723,775     | 726,660                   | —   |
| Agricultural loans                 | 122                       | 49                        | —                              | 171               | 63,957      | 64,128                    | —   |
| Commercial and industrial loans    | 113                       | 88                        | 62                             | 263               | 168,090     | 168,353                   | —   |
| Consumer loans                     | 83                        | 25                        | 4                              | 112               | 14,467      | 14,579                    | —   |
| All other loans                    | —                         | —                         | —                              | —                 | 9,084       | 9,084                     | —   |
| Total loans                        | \$1,511                   | \$1,338                   | \$582                          | \$3,431           | \$979,373   | \$982,804                 | \$—                                       |

#### Impaired Loans

Within all loan portfolio segments, loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified due date. Impaired loans, excluding certain troubled debt restructured loans, are placed on nonaccrual status. Impaired loans include nonaccrual loans and loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions,

forgiveness of principal, forbearance or other actions intended to maximize collection. It is the Company's policy to have any restructured loans which are on nonaccrual status prior to being modified remain on nonaccrual status until, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal. If the restructured loan is on accrual status prior to being modified, the loan is reviewed to determine if the modified loan should remain on accrual status.

The Company's policy is to discontinue the accrual of interest income on all loans for which principal or interest is ninety days past due. The accrual of interest is discontinued earlier when, in the opinion of management, there is reasonable doubt as to the timely collection of interest or principal. Once interest accruals are discontinued, accrued but uncollected interest is charged against current year income. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Interest on loans determined to be troubled debt restructurings is recognized on an accrual basis in accordance with the restructured terms if the loan is in compliance with the modified terms. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of

the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal. The Company requires a period of satisfactory performance of not less than six months before returning a nonaccrual loan to accrual status.

The following tables present impaired loans as of June 30, 2014 and December 31, 2013 (in thousands):

|                                     | June 30, 2014    |                          |                    | December 31, 2013 |                          |                    |
|-------------------------------------|------------------|--------------------------|--------------------|-------------------|--------------------------|--------------------|
|                                     | Recorded Balance | Unpaid Principal Balance | Specific Allowance | Recorded Balance  | Unpaid Principal Balance | Specific Allowance |
| Loans with a specific allowance:    |                  |                          |                    |                   |                          |                    |
| Construction and land development   | \$844            | \$1,695                  | \$60               | \$614             | \$614                    | \$76               |
| Agricultural real estate            | —                | —                        | —                  | —                 | —                        | —                  |
| 1-4 Family residential properties   | 178              | 178                      | 1                  | —                 | —                        | —                  |
| Multifamily residential properties  | —                | —                        | —                  | —                 | —                        | —                  |
| Commercial real estate              | 439              | 439                      | 172                | 1,096             | 1,096                    | 301                |
| Loans secured by real estate        | 1,461            | 2,312                    | 233                | 1,710             | 1,710                    | 377                |
| Agricultural loans                  | —                | —                        | —                  | —                 | —                        | —                  |
| Commercial and industrial loans     | 88               | 88                       | 89                 | 275               | 275                      | 227                |
| Consumer loans                      | —                | —                        | —                  | —                 | —                        | —                  |
| All other loans                     | —                | —                        | —                  | —                 | —                        | —                  |
| Total loans                         | \$1,549          | \$2,400                  | \$322              | \$1,985           | \$1,985                  | \$604              |
| Loans without a specific allowance: |                  |                          |                    |                   |                          |                    |
| Construction and land development   | \$—              | \$—                      | \$—                | \$869             | \$1,727                  | \$—                |
| Agricultural real estate            | 36               | 43                       | —                  | 105               | 113                      | —                  |
| 1-4 Family residential properties   | 873              | 1,241                    | —                  | 1,110             | 1,558                    | —                  |
| Multifamily residential properties  | —                | —                        | —                  | —                 | —                        | —                  |
| Commercial real estate              | 1,842            | 1,868                    | —                  | 1,750             | 1,778                    | —                  |
| Loans secured by real estate        | 2,751            | 3,152                    | —                  | 3,834             | 5,176                    | —                  |
| Agricultural loans                  | —                | —                        | —                  | —                 | —                        | —                  |
| Commercial and industrial loans     | 499              | 810                      | —                  | 613               | 946                      | —                  |
| Consumer loans                      | 33               | 43                       | —                  | 37                | 51                       | —                  |
| All other loans                     | —                | —                        | —                  | —                 | —                        | —                  |
| Total loans                         | \$3,283          | \$4,005                  | \$—                | \$4,484           | \$6,173                  | \$—                |
| Total loans:                        |                  |                          |                    |                   |                          |                    |
| Construction and land development   | \$844            | \$1,695                  | \$60               | \$1,483           | \$2,341                  | \$76               |
| Agricultural real estate            | 36               | 43                       | —                  | 105               | 113                      | —                  |
| 1-4 Family residential properties   | 1,051            | 1,419                    | 1                  | 1,110             | 1,558                    | —                  |
| Multifamily residential properties  | —                | —                        | —                  | —                 | —                        | —                  |
| Commercial real estate              | 2,281            | 2,307                    | 172                | 2,846             | 2,874                    | 301                |
| Loans secured by real estate        | 4,212            | 5,464                    | 233                | 5,544             | 6,886                    | 377                |
| Agricultural loans                  | —                | —                        | —                  | —                 | —                        | —                  |
| Commercial and industrial loans     | 587              | 898                      | 89                 | 888               | 1,221                    | 227                |
| Consumer loans                      | 33               | 43                       | —                  | 37                | 51                       | —                  |
| All other loans                     | —                | —                        | —                  | —                 | —                        | —                  |
| Total loans                         | \$4,832          | \$6,405                  | \$322              | \$6,469           | \$8,158                  | \$604              |

The following tables present average recorded investment and interest income recognized on impaired loans for the three and six-month periods ended June 30, 2014 and 2013 (in thousands):

|                                   | For the three months ended           |                            |                                      |                            |
|-----------------------------------|--------------------------------------|----------------------------|--------------------------------------|----------------------------|
|                                   | June 30, 2014                        |                            | June 30, 2013                        |                            |
|                                   | Average Investment in Impaired Loans | Interest Income Recognized | Average Investment in Impaired Loans | Interest Income Recognized |
| Construction and land development | \$1,112                              | \$—                        | \$1,425                              | \$—                        |
| Agricultural real estate          | 36                                   | —                          | 216                                  | —                          |
| 1-4 Family residential properties | 1,058                                | 4                          | 1,283                                | 1                          |
| Commercial real estate            | 2,293                                | 1                          | 2,353                                | —                          |
| Loans secured by real estate      | 4,499                                | 5                          | 5,277                                | 1                          |
| Agricultural loans                | —                                    | —                          | 229                                  | —                          |
| Commercial and industrial loans   | 608                                  | —                          | 1,430                                | —                          |
| Consumer loans                    | 35                                   | —                          | 57                                   | 1                          |
| Total loans                       | \$5,142                              | \$5                        | \$6,993                              | \$2                        |

|                                   | For the six months ended             |                            |                                      |                            |
|-----------------------------------|--------------------------------------|----------------------------|--------------------------------------|----------------------------|
|                                   | June 30, 2014                        |                            | June 30, 2013                        |                            |
|                                   | Average Investment in Impaired Loans | Interest Income Recognized | Average Investment in Impaired Loans | Interest Income Recognized |
| Construction and land development | \$1,126                              | \$—                        | \$1,445                              | \$—                        |
| Agricultural real estate          | 36                                   | —                          | 217                                  | —                          |
| 1-4 Family residential properties | 1,067                                | 6                          | 1,414                                | 2                          |
| Commercial real estate            | 2,303                                | 1                          | 2,389                                | —                          |
| Loans secured by real estate      | 4,532                                | 7                          | 5,465                                | 2                          |
| Agricultural loans                | —                                    | —                          | 253                                  | —                          |
| Commercial and industrial loans   | 627                                  | —                          | 1,482                                | —                          |
| Consumer loans                    | 37                                   | 1                          | 59                                   | 1                          |
| Total loans                       | \$5,196                              | \$8                        | \$7,259                              | \$3                        |

The amount of interest income recognized by the Company within the periods stated above was due to loans modified in a troubled debt restructuring that remained on accrual status. The balance of loans modified in a troubled debt restructuring included in the impaired loans stated above that were still accruing was \$305,000 of 1-4 Family residential properties, \$39,000 of commercial real estate, and \$20,000 of consumer loans at June 30, 2014 and \$103,000 of 1-4 family residential properties, and \$22,000 of consumer loans at June 30, 2013. For the six months ended June 30, 2014 and 2013, the amount of interest income recognized using a cash-basis method of accounting during the period that the loans were impaired was not material.



## Non Accrual Loans

The following table presents the Company's recorded balance of nonaccrual loans as June 30, 2014 and December 31, 2013 (in thousands). This table excludes purchased impaired loans and performing troubled debt restructurings.

|                                   | June 30,<br>2014 | December 31,<br>2013 |
|-----------------------------------|------------------|----------------------|
| Construction and land development | \$844            | \$1,483              |
| Agricultural real estate          | 36               | 105                  |
| 1-4 Family residential properties | 746              | 1,009                |
| Commercial real estate            | 2,242            | 2,807                |
| Loans secured by real estate      | 3,868            | 5,404                |
| Agricultural loans                | —                | —                    |
| Commercial and industrial loans   | 587              | 706                  |
| Consumer loans                    | 13               | 11                   |
| Total loans                       | \$4,468          | \$6,121              |

Interest income that would have been recorded under the original terms of such nonaccrual loans totaled \$32,000 and \$72,000 for the six months ended June 30, 2014 and 2013, respectively.

## Troubled Debt Restructuring

The balance of troubled debt restructurings at June 30, 2014 and December 31, 2013 was \$3.0 million and \$3.2 million, respectively. Approximately \$265,000 and \$431,000 in specific reserves have been established with respect to these loans as of June 30, 2014 and December 31, 2013, respectively. As troubled debt restructurings, these loans are included in nonperforming loans and are classified as impaired which requires that they be individually measured for impairment. The modification of the terms of these loans included one or a combination of the following: a reduction of stated interest rate of the loan; an extension of the maturity date and change in payment terms; or a permanent reduction of the recorded investment in the loan.

The following table presents the Company's recorded balance of troubled debt restructurings at June 30, 2014 and December 31, 2013 (in thousands).

|  | June 30,<br>2014 | December 31,<br>2013 |
|--|------------------|----------------------|
| Troubled debt restructurings:            |                  |                      |
| Construction and land development        | \$844            | \$1,482              |
| 1-4 Family residential properties        | 489              | 306                  |
| Commercial real estate                   | 1,364            | 899                  |
| Loans secured by real estate             | 2,697            | 2,687                |
| Commercial and industrial loans          | 292              | 487                  |
| Consumer loans                           | 20               | 26                   |
| Total                                    | \$3,009          | \$3,200              |
| Performing troubled debt restructurings: |                  |                      |
| 1-4 Family residential properties        | \$305            | \$101                |
| Commercial real estate                   | 39               | 39                   |
| Loans secured by real estate             | 344              | 140                  |
| Commercial and industrial loans          | —                | 182                  |
| Consumer loans                           | 20               | 26                   |

|       |       |       |
|-------|-------|-------|
| Total | \$364 | \$348 |
|-------|-------|-------|

The following table presents loans modified as TDRs during the six months ended June 30, 2014 and 2013, as a result of various modified loan factors (in thousands):

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|                                   | June 30, 2014           |                     |                       | June 30, 2013           |                     |                       |
|-----------------------------------|-------------------------|---------------------|-----------------------|-------------------------|---------------------|-----------------------|
|                                   | Number of Modifications | Recorded Investment | Type of Modifications | Number of Modifications | Recorded Investment | Type of Modifications |
| 1-4 Family residential properties | 2                       | 207                 | (c)                   | 3                       | 98                  | (a)(b)(c)             |
| Commercial real estate            | 1                       | 501                 | (b)(c)                | —                       | —                   |                       |
| Loans secured by real estate      | 3                       | 708                 |                       | 3                       | 98                  |                       |
| Commercial and industrial loans   | —                       | —                   |                       | 1                       | 56                  | (a)(b)                |
| Consumer Loans                    | —                       | —                   |                       | 1                       | 8                   | (c)                   |
| Total                             | 3                       | \$ 708              |                       | 5                       | \$ 162              |                       |

Type of modifications:

- (a) Reduction of stated interest rate of loan
- (b) Change in payment terms
- (c) Extension of maturity date
- (d) Permanent reduction of the recorded investment

A loan is considered to be in payment default once it is 90 days past due under the modified terms. There were no loans modified as troubled debt restructurings during the prior twelve months that experienced defaults during the six months ended June 30, 2014 or the year ended December 31, 2013.

#### Note 5 -- Repurchase Agreements and Other Borrowings

Securities sold under agreements to repurchase were \$95.2 million at June 30, 2014, a decrease of \$24.0 million from \$119.2 million at December 31, 2013. The decrease during the first six months of 2014 was primarily due to declines in balances of a few customers due to changes in cash flow needs for their businesses.

FHLB borrowings decreased \$10 million to \$10 million at June 30, 2014 from \$20 million at December 31, 2013 due to the maturity of one \$10 million short-term advance. At June 30, 2014 the advances were as follows:

\$5 million advance with a 2-year maturity, at .57%, due August 26, 2015

\$5 million advance with a 10-year maturity, at 4.58%, due July 14, 2016, on year lockout, callable quarterly

#### Note 6 -- Fair Value of Assets and Liabilities

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

- Level 1 Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2 Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities which use observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3



Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

Following is a description of the inputs and valuation methodologies used for assets measured at fair value on a recurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

Available-for-Sale Securities. The fair value of available-for-sale securities is determined by various valuation methodologies. Where quoted market prices are available in an active market, securities are classified within Level 1. If quoted market prices are not available, then fair values are estimated by using quoted prices of securities with similar characteristics or independent asset pricing services and pricing models, the inputs of which are market-based or independent sources of market parameters, including but not limited to, yield curves, interest rates, volatilities, prepayments, defaults, cumulative loss projections and cash flows. Such securities are classified in Level 2 of the valuation hierarchy. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy and include subordinated tranches of collateralized mortgage obligations and investments in trust preferred securities.

Fair value determinations for Level 3 measurements of securities are the responsibility of the Treasury function of the Company. The Company contracts with a pricing specialist to generate fair value estimates on a monthly basis. The Treasury function of the Company challenges the reasonableness of the assumptions used and reviews the methodology to ensure the estimated fair value complies with accounting standards generally accepted in the United States, analyzes the changes in fair value and compares these changes to internally developed expectations and monitors these changes for appropriateness.

The trust preferred securities are collateralized debt obligation securities that are backed by trust preferred securities issued by banks, thrifts, and insurance companies. The market for these securities at June 30, 2014 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive and will continue to be, as a result of the Dodd-Frank Act's elimination of trust preferred securities from Tier 1 capital for certain holding companies. There are currently very few market participants who are willing and or able to transact for these securities. The market values for these securities are very depressed relative to historical levels. Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, we determined:

The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at June 30, 2014,

An income valuation approach technique (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs will be equally or more representative of fair value than the market approach valuation technique used at prior measurement dates, and

The trust preferred securities held by the Company will be classified within Level 3 of the fair value hierarchy because we determined that significant adjustments are required to determine fair value at the measurement date.



