

FIRST MERCHANTS CORP
Form 10-Q
November 09, 2012

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

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

For the quarterly period ended September 30, 2012

OR

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

For the Transition Period from _____ to _____

Commission File Number 0-17071

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

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

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

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

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

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

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

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

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

As of October 31, 2012, there were 28,672,461 outstanding common shares of the registrant.

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PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
CONSOLIDATED CONDENSED BALANCE SHEETS
(Dollars in thousands)

	September 30, 2012 (Unaudited)	December 31, 2011
ASSETS		
Cash and cash equivalents	\$ 57,027	\$ 73,312
Interest-bearing time deposits	35,324	52,851
Investment securities available for sale	551,619	518,491
Investment securities held to maturity (fair value of \$396,217 and \$442,469)	377,097	427,909
Mortgage loans held for sale	27,711	17,864
Loans, net of allowance for loan losses of \$69,493 and \$70,898	2,766,831	2,642,517
Premises and equipment	51,373	51,013
Federal Reserve and Federal Home Loan Bank stock	32,824	31,270
Interest receivable	17,519	17,723
Core deposit intangibles	8,644	9,114
Goodwill	141,375	141,357
Cash surrender value of life insurance	124,702	124,329
Other real estate owned	13,780	16,289
Tax asset, deferred and receivable	29,344	36,424
Other assets	14,998	12,613
TOTAL ASSETS	\$ 4,250,168	\$ 4,173,076
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 679,818	\$ 646,508
Interest-bearing	2,514,933	2,488,147
Total Deposits	3,194,751	3,134,655
Borrowings:		
Federal funds purchased	57,024	
Securities sold under repurchase agreements	153,454	156,305
Federal Home Loan Bank advances	145,467	138,095
Subordinated debentures and term loans	112,169	194,974
Total Borrowings	468,114	489,374
Interest payable	1,591	2,925
Other liabilities	38,857	31,655
Total Liabilities	3,703,313	3,658,609
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY		
Preferred Stock, no-par value, \$1,000 liquidation value:		
Authorized - 500,000 shares		
Senior Non-Cumulative Perpetual Preferred Stock, Series B		
Issued and outstanding - 90,782.94 shares	90,783	90,783
Cumulative Preferred Stock, \$1,000 par value, \$1,000 liquidation value:		
Authorized - 600 shares		
Issued and outstanding - 125 shares	125	125

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Common Stock, \$.125 stated value:

Authorized - 50,000,000 shares

Issued and outstanding - 28,672,177 and 28,559,707 shares	3,584	3,570
Additional paid-in capital	256,290	254,874
Retained earnings	198,094	168,717
Accumulated other comprehensive loss	(2,021)	(3,602)
Total Stockholders' Equity	546,855	514,467
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 4,250,168	\$ 4,173,076

See notes to consolidated condensed financial statements.

CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
INTEREST INCOME				
Loans receivable:				
Taxable	\$ 38,160	\$ 37,024	\$ 110,660	\$ 113,219
Tax exempt	118	86	358	435
Investment securities:				
Taxable	4,176	5,078	13,218	14,665
Tax exempt	2,532	2,529	7,645	7,617
Federal funds sold				3
Deposits with financial institutions	16	45	69	228
Federal Reserve and Federal Home Loan Bank stock	345	323	1,035	1,005
Total Interest Income	45,347	45,085	132,985	137,172
INTEREST EXPENSE				
Deposits	3,517	5,046	11,566	17,776
Federal funds purchased	38	16	62	22
Securities sold under repurchase agreements	211	384	703	1,148
Federal Home Loan Bank advances	492	1,089	2,123	3,067
Subordinated debentures and term loans	1,187	2,699	4,460	7,984
Total Interest Expense	5,445	9,234	18,914	29,997
NET INTEREST INCOME	39,902	35,851	114,071	107,175
Provision for loan losses	4,609	5,556	14,029	16,775
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	35,293	30,295	100,042	90,400
OTHER INCOME				
Service charges on deposit accounts	2,913	3,169	8,625	8,945
Fiduciary activities	1,986	1,881	5,907	5,846
Other customer fees	2,740	2,583	8,476	7,452
Commission income	1,618	1,528	4,770	4,440
Earnings on cash surrender value of life insurance	685	644	2,725	1,793
Net gains and fees on sales of loans	2,849	1,768	7,115	4,671
Net realized gains on sales of available for sale securities	843	861	2,134	2,149
Other-than-temporary impairment on available for sale securities				(2,780)
Portion of loss recognized in other comprehensive income before taxes				2,380
Net impairment losses recognized in earnings				(400)
Gain on FDIC modified whole bank transaction			9,124	
Other income	639	796	1,220	1,253
Total Other Income	14,273	13,230	50,096	36,149
OTHER EXPENSES				
Salaries and employee benefits	20,083	19,964	59,078	55,700
Net occupancy	2,568	2,530	7,692	7,690
Equipment	1,798	1,662	5,259	5,122

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Marketing	536	534	1,542	1,352
Outside data processing fees	1,413	1,391	4,295	4,294
Printing and office supplies	287	301	848	902
Core deposit amortization	489	755	1,438	2,957
FDIC assessments	792	1,201	2,771	4,756
Other real estate owned and credit-related expenses	2,104	2,007	6,412	8,045
Other expenses	4,334	3,877	13,277	11,684
Total Other Expenses	34,404	34,222	102,612	102,502
INCOME BEFORE INCOME TAX	15,162	9,303	47,526	24,047
Income tax expense	3,926	2,561	12,714	6,356
NET INCOME	11,236	6,742	34,812	17,691
Loss on retirement of CPP preferred stock		(1,401)		(1,401)
Loss on extinguishment of trust preferred securities		(10,857)		(10,857)
Preferred stock dividends and discount accretion	(1,134)	(868)	(3,404)	(2,846)
NET INCOME (LOSS) AVAILABLE TO COMMON STOCKHOLDERS	\$ 10,102	\$ (6,384)	\$ 31,408	\$ 2,587

Per Share Data:

Basic Net Income (Loss) Available to Common Stockholders	\$ 0.35	\$ (0.25)	\$ 1.09	\$ 0.10
Diluted Net Income (Loss) Available to Common Stockholders	\$ 0.35	\$ (0.25)	\$ 1.09	\$ 0.10
Cash Dividends Paid	\$ 0.03	\$ 0.01	\$ 0.07	\$ 0.03
Average Diluted Shares Outstanding (in thousands)	28,888	26,367	28,819	26,019

See notes to consolidated condensed financial statements.

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(Dollars in thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income	\$ 11,236	\$ 6,742	\$ 34,812	\$ 17,691
Other comprehensive income net of tax:				
Unrealized holding gain on securities available for sale arising during the period,				
net of income tax of \$1,018, \$4,553, \$1,670, and \$8,212	1,891	8,457	3,102	15,255
Unrealized loss on securities available for sale for which a portion of an other than temporary impairment has been recognized in income, net of tax of \$12, \$0, \$43, and \$831	(22)		(80)	(1,546)
Unrealized loss on cash flow hedges arising during the period,				
net of income tax of \$131, \$778, \$535, and \$949	(244)	(1,446)	(994)	(1,762)
Amortization of items previously recorded in accumulated other comprehensive income (loss), net of income tax of \$113, \$10, \$506, and \$29	210	(18)	940	(53)
Reclassification adjustment for gains included in net income net of income tax expense of \$295, \$301, \$747, and \$612	(549)	(560)	(1,387)	(1,137)
	1,286	6,433	1,581	10,757
Comprehensive income	\$ 12,522	\$ 13,175	\$ 36,393	\$ 28,448

The components of accumulated other comprehensive loss, net of tax, included in stockholders' equity, are as follows:

	September 30, 2012	December 31, 2011
Net unrealized gain on securities available for sale	\$ 19,959	\$ 18,244
Net unrealized loss on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in income	(3,248)	(3,168)
Net unrealized loss on cash flow hedges	(2,834)	(1,841)
Defined benefit plans	(15,898)	(16,837)
	\$ (2,021)	\$ (3,602)

See notes to consolidated condensed financial statements.

CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY

(Dollars in thousands, except per share data)

(Unaudited)

	Preferred		Common Stock		Additional Paid in	Retained	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount	Capital	Earnings		
Balances, December 31, 2011	90,908	\$ 90,908	28,559,707	\$ 3,570	\$ 254,874	\$ 168,717	\$ (3,602)	\$ 514,467
Comprehensive Income								
Net Income						34,812		34,812
Other Comprehensive Income, net of tax							1,581	1,581
Cash Dividends on Common Stock (\$0.07 per Share)						(2,031)		(2,031)
Cash Dividends on Preferred Stock under Small Business Lending Fund						(3,404)		(3,404)
Share-based Compensation			79,385	10	1,091			1,101
Stock Issued Under Employee Benefit Plans			34,352	4	350			354
Stock Issued Under Dividend Reinvestment and Stock Purchase Plan			11,475	1	142			143
Stock options exercised			8,750	1	66			67
Stock Redeemed			(21,492)	(2)	(233)			(235)
Balances, September 30, 2012	90,908	\$ 90,908	28,672,177	\$ 3,584	\$ 256,290	\$ 198,094	\$ (2,021)	\$ 546,855

See notes to consolidated condensed financial statements.