The following table presents the Company's assets that are measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall as of June 30, 2014 and December 31, 2013 (in thousands):

|   | Fair Value | Fair Value Measurements Using<br>Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|---|------------|--|---|--|
| June 30, 2014   |            |  |   |  |
| Available-for-sale securities:  |            |  |   |  |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 160,236 | \$—  | \$ 160,236  | \$—  |
| Obligations of states and political subdivisions                                      | 69,610     | —  | 69,610  | —  |
| Mortgage-backed securities  | 204,943    | —  | 204,943   | —  |
| Trust preferred securities  | 369        | —  | —   | 369  |
| Other securities  | 4,032      | 60   | 3,972   | —  |
| Total available-for-sale securities   | \$ 439,190 | \$ 60  | \$ 438,761  | \$ 369   |
| December 31, 2013   |            |  |   |  |
| Available-for-sale securities:  |            |  |   |  |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$ 190,368 | \$—  | \$ 190,368  | \$—  |
| Obligations of states and political subdivisions                                      | 64,562     | —  | 64,562  | —  |
| Mortgage-backed securities  | 227,601    | —  | 227,601   | —  |
| Trust preferred securities  | 191        | —  | —   | 191  |
| Other securities  | 6,002      | 67   | 5,935   | —  |
| Total available-for-sale securities   | \$ 488,724 | \$ 67  | \$ 488,466  | \$ 191   |

The change in fair value of assets measured on a recurring basis using significant unobservable inputs (Level 3) for the six months ended June 30, 2014 and 2013 is summarized as follows (in thousands):

|   | Trust Preferred Securities |               |
|---|----------------------------|---------------|
|   | June 30, 2014              | June 30, 2013 |
| Beginning balance   | \$191                      | \$585         |
| Transfers into Level 3  | —                          | —             |
| Transfers out of Level 3  | —                          | —             |
| Total gains or losses:  |                            |               |
| Included in net income  | —                          | —             |
| Included in other comprehensive income (loss)   | 381                        | 434           |
| Purchases, issuances, sales and settlements:  |                            |               |
| Purchases   | —                          | —             |
| Issuances   | —                          | —             |
| Sales   | —                          | —             |
| Settlements   | (203                       | ) (184        |
| Ending balance  | \$369                      | \$835         |
| Total gains or losses for the period included in net income attributable to the change in unrealized gains or losses related to assets and liabilities still held at the reporting date | \$—                        | \$—           |

Following is a description of the valuation methodologies used for assets measured at fair value on a nonrecurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy.

**Impaired Loans (Collateral Dependent).** Loans for which it is probable that the Company will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment and estimating fair value include 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. 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.

Management establishes a specific allowance for impaired loans that have an estimated fair value that is below the carrying value. The total carrying amount of loans for which a change in specific allowance has occurred as of June 30, 2014 was \$1,374,000 and a fair value of \$1,053,000 resulting in specific loss exposures of \$321,000.

When there is little prospect of collecting principal or interest, loans, or portions of loans, may be charged-off to the allowance for loan losses. Losses are recognized in the period an obligation becomes uncollectible. The recognition of a loss does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan even though partial recovery may be affected in the future.

**Foreclosed Assets Held For Sale.** Other real estate owned acquired through loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. The adjustment at the time of foreclosure is recorded through the allowance for loan losses. Due to the subjective nature of establishing the fair value when the asset is acquired, the actual fair value of the other real estate owned or foreclosed asset could differ from the original estimate. If it is determined that fair value declines subsequent to foreclosure, a valuation allowance is recorded

through noninterest expense. Operating costs associated with the assets after acquisition are also recorded as noninterest expense. Gains and losses on the disposition of other real estate owned and foreclosed assets are netted and posted to other noninterest expense. The total carrying amount of other real estate owned as of June 30, 2014 was \$397,000. Other real estate owned included in the total carrying amount and measured at fair value on a nonrecurring basis during the period amounted to \$12,000.

The following table presents the fair value measurement of assets 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, 2014 and December 31, 2013 (in thousands):

|                                       | Fair Value Measurements Using |   |   |  |
|---------------------------------------|-------------------------------|---|---|--|
|                                       | Fair Value                    | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| June 30, 2014                         |                               |   |   |  |
| Impaired loans (collateral dependent) | \$1,053                       | \$—   | \$—   | \$1,053  |
| Foreclosed assets held for sale       | 12                            | —   | —   | 12   |
| December 31, 2013                     |                               |   |   |  |
| Impaired loans (collateral dependent) | \$1,383                       | \$—   | \$—   | \$1,383  |
| Foreclosed assets held for sale       | 172                           | —   | —   | 172  |

#### Sensitivity of Significant Unobservable Inputs

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

Trust Preferred Securities. The significant unobservable inputs used in the fair value measurement of the Company's trust preferred securities are offered quotes and comparability adjustments. Significant increases (decreases) in any of those inputs in isolation would result in a significantly lower (higher) fair value measurement. Generally, changes in either of those inputs will not affect the other input.

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

|  | Fair Value at<br>June 30, 2014 | Valuation<br>Technique    | Unobservable Inputs  | Range (Weighted<br>Average) |
|--|--------------------------------|---------------------------|--|-----------------------------|
| Trust Preferred Securities               | \$369                          | Discounted<br>cash flow   | Discount rate  | 14.3%                       |
|  |                                |                           | Constant prepayment rate (1)   | 1.3%                        |
|  |                                |                           | Cumulative projected prepayments                                     | 24.1%                       |
|  |                                |                           | Probability of default   | 0.3%                        |
|  |                                |                           | Projected cures given deferral                                       | 43.5%                       |
|  |                                |                           | Loss severity  | 97.1%                       |
| Impaired loans (collateral<br>dependent) | \$1,053                        | Third party<br>valuations | Discount to reflect realizable value                                 | 0 %-40% ( 20% )             |
| Foreclosed assets held for<br>sale       | \$12                           | Third party<br>valuations | Discount to reflect realizable value<br>less estimated selling costs | 0 %-40% ( 35% )             |

|  | Fair Value at<br>December 31,<br>2013 | Valuation<br>Technique    | Unobservable Inputs  | Range (Weighted<br>Average) |
|--|---------------------------------------|---------------------------|--|-----------------------------|
| Trust Preferred Securities               | \$191                                 | Discounted<br>cash flow   | Discount rate  | 15.5%                       |
|  |                                       |                           | Constant prepayment rate (1)   | 1.3%                        |
|  |                                       |                           | Cumulative projected<br>prepayments                                  | 23.5%                       |
|  |                                       |                           | Probability of default   | 0.20%                       |
|  |                                       |                           | Projected cures given deferral                                       | 50.7%                       |
|  |                                       |                           | Loss severity  | 96.1%                       |
| Impaired loans (collateral<br>dependent) | \$1,383                               | Third party<br>valuations | Discount to reflect realizable<br>value                              | 0 %-40% ( 20% )             |
| Foreclosed assets held for<br>sale       | \$172                                 | Third party<br>valuations | Discount to reflect realizable<br>value less estimated selling costs | 0 %-40% ( 35% )             |

(1)Every five years

Other. The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying balance sheets at amounts other than fair value.

Cash and Cash Equivalents and Federal Reserve and Federal Home Loan Bank Stock  
The carrying amount approximates fair value.

#### Loans

For loans with floating interest rates, it is assumed that the estimated fair values generally approximate the carrying amount balances. Fixed rate loans have been valued using a discounted present value of projected cash flow. The discount rate used in these calculations is the current rate at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The carrying amount of accrued interest approximates its fair value.

#### Deposits

Deposits include demand deposits, savings accounts, NOW accounts and certain money market deposits. The carrying amount of these deposits approximates fair value. The fair value of fixed-maturity time deposits is estimated using a discounted cash flow calculation that applies the rates currently offered for deposits of similar remaining maturities.

#### Securities Sold Under Agreements to Repurchase

The fair value of securities sold under agreements to repurchased is estimated using a discounted cash flow calculation that applies the rates currently offered for deposits of similar remaining maturities.

#### Other Borrowings and Interest Payable

The carrying amount approximates fair value.

#### Subordinated Debentures and Federal Home Loan Bank Advances

Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt.





The following tables present estimated fair values of the Company's financial instruments at June 30, 2014 and December 31, 2013 in accordance with FAS 107-1 and APB 28-1, codified with ASC 805 (in thousands):

|  | Carrying Amount | Fair Value  | Level 1  | Level 2     | Level 3   |
|--|-----------------|-------------|----------|-------------|-----------|
| June 30, 2014                                  |                 |             |          |             |           |
| Financial Assets                               |                 |             |          |             |           |
| Cash and due from banks                        | \$57,040        | \$57,040    | \$57,040 | \$—         | \$—       |
| Federal funds sold                             | 495             | 495         | 495      | —           | —         |
| Available-for-sale securities                  | 439,190         | 439,190     | 60       | 438,761     | 369       |
| Loans held for sale                            | 929             | 929         | —        | 929         | —         |
| Loans net of allowance for loan losses         | 1,007,641       | 1,018,357   | —        | —           | 1,018,357 |
| Interest receivable                            | 5,988           | 5,988       | —        | 5,988       | —         |
| Federal Reserve Bank stock                     | 1,522           | 1,522       | —        | 1,522       | —         |
| Federal Home Loan Bank stock                   | 3,391           | 3,391       | —        | 3,391       | —         |
| Financial Liabilities                          |                 |             |          |             |           |
| Deposits                                       | \$1,290,897     | \$1,290,988 | \$—      | \$1,062,000 | \$228,988 |
| Securities sold under agreements to repurchase | 95,159          | 95,164      | —        | 95,164      | —         |
| Interest payable                               | 292             | 292         | —        | 292         | —         |
| Federal Home Loan Bank borrowings              | 10,000          | 10,440      | —        | 10,440      | —         |
| Other borrowings                               | —               | —           | —        | —           | —         |
| Junior subordinated debentures                 | 20,620          | 12,267      | —        | 12,267      | —         |
| December 31, 2013                              |                 |             |          |             |           |
| Financial Assets                               |                 |             |          |             |           |
| Cash and due from banks                        | \$64,605        | \$64,605    | \$64,605 | \$—         | \$—       |
| Federal funds sold                             | 497             | 497         | 497      | —           | —         |
| Available-for-sale securities                  | 488,724         | 488,724     | 67       | 488,466     | 191       |
| Loans held for sale                            | 514             | 514         | —        | 514         | —         |
| Loans net of allowance for loan losses         | 969,041         | 964,253     | —        | —           | 964,253   |
| Interest receivable                            | 6,614           | 6,614       | —        | 6,614       | —         |
| Federal Reserve Bank stock                     | 1,522           | 1,522       | —        | 1,522       | —         |
| Federal Home Loan Bank stock                   | 3,391           | 3,391       | —        | 3,391       | —         |
| Financial Liabilities                          |                 |             |          |             |           |
| Deposits                                       | \$1,287,616     | \$1,287,887 | \$—      | \$1,058,965 | \$228,922 |
| Securities sold under agreements to repurchase | 119,187         | 119,190     | —        | 119,190     | —         |
| Interest payable                               | 277             | 277         | —        | 277         | —         |
| Federal Home Loan Bank borrowings              | 20,000          | 20,530      | —        | 20,530      | —         |
| Junior subordinated debentures                 | 20,620          | 12,041      | —        | 12,041      | —         |

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

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of the Company and its subsidiaries as of, and for the three and six-month periods ended June 30, 2014 and 2013. This discussion and analysis should be read in conjunction with the consolidated financial statements, related notes and selected financial data appearing elsewhere in this report.

### Forward-Looking Statements

This report may contain certain forward-looking statements, such as discussions of the Company's pricing and fee trends, credit quality and outlook, liquidity, new business results, expansion plans, anticipated expenses and planned schedules. The Company intends such 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. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project," or similar expressions. Actual results could differ materially from the results indicated by these statements because the realization of those results is subject to many risks and uncertainties, including those described in Item 1A-"Risk Factors" and other sections of the Company's Annual Report on Form 10-K and the Company's other filings with the SEC, and changes in interest rates, general economic conditions and those in the Company's market area, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios and the valuation of the investment portfolio, the Company's success in raising capital and effecting and integrating acquisitions, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area and accounting principles, policies and guidelines. Furthermore, forward-looking statements speak only as of the date they are made. Except as required under the federal securities laws or the rules and regulations of the SEC, we do not undertake any obligation to update or review any forward-looking information, whether as a result of new information, future events or otherwise. Further information concerning the Company and its business, including a discussion of these and additional factors that could materially affect the Company's financial results, is included in the Company's 2013 Annual Report on Form 10-K under the headings "Item 1. Business" and "Item 1A. Risk Factors."

### Overview

This overview of management's discussion and analysis highlights selected information in this document and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources, and critical accounting estimates which have an impact on the Company's financial condition and results of operations you should carefully read this entire document.

Net income was \$7,636,000 and \$7,193,000 for the six months ended June 30, 2014 and 2013, respectively. Diluted net income per common share available to common stockholders was \$0.91 and \$0.84 for the six months ended June 30, 2014 and 2013. The following table shows the Company's annualized performance ratios for the six months ended June 30, 2014 and 2013, compared to the performance ratios for the year ended December 31, 2013:

|                          | Six months ended |                  | Year ended           |  |   |
|--------------------------|------------------|------------------|----------------------|--|---|
|                          | June 30,<br>2014 | June 30,<br>2013 | December 31,<br>2013 |  |   |
| Return on average assets | 0.96             | % 0.91           | % 0.94               |  | % |

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|                                  |       |   |       |   |       |   |
|----------------------------------|-------|---|-------|---|-------|---|
| Return on average common equity  | 10.84 | % | 9.45  | % | 10.11 | % |
| Average equity to average assets | 9.76  | % | 10.02 | % | 9.81  | % |

Total assets were \$1.58 billion at June 30, 2014, compared to \$1.61 billion as of December 31, 2013. From December 31, 2013 to June 30, 2014, cash and interest bearing deposits decreased \$7.6 million, net loan balances increased \$38.6 million and investment securities decreased \$49.5 million. The decline in investment securities balance was primarily due to securities that matured or were sold and were not replaced as funds were used to fund loans and repay maturing borrowings.

Net loan balances were \$1.01 billion at June 30, 2014, an increase of \$38.6 million, from \$969 million at December 31, 2013. The increase in loan balances was primarily in commercial and industrial loans offset by declines in agricultural operating loans.

Net interest margin, defined as net interest income divided by average interest-earning assets, was 3.43% for the six months ended June 30, 2014, up from 3.34% for the same period in 2013. This increase was primarily due to the shift in balances from investment securities to higher-yielding loans and a the reduction in deposit costs. Net interest income before the provision for loan losses was \$25.4 million compared to net interest income of \$24.5 million for the same period in 2013.

Total non-interest income of \$9.5 million increased \$207,000 or 2.2% from \$9.3 million for the same period last year. Gains on the sale of securities were \$734,000 for the six months ended June 30, 2014 compared to \$835,000 for the same period last year. Mortgage banking income decreased from \$591,000 for the second quarter of 2013 to \$256,000 for the second quarter of this year as the greater refinance activity and new purchase activity has slowed. Revenues from trust and brokerage increased from the second quarter of last year. Insurance revenues also increased due to more commissions received from new commercial insurance customers. Income from electronic transactions increased \$145,000 to \$1,975,000 compared to \$1,830,000 from the same period last year.

Total non-interest expense of \$22.2 million increased \$644,000 or 3% from \$21.5 for the same period last year primarily due to increases in salaries and employee benefits and building maintenance fees offset by declines in expenses related to other real estate owned.

Following is a summary of the factors that contributed to the changes in net income (in thousands):

|   | Change in Net Income<br>2014 versus 2013 |                              |
|---|--|------------------------------|
|   | Three months<br>ended June 30,           | Six months<br>ended June 30, |
| Net interest income                             | \$471                                    | \$814                        |
| Provision for loan losses                       | 124                                      | 281                          |
| Other income, including securities transactions | 276                                      | 207                          |
| Other expenses                                  | (296                                     | ) (644                       |
| Income taxes                                    | (211                                     | ) (215                       |
| Increase in net income                          | \$364                                    | \$443                        |

Credit quality is an area of importance to the Company. Total nonperforming loans were \$4.8 million at June 30, 2014, compared to \$6.8 million at June 30, 2013 and \$6.5 million at December 31, 2013. See the discussion under the heading "Loan Quality and Allowance for Loan Losses" for a detailed explanation of these balances. Repossessed asset balances totaled \$403,000 at June 30, 2014 compared to \$1.0 million on June 30, 2013 and \$568,000 on December 31, 2013. The Company's provision for loan losses for the six months ended June 30, 2014 and 2013 was \$451,000 and \$732,000, respectively. Total loans past due 30 days or more declined to .35% of loans at June 30, 2014 compared to .36% at June 30 2013, and .35% of loans at December 31, 2013. At June 30, 2014, the composition of the loan portfolio remained similar to the same period last year. Loans secured by both commercial and residential real estate comprised approximately 73.7% of the loan portfolio as of June 30, 2014 and 74% as of December 31, 2013. During the six months ended June 30, 2014, annualized net chargeoffs were 0.00% of average loans compared to 0.08% for the same period in 2013.

The Company's capital position remains strong and the Company has consistently maintained regulatory capital ratios above the "well-capitalized" standards. The Company's Tier 1 capital to risk weighted assets ratio calculated under the regulatory risk-based capital requirements at June 30, 2014 and 2013 and December 31, 2013 was 14.58%, 15.03% and 14.37%, respectively. The Company's total capital to risk weighted assets ratio calculated under the regulatory risk-based capital requirements at June 30, 2014 and 2013 and December 31, 2013 was 15.81%, 16.21% and 15.58%, respectively.

The Company's liquidity position remains sufficient to fund operations and meet the requirements of borrowers, depositors, and creditors. The Company maintains various sources of liquidity to fund its cash needs. See the discussion under the heading "Liquidity" for a full listing of sources and anticipated significant contractual obligations.

The Company enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include lines of credit, letters of credit and other commitments to extend credit. The total outstanding commitments at June 30, 2014 and 2013 were \$243 million and \$253 million, respectively. The increase in 2014 was primarily the result of several larger commercial and commercial real estate lines of credit that were paid down at June 30, 2014.

Federal Deposit Insurance Corporation Insurance Coverage. As an FDIC-insured institution, First Mid Bank is required to pay deposit insurance premium assessments to the FDIC. A number of developments with respect to the FDIC insurance system have affected recent results.

On July 21, 2010, The Dodd-Frank Act permanently raised the standard maximum deposit insurance amount (SMDIA) to \$250,000. On November 9, 2010, the FDIC issued a final rule to implement Section 343 of the Dodd-Frank Act, which provides unlimited deposit insurance coverage for “noninterest-bearing transaction accounts” from December 31, 2010 through December 31, 2012. Also, the FDIC will no longer charge a separate assessment for the insurance of these accounts under the Dodd-Frank Act provision.

On February 27, 2009, the FDIC adopted a final rule setting initial base assessment rates beginning April 1, 2009, at 12 to 45 basis points and, due to extraordinary circumstances, extended the period of the restoration plan to increase the deposit insurance fund to seven years. Also on February 27, 2009, the FDIC issued final rules on changes to the risk-based assessment system which imposes rates based on an institution’s risk to the deposit insurance fund. The new rates increased the range of annual risk based assessment rates from 5 to 7 basis points to 7 to 24 basis points. The final rules both increase base assessment rates and incorporate additional assessments for excess reliance on brokered deposits and FHLB advances. This new assessment took effect April 1, 2009. The Company expensed \$361,000 and \$389,000 for this assessment during the first six months of 2014 and 2013, respectively. The decrease in this assessment was primarily due to a lower assessment rate as a result of improvement in asset quality during 2013 and 2014.

In addition to its insurance assessment, each insured bank was subject to quarterly debt service assessments in connection with bonds issued by a government corporation that financed the federal savings and loan bailout. The Company expensed \$44,000 and \$46,000 during the first six months of 2014 and 2013, respectively, for this assessment.

Basel III. In September 2010, the Basel Committee on Banking Supervision proposed higher global minimum capital standards, including a minimum Tier 1 common capital ratio and additional capital and liquidity requirements. On July 2, 2013, the Federal Reserve Board approved a final rule to implement these reforms and changes required by the Dodd-Frank Act. This final rule was subsequently adopted by the OCC and the FDIC.

As included in the proposed rule of June 2012, the final rule includes new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019, and refines the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Company and First Mid Bank beginning in 2015 are: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6%; (iii) a total capital ratio of 8%; and (iv) a Tier 1 leverage ratio of 4%. The rule also establishes a “capital conservation buffer” of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a

Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk weighted assets and will increase by that amount each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if its capital level falls below the buffer amount.



The final rule also makes three changes to the proposed rule of June 2012 that impact the Company. First, the proposed rule would have required banking organizations to include accumulated other comprehensive income (“AOCI”) in common equity tier 1 capital. AOCI includes accumulated unrealized gains and losses on certain assets and liabilities that have not been included in net income. Under existing general risk-based capital rules, most components of AOCI are not included in a banking organization's regulatory capital calculations. The final rule allows community banking organizations to make a one-time election not to include these additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital.

Second, the proposed rule would have modified the risk-weight framework applicable to residential mortgage exposures to require banking organizations to divide residential mortgage exposure into two categories in order to determine the applicable risk weight. The final rule, however, retains the existing treatment for residential mortgage exposures under the general risk-based capital rules.

Third, the proposed rule would have required banking organizations with total consolidated assets of less than \$15 billion as of December 31, 2009, such as the Company, to phase out over ten years any trust preferred securities and cumulative perpetual preferred securities from its Tier 1 capital regulatory capital. The final rule, however, permanently grandfathers into Tier 1 capital of depository institution holding companies with total consolidated assets of less than \$15 billion as of December 31, 2009 any trust preferred securities or cumulative perpetual preferred stock issued before May 19, 2010.

#### Critical Accounting Policies and Use of Significant Estimates

The Company has established various accounting policies that govern the application of U.S. generally accepted accounting principles in the preparation of the Company's financial statements. The significant accounting policies of the Company are described in the footnotes to the consolidated financial statements included in the Company's 2013 Annual Report on Form 10-K. Certain accounting policies involve significant judgments and assumptions by management that have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and assumptions, which could have a material impact on the carrying values of assets and liabilities and the results of operations of the Company.

**Allowance for Loan Losses.** The Company believes the allowance for loan losses is the critical accounting policy that requires the most significant judgments and assumptions used in the preparation of its consolidated financial statements. An estimate of potential losses inherent in the loan portfolio are determined and an allowance for those losses is established by considering factors including historical loss rates, expected cash flows and estimated collateral values. In assessing these factors, the Company use organizational history and experience with credit decisions and related outcomes. The allowance for loan losses represents the best estimate of losses inherent in the existing loan portfolio. The allowance for loan losses is increased by the provision for loan losses charged to expense and reduced by loans charged off, net of recoveries. The Company evaluates the allowance for loan losses quarterly. If the underlying assumptions later prove to be inaccurate based on subsequent loss evaluations, the allowance for loan losses is adjusted.

The Company estimates the appropriate level of allowance for loan losses by separately evaluating impaired and nonimpaired loans. A specific allowance is assigned to an impaired loan when expected cash flows or collateral do not justify the carrying amount of the loan. The methodology used to assign an allowance to a nonimpaired loan is more

subjective. Generally, the allowance assigned to nonimpaired loans is determined by applying historical loss rates to existing loans with similar risk characteristics, adjusted for qualitative factors including the volume and severity of identified classified loans, changes in economic conditions, changes in credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets. Because the economic and business climate in any given industry or market, and its impact on any given borrower, can change rapidly, the risk profile of the loan portfolio is continually assessed and adjusted when appropriate. Notwithstanding these procedures, there still exists the possibility that the assessment could prove to be significantly incorrect and that an immediate adjustment to the allowance for loan losses would be required.

**Other Real Estate Owned.** Other real estate owned acquired through loan foreclosure is initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. The adjustment at the time of foreclosure is recorded through the allowance for loan losses. Due to the subjective nature of establishing the fair value when the asset is acquired, the actual fair value of the other real estate owned or foreclosed asset could differ from the original estimate. If it is determined that fair value temporarily declines subsequent to foreclosure, a valuation allowance is recorded through noninterest expense. Operating costs associated with the assets after acquisition are also recorded as noninterest expense. Gains and losses on the disposition of other real estate owned and foreclosed assets are netted and posted to other noninterest expense.

**Investment in Debt and Equity Securities.** The Company classifies its investments in debt and equity securities as either held-to-maturity or available-for-sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities," which was codified into ASC 320. Securities classified as held-to-maturity are recorded at cost or amortized cost. Available-for-sale securities are carried at fair value. Fair value calculations are based on quoted market prices when such prices are available. If quoted market prices are not available, estimates of fair value are computed using a variety of techniques, including extrapolation from the quoted prices of similar instruments or recent trades for thinly traded securities, fundamental analysis, or through obtaining purchase quotes. Due to the subjective nature of the valuation process, it is possible that the actual fair values of these investments could differ from the estimated amounts, thereby affecting the financial position, results of operations and cash flows of the Company. If the estimated value of investments is less than the cost or amortized cost, the Company evaluates whether an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of the investment. If such an event or change has occurred and the Company determines that the impairment is other-than-temporary, a further determination is made as to the portion of impairment that is related to credit loss. The impairment of the investment that is related to the credit loss is expensed in the period in which the event or change occurred. The remainder of the impairment is recorded in other comprehensive income.

**Deferred Income Tax Assets/Liabilities.** The Company's net deferred income tax asset arises from differences in the dates that items of income and expense enter into our reported income and taxable income. Deferred tax assets and liabilities are established for these items as they arise. From an accounting standpoint, deferred tax assets are reviewed to determine if they are realizable based on the historical level of taxable income, estimates of future taxable income and the reversals of deferred tax liabilities. In most cases, the realization of the deferred tax asset is based on future profitability. If the Company were to experience net operating losses for tax purposes in a future period, the realization of deferred tax assets would be evaluated for a potential valuation reserve.

Additionally, the Company reviews its uncertain tax positions annually under FASB Interpretation No. 48 (FIN No. 48), "Accounting for Uncertainty in Income Taxes," codified within ASC 740. An uncertain tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount actually recognized is the largest amount of tax benefit that is greater than 50% likely to be recognized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. A significant amount of judgment is applied to determine both whether the tax position meets the "more likely than not" test as well as to determine the largest amount of tax benefit that is greater than 50% likely to be recognized. Differences between the position taken by management and that of taxing authorities could result in a reduction of a tax benefit or increase to tax liability, which could adversely affect future income tax expense.

**Impairment of Goodwill and Intangible Assets.** Core deposit and customer relationships, which are intangible assets with a finite life, are recorded on the Company's balance sheets. These intangible assets were capitalized as a result of past acquisitions and are being amortized over their estimated useful lives of up to 15 years. Core deposit intangible assets, with finite lives will be tested for impairment when changes in events or circumstances indicate that its

carrying amount may not be recoverable. Core deposit intangible assets were tested for impairment as of September 30, 2013 as part of the goodwill impairment test and no impairment was identified.

As a result of the Company's acquisition activity, goodwill, an intangible asset with an indefinite life, is reflected on the balance sheets. Goodwill is evaluated for impairment annually, unless there are factors present that indicate a potential impairment, in which case, the goodwill impairment test is performed more frequently than annually.

**Fair Value Measurements.** The fair value of a financial instrument is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The Company estimates the fair value of a financial instrument using a variety of valuation methods. Where financial instruments are actively traded and have quoted market prices, quoted market prices are used for fair value. When the financial instruments are not actively traded, other observable market inputs, such as quoted prices of securities with similar characteristics, may be used, if available, to determine fair value. When observable market prices do not exist, the Company estimates fair value. The Company's valuation methods consider factors such as liquidity and concentration concerns. Other factors such as model assumptions, market dislocations, and unexpected correlations can affect estimates of fair value. Imprecision in estimating these factors can impact the amount of revenue or loss recorded.

SFAS No. 157, "Fair Value Measurements", which was codified into ASC 820, establishes a framework for measuring the fair value of financial instruments that considers the attributes specific to particular assets or liabilities and establishes a three-level hierarchy for determining fair value based on the transparency of inputs to each valuation as of the fair value measurement date. The three levels are defined as follows:

Level 1 — quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 — inputs include quoted prices for similar assets and liabilities in active markets, quoted prices of identical or similar assets or liabilities in markets that are not active, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 — inputs that are unobservable and significant to the fair value measurement.

At the end of each quarter, the Company assesses the valuation hierarchy for each asset or liability measured. From time to time, assets or liabilities may be transferred within hierarchy levels due to changes in availability of observable market inputs to measure fair value at the measurement date. Transfers into or out of hierarchy levels are based upon the fair value at the beginning of the reporting period. A more detailed description of the fair values measured at each level of the fair value hierarchy can be found in Note 6 – Fair Value of Assets and Liabilities.

## Results of Operations

### Net Interest Income

The largest source of revenue for the Company is net interest income. Net interest income represents the difference between total interest income earned on earning assets and total interest expense paid on interest-bearing liabilities. The amount of interest income is dependent upon many factors, including the volume and mix of earning assets, the general level of interest rates and the dynamics of changes in interest rates. The cost of funds necessary to support earning assets varies with the volume and mix of interest-bearing liabilities and the rates paid to attract and retain such funds.

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The Company's average balances, interest income and expense and rates earned or paid for major balance sheet categories are set forth for the three months ended June 30, 2014 and 2013 in the following table (dollars in thousands):

|   | Three months ended June 30, 2014 |          |              | Three months ended June 30, 2013 |          |              |   |
|---|----------------------------------|----------|--------------|----------------------------------|----------|--------------|---|
|   | Average Balance                  | Interest | Average Rate | Average Balance                  | Interest | Average Rate |   |
| <b>ASSETS</b>   |                                  |          |              |                                  |          |              |   |
| Interest-bearing deposits with other financial institutions | \$21,760                         | \$16     | 0.29         | % \$14,608                       | \$11     | 0.30         | % |
| Federal funds sold  | 496                              | —        | —            | % 5,938                          | 2        | 0.14         | % |
| Certificates of deposit investments                         | —                                | —        | —            | % 3,456                          | 5        | 0.58         | % |
| Investment securities                                       |                                  |          |              |                                  |          |              |   |
| Taxable   | 386,891                          | 1,966    | 2.03         | % 483,528                        | 2,305    | 1.91         | % |
| Tax-exempt (1)  | 69,975                           | 579      | 3.31         | % 59,870                         | 493      | 3.29         | % |
| Loans (2)(3)(4)   | 1,007,226                        | 11,039   | 4.40         | % 907,562                        | 10,390   | 4.59         | % |
| Total earning assets  | 1,486,348                        | 13,600   | 3.67         | % 1,474,962                      | 13,206   | 3.59         | % |
| Cash and due from banks                                     | 30,091                           |          |              | 30,853                           |          |              |   |
| Premises and equipment                                      | 27,877                           |          |              | 29,185                           |          |              |   |
| Other assets  | 44,999                           |          |              | 44,696                           |          |              |   |
| Allowance for loan losses                                   | (13,601 )                        |          |              | (12,129 )                        |          |              |   |
| Total assets  | \$1,575,714                      |          |              | \$1,567,567                      |          |              |   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                 |                                  |          |              |                                  |          |              |   |
| Interest-bearing deposits                                   |                                  |          |              |                                  |          |              |   |
| Demand deposits   | \$555,107                        | \$165    | 0.12         | % \$544,777                      | \$198    | 0.15         | % |
| Savings deposits  | 287,429                          | 95       | 0.13         | % 300,263                        | 92       | 0.12         | % |
| Time deposits   | 227,227                          | 323      | 0.57         | % 202,348                        | 374      | 0.74         | % |
| Securities sold under agreements to repurchase              | 83,662                           | 10       | 0.05         | % 86,871                         | 10       | 0.05         | % |
| FHLB advances   | 10,000                           | 65       | 2.61         | % 6,346                          | 59       | 3.73         | % |
| Fed Funds Purchased   | 66                               | —        | —            | % 478                            | 1        | 0.61         | % |
| Junior subordinated debt                                    | 20,620                           | 129      | 2.51         | % 20,620                         | 131      | 2.55         | % |
| Other debt  | 396                              | 1        | 1.0          | % —                              | —        | —            | % |
| Total interest-bearing liabilities                          | 1,184,507                        | 788      | 0.27         | % 1,161,703                      | 865      | 0.30         | % |
| Non interest-bearing demand deposits                        | 226,535                          |          |              | 240,388                          |          |              |   |
| Other liabilities   | 7,988                            |          |              | 7,728                            |          |              |   |
| Stockholders' equity  | 156,684                          |          |              | 157,748                          |          |              |   |
| Total liabilities & equity                                  | \$1,575,714                      |          |              | \$1,567,567                      |          |              |   |
| Net interest income   |                                  | \$12,812 |              |                                  | \$12,341 |              |   |
| Net interest spread   |                                  |          | 3.40         | %                                |          | 3.29         | % |
| Impact of non-interest bearing funds                        |                                  |          | 0.04         | %                                |          | 0.06         | % |
| Net yield on interest-earning assets                        |                                  |          | 3.44         | %                                |          | 3.35         | % |

(1) The tax-exempt income is not recorded on a tax equivalent basis.