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

	September 30,	
	2012	2011
Cash Flow From Operating Activities:		
Net income	\$ 34,812	\$ 17,691
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	14,029	16,775
Depreciation and amortization	3,432	3,998
Change in deferred taxes	11,239	7,211
Share-based compensation	1,101	1,009
Mortgage loans originated for sale	(314,240)	(185,658)
Proceeds from sales of mortgage loans	304,393	194,870
Gain on acquisition	(9,124)	
Gains on sales of securities available for sale	(2,134)	(2,149)
Recognized loss on other-than-temporary-impairment		400
Change in interest receivable	732	904
Change in interest payable	(1,701)	(2,076)
Other adjustments	4,650	14,171
Net cash provided by operating activities	\$ 47,189	\$ 67,146
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	\$ 17,527	\$ 49,101
Purchases of:		
Securities available for sale	(129,297)	(133,526)
Securities held to maturity	(566)	(77,678)
Proceeds from sales of securities available for sale	43,147	54,606
Proceeds from maturities of:		
Securities available for sale	77,898	37,894
Securities held to maturity	49,073	28,120
Change in Federal Reserve and Federal Home Loan Bank stock	207	2,503
Purchase of bank owned life insurance		(25,000)
Net change in loans	(52,442)	73,520
Net cash received from acquisition	29,113	
Proceeds from the sale of other real estate owned	4,295	9,916
Other adjustments	351	6,921
Net cash provided by investing activities	\$ 39,306	\$ 26,377
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	\$ 42,994	\$ (54,157)
Certificates of deposit and other time deposits	(108,807)	(150,473)
Borrowings	138,127	242,323
Repayment of borrowings	(169,988)	(168,894)
Cash dividends on common stock	(2,031)	(778)
Cash dividends on preferred stock	(3,404)	(2,527)
Stock issued in private equity placement		21,165
Stock issued under employee benefit plans	354	561
Stock issued under dividend reinvestment and stock purchase plans	143	60

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Stock options exercised	67	
Stock redeemed	(235)	(127)
Cumulative preferred stock issued (SBLF)		90,783
Cumulative preferred stock redeemed (CPP)		(69,600)
Net cash used in financing activities	\$ (102,780)	\$ (91,664)
Net Change in Cash and Cash Equivalents	(16,285)	1,859
Cash and Cash Equivalents, January 1	73,312	58,307
Cash and Cash Equivalents, September 30	\$ 57,027	\$ 60,166
Additional cash flow information:		
Interest paid	\$ 20,248	\$ 32,073
Income tax paid (refunded)	\$ 5,988	\$ (2,977)
Loans transferred to other real estate owned	\$ 4,364	\$ 12,646
Non-cash investing activities using trade date accounting	\$ 3,043	\$ 2,298

See notes to consolidated condensed financial statements.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 1. General

Financial Statement Preparation

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

The consolidated condensed balance sheet of the Corporation as of December 31, 2011, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation’s annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation’s Form 10-K annual report filed with the Securities and Exchange Commission. The results of operations for the nine months ended September 30, 2012, are not necessarily indicative of the results to be expected for the year.

NOTE 2. Purchase and Assumption

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

Under the terms of the Agreement, the Bank acquired \$147.7 million in assets, including approximately \$11.9 million of cash and cash equivalents, \$18.9 million of marketable securities, \$1.8 million in Federal Home Loan Bank stock, \$113.0 million in loans and \$2.1 million of premises and other assets. The Bank assumed approximately \$135.7 million of liabilities, including approximately \$125.7 million in customer deposits, \$9.6 million of other borrowed money and \$402,000 in other liabilities. These balances are book balances and do not reflect the fair value adjustments which are shown on the following table. The acquisition did not include any loss sharing agreement with the FDIC.

The bid accepted by the FDIC included no deposit premium. The assets were acquired at a discount of \$29.0 million from book value. The FDIC made a payment of \$17.2 million to the Bank upon the final closing date balance sheet for SCB Bank that reflected the difference between the purchase price of the assets acquired and the value of the liabilities assumed.

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Purchase and Assumption continued

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

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

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

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

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

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

Preliminary estimate of contractually required principal and interest at acquisition	\$ 31,143
Preliminary estimate of contractual cash flows not expected to be collected (nonaccretable differences)	9,688

Preliminary estimate of expected cash flows at acquisition	21,455
Preliminary estimate of interest component of expected cash flows (accretable discount)	4,152
Preliminary estimate of fair value of acquired loans accounted for under ASC 310-30	\$ 17,303

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 2. Purchase and Assumption continued

The carrying amount of these loans is included in the balance sheet amounts of loans receivable at September 30, 2012. The amounts are as follows:

	September 30, 2012
Commercial and industrial loans	\$ 12,494
Agricultural production finance and other loans to farmers	1,531
Real estate loans	
Construction	92
Commercial and farmland	23,724
Residential	32,936
Individuals' loans for household and other personal expenditures	922
Tax exempt	
Lease financing	
Other loans	987
Total	\$ 72,686

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

	Three Months ended September 30, 2012
Beginning balance, June 30, 2012	\$ 9,048
Accretions	(2,612)
Ending balance, September 30, 2012	\$ 6,436

	Nine Months ended September 30, 2012
Beginning balance, February 10, 2012	\$ 9,774
Accretions	(3,338)
Ending balance, September 30, 2012	\$ 6,436

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 3. Investment Securities

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at September 30, 2012				
U.S. Government-sponsored agency securities	\$ 4,610	\$ 172		\$ 4,782
State and municipal	150,281	10,761	\$ 25	161,017
U.S. Government-sponsored mortgage-backed securities	370,800	13,142	30	383,912
Corporate obligations	6,008		5,806	202
Equity securities	1,706			1,706
Total available for sale	533,405	24,075	5,861	551,619
Held to maturity at September 30, 2012				
State and municipal	116,966	5,698		122,664
U.S. Government-sponsored mortgage-backed securities	260,131	13,422		273,553
Total held to maturity	377,097	19,120		396,217
Total Investment Securities	\$ 910,502	\$ 43,195	\$ 5,861	\$ 947,836

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2011				
U.S. Government-sponsored agency securities	\$ 99	\$ 18		\$ 117
State and municipal	136,857	10,496		147,353
U.S. Government-sponsored mortgage-backed securities	358,928	10,086	\$ 16	368,998
Corporate obligations	5,765		5,572	193
Equity securities	1,830			1,830
Total available for sale	503,479	20,600	5,588	518,491
Held to maturity at December 31, 2011				
State and municipal	120,171	3,785		123,956
U.S. Government-sponsored mortgage-backed securities	307,738	10,775		318,513
Total held to maturity	427,909	14,560		442,469
Total Investment Securities	\$ 931,388	\$ 35,160	\$ 5,588	\$ 960,960

The amortized cost and fair value of available for sale securities and held to maturity securities at September 30, 2012, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

Available for Sale		Held to Maturity	
Amortized	Fair	Amortized	Fair

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	Cost	Value	Cost	Value
Maturity Distribution at September 30, 2012:				
Due in one year or less	\$ 4,802	\$ 4,846	\$ 2,425	\$ 2,431
Due after one through five years	14,559	15,277	2,208	2,233
Due after five through ten years	48,134	51,156	55,679	57,975
Due after ten years	93,404	94,722	56,654	60,025
	160,899	166,001	116,966	122,664
U.S. Government-sponsored mortgage-backed securities	370,800	383,912	260,131	273,553
Equity securities	1,706	1,706		
Total Investment Securities	\$ 533,405	\$ 551,619	\$ 377,097	\$ 396,217

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$348,748,000 at September 30, 2012, and \$299,478,000 at December 31, 2011.

The book value of securities sold under agreements to repurchase amounted to \$148,486,000 at September 30, 2012, and \$129,311,000 at December 31, 2011.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Investment Securities continued

Gross gains and losses on the sales and redemptions of available for sale securities, and other-than-temporary impairment ("OTTI") losses recognized for the three and nine months ended September 30, 2012 and 2011 are shown below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Sales and Redemptions of Available for Sale Securities:				
Gross gains	\$ 843	\$ 861	\$ 2,134	\$ 2,149
Gross losses				
Other-than-temporary impairment losses			\$ 400	

The Corporation's management has evaluated all securities with unrealized losses for OTTI as of September 30, 2012. The evaluations are based on the nature of the securities, the extent and duration of the loss and the intent and ability of the Corporation to hold these securities either to maturity or through the expected recovery period.

The current unrealized losses are primarily concentrated within trust preferred securities held by the Corporation. Such investments have an amortized cost of \$6.0 million and a fair value of \$171,000, which is less than 1 percent of the Corporation's entire investment portfolio. On all but one small pool investment, the Corporation utilized Moody's to determine their fair value.

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

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Investment Securities continued

The following table shows the Corporation's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2012, and December 31, 2011:

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Investment Securities at September 30, 2012						
State and municipal	\$ 3,868	\$ (25)			\$ 3,868	\$ (25)
U.S. Government-sponsored mortgage-backed securities	6,463	(30)			6,463	(30)
Corporate obligations			\$ 171	\$ (5,806)	171	(5,806)
Total Temporarily Impaired Investment Securities	\$ 10,331	\$ (55)	\$ 171	\$ (5,806)	\$ 10,502	\$ (5,861)

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Investment Securities at December 31, 2011						
State and municipal						
U.S. Government-sponsored mortgage-backed securities	\$ 6,176	\$ (16)			\$ 6,176	\$ (16)
Corporate obligations			\$ 163	\$ (5,572)	163	(5,572)
Total Temporarily Impaired Investment Securities	\$ 6,176	\$ (16)	\$ 163	\$ (5,572)	\$ 6,339	\$ (5,588)

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

	September 30, 2012	December 31, 2011
Investments reported at less than historical cost:		
Historical cost	\$ 16,364	\$ 11,925
Fair value	\$ 10,502	\$ 6,339

Percent of the Corporation's available for sale and held to maturity portfolio	1.1%	0.7%
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Except as discussed below, management believes the declines in fair value for these securities are temporary. Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the OTTI is identified.

U.S. Government-Sponsored Mortgage-Backed Securities

The unrealized losses on the Corporation's investment in U.S. Government-sponsored mortgage-backed securities were a result of changes in interest rates. The Corporation expects to recover the amortized cost basis over the term of the securities as the decline in market value is attributable to changes in interest rates and not credit quality. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2012.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Investment Securities continued

State and Municipal

The unrealized losses on the Corporation's investments in securities of state and political subdivisions were caused by changes in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2012.

Corporate Obligations

The Corporation's unrealized losses on Corporate Obligations were due to the decline in value related to the pooled trust preferred securities, and is attributable to temporary illiquidity and the financial crisis affecting these markets, coupled with the potential credit loss resulting from the adverse change in expected cash flows. Due to the illiquidity in the market, it is unlikely that the Corporation would be able to recover its investment in these securities if the Corporation sold the securities at this time. Management has analyzed the cash flow characteristics of the securities and this analysis included utilizing the most recent trustee reports and any other relevant market information, including announcements of deferrals or defaults of trust preferred securities. The Corporation compared expected discounted cash flows, based on performance indicators of the underlying assets in the security, to the carrying value of the investment to determine if OTTI existed. The Corporation does not consider the remainder of the investment securities, which are classified as Level 3 inputs in the fair value hierarchy, to be other-than-temporarily impaired at September 30, 2012. The Corporation does not intend to sell the investment, and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity.