- (2) Nonaccrual loans have been included in the average balances.
- (3) Net of unaccreted discount related to loans acquired
- (4) Includes loans held for sale.

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|   | Six months ended June 30, 2014 |          |              | Six months ended June 30, 2013 |          |              |   |  |
|---|--------------------------------|----------|--------------|--------------------------------|----------|--------------|---|--|
|   | Average Balance                | Interest | Average Rate | Average Balance                | Interest | Average Rate |   |  |
| <b>ASSETS</b>   |                                |          |              |                                |          |              |   |  |
| Interest-bearing deposits with other financial institutions | \$34,146                       | \$43     | 0.26         | % \$19,489                     | \$25     | 0.26         | % |  |
| Federal funds sold  | 496                            | —        | 0.10         | % 13,454                       | 6        | 0.09         | % |  |
| Certificates of deposit investments                         | —                              | —        | —            | % 4,896                        | 13       | 0.54         | % |  |
| <b>Investment securities</b>                                |                                |          |              |                                |          |              |   |  |
| Taxable   | 385,205                        | 3,917    | 2.03         | % 478,239                      | 4,568    | 1.91         | % |  |
| Tax-exempt (1)  | 68,515                         | 1,151    | 3.36         | % 58,560                       | 971      | 3.32         | % |  |
| Loans (2)(3)(4)   | 998,963                        | 21,851   | 4.41         | % 904,462                      | 20,825   | 4.64         | % |  |
| Total earning assets  | 1,487,325                      | 26,962   | 3.66         | % 1,479,100                    | 26,408   | 3.60         | % |  |
| Cash and due from banks                                     | 36,142                         |          |              | 32,196                         |          |              |   |  |
| Premises and equipment                                      | 28,087                         |          |              | 29,320                         |          |              |   |  |
| Other assets  | 45,795                         |          |              | 44,126                         |          |              |   |  |
| Allowance for loan losses                                   | (13,535 )                      |          |              | (12,093 )                      |          |              |   |  |
| Total assets  | \$1,583,814                    |          |              | \$1,572,649                    |          |              |   |  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                 |                                |          |              |                                |          |              |   |  |
| <b>Interest-bearing deposits</b>                            |                                |          |              |                                |          |              |   |  |
| Demand deposits   | \$554,283                      | \$349    | 0.13         | % \$540,574                    | \$417    | 0.16         | % |  |
| Savings deposits  | 286,123                        | 186      | 0.13         | % 300,333                      | 269      | 0.18         | % |  |
| Time deposits   | 228,484                        | 657      | 0.58         | % 204,448                      | 774      | 0.76         | % |  |
| Securities sold under agreements to repurchase              | 91,526                         | 22       | 0.05         | % 88,921                       | 25       | 0.06         | % |  |
| FHLB advances   | 13,039                         | 133      | 2.05         | % 5,677                        | 116      | 4.13         | % |  |
| Fed Funds Purchased   | 33                             | —        | 0.51         | % 240                          | 1        | 0.61         | % |  |
| Junior subordinated debt                                    | 20,620                         | 255      | 2.49         | % 20,620                       | 261      | 2.55         | % |  |
| Other debt  | 204                            | 1        | 1.22         | % —                            | —        | —            | % |  |
| Total interest-bearing liabilities                          | 1,194,312                      | 1,603    | 0.27         | % 1,160,813                    | 1,863    | 0.32         | % |  |
| Non interest-bearing demand deposits                        | 226,196                        |          |              | 246,099                        |          |              |   |  |
| Other liabilities   | 8,677                          |          |              | 8,207                          |          |              |   |  |
| Stockholders' equity  | 154,629                        |          |              | 157,530                        |          |              |   |  |
| Total liabilities & equity                                  | \$1,583,814                    |          |              | \$1,572,649                    |          |              |   |  |
| Net interest income   |                                | \$25,359 |              |                                | \$24,545 |              |   |  |
| Net interest spread   |                                |          | 3.39         | %                              |          | 3.28         | % |  |
| Impact of non-interest bearing funds                        |                                |          | 0.04         | %                              |          | 0.06         | % |  |
| Net yield on interest-earning assets                        |                                |          | 3.43         | %                              |          | 3.34         | % |  |

(1) The tax-exempt income is not recorded on a tax equivalent basis.

(2) Nonaccrual loans have been included in the average balances.

(3) Net of unaccreted discount related to loans acquired

(4) Includes loans held for sale.





Changes in net interest income may also be analyzed by segregating the volume and rate components of interest income and interest expense. The following table summarizes the approximate relative contribution of changes in average volume and interest rates to changes in net interest income for the three and six-months ended June 30, 2014, compared to the same periods in 2013 (in thousands):

|   | Three months ended June 30, 2014<br>compared to 2013 Increase / (Decrease) |            |           | Six months ended June 30,<br>2014 compared to 2013<br>Increase / (Decrease) |            |           |
|---|--|------------|-----------|---|------------|-----------|
|   | Total<br>Change  | Volume (1) | Rate (1)  | Total<br>Change   | Volume (1) | Rate (1)  |
| <b>Earning Assets:</b>                            |  |            |           |   |            |           |
| Interest-bearing deposits                         | \$5  | \$7        | \$(2)     | \$18  | \$18       | \$—       |
| Federal funds sold                                | (2)  | (1)        | (1)       | (6)   | (7)        | 1         |
| Certificates of deposit<br>investments            | (5)  | (3)        | (2)       | (13)  | (7)        | (6)       |
| <b>Investment securities:</b>                     |  |            |           |   |            |           |
| Taxable   | (339)  | (1,141)    | 802       | (651)   | (1,360)    | 709       |
| Tax-exempt (2)                                    | 86   | 84         | 2         | 180   | 167        | 13        |
| Loans (3)   | 649  | 2,976      | (2,327)   | 1,026   | 3,517      | (2,491)   |
| Total interest income                             | 394  | 1,922      | (1,528)   | 554   | 2,328      | (1,774)   |
| <b>Interest-Bearing Liabilities:</b>              |  |            |           |   |            |           |
| <b>Interest-bearing deposits</b>                  |  |            |           |   |            |           |
| Demand deposits                                   | (33)   | 25         | (58)      | (68)  | 31         | (99)      |
| Savings deposits                                  | 3  | (19)       | 22        | (83)  | (12)       | (71)      |
| Time deposits                                     | (51)   | 222        | (273)     | (117)   | 206        | (323)     |
| Securities sold under agreements<br>to repurchase | —  | —          | —         | (3)   | 3          | (6)       |
| FHLB advances                                     | 6  | 97         | (91)      | 17  | 182        | (165)     |
| Federal Funds Purchased                           | (1)  | (1)        | —         | (1)   | (1)        | —         |
| Junior subordinated debt                          | (2)  | —          | (2)       | (6)   | —          | (6)       |
| Other debt  | 1  | 1          | —         | 1   | (326)      | 327       |
| Total interest expense                            | (77)   | 325        | (402)     | (260)   | 83         | (343)     |
| Net interest income                               | \$471  | \$1,597    | \$(1,126) | \$814   | \$2,245    | \$(1,431) |

(1) Changes attributable to the combined impact of volume and rate have been allocated proportionately to the change due to volume and the change due to rate.

(2) The tax-exempt income is not recorded on a tax-equivalent basis.

(3) Nonaccrual loans have been included in the average balances.

Net interest income increased \$814,000, or 3.3%, to \$25.4 million for the six months ended June 30, 2014, from \$24.5 million for the same period in 2013. Net interest income increased due to the growth in average earning assets and an increase in the net interest margin. The net interest margin increased due to the shift in balances of investment securities to higher-yielding loans, an increase in yield on investments and the reduction in deposit costs.

For the six months ended June 30, 2014, average earning assets increased by \$8.2 million, or .6%, and average interest-bearing liabilities increased \$33.5 million or 2.9%, compared with average balances for the same period in 2013. The changes in average balances for these periods are shown below:

▲Average interest-bearing deposits held by the Company increased \$14.7 million or 75.2%.

- ▲Average federal funds sold decreased \$13.0 million or 96.3%.
- ▲Average certificates of deposit investments decreased by \$4.9 million or 100%.
- ▲Average loans increased by \$94.5 million or 10.4%.
- ▲Average securities decreased by \$83.1 million or 15.5%.
- ▲Average deposits increased by \$23.5 million or 2.3%.
- ▲Average securities sold under agreements to repurchase increased by \$2.6 million or 2.9%.
- ▲Average borrowings and other debt increased by \$7.4 million or 27.7%.
- ▲Net interest margin increased to 3.43% for the first six months of 2014 from 3.34% for the first six months of 2013.

To compare the tax-exempt yields on interest-earning assets to taxable yields, the Company also computes non-GAAP net interest income on a tax equivalent basis (TE) where the interest earned on tax-exempt securities is adjusted to an amount comparable to interest subject to normal income taxes assuming a federal tax rate of 35% (referred to as the tax equivalent adjustment). The year-to-date net yield on interest-earning assets (TE) was 3.53% and 3.42% for the first six months of 2014 and 2013, respectively. The TE adjustments to net interest income for the six months ended June 30, 2014 and 2013 were \$708,000 and \$620,000, respectively.

#### Provision for Loan Losses

The provision for loan losses for the six months ended June 30, 2014 and 2013 was \$451,000 and \$732,000, respectively. Nonperforming loans were \$5.5 million and \$6.8 million as of June 30, 2014 and 2013, respectively. Net charge offs were \$19,000 for the six months ended June 30, 2014 compared to \$377,000 during the same period in 2013. For information on loan loss experience and nonperforming loans, see discussion under the “Nonperforming Loans” and “Loan Quality and Allowance for Loan Losses” sections below.

#### Other Income

An important source of the Company’s revenue is other income. The following table sets forth the major components of other income for the three and six-months ended June 30, 2014 and 2013 (in thousands):

|                               | Three months ended June 30, |         |           | Six months ended June 30, |         |           |
|-------------------------------|-----------------------------|---------|-----------|---------------------------|---------|-----------|
|                               | 2014                        | 2013    | \$ Change | 2014                      | 2013    | \$ Change |
| Trust revenues                | \$848                       | \$806   | \$42      | \$1,781                   | \$1,699 | \$82      |
| Brokerage commissions         | 233                         | 218     | 15        | 483                       | 389     | 94        |
| Insurance commissions         | 441                         | 410     | 31        | 999                       | 896     | 103       |
| Service charges               | 1,353                       | 1,215   | 138       | 2,497                     | 2,355   | 142       |
| Security gains, net           | 543                         | 482     | 61        | 734                       | 835     | (101)     |
| Mortgage banking revenue, net | 158                         | 305     | (147)     | 256                       | 591     | (335)     |
| ATM / debit card revenue      | 1,002                       | 947     | 55        | 1,975                     | 1,830   | 145       |
| Other                         | 412                         | 331     | 81        | 746                       | 669     | 77        |
| Total other income            | \$4,990                     | \$4,714 | \$276     | \$9,471                   | \$9,264 | \$207     |

Following are explanations of the changes in these other income categories for the three months ended June 30, 2014 compared to the same period in 2013:

Trust revenues increased \$42,000 or 5.2% to \$848,000 from \$806,000 primarily due to an increase in revenues from Investment Management & Advisory Agency accounts and increases in market value related fees. Trust assets, at market value, were \$753.2 million at June 30, 2014 compared to \$673.8 million at June 30, 2013.

Revenues from brokerage increased \$15,000 or 6.9% to \$233,000 from \$218,000 due to an increase in the number of brokerage accounts from new business development efforts.

Insurance commissions increased \$31,000 or 7.6% to \$441,000 from \$410,000 due to an increase in contingency income received from carriers based on claims experience during 2014 compared to 2013.

Fees from service charges increased \$138,000 or 11.4% to \$1.35 million from \$1.2 million for the three-month periods ended June 30, 2014 and 2013 due to an increase in overdraft fees and transaction service charges.

The sale of securities during the three months ended June 30, 2014 resulted in net securities gains of \$543,000 compared to \$482,000 during the three months ended June 30, 2013.

Mortgage banking income decreased \$147,000 or 48.2% to \$158,000 from \$305,000. Loans sold balances were as follows:

\$12.6 million (representing 103 loans) for the second quarter of 2014.

\$20.2 million (representing 169 loans) for the second quarter of 2013.

First Mid Bank generally releases the servicing rights on loans sold into the secondary market.

- Revenue from ATMs and debit cards increased \$55,000 or 5.8% to \$1.0 million from \$947,000 due to an increase in electronic transactions and incentives received from VISA.

Other income increased \$81,000 or 24.5% to \$412,000 from \$331,000 due to an increase in bank card fees.

Following are explanations of the changes in these other income categories for the six months ended June 30, 2014 compared to the same period in 2013:

Trust revenues increased \$82,000 or 4.8% to \$1,781,000 from \$1,699,000 primarily due to an increase in revenues from from Investment Management & Advisory Agency accounts and increases in market value related fees. Trust assets, at market value, were \$753.2 million at June 30, 2014 compared to \$673.8 million at June 30, 2013.

Revenues from brokerage increased \$94,000 or 24.2% to \$483,000 from \$389,000 due to an increase in the number of brokerage accounts from new business development efforts.

Insurance commissions increased \$103,000 or 11.5% to \$999,000 from \$896,000 due to an increase in contingency income received from carriers based on claims experience during 2014 compared to 2013.

Fees from service charges increased \$142,000 or 6% to \$2,497,000 from \$2,355,000 for the six-month periods ended June 30, 2014 and 2013.

The sale of securities during the six months ended June 30, 2014 resulted in net securities gains of \$734,000 compared to \$835,000 during the six months ended June 30, 2013.

Mortgage banking income decreased \$335,000 or 56.7% to \$256,000 from \$591,000. Loans sold balances were as follows:

\$19.3 million (representing 161 loans) for the six months ended of June 30, 2014

\$39.5 million (representing 328 loans) for the six months ended of June 30, 2013

First Mid Bank generally releases the servicing rights on loans sold into the secondary market.

Revenue from ATMs and debit cards increased \$145,000 or 7.9% to \$1,975,000 from \$1,830,000 due to an increase in electronic transactions and incentives received from VISA.

Other income increased \$77,000 or 11.5% to \$746,000 from \$669,000 due to an increase in bank card fees.



## Other Expense

The major categories of other expense include salaries and employee benefits, occupancy and equipment expenses and other operating expenses associated with day-to-day operations. The following table sets forth the major components of other expense for the three and six-months ended June 30, 2014 and 2013 (in thousands):

|  | Three months ended June 30, |          |           | Six months ended June 30, |          |           |
|--|-----------------------------|----------|-----------|---------------------------|----------|-----------|
|  | 2014                        | 2013     | \$ Change | 2014                      | 2013     | \$ Change |
| Salaries and employee benefits               | \$6,054                     | \$5,972  | \$82      | \$12,107                  | \$11,769 | \$338     |
| Net occupancy and equipment expense          | 2,114                       | 2,102    | 12        | 4,263                     | 4,145    | 118       |
| Net other real estate owned expense (income) | (39 )                       | 46       | (85 )     | (18 )                     | 162      | (180 )    |
| FDIC insurance                               | 199                         | 213      | (14 )     | 405                       | 435      | (30 )     |
| Amortization of intangible assets            | 163                         | 171      | (8 )      | 325                       | 341      | (16 )     |
| Stationery and supplies                      | 173                         | 121      | 52        | 328                       | 262      | 66        |
| Legal and professional                       | 677                         | 614      | 63        | 1,239                     | 1,162    | 77        |
| Marketing and donations                      | 245                         | 264      | (19 )     | 509                       | 507      | 2         |
| Other operating expenses                     | 1,628                       | 1,415    | 213       | 3,016                     | 2,747    | 269       |
| Total other expense                          | \$11,214                    | \$10,918 | \$296     | \$22,174                  | \$21,530 | \$644     |

Following are explanations for the changes in these other expense categories for the three months ended June 30, 2014 compared to the same period in 2013:

Salaries and employee benefits, the largest component of other expense, increased \$82,000 or 1.4% to \$6,054,000 from \$5,972,000. This increase was primarily due to merit increases for continuing employees during the first quarter of 2014. There were 404 and 406 full-time equivalent employees at June 30, 2014 and 2013, respectively.

Occupancy and equipment expense increased \$12,000 or .6% to \$2,114,000 from \$2,102,000. This increase was primarily due to increases in maintenance and repair expense for equipment and software and buildings owned by the company.

Net other real estate owned expense decreased \$85,000 or 184.8% to (\$39,000) from \$46,000. The decrease in 2014 was primarily due to gains on properties sold during 2014 compared to losses on properties sold during 2013.

FDIC insurance expense decreased \$14,000 or 6.6% to \$199,000 from \$213,000 due to lower assessment rates during 2014 compared to 2013.

Expense for amortization of intangible assets decreased \$8,000 or 4.7% to \$163,000 from \$171,000 for the six months ended June 30, 2014 and 2013, respectively. The decrease in intangible amortization expense in 2014 was due to less amortization expense for core deposit intangibles in 2014 compared to 2013.

Other operating expenses increased \$213,000 or 15.1% to \$1,628,000 in 2014 from \$1,415,000 in 2013 primarily due to filing and listing fees paid to NASDAQ during 2014 that were not paid in 2013.

On a net basis, all other categories of operating expenses increased \$96,000 or 9.6% to \$1,095,000 in 2014 from \$999,000 in 2013. The increase was due to various increases in stationery and supplies, legal and professional fees, offset by a decline in marketing and promotion.



Following are explanations for the changes in these other expense categories for the six months ended June 30, 2014 compared to the same period in 2013:

Salaries and employee benefits, the largest component of other expense, increased \$338,000 or 2.9% to \$12.1 million from \$11.8 million. This increase was primarily due to merit increases for continuing employees during the first quarter of 2014. There were 404 and 406 full-time equivalent employees at June 30, 2014 and 2013, respectively.

Occupancy and equipment expense increased \$118,000 or 2.8% to \$4,263,000 from \$4,145,000. This increase was primarily due to increases in maintenance and repair expense for equipment and software and buildings owned by the company.

Net other real estate owned expense decreased \$180,000 or 111.1% to (\$18,000) from \$162,000. The decrease in 2014 was primarily due to a gains on properties sold during 2014 compared to losses on properties sold in 2013.

FDIC insurance expense decreased \$30,000 or 6.9% to \$405,000 from \$435,000 due to lower assessment rates during 2014 compared to 2013.

Expense for amortization of intangible assets decreased \$16,000 or 4.7% to \$325,000 from \$341,000 for the six months ended June 30, 2014 and 2013, respectively. The decrease in intangible amortization expense in 2013 was due to less amortization expense for core deposit intangibles in 2014 compared to 2013.

Other operating expenses increased \$269,000 or 9.8% to \$3,016,000 in 2014 from \$2,747,000 million in 2013 primarily due to filing and listing fees paid to NASDAQ during 2014 that was not paid during 2013.

On a net basis, all other categories of operating expenses increased \$145,000 or 7.5% to \$2,076,000 in 2014 from \$1,931,000 in 2013. The increase was due to various increases in stationery and supplies, legal and professional fees, and marketing and promotion.

#### Income Taxes

Total income tax expense amounted to \$4,569,000 (37.4% effective tax rate) for the six months ended June 30, 2014, compared to \$4,354,000 (37.7% effective tax rate) for the same period in 2013.

The Company files U.S. federal and state of Illinois income tax returns. The Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2010.

## Analysis of Balance Sheets

## Securities

The Company's overall investment objectives are to insulate the investment portfolio from undue credit risk, maintain adequate liquidity, insulate capital against changes in market value and control excessive changes in earnings while optimizing investment performance. The types and maturities of securities purchased are primarily based on the Company's current and projected liquidity and interest rate sensitivity positions.

The following table sets forth the amortized cost of the available-for-sale securities as of June 30, 2014 and December 31, 2013 (dollars in thousands):

|   | June 30, 2014  |                        | December 31, 2013 |                        |   |
|---|----------------|------------------------|-------------------|------------------------|---|
|   | Amortized Cost | Weighted Average Yield | Amortized Cost    | Weighted Average Yield |   |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$163,914      | 1.56                   | % \$197,805       | 1.56                   | % |
| Obligations of states and political subdivisions                                      | 67,786         | 3.38                   | % 65,304          | 3.43                   | % |
| Mortgage-backed securities: GSE residential   | 205,411        | 2.49                   | % 229,661         | 2.60                   | % |
| Trust preferred securities  | 3,449          | 1.13                   | % 3,652           | 1.14                   | % |
| Other securities  | 4,035          | 1.19                   | % 6,035           | 1.17                   | % |
| Total securities  | \$444,595      | 2.26                   | % \$502,457       | 2.27                   | % |

At June 30, 2014, the Company's investment portfolio decreased by \$57.9 million from December 31, 2013 due to maturities and sales of various securities that have not been replaced. When purchasing investment securities, the Company considers its overall liquidity and interest rate risk profile, as well as the adequacy of expected returns relative to the risks assumed.

The table below presents the credit ratings as of June 30, 2014 for certain investment securities (in thousands):

|   | Amortized Cost | Estimated Fair Value | Average Credit Rating of Fair Value at June 30, 2014 (1) |           |          |         |         |           |
|---|----------------|----------------------|--|-----------|----------|---------|---------|-----------|
|   |                |                      | AAA  | AA +/-    | A +/-    | BBB +/- | < BBB - | Not rated |
| U.S. Treasury securities and obligations of U.S. government corporations and agencies | \$163,914      | \$160,236            | \$498  | \$159,738 | \$—      | \$—     | \$—     | \$—       |
| Obligations of state and political subdivisions                                       | 67,786         | 69,610               | 4,946  | 37,901    | 25,305   | —       | —       | 1,458     |
| Mortgage-backed securities (2)  | 205,411        | 204,943              | —  | —         | —        | —       | —       | 204,943   |
| Trust preferred securities  | 3,449          | 369                  | —  | —         | —        | —       | 369     | —         |
| Other securities  | 4,035          | 4,032                | —  | —         | 2,005    | 1,967   | —       | 60        |
| Total investments   | \$444,595      | \$439,190            | \$5,444  | \$197,639 | \$27,310 | \$1,967 | \$369   | \$206,461 |

(1) Credit ratings reflect the lowest current rating assigned by a nationally recognized credit rating agency.

(2) Mortgage-backed securities include mortgage-backed securities (MBS) and collateralized mortgage obligation (CMO) issues from the following government sponsored enterprises: FHLMC, FNMA, GNMA and FHLB. While MBS and CMOs are no longer explicitly rated by credit rating agencies, the industry recognizes that they are backed by agencies which have an implied government guarantee.

The trust preferred securities is one trust preferred pooled security issued by FTN Financial Securities Corp. ("FTN"). On July 22, 2013, the Company sold two of its trust preferred securities (PreTSL I and PreTSL II). This sale resulted in recovery of all of the book value of these securities. The net proceeds exceeded the aggregate book value of these securities by approximately \$1.4 million and this amount was recorded as a security gain during the third quarter of 2013.

The following table contains information regarding the remaining trust preferred security as of June 30, 2014:

|  |               |   |
|--|---------------|---|
| Deal name  | PreTSL XXVIII |   |
| Class  | Mezzanine C-1 |   |
| Book value   | \$3,449,000   |   |
| Fair value   | \$369,000     |   |
| Unrealized gains/(losses)  | \$(3,080,000  | ) |
| Other-than-temporary impairment recorded in earnings             | \$1,111,000   |   |
| Lowest credit rating assigned                                    | C             |   |
| Number of performing banks                                       | 31            |   |
| Number of issuers in default                                     | 8             |   |
| Number of issuers in deferral                                    | 4             |   |
| Original collateral  | \$360,850,000 |   |
| Actual defaults & deferrals as a % of original collateral        | 18.2          | % |
| Remaining collateral   | \$340,988,000 |   |
| Actual defaults & deferrals as a % of remaining collateral       | 19.2          | % |
| Expected defaults & deferrals as a % of remaining collateral     | 24.3          | % |
| Estimated incremental defaults required to break yield           | \$40,894,000  |   |
| Performing collateral  | \$276,603,000 |   |
| Current balance of class   | \$36,358,000  |   |
| Subordination  | \$275,813,000 |   |
| Excess subordination   | \$790,000     |   |
| Excess subordination as a % of remaining performing collateral   | 0.3           | % |
| Discount rate (1)  | 1.52%-5.38%   |   |
| Expected defaults & deferrals as a % of remaining collateral (2) | 2% / .36      |   |
| Recovery assumption (3)  | 10            | % |
| Prepayment assumption (4)  | 1             | % |

(1) The discount rate for floating rate bonds is a compound interest formula based on the LIBOR forward curve for each payment date

(2) 2% annually for 2 years and 36 basis points annually thereafter

(3) With 2 year lag

(4) Additional assumptions regarding prepayments:

Banks with more than \$15 billion in total assets as of 12/31/2009:

(a) For fixed rate TruPS, all securities will be called in one year

(b) For floating rate TruPS, (1) all securities with spreads greater than 250 bps will be called in one year (2) all securities with spreads between 150 bps and 250 bps will be called at a rate of 5% annually (3) all securities with spreads less than 150 bps will be called at a rate of 1% annually

Banks with less than \$15 billion in total assets as of 12/31/2009:

(a) For fixed rate TruPS, (1) all securities with coupons greater than 8% that were issued by healthy banks with the capacity to prepay will be called in one year (2) All remaining fixed rate securities will be called at a rate of 1% annually

(b) For floating rate TruPs, all securities will be called at a rate of 1% annually

The trust preferred pooled security is a Collateralized Debt Obligation (“CDOs”) backed by a pool of debt securities issued by financial institutions. The collateral consists of trust-preferred securities and subordinated debt securities issued by banks, bank holding companies and insurance companies. Performing collateral is the amount of remaining collateral less the balances of collateral in deferral or default. Subordination is the amount of performing collateral in excess of the current balance of a specified class and all classes senior to the specified class. Excess subordination is the amount that the performing collateral balance exceeds the current outstanding balance of the specific class, plus all senior classes. It is a static measure of credit enhancement, but does not incorporate all of the structural elements of the security deal. This amount can also be impacted by future defaults and deferrals, deferring balances that cure or redemptions of securities by issuers. A negative excess subordination indicates that the current performing collateral of the security would be insufficient to pay the current principal balance of the class notes after all of the senior classes’ notes were paid. However, the performing collateral balance excludes the collateral of issuers currently deferring their interest payments. Because these issuers are expected to resume payment in the future (within five years of the first deferred interest period), a negative excess subordination does not necessarily mean a class note holder will not receive a greater than projected or even full payment of cash flow at maturity.

At June 30, 2014 and 2013 the Company was receiving “payment in kind” (“PIK”) in lieu of cash interest on its trust preferred security investment as and to the extent described below. The Company’s use of “PIK” does not indicate that additional securities have been issued in satisfaction of any outstanding obligation; rather, it indicates that a coverage test of a class or tranche directly senior to the class in question has failed and interest received on the PIK note is being capitalized, which means the principal balance is being increased. Once the coverage test is met, the capitalized interest will be paid in cash and current cash interest payments will resume.

The Company’s trust preferred security investment allows, under the terms of the issue, for issuers to defer interest for up to five consecutive years. After five years, if not cured, the security is considered to be in default and the trustee may demand payment in full of principal and accrued interest. Issuers are also considered to be in default in the event of the failure of the issuer or a subsidiary. The structuring of the trust preferred security provides for a waterfall approach to absorbing losses whereby lower classes or tranches are initially impacted and more senior tranches are only impacted after lower tranches can no longer absorb losses. Likewise, the waterfall approach also applies to principal and interest payments received, as senior tranches have priority over lower tranches in the receipt of payments. Both deferred and defaulted issuers are considered non-performing, and the trustee calculates, on a quarterly basis, certain coverage tests prior to the payment of cash interest to owners of the various tranches of the securities. The coverage tests are compared to an over-collateralization target that states the balance of performing collateral as a percentage of the tranche balance plus the balance of all senior tranches. The tests must show that performing collateral is sufficient to meet requirements for the senior tranches, both in terms of cash flow and collateral value, before cash interest can be paid to subordinate tranches. As a result of the cash flow waterfall provisions within the structure of the security, when a senior tranche fails its coverage test, all of the cash flows that would have been paid to lower tranches are paid to the senior tranche and recorded as a reduction of the senior tranches’ principal. This principal reduction in the senior tranche continues until the coverage test of the senior tranche is passed or the principal of the tranche is paid in full. For so long as the cash flows are being diverted to the senior tranches, the amount of interest due and payable to the subordinate tranches is capitalized and recorded as an increase in the principal value of the tranche. The Company’s trust preferred security investment is in the mezzanine tranche or class which is subordinate to more senior tranches of the issue. The Company is receiving PIK for this security due to failure of the required senior tranche coverage tests described. This security is projected to remain in PIK status for approximately two more quarters.

The impact of payment of PIK to subordinate tranches is to strengthen the position of the senior tranches by reducing the senior tranches’ principal balances relative to available collateral and cash flow. The impact to the subordinate tranches is to increase principal balances, decrease cash flow, and increase credit risk to the tranches receiving the PIK. The risk to holders of a security of a tranche in PIK status is that the remaining total cash flow will not be

sufficient to repay all principal and capitalized interest related to the investment.

During the fourth quarter of 2010, after analysis of the expected future cash flows and the timing of resumed interest payments, the Company determined that placing the trust preferred security on non-accrual status was the most prudent course of action. The Company stopped all accrual of interest and ceased to capitalize any PIK to the principal balance of the security. The Company intends to keep the security on non-accrual status until the scheduled interest payments resume on a regular basis and any previously recorded PIK has been paid. The PIK status of the securities, among other factors, indicates potential other-than-temporary impairment (“OTTI”) and accordingly, the Company has performed further detailed analysis of the investments cash flows and the credit conditions of the underlying issuers. This analysis incorporates, among other things, the waterfall provisions and any resulting PIK status of these securities to determine if cash flow will be sufficient to pay all principal and interest due to the investment tranche held by the Company.

See discussion below and Note 3 – Investment Securities in the notes to the financial statements for more detail regarding this analysis. Based on this analysis, the Company believes the amortized costs recorded for the trust preferred security investment accurately reflects the position of the security at June 30, 2014 and December 31, 2013.

#### Other-than-temporary Impairment of Securities

Declines in the fair value, or unrealized losses, of all available for sale investment securities, are reviewed to determine whether the losses are either a temporary impairment or OTTI. Temporary adjustments are recorded when the fair value of a security fluctuates from its historical cost. Temporary adjustments are recorded in accumulated other comprehensive income, and impact the Company's equity position. Temporary adjustments do not impact net income. A recovery of available for sale security prices also is recorded as an adjustment to other comprehensive income for securities that are temporarily impaired, and results in a positive impact to the Company's equity position.

OTTI is recorded when the fair value of an available for sale security is less than historical cost, and it is probable that all contractual cash flows will not be collected. Investment securities are evaluated for OTTI on at least a quarterly basis. In conducting this assessment, the Company evaluates a number of factors including, but not limited to:

- how much fair value has declined below amortized cost;
- how long the decline in fair value has existed;
- the financial condition of the issuers;
- contractual or estimated cash flows of the security;
- underlying supporting collateral;
- past events, current conditions and forecasts;
- significant rating agency changes on the issuer; and
- the Company's intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

If the Company intends to sell the security or if it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, the entire amount of OTTI is recorded to noninterest income, and therefore, results in a negative impact to net income. Because the available for sale securities portfolio is recorded at fair value, the conclusion as to whether an investment decline is other-than-temporarily impaired, does not significantly impact the Company's equity position, as the amount of the temporary adjustment has already been reflected in accumulated other comprehensive income/loss.

If the Company does not intend to sell the security and it is not more-likely-than-not it will be required to sell the security before recovery of its amortized cost basis, only the amount related to credit loss is recognized in earnings. In determining the portion of OTTI that is related to credit loss, the Company compares the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. The remaining portion of OTTI, related to other factors, is recognized in other comprehensive earnings, net of applicable taxes.