Credit Losses Recognized on Investments

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

	Accumulated Credit Losses in 2012	Accumulated Credit Losses in 2011
Credit losses on debt securities held:		
Balance, January 1	\$ 11,355	\$ 10,955
Additions related to other-than-temporary losses not previously recognized		400
Balance, September 30	\$ 11,355	\$ 11,355

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance

The Corporation's primary lending focus is small business and middle market commercial, residential real estate, auto and small consumer lending, which results in portfolio diversification. The following tables show the composition in the loan portfolio, loan grades and the allowance for loan losses excluding loans held for sale. Residential real estate loans held for sale at September 30, 2012, and December 31, 2011, were \$27,711,000 and \$17,864,000, respectively.

Effective February 10, 2012, the Bank assumed \$113.0 million in loans as part of the Purchase and Assumption Agreement discussed in NOTE 2. PURCHASE AND ASSUMPTION included in the Notes to Consolidated Condensed Financial Statements of this Form 10-Q. This loan portfolio was acquired at a fair value discount of \$19.2 million.

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

	September 30, 2012	December 31, 2011
Loans:		
Commercial and industrial loans	\$ 592,517	\$ 532,523
Agricultural production financing and other loans to farmers	107,166	104,526
Real estate loans:		
Construction	93,610	81,780
Commercial and farm land	1,241,054	1,194,230
Residential	475,272	481,493
Home Equity	204,888	191,631
Individual's loans for household and other personal expenditures	77,171	84,172
Lease financing receivables, net of unearned income	2,970	3,555
Other loans	41,676	39,505
	2,836,324	2,713,415
Allowance for loan losses	(69,493)	(70,898)
Total Loans	\$ 2,766,831	\$ 2,642,517

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. The allowance is increased by the provision for loan losses and decreased by charge offs less recoveries. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off. The Bank charges off loans when a determination is made that all or a portion of a loan is uncollectible. The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings.

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

management's judgment as to the impact of current economic conditions on the portfolio.

Management believes that the allowance for loan losses is adequate to cover probable incurred losses inherent in the loan portfolio at September 30, 2012. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments, to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examination processes, and will increase or decrease as deemed necessary to ensure the allowance for loan losses remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

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

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

The risk characteristics of the Corporation's material portfolio segments are as follows:

Commercial

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

Commercial real estate

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

Residential and Consumer

With respect to residential loans that are secured by 1-4 family residences and are generally owner occupied, the Corporation generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer loans are secured by consumer assets such as automobiles or recreational vehicles. Some consumer loans are unsecured such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income and credit rating of the borrowers, which can be impacted by economic conditions in their market areas such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

The following tables summarize changes in the allowance for loan losses by loan segment for the three and nine months ended September 30, 2012, and September 30, 2011:

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

Nine Months Ended September 30, 2012						
	Commercial	Real Estate Commercial	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, January 1	\$ 17,731	\$ 37,919	\$ 2,902	\$ 12,343	\$ 3	\$ 70,898
Provision for losses	10,333	149	(14)	3,565	(4)	14,029
Recoveries on loans	1,193	3,462	595	968	1	6,219
Loans charged off	(6,933)	(10,117)	(854)	(3,749)		(21,653)
Balances, September 30, 2012	\$ 22,324	\$ 31,413	\$ 2,629	\$ 13,127		\$ 69,493

Three Months Ended September 30, 2011						
	Commercial	Real Estate Commercial	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, April 1	\$ 23,715	\$ 38,668	\$ 2,859	\$ 11,877	\$ 14	\$ 77,133
Provision for losses	(903)	3,042	281	3,142	(6)	5,556
Recoveries on loans	1,176	378	163	237	1	1,955
Loans charged off	(4,344)	(5,003)	(266)	(1,957)		(11,570)
Balances, September 30, 2011	\$ 19,644	\$ 37,085	\$ 3,037	\$ 13,299	\$ 9	\$ 73,074

Nine Months Ended September 30, 2011						
	Commercial	Real Estate Commercial	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						

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Balances, January 1	\$	32,508	\$	36,341	\$	3,622	\$	10,408	\$	98	\$	82,977
Provision for losses		(14,778)		24,232		(187)		7,601		(93)		16,775
Recoveries on loans		8,174		1,244		781		934		4		11,137
Loans charged off		(6,260)		(24,732)		(1,179)		(5,644)				(37,815)
Balances, September 30, 2011	\$	19,644	\$	37,085	\$	3,037	\$	13,299	\$	9	\$	73,074

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

The following table shows the Corporation's allowance for credit losses and loan portfolio by loan segment for the periods indicated:

		September 30, 2012						
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total		
Allowance Balances:								
Individually evaluated for impairment	\$ 1,775	\$ 4,157		\$ 319		\$	6,251	
Collectively evaluated for impairment	20,549	27,256	\$ 2,629	12,808			63,242	
Total Allowance for Loan Losses	\$ 22,324	\$ 31,413	\$ 2,629	\$ 13,127		\$	69,493	
Loan Balances:								
Individually evaluated for impairment	\$ 16,286	\$ 54,773		\$ 8,906		\$	79,965	
Collectively evaluated for impairment	725,073	1,279,891	\$ 77,171	671,254	\$ 2,970		2,756,359	
Total Loans	\$ 741,359	\$ 1,334,664	\$ 77,171	\$ 680,160	\$ 2,970	\$	2,836,324	
		December 31, 2011						
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total		
Allowance Balances:								
Individually evaluated for impairment	\$ 4,701	\$ 2,504		\$ 733		\$	7,938	
Collectively evaluated for impairment	13,030	35,415	\$ 2,902	11,610	\$ 3		62,960	
Total Allowance for Loan Losses	\$ 17,731	\$ 37,919	\$ 2,902	\$ 12,343	\$ 3	\$	70,898	
Loan Balances:								
Individually evaluated for impairment	\$ 18,793	\$ 51,980		\$ 12,546		\$	83,319	
Collectively evaluated for impairment	657,760	1,224,031	\$ 84,172	660,578	\$ 3,555		2,630,096	
Total Loans	\$ 676,553	\$ 1,276,011	\$ 84,172	\$ 673,124	\$ 3,555	\$	2,713,415	

Loans are reclassified to a non-accruing status when, in management's judgment, the collateral value and financial condition of the borrower do not justify accruing interest. Interest previously recorded, but not deemed collectible, is

reversed and charged against current income. Payments subsequently received on nonaccrual loans are applied to principal. A loan is returned to accrual status when principal and interest are no longer past due and collectability is probable, typically after a minimum of six consecutive months of performance. Payments received on impaired accruing or delinquent loans are applied to interest income as accrued.

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

	September 30, 2012	December 31, 2011
Commercial and Industrial	\$ 12,507	\$ 12,246
Real Estate Loans:		
Construction	5,440	8,990
Commercial and farm land	24,501	31,093
Residential	12,444	14,805
Home Equity	1,761	1,896
Individuals loans for household and other personal expenditures	3	1
Lease financing receivables, net of unearned income	337	
Other Loans	6	561
Total	\$ 56,999	\$ 69,592

Commercial impaired loans include all non-accrual loans, loans accounted for under SOP-03-3 and renegotiated loans, as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

Impaired loans are measured by the present value of expected future cash flows or the fair value of the collateral of the loans, if collateral dependent. The fair value for impaired loans is measured based on the value of the collateral securing those loans and is determined using several methods. The fair value of real estate is generally based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral, such as business assets, is typically valued by using financial information such as financial statements and aging reports provided by the borrower and is discounted as considered appropriate.

The following table shows the composition of the Corporation's commercial impaired loans by loan class as of September 30, 2012:

	September 30, 2012			Three Months Ended September 30, 2012		Nine Months Ended September 30, 2012	
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:							
Commercial and industrial	\$ 27,363	\$ 10,743		\$ 9,994	\$ 26	\$ 11,615	\$ 68
Agriculture production financing and other loans to farmers	300	300		300		300	
Real Estate Loans:							
Construction	10,743	6,378		6,658	17	7,665	47
Commercial and farm land	52,953	35,606		31,081	250	33,459	706
Residential	9,307	6,716		6,936	20	7,342	54
Home equity	3,901	711		713	3	727	10
Other loans	87	16		17		18	1
Total	\$ 104,654	\$ 60,470		\$ 55,699	\$ 316	\$ 61,126	\$ 886

Impaired loans with
related allowance:

Commercial and industrial	\$ 5,570	\$ 5,227	\$ 1,775	\$ 5,244	\$ 11	\$ 5,307	\$ 32
Real Estate Loans:							
Construction	725	480	51	510		541	
	13,021	12,309	4,106	12,326	32	12,371	95

Commercial and farm land									
Residential	1,578	1,479	319	1,485	19	1,485	56		
Total	\$ 20,894	\$ 19,495	\$ 6,251	\$ 19,565	\$ 62	\$ 19,704	\$ 183		
Total Impaired Loans	\$ 125,548	\$ 79,965	\$ 6,251	\$ 75,264	\$ 378	\$ 80,830	\$ 1,069		

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

The following table shows the composition of the Corporation's commercial impaired loans by loan class as of December 31, 2011:

	December 31, 2011				
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:					
Commercial and industrial	\$ 23,364	\$ 10,116		\$ 13,399	\$ 615
Real Estate Loans:					
Construction	14,301	7,701		8,836	
Commercial and farm land	49,242	34,571		39,032	591
Residential	7,491	6,185		6,539	20
Home equity	4,425	1,241		1,500	15
Other loans	99	21		24	
Total	\$ 98,922	\$ 59,835		\$ 69,330	\$ 1,241
Impaired loans with related allowance:					
Commercial and industrial	\$ 8,691	\$ 8,104	\$ 4,142	\$ 8,196	\$ 174
Real Estate Loans:					
Construction	961	961	321	961	
Commercial and farm land	12,115	8,748	2,183	10,028	140
Residential	1,888	1,575	391	1,687	7
Other loans	579	552	559	590	
Total	\$ 24,234	\$ 19,940	\$ 7,596	\$ 21,462	\$ 321
Total Impaired Loans	\$ 123,156	\$ 79,775	\$ 7,596	\$ 90,792	\$ 1,562