The term "other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value are not necessarily favorable, or that there is a general lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. See Note 3 -- Investment Securities in the Notes to Condensed Consolidated Financial Statements (unaudited) for a discussion of the Company's evaluation and subsequent charges for OTTI.



## Loans

The loan portfolio (net of unearned interest) is the largest category of the Company's earning assets. The following table summarizes the composition of the loan portfolio, including loans held for sale, as of June 30, 2014 and December 31, 2013 (in thousands):

|                                    | June 30, 2014 | % Outstanding<br>Loans | December 31,<br>2013 | % Outstanding<br>Loans |   |
|------------------------------------|---------------|------------------------|----------------------|------------------------|---|
| Construction and land development  | \$18,945      | 1.9                    | % \$25,321           | 2.6                    | % |
| Agricultural real estate           | 109,610       | 10.7                   | % 109,405            | 11.1                   | % |
| 1-4 Family residential properties  | 182,795       | 17.9                   | % 184,761            | 18.8                   | % |
| Multifamily residential properties | 53,295        | 5.2                    | % 50,174             | 5.1                    | % |
| Commercial real estate             | 378,631       | 37.0                   | % 356,999            | 36.4                   | % |
| Loans secured by real estate       | 743,276       | 72.7                   | % 726,660            | 74.0                   | % |
| Agricultural loans                 | 55,660        | 5.4                    | % 64,128             | 6.5                    | % |
| Commercial and industrial loans    | 200,219       | 19.6                   | % 168,353            | 17.1                   | % |
| Consumer loans                     | 14,052        | 1.4                    | % 14,579             | 1.5                    | % |
| All other loans                    | 9,044         | 0.9                    | % 9,084              | 0.9                    | % |
| Total loans                        | \$1,022,251   | 100.0                  | % \$982,804          | 100.0                  | % |

Overall net loans increased \$39.4 million, or 4%. The increase was primarily due to increases in commercial and industrial loans offset by a decrease in agricultural operating loans and construction and land development loans. The balance of real estate loans held for sale, included in the balances shown above, amounted to \$929,000 and \$514,000 as of June 30, 2014 and December 31, 2013, respectively.

Commercial and commercial real estate loans generally involve higher credit risks than residential real estate and consumer loans. Because payments on loans secured by commercial real estate or equipment are often dependent upon the successful operation and management of the underlying assets, repayment of such loans may be influenced to a great extent by conditions in the market or the economy. The Company does not have any sub-prime mortgages or credit card loans outstanding which are also generally considered to be higher credit risk.

The following table summarizes the loan portfolio geographically by branch region as of June 30, 2014 and December 31, 2013 (dollars in thousands):

|                   | June 30, 2014        |                        | December 31, 2013    |                        |   |
|-------------------|----------------------|------------------------|----------------------|------------------------|---|
|                   | Principal<br>balance | % Outstanding<br>Loans | Principal<br>balance | % Outstanding<br>loans |   |
| Central region    | 364,682              | 35.8                   | % 323,220            | 32.9                   | % |
| Sullivan region   | 138,504              | 13.5                   | % 133,573            | 13.6                   | % |
| Decatur region    | 243,499              | 23.8                   | % 241,784            | 24.6                   | % |
| Peoria region     | 160,595              | 15.7                   | % 166,618            | 16.9                   | % |
| Highland region   | 114,971              | 11.2                   | % 117,609            | 12.0                   | % |
| Total all regions | \$1,022,251          | 100.0                  | % \$982,804          | 100.0                  | % |

Loans are geographically dispersed among these regions located in central and southwestern Illinois. While these regions have experienced some economic stress during 2014 and 2013, the Company does not consider these locations high risk areas since these regions have not experienced the significant declines in real estate values seen in some other areas in the United States.



The Company does not have a concentration, as defined by the regulatory agencies, in construction and land development loans or commercial real estate loans as a percentage of total risk-based capital for the periods shown above. At June 30, 2014 and December 31, 2013, the Company did have industry loan concentrations in excess of 25% of total risk-based capital in the following industries (dollars in thousands):

|  | June 30, 2014     |                     | December 31, 2013 |                     |   |
|--|-------------------|---------------------|-------------------|---------------------|---|
|  | Principal balance | % Outstanding Loans | Principal balance | % Outstanding Loans |   |
| Other grain farming                          | \$136,588         | 13.36               | % \$147,110       | 14.97               | % |
| Lessors of non-residential buildings         | 104,901           | 10.26               | % 97,982          | 9.97                | % |
| Lessors of residential buildings & dwellings | 63,952            | 6.26                | % 58,792          | 5.98                | % |
| Hotels and motels                            | 51,214            | 5.01                | % 50,608          | 5.15                | % |

The Company had no further industry loan concentrations in excess of 25% of total risk-based capital.

The following table presents the balance of loans outstanding as of June 30, 2014, by contractual maturities (in thousands):

|                                    | Maturity (1)        |                        |              | Total       |
|------------------------------------|---------------------|------------------------|--------------|-------------|
|                                    | One year or less(2) | Over 1 through 5 years | Over 5 years |             |
| Construction and land development  | \$12,466            | \$6,359                | \$120        | \$18,945    |
| Agricultural real estate           | 10,516              | 41,230                 | 57,864       | 109,610     |
| 1-4 Family residential properties  | 20,216              | 84,079                 | 78,500       | 182,795     |
| Multifamily residential properties | 1,456               | 20,155                 | 31,684       | 53,295      |
| Commercial real estate             | 29,467              | 230,934                | 118,230      | 378,631     |
| Loans secured by real estate       | 74,121              | 382,757                | 286,398      | 743,276     |
| Agricultural loans                 | 42,247              | 12,194                 | 1,219        | 55,660      |
| Commercial and industrial loans    | 102,070             | 78,353                 | 19,796       | 200,219     |
| Consumer loans                     | 2,822               | 10,712                 | 518          | 14,052      |
| All other loans                    | 971                 | 2,142                  | 5,931        | 9,044       |
| Total loans                        | \$222,231           | \$486,158              | \$313,862    | \$1,022,251 |

(1) Based upon remaining contractual maturity.

(2) Includes demand loans, past due loans and overdrafts.

As of June 30, 2014, loans with maturities over one year consisted of approximately \$697.1 million in fixed rate loans and approximately \$102.9 million in variable rate loans. The loan maturities noted above are based on the contractual provisions of the individual loans. The Company has no general policy regarding renewals and borrower requests, which are handled on a case-by-case basis.

#### Nonperforming Loans and Nonperforming Other Assets

Nonperforming loans include: (a) loans accounted for on a nonaccrual basis; (b) accruing loans contractually past due ninety days or more as to interest or principal payments; and (c) loans not included in (a) and (b) above which are defined as “troubled debt restructurings”. Repossessed assets include primarily repossessed real estate and automobiles.

The Company’s policy is to discontinue the accrual of interest income on any loan for which principal or interest is ninety days past due. The accrual of interest is discontinued earlier when, in the opinion of management, there is

reasonable doubt as to the timely collection of interest or principal. Once interest accruals are discontinued, accrued but uncollected interest is charged against current year income. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal.

Restructured loans are loans on which, due to deterioration in the borrower's financial condition, the original terms have been modified in favor of the borrower or either principal or interest has been forgiven.

Reposessed assets represent property acquired as the result of borrower defaults on loans. These assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure or repossession. Write-downs occurring at foreclosure are charged against the allowance for loan losses. On an ongoing basis, properties are appraised as required by market indications and applicable regulations. Write-downs for subsequent declines in value are recorded in non-interest expense in other real estate owned along with other expenses related to maintaining the properties.

The following table presents information concerning the aggregate amount of nonperforming loans and reposessed assets at June 30, 2014 and December 31, 2013 (in thousands):

|  | June 30,<br>2014 | December 31,<br>2013 |  |   |
|--|------------------|----------------------|--|---|
| Nonaccrual loans   | \$4,468          | \$6,121              |  |   |
| Restructured loans which are performing in accordance with revised terms             | 364              | 348                  |  |   |
| Total nonperforming loans  | 4,832            | 6,469                |  |   |
| Reposessed assets  | 403              | 568                  |  |   |
| Total nonperforming loans and reposessed assets                                      | \$5,235          | \$7,037              |  |   |
| Nonperforming loans to loans, before allowance for loan losses                       | 0.47             | % 0.66               |  | % |
| Nonperforming loans and reposessed assets to loans, before allowance for loan losses | 0.51             | % 0.72               |  | % |

The \$1,653,000 decrease in nonaccrual loans during 2014 resulted from the net of \$651,000 of loans put on nonaccrual status, offset by \$242,000 of loans transferred to other real estate owned, \$62,000 of loans charged off and \$2,000,000 of loans becoming current or paid-off. The following table summarizes the composition of nonaccrual loans (in thousands):

|                                   | June 30, 2014 |            | December 31, 2013 |            |   |
|-----------------------------------|---------------|------------|-------------------|------------|---|
|                                   | Balance       | % of Total | Balance           | % of Total |   |
| Construction and land development | \$844         | 18.9       | % \$1,483         | 24.2       | % |
| Agricultural real estate          | 36            | 0.8        | % 105             | 1.7        | % |
| 1-4 Family residential properties | 746           | 16.7       | % 1,009           | 16.5       | % |
| Commercial real estate            | 2,242         | 50.2       | % 2,807           | 45.9       | % |
| Loans secured by real estate      | 3,868         | 86.6       | % 5,404           | 88.3       | % |
| Commercial and industrial loans   | 587           | 13.1       | % 706             | 11.5       | % |
| Consumer loans                    | 13            | 0.3        | % 11              | 0.2        | % |
| Total loans                       | \$4,468       | 100.0      | % \$6,121         | 100.0      | % |

Interest income that would have been reported if nonaccrual and restructured loans had been performing totaled \$32,000 and \$72,000 for the six months ended June 30, 2014 and 2013, respectively.

The \$165,000 decrease in repossessed assets during the first six months of 2014 resulted from the net of \$248,000 of additional assets repossessed and \$413,000 of repossessed assets sold.

The following table summarizes the composition of repossessed assets (in thousands):

|                                   | June 30, 2014 |            | December 31, 2013 |            |   |
|-----------------------------------|---------------|------------|-------------------|------------|---|
|                                   | Balance       | % of Total | Balance           | % of Total | % |
| Construction and land development | \$278         | 69.0       | % \$278           | 49.0       | % |
| Farm Loans                        | —             | —          | % 3               | 0.5        | % |
| 1-4 family residential properties | 119           | 29.5       | % 135             | 23.8       | % |
| Commercial real estate            | —             | —          | % 46              | 8.0        | % |
| Total real estate                 | 397           | 98.5       | % 462             | 81.3       | % |
| Agricultural Loans                | —             | —          | % 106             | 18.7       | % |
| Consumer Loans                    | 6             | 1.5        | % —               | —          | % |
| Total repossessed collateral      | \$403         | 100.0      | % \$568           | 100.0      | % |

Repossessed assets sold during the first six months of 2014 resulted in net gains of \$38,000, all of which was related to real estate asset sales. Repossessed assets sold during 2013 resulted in net losses of \$57,000, of which \$59,000 was related to real estate asset sales and \$2,000 in gains was related to other repossessed assets.

#### Loan Quality and Allowance for Loan Losses

The allowance for loan losses represents management's estimate of the reserve necessary to adequately account for probable losses existing in the current portfolio. The provision for loan losses is the charge against current earnings that is determined by management as the amount needed to maintain an adequate allowance for loan losses. In determining the adequacy of the allowance for loan losses, and therefore the provision to be charged to current earnings, management relies predominantly on a disciplined credit review and approval process that extends to the full range of the Company's credit exposure. The review process is directed by overall lending policy and is intended to identify, at the earliest possible stage, borrowers who might be facing financial difficulty. Once identified, the magnitude of exposure to individual borrowers is quantified in the form of specific allocations of the allowance for loan losses. Management considers collateral values and guarantees in the determination of such specific allocations. Additional factors considered by management in evaluating the overall adequacy of the allowance include historical net loan losses, the level and composition of nonaccrual, past due and renegotiated loans, trends in volumes and terms of loans, effects of changes in risk selection and underwriting standards or lending practices, lending staff changes, concentrations of credit, industry conditions and the current economic conditions in the region where the Company operates.

Given the current state of the economy, management did assess the impact of the recession on each category of loans and adjusted historical loss factors for more recent economic trends. Management utilizes a five-year loss history as one of several components in assessing the probability of inherent future losses. Given the continued weakened economic conditions, management also increased its allocation to various loan categories for economic factors during 2014 and 2013. Some of the economic factors include the potential for reduced cash flow for commercial operating loans from reduction in sales or increased operating costs, decreased occupancy rates for commercial buildings, reduced levels of home sales for commercial land developments, the uncertainty regarding grain prices, drought conditions and increased operating costs for farmers, and increased levels of unemployment and bankruptcy impacting consumer's ability to pay. Each of these economic uncertainties was taken into consideration in developing the level of

the reserve. Management considers the allowance for loan losses a critical accounting policy.

Management recognizes there are risk factors that are inherent in the Company's loan portfolio. All financial institutions face risk factors in their loan portfolios because risk exposure is a function of the business. The Company's operations (and therefore its loans) are concentrated in east central Illinois, an area where agriculture is the dominant industry. Accordingly, lending and other business relationships with agriculture-based businesses are critical to the Company's success. At June 30, 2014, the Company's loan portfolio included \$165.2 million of loans to borrowers whose businesses are directly related to agriculture. Of this amount, \$136.6 million was concentrated in other grain farming. Total loans to borrowers whose businesses are directly related to agriculture decreased \$8.2 million from \$173.4 million at December 31, 2013 while loans concentrated in other grain farming decreased \$10.5 million from \$147.1 million at December 31, 2013.

While the Company adheres to sound underwriting practices, including collateralization of loans, any extended period of low commodity prices, drought conditions, significantly reduced yields on crops and/or reduced levels of government assistance to the agricultural industry could result in an increase in the level of problem agriculture loans and potentially result in loan losses within the agricultural portfolio.

In addition, the Company has \$50.9 million of loans to motels and hotels. The performance of these loans is dependent on borrower specific issues as well as the general level of business and personal travel within the region. While the Company adheres to sound underwriting standards, a prolonged period of reduced business or personal travel could result in an increase in nonperforming loans to this business segment and potentially in loan losses. The Company also has \$104.9 million of loans to lessors of non-residential buildings and \$64.0 million of loans to lessors of residential buildings and dwellings.

The structure of the Company's loan approval process is based on progressively larger lending authorities granted to individual loan officers, loan committees, and ultimately the Board of Directors. Outstanding balances to one borrower or affiliated borrowers are limited by federal regulation; however, limits well below the regulatory thresholds are generally observed. The vast majority of the Company's loans are to businesses located in the geographic market areas served by the Company's branch bank system. Additionally, a significant portion of the collateral securing the loans in the portfolio is located within the Company's primary geographic footprint. In general, the Company adheres to loan underwriting standards consistent with industry guidelines for all loan segments.

The Company minimizes credit risk by adhering to sound underwriting and credit review policies. Management and the board of directors of the Company review these policies at least annually. Senior management is actively involved in business development efforts and the maintenance and monitoring of credit underwriting and approval. The loan review system and controls are designed to identify, monitor and address asset quality problems in an accurate and timely manner. On a quarterly basis, the board of directors and management review the status of problem loans and determine a best estimate of the allowance. In addition to internal policies and controls, regulatory authorities periodically review asset quality and the overall adequacy of the allowance for loan losses.



Analysis of the allowance for loan losses as of June 30, 2014 and 2013, and of changes in the allowance for the three and six month periods ended June 30, 2014 and 2013, is as follows (dollars in thousands):

|   | Three months ended June 30, |           | Six months ended June 30, |           |   |
|---|-----------------------------|-----------|---------------------------|-----------|---|
|   | 2014                        | 2013      | 2014                      | 2013      |   |
| Average loans outstanding, net of unearned income   | \$1,007,226                 | \$907,562 | \$998,963                 | \$904,461 |   |
| Allowance-beginning of period   | 13,603                      | 11,984    | 13,249                    | 11,776    |   |
| Charge-offs:  |                             |           |                           |           |   |
| Real estate-mortgage  | 38                          | 102       | 69                        | 238       |   |
| Commercial, financial & agricultural  | 4                           | 15        | 8                         | 215       |   |
| Installment   | 10                          | 5         | 17                        | 10        |   |
| Other   | 50                          | 46        | 88                        | 87        |   |
| Total charge-offs   | 102                         | 168       | 182                       | 550       |   |
| Recoveries:   |                             |           |                           |           |   |
| Real estate-mortgage  | 7                           | 6         | 47                        | 16        |   |
| Commercial, financial & agricultural  | 16                          | 16        | 56                        | 80        |   |
| Installment   | 8                           | 20        | 15                        | 23        |   |
| Other   | 21                          | 21        | 45                        | 54        |   |
| Total recoveries  | 52                          | 63        | 163                       | 173       |   |
| Net charge-offs (recoveries)  | 50                          | 105       | 19                        | 377       |   |
| Provision for loan losses   | 128                         | 252       | 451                       | 732       |   |
| Allowance-end of period   | \$13,681                    | \$12,131  | \$13,681                  | \$12,131  |   |
| Ratio of annualized net charge-offs to average loans  | 0.02                        | % 0.05    | % 0.04                    | % 0.08    | % |
| Ratio of allowance for loan losses to loans outstanding (less unearned interest at end of period) | 1.34                        | % 1.33    | % 1.34                    | % 1.33    | % |
| Ratio of allowance for loan losses to nonperforming loans   | 283.1                       | % 177.5   | % 283.1                   | % 177.5   | % |

The ratio of the allowance for loan losses to nonperforming loans is 283.1% as of June 30, 2014 compared to 177.5% as of June 30, 2013. During the first six months of 2014, the Company had net charge offs of \$19,000 compared to net charge offs of \$377,000 in 2013. There were no significant charge offs during the first six months of 2014.

## Deposits

Funding of the Company's earning assets is substantially provided by a combination of consumer, commercial and public fund deposits. The Company continues to focus its strategies and emphasis on retail core deposits, the major component of funding sources. The following table sets forth the average deposits and weighted average rates for the six months ended June 30, 2014 and 2013 and for the year ended December 31, 2013 (dollars in thousands):

|                        | Six Months Ended June 30, 2014 |                       | Six months ended June 30, 2013 |                       | Year ended December 31, 2013 |                       |   |  |
|------------------------|--------------------------------|-----------------------|--------------------------------|-----------------------|------------------------------|-----------------------|---|--|
|                        | Average Balance                | Weighted Average Rate | Average Balance                | Weighted Average Rate | Average Balance              | Weighted Average Rate |   |  |
| Demand deposits:       |                                |                       |                                |                       |                              |                       |   |  |
| Non-interest-bearing   | \$226,196                      | —                     | % \$246,099                    | —                     | % \$237,373                  | —                     | % |  |
| Interest-bearing       | 554,283                        | 0.13                  | % 540,574                      | 0.16                  | % 544,157                    | 0.15                  | % |  |
| Savings                | 286,123                        | 0.13                  | % 300,333                      | 0.18                  | % 294,615                    | 0.15                  | % |  |
| Time deposits          | 228,484                        | 0.58                  | % 204,448                      | 0.76                  | % 207,454                    | 0.70                  | % |  |
| Total average deposits | \$1,295,086                    | 0.19                  | % \$1,291,454                  | 0.23                  | % \$1,283,599                | 0.21                  | % |  |

The following table sets forth the high and low month-end balances for the six months ended June 30, 2014 and 2013 and for the year ended December 31, 2013 (in thousands):

|   | Six months ended June 30, 2014 | Six months ended June 30, 2013 | Year ended December 31, 2013 |
|---|--------------------------------|--------------------------------|------------------------------|
| High month-end balances of total deposits | \$1,305,825                    | \$1,310,169                    | \$1,310,169                  |
| Low month-end balances of total deposits  | 1,279,569                      | 1,271,134                      | 1,263,941                    |

During the first six months of 2014, the average balance of deposits increased by \$11.5 million from the average balance for the year ended December 31, 2013. Average non-interest bearing deposits decreased by \$11.1 million, average interest bearing account balances increased by \$10.1 million, savings account balances decreased \$8.5 million and balances of time deposits increased \$21.0 million.

Balances of time deposits of \$100,000 or more include time deposits maintained for public fund entities and consumer time deposits. The following table sets forth the maturity of time deposits of \$100,000 or more at June 30, 2014 and December 31, 2013 (in thousands):

|                          | June 30, 2014 | December 31, 2013 |
|--------------------------|---------------|-------------------|
| 3 months or less         | \$27,629      | \$17,946          |
| Over 3 through 6 months  | 29,335        | 12,625            |
| Over 6 through 12 months | 18,885        | 38,084            |
| Over 12 months           | 24,537        | 28,060            |
| Total                    | \$100,386     | \$96,715          |

## Repurchase Agreements and Other Borrowings

Securities sold under agreements to repurchase are short-term obligations of First Mid Bank. First Mid Bank collateralizes these obligations with certain government securities that are direct obligations of the United States or one of its agencies. First Mid Bank offers these retail repurchase agreements as a cash management service to its corporate customers. Other borrowings consist of Federal Home Loan Bank (“FHLB”) advances, federal funds purchased, loans (short-term or long-term debt) that the Company has outstanding and junior subordinated debentures.

Information relating to securities sold under agreements to repurchase and other borrowings as of June 30, 2014 and December 31, 2013 is presented below (dollars in thousands):

|  | June 30, 2014 | December 31, 2013 |  |   |
|--|---------------|-------------------|--|---|
| Securities sold under agreements to repurchase | \$95,159      | \$119,187         |  |   |
| Federal Home Loan Bank advances:               |               |                   |  |   |
| Fixed term – due in one year or less           | 10,000        | 10,000            |  |   |
| Fixed term – due after one year                | —             | 10,000            |  |   |
| Debt:  |               |                   |  |   |
| Debt due in one year or less                   | —             | —                 |  |   |
| Junior subordinated debentures                 | 20,620        | 20,620            |  |   |
| Total  | \$125,779     | \$159,807         |  |   |
| Average interest rate at end of period         | 0.64          | % 0.47            |  | % |
| Maximum outstanding at any month-end:          |               |                   |  |   |
| Securities sold under agreements to repurchase | \$103,213     | \$119,187         |  |   |
| Fed funds                                      | —             | 5,000             |  |   |
| Federal Home Loan Bank advances:               |               |                   |  |   |
| FHLB-Overnight                                 | —             | 11,000            |  |   |
| Fixed term – due in one year or less           | 10,000        | 10,000            |  |   |
| Fixed term – due after one year                | 10,000        | 10,000            |  |   |
| Debt:  |               |                   |  |   |
| Debt due in one year or less                   | 1,000         | —                 |  |   |
| Junior subordinated debentures                 | 20,620        | 20,620            |  |   |
| Averages for the period (YTD):                 |               |                   |  |   |
| Securities sold under agreements to repurchase | \$91,526      | \$87,468          |  |   |
| Federal funds purchased                        | 33            | 1,463             |  |   |
| Federal Home Loan Bank advances:               |               |                   |  |   |
| FHLB-overnight                                 | —             | 2,915             |  |   |
| Fixed term – due in one year or less           | 3,039         | 3,589             |  |   |
| Fixed term – due after one year                | 10,000        | 6,754             |  |   |
| Debt:  |               |                   |  |   |
| Loans due in one year or less                  | 204           | —                 |  |   |
| Junior subordinated debentures                 | 20,620        | 20,620            |  |   |
| Total  | \$125,422     | \$122,809         |  |   |
| Average interest rate during the period        | 0.29          | % 0.68            |  | % |

Securities sold under agreements to repurchase declined \$24.0 million during the first six months of 2014 primarily due to the seasonal declines in balances of various customers. FHLB advances represent borrowings by First Mid Bank to economically fund loan demand. At June 30, 2014 the fixed term advances consisted of \$10 million as follows:

\$5 million advance at .57% with a 2-year maturity, due August 26, 2015

\$5 million advance at 4.58% with a 10-year maturity, due July 13, 2016, one year lockout, callable quarterly

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The Company is party to a revolving credit agreement with The Northern Trust Company in the amount of \$15 million. The balance on this line of credit was \$0 as of June 30, 2014. This loan was renewed on April 18, 2014 for one year as a revolving credit agreement with a maximum available balance of \$15 million. The interest rate is floating at 2.25% over the federal funds rate (2.34% at June 30, 2014). The loan is unsecured and subject to a borrowing agreement containing requirements for the Company and First Mid Bank, including requirements for operating and capital ratios. The Company and its subsidiary bank were in compliance with the then existing covenants at June 30, 2014 and 2013 and December 31, 2013.

On February 27, 2004, the Company completed the issuance and sale of \$10 million of floating rate trust preferred securities through First Mid-Illinois Statutory Trust I (“Trust I”), a statutory business trust and wholly-owned unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust I for the purpose of issuing the trust preferred securities. The \$10 million in proceeds from the trust preferred issuance and an additional \$310,000 for the Company’s investment in common equity of Trust I, a total of \$10,310 000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust I mature in 2034, bear interest at three-month London Interbank Offered Rate (“LIBOR”) plus 280 basis points (3.08% and 3.09% at June 30, 2014 and December 31, 2013), reset quarterly, and are callable at par, at the option of the Company, quarterly. The Company used the proceeds of the offering for general corporate purposes.

On April 26, 2006, the Company completed the issuance and sale of \$10 million of fixed/floating rate trust preferred securities through First Mid-Illinois Statutory Trust II (“Trust II”), a statutory business trust and wholly-owned unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust II for the purpose of issuing the trust preferred securities. The \$10 million in proceeds from the trust preferred issuance and an additional \$310,000 for the Company’s investment in common equity of Trust II, a total of \$10,310 000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust II mature in 2036, bore interest at a fixed rate of 6.98% paid quarterly until June 15, 2011 and then converted to floating rate (LIBOR plus 160 basis points) after June 15, 2011 (1.83% and 1.84% at and June 30, 2014 and December 31, 2013, respectively). The net proceeds to the Company were used for general corporate purposes, including the Company’s acquisition of Mansfield Bancorp, Inc. in 2006.

The trust preferred securities issued by Trust I and Trust II are included as Tier 1 capital of the Company for regulatory capital purposes. On March 1, 2005, the Federal Reserve Board adopted a final rule that allows the continued limited inclusion of trust preferred securities in the calculation of Tier 1 capital for regulatory purposes. The final rule provided a five-year transition period, ending September 30, 2010, for application of the revised quantitative limits. On March 17, 2009, the Federal Reserve Board adopted an additional final rule that delayed the effective date of the new limits on inclusion of trust preferred securities in the calculation of Tier 1 capital until March 31, 2012. The application of the revised quantitative limits did not and is not expected to have a significant impact on its calculation of Tier 1 capital for regulatory purposes or its classification as well-capitalized. The Dodd-Frank Act, signed into law July 21, 2010, removes trust preferred securities as a permitted component of a holding company’s Tier 1 capital after a three-year phase-in period beginning January 1, 2013 for larger holding companies. For holding companies with less than \$15 billion in consolidated assets, existing issues of trust preferred securities are grandfathered and not subject to this new restriction. Similarly, the final rule implementing the Basel III reforms allows holding companies with less than \$15 billion in consolidated assets as of December 31, 2009 to continue to count toward Tier 1 capital any trust preferred securities issued before May 19, 2010. New issuances of trust preferred securities, however would not count as Tier 1 regulatory capital.

In addition to requirements of the Dodd-Frank Act discussed above, the act also required the federal banking agencies to adopt rules that prohibit banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds). This rule is generally referred to as the “Volcker Rule.” On December 10, 2013, the federal banking agencies issued final rules to

implement the prohibitions required by the Volcker Rule. Following the publication of the final rule, and in reaction to concerns in the banking industry regarding the adverse impact the final rule's treatment of certain collateralized debt instruments has on community banks, the federal banking agencies approved an interim final rule to permit banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities. Under the interim final rule, the agencies permit the retention of an interest in or sponsorship of covered funds by banking entities under \$15 billion in assets if (1) the collateralized debt obligation was established and issued prior to May 19, 2010, (2) the banking entity reasonably believes that the offering proceeds received by the collateralized debt obligation were invested primarily in qualifying trust preferred collateral, and (3) the banking entity's interests in the collateralized debt obligation was acquired on or prior to December 10, 2013. Although the Volcker Rule impacts many large banking entities, the Company does not currently anticipate that the Volcker Rule will have a material effect on the operations of the Company or First Mid Bank.

### Interest Rate Sensitivity

The Company seeks to maximize its net interest margin while maintaining an acceptable level of interest rate risk. Interest rate risk can be defined as the amount of forecasted net interest income that may be gained or lost due to changes in the interest rate environment, a variable over which management has no control. Interest rate risk, or sensitivity, arises when the maturity or repricing characteristics of interest-bearing assets differ significantly from the maturity or repricing characteristics of interest-bearing liabilities. The Company monitors its interest rate sensitivity position to maintain a balance between rate sensitive assets and rate sensitive liabilities. This balance serves to limit the adverse effects of changes in interest rates. The Company's asset liability management committee (ALCO) oversees the interest rate sensitivity position and directs the overall allocation of funds.

In the banking industry, a traditional way to measure potential net interest income exposure to changes in interest rates is through a technique known as "static GAP" analysis which measures the cumulative differences between the amounts of assets and liabilities maturing or repricing at various intervals. By comparing the volumes of interest-bearing assets and liabilities that have contractual maturities and repricing points at various times in the future, management can gain insight into the amount of interest rate risk embedded in the balance sheet.

The following table sets forth the Company's interest rate repricing GAP for selected maturity periods at June 30, 2014 (dollars in thousands):

|  | Rate Sensitive Within |             |           |           |           |            | Total       | Fair Value  |
|--|-----------------------|-------------|-----------|-----------|-----------|------------|-------------|-------------|
|  | 1 year                | 1-2 years   | 2-3 years | 3-4 years | 4-5 years | Thereafter |             |             |
| Interest-earning assets:                               |                       |             |           |           |           |            |             |             |
| Federal funds sold and other interest-bearing deposits |                       |             |           |           |           |            |             |             |
|  | \$21,741              | \$—         | \$—       | \$—       | \$—       | \$—        | \$21,741    | \$21,741    |
| Taxable investment securities                          |                       |             |           |           |           |            |             |             |
|  | 703                   | 498         | 5,001     | 28,861    | 34,143    | 300,374    | 369,580     | 369,580     |
| Nontaxable investment securities                       |                       |             |           |           |           |            |             |             |
|  | 10                    | 557         | 1,841     | 404       | 906       | 65,892     | 69,610      | 69,610      |
| Loans  | 426,909               | 149,981     | 160,261   | 169,032   | 57,682    | 58,386     | 1,022,251   | 1,032,967   |
| Total  | \$449,363             | \$151,036   | \$167,103 | \$198,297 | \$92,731  | \$424,652  | \$1,483,182 | \$1,493,898 |
| Interest-bearing liabilities:                          |                       |             |           |           |           |            |             |             |
| Savings and NOW accounts                               |                       |             |           |           |           |            |             |             |
|  | \$146,410             | \$32,079    | \$33,272  | \$46,402  | \$47,747  | \$282,267  | \$588,177   | \$588,177   |
| Money market accounts                                  |                       |             |           |           |           |            |             |             |
|  | 206,546               | 3,418       | 3,513     | 4,558     | 4,652     | 24,592     | 247,279     | 247,279     |
| Other time deposits                                    |                       |             |           |           |           |            |             |             |
|  | 169,830               | 30,059      | 12,908    | 10,231    | 5,722     | 147        | 228,897     | 228,988     |
| Short-term borrowings/debt                             |                       |             |           |           |           |            |             |             |
|  | 95,159                | —           | —         | —         | —         | —          | 95,159      | 95,164      |
| Long-term borrowings/debt                              |                       |             |           |           |           |            |             |             |
|  | 20,620                | 5,000       | 5,000     | —         | —         | —          | 30,620      | 22,707      |
| Total  | \$638,565             | \$70,556    | \$54,693  | \$61,191  | \$58,121  | \$307,006  | \$1,190,132 | \$1,182,315 |
| Rate sensitive assets – rate sensitive liabilities     |                       |             |           |           |           |            |             |             |
|  | \$(189,202)           | \$80,480    | \$112,410 | \$137,106 | \$34,610  | \$117,646  | \$293,050   |             |
| Cumulative GAP   |                       |             |           |           |           |            |             |             |
|  | \$(189,202)           | \$(108,722) | \$3,688   | \$140,794 | \$175,404 | \$293,050  |             |             |
| Cumulative amounts as % of total Rate sensitive assets |                       |             |           |           |           |            |             |             |
|  | (12.8)                | )% 5.4      | % 7.6     | % 9.2     | % 2.3     | % 7.9      | %           |             |
| Cumulative Ratio                                       |                       |             |           |           |           |            |             |             |
|  | (12.8)                | )% (7.3)    | )% 0.2    | % 9.5     | % 11.8    | % 19.8     | %           |             |

The static GAP analysis shows that at June 30, 2014, the Company was liability sensitive, on a cumulative basis, through the twelve-month time horizon. This indicates that future increases in interest rates could have an adverse effect on net interest income.