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

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

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

Special Mention – Loans which possess some credit deficiency or potential weakness, which deserves close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Corporation's credit position at some future date. Special mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification. The key distinctions of this category's classification are that it is indicative of an unwarranted level of risk; and weaknesses are considered

“potential”, not “defined”, impairments to the primary source of repayment. Examples include businesses that may be suffering from inadequate management, loss of key personnel or significant customer or litigation.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

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

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

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

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

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

September 30, 2012

	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Consumer Performing	Consumer Non-Performing	Total Loans
Commercial and industrial	\$ 524,180	\$ 25,143	\$ 36,564	\$ 6,630			\$ 592,517
Agriculture production financing and other loans	106,775	230	161				107,166
Real Estate Loans:							
Construction	78,655	1,639	13,140			\$ 176	93,610
Commercial and farm land	1,105,407	48,344	86,500	475		328	1,241,054
Residential	142,394	4,909	14,709	1,360	\$ 304,255	7,645	475,272
Home equity	11,036	1,344	1,021		189,938	1,549	204,888
Individuals loans for household and other personal expenditures					77,168	3	77,171
Lease financing receivables, net of unearned income					2,633	337	2,970
Other loans	41,640		36				41,676
Total	\$ 2,010,087	\$ 81,609	\$ 152,131	\$ 8,465	\$ 573,994	\$ 10,038	\$ 2,836,324

December 31, 2011

	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Consumer Performing	Consumer Non-Performing	Total Loans
Commercial and industrial	\$ 478,885	\$ 22,405	\$ 28,025	\$ 3,208			\$ 532,523
Agriculture production financing	101,289	1,582	1,655				104,526

and other loans								
Real Estate Loans:								
Construction	47,611	3,672	22,376		\$ 7,762	\$ 359		81,780
Commercial								
and farm land	1,033,397	54,697	103,330	1,724	1,035	47		1,194,230
Residential	139,237	9,175	16,699	500	308,306	7,576		481,493
Home equity	15,912	499	3,317		170,776	1,127		191,631
Individuals loans								
for household								
and other								
personal								
expenditures					84,121	51		84,172
Lease financing								
receivables, net								
of unearned								
income					3,555			3,555
Other loans	38,917	15	21	552				39,505
Total	\$ 1,855,248	\$ 92,045	\$ 175,423	\$ 5,984	\$ 575,555	\$ 9,160		\$ 2,713,415

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 4. Loans and Allowance continued

The following table shows a past due aging of the Corporation's loan portfolio, by loan class for September 30, 2012, and December 31, 2011:

	September 30, 2012						Total Past Due & Non-Accrual	Total Loans
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual			
Commercial and industrial	\$ 574,730	\$ 4,800	\$ 434	\$ 46	\$ 12,507	\$ 17,787		\$ 592,517
Agriculture production financing and other loans	106,782	74	10	300		384		107,166
Real Estate Loans:								
Construction	87,829	341			5,440	5,781		93,610
Commercial and farm land	1,209,194	6,931	65	363	24,501	31,860		1,241,054
Residential	453,234	5,835	2,788	971	12,444	22,038		475,272
Home equity	200,402	1,532	899	294	1,761	4,486		204,888
Individuals loans for household and other personal expenditures	76,053	720	395		3	1,118		77,171
Lease financing receivables, net of unearned income	2,633				337	337		2,970
Other loans	41,670				6	6		41,676
Total	\$ 2,752,527	\$ 20,233	\$ 4,591	\$ 1,974	\$ 56,999	\$ 83,797		\$ 2,836,324

	December 31, 2011						Total Past Due & Non-Accrual	Total Loans
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual			
Commercial and industrial	\$ 518,764	\$ 1,332	\$ 135	\$ 46	\$ 12,246	\$ 13,759		\$ 532,523
Agriculture production financing and other	104,464	62				62		104,526

loans							
Real Estate Loans:							
Construction	69,305	328	3,126	31	8,990	12,475	81,780
Commercial							
and farm land	1,140,897	16,457	5,783		31,093	53,333	1,194,230
Residential	458,925	5,485	2,087	191	14,805	22,568	481,493
Home equity	187,788	1,096	590	261	1,896	3,843	191,631
Individuals loans							
for household and							
other							
personal							
expenditures	82,837	1,075	208	51	1	1,335	84,172
Lease financing							
receivables, net of							
unearned							
income	3,555						3,555
Other loans	38,944				561	561	39,505
Total	\$ 2,605,479	\$ 25,835	\$ 11,929	\$ 580	\$ 69,592	\$ 107,936	\$ 2,713,415

See the information regarding the analysis of loan loss experience in the Loan Quality/Provision for Loan Losses section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as ITEM 2 of this Form 10-Q.

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 4. Loans and Allowance continued

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

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

	Three Months Ended September 30, 2011			Nine Months Ended September 30, 2011		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and Industrial	\$ 535	\$ 552	5	\$ 1,636	\$ 1,651	10
Real Estate Loans:						
Construction	40	41	1	175	184	3
Commercial and farm						
land	379	379	1	4,357	4,346	6
Residential	1,034	1,407	10	2,690	3,115	30
Home Equity				82	87	8
Total	\$ 1,988	\$ 2,379	17	\$ 8,940	\$ 9,383	57

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 4. Loans and Allowance continued

The following table shows the recorded investment, as of September 30, 2012, of troubled debt restructurings that occurred during the periods indicated:

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

	Term Modification	Nine Months Ended September 30, 2012		Total Modification
		Rate Modification	Combination	
Commercial and industrial	\$ 230		\$ 1,072	\$ 1,302
Real Estate Loans:				
Construction			639	639
Commercial and farm land	1,693	\$ 680	385	2,758
Residential	528	252	1,100	1,880
Individuals loans for household and other personal expenditures		7	109	116
Total	\$ 2,451	\$ 939	\$ 3,305	\$ 6,695

Residential real estate loans account for 29 percent and 48 percent of the troubled debt restructured loans made in the three and nine months ended September 30, 2012, respectively. Three and eleven troubled debt restructured loans made during the three and nine months ended September 30, 2012, respectively, are in non accrual status.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 4. Loans and Allowance continued

The following tables summarize troubled debt restructures that occurred during the twelve months ended September 30, 2012, and September 30, 2011, that subsequently defaulted during the period indicated:

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

	Three Months Ended September 30, 2011		Nine Months Ended September 30, 2011	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Commercial and Industrial	1	\$ 66	2	\$ 553
Real Estate Loans:				
Commercial and farm land			1	
Residential	3	271	3	657
Home Equity	1	11	1	11
Total	5	\$ 348	7	\$ 1,221

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 5. Derivative Financial Instruments

Risk Management Objective of Using Derivatives

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

Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish these objectives, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. As of September 30, 2012, the Corporation had two interest rate swaps with a notional amount of \$26.0 million and one interest rate cap with a notional amount of \$13.0 million that were designated as cash flow hedges. As of September 30, 2011, the Corporation had one interest rate swap with a notional amount of \$13.0 million and one interest rate cap with a notional amount of \$13.0 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2012, such derivatives were used to hedge the forecasted LIBOR-based outflows associated with existing trust preferred securities when the outflows converted from a fixed rate to variable rate in September of 2012. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the three and nine months ended September 30, 2012, and 2011, the Corporation did not recognize any ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation does not expect to reclassify any amounts from accumulated other comprehensive income to interest expense.

The Corporation does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Corporation provides to certain customers. The Corporation executes

interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Corporation executes with a third party, such that the Corporation minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of September 30, 2012, the notional amount of customer-facing swaps was approximately \$152,667,000. This amount is offset with third party counterparties, as described above.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 5. Derivative Financial Instruments continued

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Corporation's derivative financial instruments, as well as their classification on the Balance Sheet, as of September 30, 2012, and December 31, 2011.

	Asset Derivatives				Liability Derivatives			
	September 30, 2012		December 31, 2011		September 30, 2012		December 31, 2011	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:								
Interest rate contracts	Other Assets	\$ 206	Other Assets	\$ 424	Other Liabilities	\$ 3,617	Other Liabilities	\$ 2,305
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	\$ 6,412	Other Assets	\$ 5,241	Other Liabilities	\$ 6,789	Other Liabilities	\$ 5,492

Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Corporation's derivative financial instruments on the Income Statement for the three and nine months ended September 30, 2012, and 2011.

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

Derivatives Not Designated as Hedging Instruments under ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative Three Months Ended September 30, 2011	Amount of Gain (Loss) Recognized Income on Derivative Nine Months Ended September 30, 2011

Interest rate contracts	Other income	\$	(95)	\$	(93)
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The Corporation's exposure to credit risk occurs because of nonperformance by its counterparties. The counterparties approved by the Corporation are usually financial institutions, which are well capitalized and have credit ratings through Moody's and/or Standard & Poor's, at or above investment grade. The Corporation's control of such risk is through quarterly financial reviews, comparing mark-to-mark values with policy limitations, credit ratings and collateral pledging.

Credit-risk-related Contingent Features

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

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

As of September 30, 2012, the termination value of derivatives in a net liability position related to these agreements was \$10,567,000. As of September 30, 2012, the Corporation had minimum collateral posting thresholds with certain of its derivative counterparties and had posted collateral of \$9,337,000. If the Corporation had breached any of these provisions at September 30, 2012, it could have been required to settle its obligations under the agreements at their termination value.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

Note 6. Disclosures About Fair Value of Assets and Liabilities

The Corporation has adopted fair value accounting guidance that defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This guidance defines fair value as 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. This guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities

Level 2 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

Recurring Measurements

The following table presents the fair value measurements of assets and liabilities recognized in the Consolidated Condensed Balance Sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2012, and December 31, 2011.

		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2012	Fair Value			
Available for sale securities:				
U.S. Government-sponsored agency securities	\$ 4,782		\$ 4,782	
State and municipal	161,017		142,798	\$ 18,219
U.S. Government-sponsored mortgage-backed securities	383,912		383,912	
Corporate obligations	202			202
Equity securities	1,706		1,702	4
Interest rate swap asset	6,412		6,412	
Interest rate cap	206		206	
Interest rate swap liability	(10,406)		(10,406)	

December 31, 2011	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$ 117		\$ 117	
State and municipal	147,353		126,712	\$ 20,641
U.S. Government-sponsored mortgage-backed securities	368,998		368,998	
Corporate obligations	193			193
Equity securities	1,830		1,826	4
Interest rate swap asset	5,241			5,241
Interest rate cap	424			424
Interest rate swap liability	(7,797)			(7,797)

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

Note 6. Disclosures About Fair Value of Assets and Liabilities continued

Following is a description of the valuation methodologies and inputs used for instruments measured at fair value on a recurring basis and recognized in the accompanying Consolidated Condensed Balance Sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques during the nine months ended September 30, 2012.

Available for Sale Investment Securities

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

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

Pooled Trust Preferred Securities

Pooled trust preferred securities in the portfolio amount to \$6 million in amortized cost, with a fair value of \$171,000; all of which are classified as Level 3 inputs in the fair value hierarchy. These securities were rated A or better at inception, but at September 30, 2012, Moody's ratings on these securities ranged from Ca to C. The issuers in these securities are primarily banks, but some of the pools do include a limited number of insurance companies. On a quarterly basis, the Corporation uses an other-than-temporary impairment ("OTTI") evaluation process to compare the present value of expected cash flows to determine whether an adverse change in cash flows has occurred. The OTTI evaluation process considers the structure and term of the collateralized debt obligation ("CDO"), interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. Assumptions used in the evaluation process include expected future default rates and prepayments as well as recovery assumptions on defaults and deferrals. In addition, the process is used to "stress" each CDO, or make assumptions more severe than expected activity, to determine the degree to which assumptions could deteriorate before the CDO could no longer fully support repayment of the Corporation's note class. Upon completion of the September 30, 2012, quarterly evaluation process, the conclusion was no additional OTTI impairment for the three and nine months ending September 30, 2012. The Corporation did not recognize any OTTI impairment for the three months ended September 30, 2011, but did recognize \$400,000 of OTTI impairment for the nine months ended September 30, 2011.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

Level 3 Reconciliation

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the Consolidated Condensed Balance Sheets using significant unobservable (Level 3) inputs for the three and nine months ended September 30, 2012, and 2011.

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

	Three Months Ended September 30, 2011				Nine Months Ended September 30, 2011			
	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability
Balance at beginning of the period	\$ 180	\$ 3,783	\$ 954	\$ (3,986)	\$ 186	\$ 4,002	\$ 1,109	\$ (3,876)
Total realized and unrealized gains and losses:								

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Included in net income (loss)		3,251		(3,345)		(400)		3,363		(3,455)
Included in other comprehensive income	(45)	(1,726)	(498)			195	(2,057)	(653)		
Purchases, issuances and settlements										
Transfers in/(out) of Level 3	18,711					18,711				
Principal payments	65					219				
Ending balance at September 30, 2011	\$ 18,911	\$ 5,308	\$ 456	\$ (7,331)	\$ 18,911	\$ 5,308	\$ 456	\$ (7,331)		

There were no gains or losses for the period included in earnings that were attributable to the changes in unrealized gains or losses related to assets or liabilities held at September 30, 2012 or December 31, 2011.

Transfers Between Levels

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

	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Reason for Transfer
Transfers from Level:				
Interest rate swap asset			\$ 4,862	The interest rate swap and cap instruments were transferred from Level 3 to Level 2 as of March 31, 2012 due to the Corporation's additional analysis of valuation methodologies. These instruments are valued using widely accepted valuation techniques including discounted cash flow analysis using observable inputs such as contractual terms and Libor-based rate curves.
Interest rate cap			409	
Interest rate swap liability			6,934	
Total Transfers from Level			\$ 12,205	
Transfers to Level:				
Interest rate swap asset	\$ 4,862			The interest rate swap and cap instruments were transferred from Level 3 to Level 2 as of March 31, 2012 due to the Corporation's additional analysis of valuation
Interest rate cap	409			
Interest rate swap liability	6,934			

methodologies. These instruments are valued using widely accepted valuation techniques including discounted cash flow analysis using observable inputs such as contractual terms and Libor-based rate curves.

Total Transfers to Level	\$	12,205
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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

Nonrecurring Measurements

The following table presents the fair value measurement of assets and liabilities measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2012, and December 31, 2011.

		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2012	Fair Value			
Impaired loans	\$ 25,853			\$ 25,853
Other real estate owned (collateral dependent)	\$ 5,132			\$ 5,132

		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2011	Fair Value			
Impaired loans	\$ 22,885			\$ 22,885
Other real estate owned (collateral dependent)	\$ 7,882			\$ 7,882

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

Impaired Loans (collateral dependent) and Other Real Estate Owned

Loan impairment is reported when substantial doubt about the collectability of scheduled payments exists. Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate, or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged

against the allowance when management believes the uncollectability of the loan is confirmed. During the first nine months of 2012, certain impaired loans were partially charged-off or re-evaluated. The valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

The fair value for impaired loans and other real estate owned is measured based on the value of the collateral securing those loans or real estate and is determined using several methods. The fair value of real estate is generally determined based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically calculated by using financial information such as financial statements and aging reports provided by the borrower and is discounted as considered appropriate.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements, other than goodwill, at September 30, 2012.

	Fair Value	Valuation Technique	Unobservable Inputs	Range
State and municipal securities	\$ 18,219	Discounted cash flow	Maturity/Call date Blend of US Muni BQ curve Discount rate	1 month to 11 yrs A- to BBB- 1% - 4%
Corporate obligations/Equity securities	\$ 206	Discounted cash flow	Risk free rate plus Premium for illiquidity	3 month libor plus 200bps
Impaired loans (collateral dependent)	\$ 25,853	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 50%
Other real estate owned	\$ 5,132	Appraisals	Discount to reflect current market conditions	0% - 20%

Sensitivity of Significant Unobservable Inputs

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

State and Municipal Securities

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

Corporate Obligations/Equity Securities

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

Fair Value of Financial Instruments

The following table presents estimated fair values of the Corporation's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2012, and December 31, 2011.

		September 30, 2012 (unaudited)		
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and due from banks	\$ 57,027	\$ 57,027		
Interest-bearing time deposits	35,324	35,324		
Investment securities available for sale	551,619		\$ 533,194	\$ 18,425
Investment securities held to maturity	377,097		385,155	11,062
Mortgage loans held for sale	27,711		27,711	
Loans	2,766,831			2,793,212
Federal Reserve Bank and Federal Home Loan Bank stock	32,824		32,824	
Interest rate swap asset	6,618		6,618	
Interest receivable	17,519		17,519	
Liabilities:				
Deposits	\$ 3,194,751	\$ 2,292,977	\$ 902,678	
Borrowings:				
Federal funds purchased	57,024		57,024	
Securities sold under repurchase agreements	153,454		154,017	
Federal Home Loan Bank advances	145,467		148,985	
Subordinated debentures, revolving credit lines and term loans	112,169		67,837	
Interest rate swap liability	10,406		10,405	
Interest payable	1,591		1,591	

		December 31, 2011 (unaudited)		
	Carrying Amount	Quoted Prices in Active Markets	Significant Other Observable Inputs	Significant Unobservable Inputs

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		for Identical Assets (Level 1)	(Level 2)	(Level 3)
Assets:				
Cash and due from banks	\$ 73,312	\$ 73,312		
Interest-bearing time deposits	52,851	52,851		
Investment securities available for sale	518,491		\$ 497,653	\$ 20,838
Investment securities held to maturity	427,909		428,737	13,732
Mortgage loans held for sale	17,864		17,864	
Loans	2,642,517			2,658,227
Federal Reserve Bank and Federal Home Loan Bank stock	31,270		31,270	
Interest rate swap asset	5,665			5,665
Interest receivable	17,723		17,723	
Liabilities:				
Deposits	\$ 3,134,655	\$ 2,195,679	\$ 944,078	
Borrowings:				
Securities sold under repurchase agreements	156,305		157,342	
Federal Home Loan Bank advances	138,095		141,693	
Subordinated debentures, revolving credit lines and term loans	194,974		142,632	
Interest rate swap liability	7,797			\$ 7,797
Interest payable	2,925		2,925	

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

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

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

Investment securities: Fair value is based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

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

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

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

Interest Receivable and Interest Payable: The carrying amount approximates fair value.

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

Federal funds purchased: The carrying amount approximates fair value.

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

NOTE 7. Share-Based Compensation

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten-year life, become 100 percent vested ranging from six months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. Deferred stock units ("DSUs") can be credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of September 30, 2012, there were no outstanding DSUs.

The Corporation's 2009 Employee Stock Purchase Plan ("ESPP") provides eligible employees of the Corporation and its subsidiaries an opportunity to purchase shares of common stock of the Corporation through quarterly offerings

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

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 7. Share-Based Compensation continued

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three months and nine months ended September 30, 2012, was \$415,000 and \$1,101,000, respectively compared to \$290,000 and \$1,009,000 for the three months and nine months ended September 30, 2011. Share-based compensation has been recognized as a component of salaries and benefits expense in the accompanying CONSOLIDATED CONDENSED STATEMENTS OF INCOME.

The estimated fair value of the stock options granted during 2012 and in prior years was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2012 Black Scholes model:

Risk-free interest rate	1.36	%
Expected price volatility	46.22	%
Dividend yield	3.29	%
Forfeiture rate	4.77	%
Weighted-average expected life, until exercise	7.2	years

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

Share-based compensation expense recognized in the CONSOLIDATED CONDENSED STATEMENTS OF INCOME is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately 4.8 percent for the nine months ended September 30, 2012, based on historical experience.

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

	Three Months Ended September 30, 2012		September 30, 2011		Nine Months Ended September 30, 2012		September 30, 2011	
Stock and ESPP Options								
Pre-tax compensation expense	\$	71	\$	56	\$	197	\$	165
Income tax benefit		(11)		(7)		(13)		(8)

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Stock and ESPP option expense, net of income taxes	\$	60	\$	49	\$	184	\$	157
Restricted Stock Awards								
Pre-tax compensation expense	\$	344	\$	234	\$	904	\$	844
Income tax benefit		(104)		(76)		(322)		(289)
Restricted stock awards expense, net of income taxes	\$	240	\$	158	\$	582	\$	555
Total Share-Based Compensation:								
Pre-tax compensation expense	\$	415	\$	290	\$	1,101	\$	1,009
Income tax benefit		(115)		(83)		(335)		(297)
Total share-based compensation expense, net of income taxes	\$	300	\$	207	\$	766	\$	712

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands, except per share amounts)

(Unaudited)

NOTE 7. Share-Based Compensation continued

As of September 30, 2012, unrecognized compensation expense related to stock options and RSAs totaling \$132,000 and \$2,053,000, respectively, is expected to be recognized over weighted-average periods of .84 and 1.52 years, respectively.