There are several ways the Company measures and manages the exposure to interest rate sensitivity, including static GAP analysis. The Company's ALCO also uses other financial models to project interest income under various rate scenarios and prepayment/extension assumptions consistent with First Mid Bank's historical experience and with known industry trends. ALCO meets at least monthly to review the Company's exposure to interest rate changes as indicated by the various techniques and to make necessary changes in the composition terms and/or rates of the assets and liabilities. The Company is currently experiencing downward pressure on asset yields resulting from the extended period of historically low interest rates and heightened competition for loans. A continuation of this environment could result in a decline in interest income and the net interest margin.

### Capital Resources

At June 30, 2014, the Company's stockholders' equity had increased \$9.2 million, or 6.2%, to \$158.6 million from \$149.4 million as of December 31, 2013. During the first six months of 2014, net income contributed \$7.6 million to equity before the payment of dividends to stockholders. The change in market value of available-for-sale investment securities increased stockholders' equity by \$5.0 million, net of tax and additional purchases of treasury stock (41,105 shares at an average cost of \$21.94 per share) decreased stockholders' equity by approximately \$902,000.

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Bank holding companies follow minimum regulatory requirements established by the Board of Governors of the Federal Reserve System ("Federal Reserve System"), and First Mid Bank follows similar minimum regulatory requirements established for national banks by the Office of the Comptroller of the Currency ("OCC"). Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary action by regulators that, if undertaken, could have a direct material effect on the Company's financial statements.

Quantitative measures established by each regulatory agency to ensure capital adequacy require the reporting institutions to maintain a minimum total risk-based capital ratio of 8%, a minimum Tier 1 risk-based capital ratio of 4% and a minimum leverage ratio of 3% for the most highly rated banks that do not expect significant growth. All other institutions are required to maintain a minimum leverage ratio of 4%. Management believes that, as of June 30, 2014 and December 31, 2013, the Company and First Mid Bank met all capital adequacy requirements.

As of June 30, 2014, both the Company and First Mid Bank had capital ratios above the required minimums for regulatory capital adequacy, and First Mid Bank had capital ratios that qualified it for treatment as well-capitalized under the regulatory framework for prompt corrective action with respect to banks.



To be categorized as well-capitalized, total risk-based, Tier 1 risk-based and Tier 1 leverage ratios must be maintained as set forth in the following table (dollars in thousands):

|  | Actual     |       | Required Minimum For<br>Capital Adequacy<br>Purposes |         | To Be Well-Capitalized<br>Under Prompt<br>Corrective Action<br>Provisions |          |
|--|------------|-------|--|---------|---|----------|
|  | Amount     | Ratio | Amount   | Ratio   | Amount  | Ratio    |
| June 30, 2014                            |            |       |  |         |   |          |
| Total Capital (to risk-weighted assets)  |            |       |  |         |   |          |
| Company                                  | \$ 176,001 | 15.81 | % \$ 89,068  | > 8.00% | N/A   | N/A      |
| First Mid Bank                           | 168,446    | 15.24 | 88,424   | > 8.00  | \$ 110,531  | > 10.00% |
| Tier 1 Capital (to risk-weighted assets) |            |       |  |         |   |          |
| Company                                  | 162,361    | 14.58 | 44,534   | > 4.00  | N/A   | N/A      |
| First Mid Bank                           | 154,907    | 14.02 | 44,212   | > 4.00  | 66,318  | > 6.00   |
| Tier 1 Capital (to average assets)       |            |       |  |         |   |          |
| Company                                  | 162,361    | 10.43 | 62,246   | > 4.00  | N/A   | N/A      |
| First Mid Bank                           | 154,907    | 10.01 | 61,922   | > 4.00  | 77,402  | > 5.00   |
| December 31, 2013                        |            |       |  |         |   |          |
| Total Capital (to risk-weighted assets)  |            |       |  |         |   |          |
| Company                                  | \$ 170,344 | 15.58 | % \$ 87,472  | > 8.00% | N/A   | N/A      |
| First Mid Bank                           | 161,650    | 14.89 | 86,830   | > 8.00  | \$ 108,538  | > 10.00% |
| Tier 1 Capital (to risk-weighted assets) |            |       |  |         |   |          |
| Company                                  | 157,095    | 14.37 | 43,736   | > 4.00  | N/A   | N/A      |
| First Mid Bank                           | 148,401    | 13.67 | 43,415   | > 4.00  | 65,123  | > 6.00   |
| Tier 1 Capital (to average assets)       |            |       |  |         |   |          |
| Company                                  | 157,095    | 10.12 | 62,069   | > 4.00  | N/A   | N/A      |
| First Mid Bank                           | 148,401    | 9.62  | 61,737   | > 4.00  | 77,171  | > 5.00   |

#### Stock Plans

Participants may purchase Company stock under the following four plans of the Company: the Deferred Compensation Plan, the First Retirement and Savings Plan, the Dividend Reinvestment Plan, and the SI Plan. For more detailed information on these plans, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

At the Annual Meeting of Stockholders held May 23, 2007, the stockholders approved the SI Plan. The SI Plan was implemented to succeed the Company's 1997 Stock Incentive Plan, which had a ten-year term that expired October 21, 2007. The SI Plan is intended to provide a means whereby directors, employees, consultants and advisors of the Company and its Subsidiaries may sustain a sense of proprietorship and personal involvement in the continued development and financial success of the Company and its Subsidiaries, thereby advancing the interests of the Company and its stockholders. Accordingly, directors and selected employees, consultants and advisors may be provided the opportunity to acquire shares of Common Stock of the Company on the terms and conditions established in the SI Plan.

On September 27, 2011, the Board of Directors passed a resolution relating to the SI Plan whereby they authorized and approved the Executive Long-Term Incentive Plan ("LTIP"). The LTIP was implemented to provide methodology for granting Stock Awards and Stock Unit Awards to select senior executives of the Company or any Subsidiary.

A maximum of 300,000 shares of common stock may be issued under the SI Plan. As of June 30, 2014, the Company had awarded 59,500 shares as stock options under the SI plan. There were no stock options granted in 2014 or 2013. The Company awarded 14,770 shares and 14,054 shares during 2014 and 2013, respectively, as 50% Stock Awards and 50% Stock Unit Awards under the SI plan.

## Stock Repurchase Program

Since August 5, 1998, the Board of Directors has approved repurchase programs pursuant to which the Company may repurchase a total of approximately \$61.7 million of the Company's common stock. The repurchase programs approved by the Board of Directors are as follows:

- On August 5, 1998, repurchases of up to 3%, or \$2 million, of the Company's common stock.
- ✚ In March 2000, repurchases up to an additional 5%, or \$4.2 million of the Company's common stock.
- ✚ In September 2001, repurchases of \$3 million of additional shares of the Company's common stock.
- ✚ In August 2002, repurchases of \$5 million of additional shares of the Company's common stock.
- ✚ In September 2003, repurchases of \$10 million of additional shares of the Company's common stock.
- On April 27, 2004, repurchases of \$5 million of additional shares of the Company's common stock.
- On August 23, 2005, repurchases of \$5 million of additional shares of the Company's common stock.
- On August 22, 2006, repurchases of \$5 million of additional shares of the Company's common stock.
- On February 27, 2007, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 13, 2007, repurchases of \$5 million of additional shares of the Company's common stock.
- On December 16, 2008, repurchases of \$2.5 million of additional shares of the Company's common stock.
- On May 26, 2009, repurchases of \$5 million of additional shares of the Company's common stock.
- On February 22, 2011, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 13, 2012, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 19, 2013 repurchases of \$5 million additional shares of the Company's common stock.

During the six months ended June 30, 2014, the Company repurchased 41,105 shares at a total cost of approximately \$902,000. Since 1998, the Company has repurchased a total of 3,448,172 shares at a total price of approximately \$67,607,000. As of June 30, 2014, the Company is authorized per all repurchase programs to purchase \$4,100,000 in additional shares.

## Liquidity

Liquidity represents the ability of the Company and its subsidiaries to meet all present and future financial obligations arising in the daily operations of the business. Financial obligations consist of the need for funds to meet extensions of credit, deposit withdrawals and debt servicing. The Company's liquidity management focuses on the ability to obtain funds economically through assets that may be converted into cash at minimal costs or through other sources. The Company's other sources of cash include overnight federal fund lines, Federal Home Loan Bank advances, deposits of the State of Illinois, the ability to borrow at the Federal Reserve Bank of Chicago, and the Company's operating line of credit with The Northern Trust Company. Details for the sources include:

First Mid Bank has \$35 million available in overnight federal fund lines, including \$10 million from U.S. Bank, N.A., \$10 million from Wells Fargo Bank, N.A. and \$15 million from The Northern Trust Company. Availability of the funds is subject to First Mid Bank meeting minimum regulatory capital requirements for total capital to risk-weighted assets and Tier 1 capital to total average assets. As of June 30, 2014, First Mid Bank met these regulatory requirements.

First Mid Bank can borrow from the Federal Home Loan Bank as a source of liquidity. Availability of the funds is subject to the pledging of collateral to the Federal Home Loan Bank. Collateral that can be pledged includes one-to-four family residential real estate loans and securities. At June 30, 2014, the excess collateral at the FHLB would support approximately \$94.3 million of additional advances.

First Mid Bank is a member of the Federal Reserve System and can borrow funds provided that sufficient collateral is pledged.

In addition, as of June 30, 2014, the Company had a revolving credit agreement in the amount of \$15 million with The Northern Trust Company with an outstanding balance of \$0 and \$15 million in available funds. This loan was renewed on April 18, 2014 for one year as a revolving credit agreement. The interest rate is floating at 2.25% over the federal funds rate. The loan is unsecured and subject to a borrowing agreement containing requirements for the Company and First Mid Bank, including requirements for operating and capital ratios. The Company and its subsidiary bank were in compliance with the then existing covenants at June 30, 2014 and 2013 and December 31, 2013.

Management continues to monitor its expected liquidity requirements carefully, focusing primarily on cash flows from:

- lending activities, including loan commitments, letters of credit and mortgage prepayment assumptions;
- deposit activities, including seasonal demand of private and public funds;
- investing activities, including prepayments of mortgage-backed securities and call provisions on U.S. Treasury and government agency securities; and
- operating activities, including scheduled debt repayments and dividends to stockholders.

The following table summarizes significant contractual obligations and other commitments at June 30, 2014 (in thousands):

|                         | Total     | Less than<br>1 year | 1-3 years | 3-5 years | More than<br>5 years |
|-------------------------|-----------|---------------------|-----------|-----------|----------------------|
| Time deposits           | \$228,897 | \$163,353           | \$45,963  | \$19,434  | \$147                |
| Debt                    | 20,620    | —                   | —         | —         | 20,620               |
| Other borrowings        | 105,159   | 95,159              | 10,000    | —         | —                    |
| Operating leases        | 3,381     | 1,009               | 911       | 628       | 833                  |
| Supplemental retirement | 828       | 50                  | 200       | 178       | 400                  |
|                         | \$358,885 | \$259,571           | \$57,074  | \$20,240  | \$22,000             |

For the six months ended June 30, 2014, net cash of \$8.2 million and \$18.6 million was provided from operating activities and investing activities, respectively and \$34.4 million was used in financing activities. In total, cash and cash equivalents decreased by \$7.6 million since year-end 2013.

#### Off-Balance Sheet Arrangements

First Mid Bank enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include lines of credit, letters of credit and other commitments to extend credit. Each of these instruments involves, to varying degrees, elements of credit, interest rate and liquidity risk in excess of the amounts recognized in the consolidated balance sheets. The Company uses the same credit policies and requires similar collateral in approving lines of credit and commitments and issuing letters of credit as it does in making loans. The exposure to credit losses on financial instruments is represented by the contractual amount of these instruments. However, the Company does not anticipate any losses from these instruments.

The off-balance sheet financial instruments whose contract amounts represent credit risk at June 30, 2014 and December 31, 2013 were as follows (in thousands):

|   | June 30, 2014 | December 31, 2013 |
|---|---------------|-------------------|
| Unused commitments and lines of credit: |               |                   |
| Commercial real estate                  | \$17,542      | \$23,770          |
| Commercial operating                    | 146,477       | 139,395           |
| Home equity                             | 24,445        | 24,071            |
| Other                                   | 49,283        | 52,251            |
| Total                                   | \$237,747     | \$239,487         |
| Standby letters of credit               | \$5,510       | \$4,732           |

Commitments to originate credit represent approved commercial, residential real estate and home equity loans that generally are expected to be funded within ninety days. Lines of credit are agreements by which the Company agrees to provide a borrowing accommodation up to a stated amount as long as there is no violation of any condition established in the loan agreement. Both commitments to originate credit and lines of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the lines and some commitments are expected to expire without being drawn upon, the total amounts do not necessarily represent future cash requirements.

Standby letters of credit are conditional commitments issued by the Company to guarantee the financial performance of customers to third parties. Standby letters of credit are primarily issued to facilitate trade or support borrowing arrangements and generally expire in one year or less. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending credit facilities to customers. The maximum amount of credit that would be extended under letters of credit is equal to the total off-balance sheet contract amount of such instrument.

### ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no material change in the market risk faced by the Company since December 31, 2013. For information regarding the Company's market risk, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

### ITEM 4. CONTROLS AND PROCEDURES

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's "disclosure controls and procedures" (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act), as of the end of the period covered by this report. Based on such evaluation, such officers have concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective. Further, there have been no changes in the Company's internal control over financial reporting during the last fiscal quarter that have materially affected or that are reasonably likely to affect materially the Company's internal control over financial reporting.



PART II

ITEM 1. LEGAL PROCEEDINGS

None.

ITEM 1A. RISK FACTORS

Various risks and uncertainties, some of which are difficult to predict and beyond the Company's control, could negatively impact the Company. As a financial institution, the Company is exposed to interest rate risk, liquidity risk, credit risk, operational risk, risks from economic or market conditions, and general business risks among others. Adverse experience with these or other risks could have a material impact on the Company's financial condition and results of operations, as well as the value of its common stock. See the risk factors and "Supervision and Regulation" described in the Company's Annual Report on Form 10-K for the year ended December 31, 2013.

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

None

See heading "Stock Repurchase Program" for more information regarding stock purchases.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

The exhibits required by Item 601 of Regulation S-K and filed herewith are listed in the Exhibit Index that follows the Signature Page and that immediately precedes the exhibits filed.



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 MID-ILLINOIS BANCSHARES, INC.  
(Registrant)

Date: August 7, 2014

Joseph R. Dively  
President and Chief Executive Officer

Michael L. Taylor  
Chief Financial Officer

Exhibit Index to Quarterly Report on Form 10-Q

Exhibit Number Description and Filing or Incorporation Reference

- 4.1 The Registrant agrees to furnish to the Commission, upon request, a copy of each instrument with respect to issues of long-term debt involving a total amount which does not exceed 10% of the total assets of the Registrant and its subsidiaries on a consolidated basis
- 11.1 Statement re: Computation of Earnings Per Share (Filed herewith on page 12)
- 31.1 Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Certification pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002
- 101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets at June 30, 2014 and December 31, 2013, (ii) the Consolidated Statements of Income for the six months ended June 30, 2014 and 2013, (iii) the Consolidated Statements of Cash Flows for the six months ended June 30, 2014 and 2013, and (iv) the Notes to Consolidated Financial Statements.

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