Stock option activity under the Corporation's stock option plans as of September 30, 2012 and changes during the nine months ended September 30, 2012, were as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2012	1,035,871	\$ 22.57		
Granted/ Converted	46,801	\$ 11.69		
Exercised	(8,750)	\$ 7.69		
Cancelled	(165,536)	\$ 25.87		
Outstanding September 30, 2012	908,386	\$ 21.55	4.33	1,097,884
Vested and Expected to Vest at September 30, 2012	908,386	\$ 21.55	4.33	1,097,884
Exercisable at September 30, 2012	830,336	\$ 22.58	3.89	760,073

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

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

The following table summarizes information on unvested RSAs outstanding as of September 30, 2012:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2012	338,087	\$ 8.65
Granted	156,473	\$ 11.79
Forfeited	(8,800)	\$ 9.63
Vested	(79,386)	\$ 11.90

Unvested RSAs at September 30, 2012	406,374	\$	9.18
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The grant date fair value of ESPP options was estimated at the beginning of the July 1, 2012 quarterly offering period of approximately \$22,000. The ESPP options vested during the three months ending September 30, 2012, leaving no unrecognized compensation expense related to unvested ESPP options at September 30, 2012.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands, except per share amounts)

(Unaudited)

NOTE 8. Income Tax

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Income Tax Expense :				
Currently Payable:				
Federal	\$ 139	\$ 47	\$ 1,475	\$ (855)
State				
Deferred:				
Federal	3,787	2,514	11,239	7,211
State				
Total Income Tax Expense	\$ 3,926	\$ 2,561	\$ 12,714	\$ 6,356
Reconciliation of Federal Statutory to Actual Tax Expense:				
Federal statutory income tax at 35%	\$ 5,307	\$ 3,256	\$ 16,634	\$ 8,416
Tax-exempt interest income	(927)	(916)	(2,788)	(2,793)
Non-deductible interest expense		230		649
Stock compensation	14	19	56	56
Earnings on life insurance	(240)	(208)	(954)	(610)
Tax credits	(19)	(29)	(55)	(55)
Other	(209)	209	(179)	693
Actual Tax Expense	\$ 3,926	\$ 2,561	\$ 12,714	\$ 6,356

NOTE 9. Net Income Per Share

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

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

		Three Months Ended September 30,				2011	
		2012			Net		
	Net	Weighted-Average	Per Share	Income	Weighted-Average	Per Share	
	Income	Shares	Amount	(Loss)	Shares	Amount	
	\$ 11,236			\$ 6,742			

Basic net income (loss) per share:							
Loss on extinguishment of trust preferred securities					(10,857)		
Loss on CPP unamortized discount					(1,401)		
Less: Preferred Stock dividends and discount accretion	(1,134)				(868)		
Net income (loss) available to common stockholders	10,102	28,649,996	\$	0.35	(6,384)	26,367,067	\$ (0.25)
Effect of dilutive stock options and warrants		238,080					
Diluted net income (loss) per share:							
Net income (loss) available to common stockholders	\$ 10,102	28,888,076	\$	0.35	\$ (6,384)	26,367,067	\$ (0.25)

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands, except per share amounts)

(Unaudited)

NOTE 9. Net Income Per Share continued

Stock options to purchase 770,001 and 1,008,957 shares for the three months ended September 30, 2012, and 2011, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

	Nine Months Ended September 30,					
	2012			2011		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	\$ 34,812			\$ 17,691		
Loss on extinguishment of trust preferred securities				(10,857)		
Loss on CPP unamortized discount				(1,401)		
Less: Preferred Stock dividends and discount accretion	(3,404)			(2,846)		
Net income available to common stockholders	31,408	28,619,186	\$ 1.09	2,587	25,879,277	\$ 0.10
Effect of dilutive stock options and warrants		200,097			139,659	
Diluted net income (loss) per share:						
Net income available to common stockholders	\$ 31,408	28,819,283	\$ 1.09	\$ 2,587	26,018,936	\$ 0.10

Stock options to purchase 846,499 and 1,024,775 shares for the nine months ended September 30, 2012, and 2011, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

NOTE 10. Impact of Accounting Changes

ASU 2011-12, "Comprehensive Income (Topic 220) – Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05." In December 2011 the FASB issued Accounting Standards Update 2011-12, Comprehensive Income (Topic 220): Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05. This ASU defers the changes in Update 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. This ASU is effective for public entities for fiscal years, and interim periods within those years, beginning after December 15, 2011. For nonpublic entities this ASU is effective for fiscal years ending after December 15, 2012. ASU 2011-12 became effective for the Corporation on January 1, 2012 and did not have a significant impact on the Corporation's financial statements.

ASU 2012-02, “Intangibles – Goodwill and Other (Topic 350).” In July 2012, the FASB issued Accounting Standards Update 2012-02, Intangibles – Goodwill and Other: Testing Indefinite-Lived Intangible Assets for Impairment. The amendments in this ASU allow an entity to first assess qualitative factors to determine whether it is necessary to perform a quantitative impairment test. An entity would not be required to calculate the fair value of an indefinite-live intangible asset unless the entity determines, bases on qualitative assessment, that it is more likely than not, the indefinite-lived intangible asset is impaired. This ASU is effective for annual and interim impairment tests performed for fiscal years beginning after September 15, 2012, and is not expected to have a significant impact on the Corporation’s financial statements. Early adoption is permitted.

ASU 2012-04, “Technical Corrections and Improvements.” In October 2012, the FASB issued Accounting Standards Update 2012-04, Technical Corrections and Improvements. The amendments in this ASU make technical corrections, clarifications and limited-scope improvements to various Topics throughout the Codification. This ASU is effective for public entities for fiscal periods beginning after December 15, 2012 and is not expected to have a significant impact on the Corporation’s financial statements.

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

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

FORWARD-LOOKING STATEMENTS

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

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

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

• fluctuations in market rates of interest and loan and deposit pricing, which could negatively affect our net interest margin, asset valuations and expense expectations;

• adverse changes in the economy, which might affect our business prospects and could cause credit-related losses and expenses;

- adverse developments in our loan and investment portfolios;
- competitive factors in the banking industry, such as the trend towards consolidation in our market;

• changes in the banking legislation or the regulatory requirements of federal and state agencies applicable to bank holding companies and banks like our affiliate banks;

- acquisitions of other businesses by us and integration of such acquired businesses;

• changes in market, economic, operational, liquidity, credit and interest rate risks associated with our business; and

• the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends.

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

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

CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles are complex and require us to apply significant judgments to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurement is not possible or practical. For a complete discussion of our significant accounting policies, see "Notes to the Consolidated Financial Statements" in our Annual Report on Form 10-K for the year ended December 31, 2011. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

We believe there have been no significant changes during the nine months ended September 30, 2012, to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2011.

BUSINESS SUMMARY

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

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

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

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

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported net income available to common stockholders of \$10.1 million, or \$0.35 per fully diluted common share for the quarter ended September 30, 2012, an increase of \$16.5 million, compared to a net loss available to common stockholders of \$6.4 million, or \$(0.25) per common share for the quarter ended September 30, 2011.

Net income available to common stockholders for the nine months ended September 30, 2012 was \$31.4 million, or \$1.09 per fully diluted common share, compared to net income available to common stockholders of \$2.6 million, or \$0.10 per fully diluted common share for the nine months ended September 30, 2011.

In the third quarter of 2011, an after-tax loss of \$12.3 million, or \$.47 per share, was recorded due to the accounting treatment for the extinguishment of trust preferred securities. The extinguishment of the trust preferred securities was done in conjunction with the redemption of 69,600 shares of the Corporation's fixed rate cumulative perpetual preferred stock, under the Capital Purchase Program, for \$69.6 million, the issuance of 90,783 shares of the Corporation's senior non-cumulative perpetual preferred stock, through the Small Business Lending Fund, for \$90.8 million, and the issuance of 2.8 million of the Corporation's common stock for \$20.8 million.

On February 10, 2012, the Bank assumed substantially all the deposits and certain other liabilities and acquired certain assets of SCB Bank, from the FDIC as the receiver of SCB Bank. This transaction generated a pre-tax gain of \$9.1 million, or \$0.21 per common share after tax. Details of this transaction are included in NOTE 2. PURCHASE AND ASSUMPTION, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

As of September 30, 2012, total assets equaled \$4.3 billion, an increase of \$77.1 million from December 31, 2011. The three most significant assets acquired through the SCB transaction were cash and due from banks of \$29.1 million, loans of \$93.8 million and securities of approximately \$18.9 million.

The Corporation's allowance for loan losses totaled \$69.5 million as of September 30, 2012. The allowance provides 121.9 percent coverage of all non-accrual loans and 2.43 percent of total loans. Provision expense totaled \$4.6 million for the three months ended September 30, 2012, compared to \$5.6 million in the three months ended September 30, 2011. Net charge-offs totaled \$5.3 million for the third quarter of 2012, down from \$9.6 million for the third quarter of 2011. The decline in the provision expense for the three months ended September 30, 2012 compared to the same period in 2011 was directionally consistent with the improvements in non-performing and adversely classified loans. Additional details are discussed within the "PROVISION/ALLOWANCE FOR LOAN LOSSES" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

Taxes, both current and deferred, decreased from December 31, 2011 by \$7.1 million, mainly due to the temporary difference related to the \$9.1 million gain on the FDIC modified whole bank transaction and a lower deferred tax asset associated with the reduction in the allowance for loan losses.

Deposits increased from December 31, 2011 by \$60.1 million. As part of the SCB transaction, the Bank assumed deposits of \$125.9 million. The Bank also completed repayment of \$79.0 million of Senior Notes (the "Notes") that matured on March 30, 2012. The Notes were originally issued by the Bank on March 31, 2009 and were guaranteed by the FDIC under its Temporary Liquidity Guarantee Program. Additionally, on August 22, 2012 the Corporation

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

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

NET INTEREST INCOME

Net interest income is the primary source of the Corporation’s earnings. Net interest margin is a function of net interest income and the level of average earning assets. Net interest income and net interest margin are presented in the following table on a fully taxable equivalent basis (“FTE”), which adjusts tax-exempt or nontaxable interest income to an amount that would be comparable to interest subject to income taxes using the federal statutory tax rate of 35 percent in effect for all periods. Net interest margin increased 30 basis points from 4.02 percent in the third quarter of 2011 to 4.32 percent in the third quarter of 2012, while earning assets increased by \$114.7 million.

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

NET INTEREST INCOME continued

The increased net interest income during the three months ended September 30, 2012 compared with the same period in 2011 was driven by two primary factors. The first factor is a higher level of earning assets and interest income resulting from the assumption of SCB loans and related fair value accretion recognized in interest income. Additional details can be found in NOTE 2. PURCHASE AND ASSUMPTION, included within the Notes to Consolidated condensed Financial Statements of this Form 10-Q. The second factor contributing to the improvement in the net interest margin, expressed as a percentage of earning assets, was largely the result of the Corporation's ability to lower its cost of funds and in particular its cost of deposits, due to the growth of the Corporation's non-interest bearing demand deposits and interest-bearing non-maturity deposits.

During the nine months ended September 30, 2012, asset yields decreased 26 basis points FTE and interest costs decreased 41 basis points, resulting in a 15 basis point FTE increase in net interest income as compared to the same period in 2011. The following table presents the Corporation's interest income, interest expense, and net interest income as a percent of average earning assets for the three and nine months ended September 30, 2012, and 2011.

(Dollars in Thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Annualized net interest income	\$ 159,611	\$ 143,402	\$ 152,095	\$ 142,900
Annualized FTE adjustment	\$ 5,707	\$ 5,633	\$ 5,746	\$ 5,781
Annualized net interest income on a fully taxable equivalent basis	\$ 165,318	\$ 149,035	\$ 157,841	\$ 148,681
Average earning assets	\$ 3,829,127	\$ 3,714,401	\$ 3,818,805	\$ 3,736,503
Interest income (FTE) as a percent of average earning assets	4.89%	5.01%	4.79%	5.05%
Interest expense as a percent of average earning assets	0.57%	0.99%	0.66%	1.07%
Net interest income (FTE) as a percent of average earning assets	4.32%	4.02%	4.13%	3.98%

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

NON-INTEREST INCOME

Non-interest income increased \$1.0 million or 7.9 percent in the third quarter of 2012, compared to the third quarter of 2011. The primary reason for the increase during the third quarter of 2012 was increased mortgage origination volume which resulted in an increase in the gains on the sale of mortgage loans totaling \$1.1 million more than the third quarter 2011.

During the first nine months of 2012, non-interest income increased \$13.9 million or 38.6 percent over the same period in 2011. The largest item contributing to the increase was a gross purchase gain of \$9.1 million recognized from the purchase of certain assets and assumption of certain liabilities of SCB Bank. See NOTE 2. PURCHASE AND ASSUMPTION in the Notes to Consolidated Condensed Financial Statements included of this Form 10-Q for

additional discussion of this transaction.

Additionally, gains on the sale of mortgage loans increased \$2.4 million due to increased mortgage origination volume in 2012 than in the same period of 2011. In 2012, \$576,000 was received in the first nine months of 2012 from a Bank Owned Life Insurance death benefit, while none was received in the first nine months of 2011.

Also, an increase of \$740,000 from more interchange income from electronic card transactions was realized in the first nine months of 2012 than the same period of 2011 due to increased customer volumes.

NON-INTEREST EXPENSE

Non-interest expenses increased \$182,000 or 0.5 percent in the third quarter of 2012, compared to the third quarter of 2011. Salaries and employee benefits increased \$119,000 over the same period in 2011. Base salaries were \$351,000 less than the same period in 2011, while commissions and incentives increased \$1.1 million over the same quarter last year. Employee health insurance decreased \$1.0 million when compared to the third quarter of 2011. Increases were also noted in equipment and other expenses of \$136,000 and \$457,000, respectively, mainly due to expenses associated with the integration of the Shelbyville acquisition into our core business platform. A portion of the increase in other expenses was also due to a prepayment penalty of \$184,000 related to the early payoff of \$4.1 million in subordinated debentures. See the "LIQUIDITY" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q for additional information related to this reduction in borrowings.

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

NON-INTEREST EXPENSE continued

The increases mentioned above were offset by declines in core deposit intangible amortization of \$266,000 and FDIC expenses of \$409,000, from the third quarter of 2011 to the third quarter of 2012.

During the first nine months of 2012, non-interest expense decreased \$110,000 when compared to the first nine months of 2011. Salaries and employee benefits increased \$3.4 million or 6.1 percent over the same period in 2011. Base salaries were down \$7,000, while commissions and incentives increased \$2.3 million and temporary employee expenses associated with the Shelbyville acquisition increased \$567,000 over the same period last year. Employee retirement plan expenses also increased \$743,000 when compared to the first nine months of 2011.

Additionally, other expenses were \$1.6 million higher than the same period in 2011 due to expenses associated with the integration of the Shelbyville acquisition into our core business platform. A portion of the increase in other expenses was also due to a prepayment penalty of \$184,000 related to the early payoff of \$4.1 million in subordinated debentures. See the "LIQUIDITY" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q for additional information related to this reduction in borrowings.

The increase in salaries and benefits and other expenses was offset by declines in core deposit intangible amortization of \$1.5 million, FDIC expenses of \$2.0 million and credit related expenses of \$1.6 million, from the first nine months of 2011 to the first nine months of 2012.

INCOME TAX

The income tax expense for the nine months ended September 30, 2012, was \$12,714,000 on pre-tax net income of \$47,526,000. For the same period in 2011, the income tax expense was \$6,356,000 on pre-tax net income of \$24,047,000. Additional details are discussed within the "Results of Operations" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

CAPITAL

Capital adequacy is an important indicator of financial stability and performance. The Corporation maintained a strong capital position as tangible common equity to tangible assets was 7.51 percent at September 30, 2012, and 6.84 percent at December 31, 2011.

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk-based capital, Tier 1 capital, and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios. At September 30, 2012, the management of the Corporation believes that it meets all capital adequacy requirements to which it is subject. The most recent notifications from the regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

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

material effect on a bank's operations.

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

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

CAPITAL continued

As of September 30, 2012, the Corporation, on a consolidated basis, as well as the Bank, exceeded the minimum capital levels of the well capitalized category.

(Dollars in Thousands)	September 30, 2012		December 31, 2011	
	Amount	Ratio	Amount	Ratio
Consolidated				
Total risk-based capital (to risk-weighted assets)	\$ 517,552	16.62%	\$ 487,393	16.54%
Tier 1 capital (to risk-weighted assets)	448,239	14.39%	410,132	13.92%
Tier 1 capital (to average assets)	448,239	10.98%	410,132	10.17%
First Merchants Bank				
Total risk-based capital (to risk-weighted assets)	\$ 507,609	16.31%	\$ 477,805	16.26%
Tier 1 capital (to risk-weighted assets)	468,311	15.04%	440,909	15.00%
Tier 1 capital (to average assets)	468,311	11.49%	440,909	10.96%

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

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

(Dollars in Thousands, Except Per Share Amounts)	September 30, 2012	December 31, 2011
Average goodwill	\$ 141,357	\$ 141,357
Average core deposit intangible (CDI)	8,826	10,655
Average deferred tax on CDI	(2,200)	(2,458)
Intangible adjustment	\$ 147,983	\$ 149,554
Average stockholders' equity (GAAP capital)	\$ 530,165	\$ 478,440
Average cumulative preferred stock	(125)	(125)
Average non-cumulative preferred stock issued under the Small Business Lending Fund Program	(90,783)	(74,181)
Intangible adjustment	(147,983)	(149,554)
Average tangible capital	\$ 291,274	\$ 254,580
Average assets	\$ 4,230,009	\$ 4,143,850
Intangible adjustment	(147,983)	(149,554)
Average tangible assets	\$ 4,082,026	\$ 3,994,296
Net income available to common stockholders	\$ 31,408	\$ 9,013
CDI amortization, net of tax	809	2,112
Tangible net income available to common stockholders	\$ 32,217	\$ 11,125

Per Share Data:

Diluted net income available to common stockholders	\$	1.09	\$	0.34
Diluted tangible net income available to common stockholders	\$	1.12	\$	0.42

Ratios:

Return on average GAAP capital (ROE)	7.90%	1.88%
Return on average tangible capital	14.75%	4.37%
Return on average assets (ROA)	0.99%	0.22%
Return on average tangible assets	1.05%	0.28%

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

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

LOAN QUALITY/PROVISION FOR LOAN LOSSES

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

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

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

Non-accrual loans decreased by \$12,593,000 during the nine months ended September 30, 2012, from \$69,592,000 at December 31, 2011 to the September 30, 2012, balance of \$56,999,000. In addition, other real estate owned declined \$2,509,000 during the same period. For other real estate owned, current appraisals are obtained to determine value as management continues to aggressively market these real estate assets. Accruing loans delinquent 90 or more days were \$1,974,000 at September 30, 2012, up from \$580,000 at December 31, 2011.

	September 30, 2012	December 31, 2011
(Dollars in Thousands)		
Non-Performing Assets:		
Non-accrual loans	\$ 56,999	\$ 69,592
Renegotiated loans	6,871	14,308
Non-performing loans (NPL)	63,870	83,900
Other real estate owned	13,780	16,289
Non-performing assets (NPA)	77,650	100,189
90+ days delinquent and still accruing	1,974	580
NPAs & 90+ days delinquent	\$ 79,624	\$ 100,769
Impaired Loans	\$ 79,965	\$ 79,775

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

A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected substantially within the contractual terms of the note. At September 30, 2012, commercial impaired loans totaled \$79,965,000, a

decrease of \$1,276,000 from the June 30, 2012, balance of \$81,241,000, and up slightly from the December 31, 2011 balance of \$79,775,000 despite the addition of the purchased loans discussed in NOTE 2. PURCHASE AND ASSUMPTION included in the Notes to Consolidated Condensed Financial Statements of this Form 10-Q. At September 30, 2012, an allowance for losses was not deemed necessary for commercial impaired loans totaling \$60,470,000 as there was no identified loss on these credits. An allowance of \$6,251,000 was recorded for the remaining balance of these impaired loans totaling \$19,495,000 and is included in the corporation's allowance for loan losses.

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

LOAN QUALITY/PROVISION FOR LOAN LOSSES continued

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

	September 30, 2012	December 31, 2011
(Dollars in Thousands)		
Non Performing Assets and 90+ Days Delinquent:		
Commercial and industrial loans	\$ 13,731	\$ 13,725
Agricultural production financing and other loans to farmers	300	
Real estate loans:		
Construction	12,377	17,784
Commercial and farm land	31,564	46,985
Residential	18,731	18,398
Home Equity	2,460	3,142
Individual's loans for household and other personal expenditures	119	162
Other loans	342	573
Non performing assets plus 90+ days delinquent	\$ 79,624	\$ 100,769

At September 30, 2012, the allowance for loan losses was \$69,493,000, a decrease of \$650,000 from June 30, 2012. As a percent of loans, the allowance was 2.43 percent at September 30, 2012, 2.49 percent at June 30, 2012, 2.50 percent at March 31, 2012 and 2.60 percent at December 31, 2011. The provision for loan losses for the three months ended September 30, 2012 was \$4,609,000, a decrease of \$947,000 from \$5,556,000 for the same period in 2011. The continued improvement in credit quality, primarily the declines in loans graded substandard, doubtful and loss, contributed to the decrease in provision expense. Specific reserves, on impaired loans increased \$175,000 from \$6,076,000 at June 30, 2012, to \$6,251,000 at September 30, 2012.

Net charge offs for the three months ended September 30, 2012, were \$5,259,000, a decrease of \$4,356,000 from the same period in 2011. Of this amount, a single charge off, totaling 9.8 percent of net charge offs, was greater than \$500,000. The distribution of the net charge offs for the three and nine months ended September 30, 2012 and September 30, 2011 is reflected in the following table:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in Thousands)	2012	2011	2012	2011
Net Charge Offs (Recoveries):				
Commercial and industrial loans	\$ 923	\$ 3,238	\$ 5,266	\$ (1,682)
Agricultural production financing and other loans to farmers	(3)	(68)	(23)	(224)
Real estate loans:				
Construction	433	640	105	5,830
Commercial and farm land	2,408	3,985	6,550	17,658
Residential	1,571	1,720	2,781	4,710
Individual's loans for household and other personal expenditures	(51)	103	259	398
Lease financing receivables, net of unearned income		(1)	(1)	(4)

Other Loans		(22)		(2)		497		(8)
Total Net Charge Offs	\$	5,259	\$	9,615	\$	15,434	\$	26,678

The declines in the value of commercial and residential real estate in our market over the last couple of years has had a negative impact on the underlying collateral value in our commercial, residential, land development and construction loans. Management continually evaluates commercial borrowers by including consideration of specific borrower cash flow analysis and estimated collateral values, types and amounts on non-performing loans, past and anticipated loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans outstanding. The determination of the provision in any period is based on management's continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio.

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

LIQUIDITY

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

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

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. In addition, Federal Home Loan Bank ("FHLB") advances are utilized as funding sources. At September 30, 2012, total borrowings from the FHLB were \$145,467,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at September 30, 2012, was \$168,223,000.

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

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

The principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$551,619,000 at September 30, 2012, an increase of \$33,128,000, or 6.4 percent, from December 31, 2011. Securities classified as held to maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held to maturity that are maturing in one year or less, totaled \$2,425,000 at September 30, 2012. In addition, other types of assets such as cash and due from banks, federal funds sold, and securities purchased under agreements to resell, loans and interest-bearing deposits with other banks maturing within one year are sources of liquidity.

The Corporation currently has a \$55.0 million credit facility with Bank of America, N.A., comprised of (a) a term loan in the principal amount of \$5.0 million (the "Term Loan") and (b) a subordinated debenture in the principal amount of \$50.0 million (the "Subordinated Debt"). Pursuant to the terms of the underlying Loan Agreement (the "Loan Agreement"), the Term Loan and the Subordinated Debt each mature on February 15, 2015. The Term Loan is secured by a pledge of all of the issued and outstanding shares of the Bank.

The Loan Agreement contains certain customary representations and warranties and financial and negative covenants. A breach of any of these covenants could result in a default under the Loan Agreement. As of September 30, 2012, the Corporation was in compliance with these financial covenants.

As of December 31, 2011, the Corporation failed to meet the minimum return on average total assets covenant of at least 0.75 percent. The Loan Agreement provides that upon an event of default as the result of the Corporation's failure to comply with a financial covenant, Bank of America may (a) declare the \$5.0 million outstanding principal amount of the Term Loan immediately due and payable, (b) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral if payment of the Term Loan is not made in full, and (c) add a default rate of 3 percent per annum to the Term Loan. Because the Subordinated Debt is treated as Tier 2 capital for regulatory capital purposes, the Loan Agreement does not provide Bank of America with any right of acceleration or other remedies with regard to the Subordinated Debt upon an event of default caused by the Corporation's breach of a financial covenant. Bank of America chose to apply the default rate through March 31, 2012, but not to accelerate the Term Loan based on the Corporation's failure to meet these financial covenants. As of March 31, 2012, the Corporation was no longer in default due to breach of a financial covenant; therefore, the default rate of 3 percent per annum was no longer applied to the Term Loan.

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

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

LIQUIDITY continued

The Bank provides customers with off-balance sheet credit support through loan commitments and standby and commercial letters of credit. Summarized credit-related financial instruments at September 30, 2012, are as follows:

	September 30, 2012
(Dollars in Thousands)	
Amounts of commitments:	
Loan commitments to extend credit	\$ 883,783
Standby and commercial letters of credit	22,006
	\$ 905,789

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

In addition to owned banking facilities, the Corporation has entered into a number of long-term leasing arrangements to support ongoing activities. The required payments under such commitments and borrowings at September 30, 2012, are as follows:

(Dollars in Thousands)	Remaining 2012	2013	2014	2015	2016	2017	2018 and after	Total
Operating leases	\$ 630	\$ 2,239	\$ 1,980	\$ 1,790	\$ 1,424	\$ 849	\$ 1,428	\$ 10,340
Federal funds purchased	57,024							57,024
Securities sold under repurchase agreements	143,454		10,000					153,454
Federal Home Loan Bank advances	51,124	1,621	26,506	30,993	29,025	2,734	3,464	145,467
Subordinated debentures and term loans	467			55,000			56,702	112,169
Total	\$ 252,699	\$ 3,860	\$ 38,486	\$ 87,783	\$ 30,449	\$ 3,583	\$ 61,594	\$ 478,454

INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK

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

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

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

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

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

INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK continued

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of September 30, 2012, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In the current rate environment, many driver rates are at or near historical lows, thus total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management have the following results:

Driver Rates	At September 30, 2012	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	0
Federal funds	200	0
One-year CMT	200	(8)
Three-year CMT	200	(1)
Five-year CMT	200	(2)
CD's	200	(27)
FHLB advances	200	(2)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at September 30, 2012. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

Driver Rates	Base	At September 30, 2012	
		RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$ 144,718	\$ 149,758	\$ 143,203
Variance from base		\$ 5,040	\$ (1,515)
Percent of change from base		3.48%	-1.05%

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2011, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management in the base simulation are as follows:

Driver Rates	At December 31, 2011	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	0
Federal funds	200	0
One-year CMT	200	(2)
Three-year CMT	200	(6)
Five-year CMT	200	0

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CD's	200	(42)
FHLB advances	200	0

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

		At December 31, 2011	
		RISING	FALLING
Driver Rates	Base	(200 Basis Points)	(100 Basis Points)
Net interest income	\$ 142,706	\$ 146,352	\$ 140,332
Variance from base		\$ 3,646	\$ (2,374)
Percent of change from base		2.55%	-1.66%

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

EARNING ASSETS

The following table presents the earning asset mix as of September 30, 2012, and December 31, 2011. Earning assets increased by \$99,099,000 in the nine months ended September 30, 2012. Interest-bearing time deposits decreased \$17,527,000. Investments decreased by approximately \$17,684,000, while loans and loans held for sale increased by \$132,756,000. The four largest loan classes that increased from December 31, 2011 were commercial and industrial, commercial and farm land, construction and home equity.

Effective February 10, 2012, the Bank assumed substantially all the deposits and certain other liabilities and acquired certain assets of SCB Bank, from the FDIC as the receiver of SCB Bank. The two most significant earning assets acquired were loans of \$93,800,000 and securities of approximately \$18,900,000. Details of this transaction are included in NOTE 2. PURCHASE AND ASSUMPTION, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

	September 30, 2012	December 31, 2011
(Dollars in Thousands)		
Interest-bearing time deposits	\$ 35,324	\$ 52,851
Investment securities available for sale	551,619	518,491
Investment securities held to maturity	377,097	427,909
Mortgage loans held for sale	27,711	17,864
Loans	2,836,324	2,713,415
Federal Reserve and Federal Home Loan Bank stock	32,824	31,270
Total	\$ 3,860,899	\$ 3,761,800

OTHER

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

At the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are

effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 1.A. RISK FACTORS

There have been no material changes to the risk factors previously disclosed in the Corporation's December 31, 2011, Annual Report on Form 10-K.

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

a. None

b. None

c. Issuer Purchases of Equity Securities

The following table presents information relating to our purchases of equity securities during the quarter ended September 30, 2012, as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as part of Publicly announced Plans or Programs	Maximum Number of Shares that may yet be Purchased Under the Plans or Programs
July, 2012	460	\$ 12.79	0	0
August, 2012			0	0
September, 2012			0	0

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

ITEM 5. OTHER INFORMATION

a. None

b. None

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ITEM 6. EXHIBITS

Exhibit No: Description of Exhibits:

3.1	First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2011)
3.2	Bylaws of First Merchants Corporation dated October 28, 2009 (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2009)
4.1	First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.2	Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.3	Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.4	Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.5	First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009)
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31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)
101.INS	XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkebase Document (2)

(1) Filed herewith.

(2) Furnished herewith.

SIGNATURES

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

First Merchants Corporation
(Registrant)

Date: November 9, 2012

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

Date: November 9, 2012

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

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