

FIRST MID ILLINOIS BANCSHARES INC
Form 10-Q
November 06, 2017

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

FORM 10-Q

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

For the quarterly period ended September 30, 2017

Or

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

For the transition period from _____ to _____

Commission file number 0-13368

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

Delaware 37-1103704
(State or other jurisdiction of incorporation or organization) (I.R.S. employer identification no.)

1421 Charleston Avenue,
Mattoon, Illinois 61938
(Address of principal executive offices) (Zip code)

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

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

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

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of November 6, 2017, 12,618,026 common shares, \$4.00 par value, were outstanding.

1

PART I

ITEM 1. FINANCIAL STATEMENTS

First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Balance Sheets

(Unaudited)

(In thousands, except share data)	September 30, 2017	December 31, 2016
Assets		
Cash and due from banks:		
Non-interest bearing	\$ 62,591	\$ 57,988
Interest bearing	6,562	79,014
Federal funds sold	490	38,900
Cash and cash equivalents	69,643	175,902
Certificates of deposit investments	1,685	14,643
Investment securities:		
Available-for-sale, at fair value	621,204	619,848
Held-to-maturity, at amortized cost (estimated fair value of \$69,137 and \$73,096 at September 30, 2017 and December 31, 2016, respectively)	69,306	74,231
Loans held for sale	2,079	1,175
Loans	1,865,483	1,824,817
Less allowance for loan losses	(18,589)	(16,753)
Net loans	1,846,894	1,808,064
Interest receivable	10,876	10,553
Other real estate owned	2,229	1,982
Premises and equipment, net	38,638	40,292
Goodwill, net	60,150	57,791
Intangible assets, net	11,181	12,832
Bank owned life insurance	41,601	41,318
Other assets	18,970	25,904
Total assets	\$ 2,794,456	\$ 2,884,535
Liabilities and Stockholders' Equity		
Deposits:		
Non-interest bearing	\$ 430,036	\$ 471,206
Interest bearing	1,787,441	1,858,681
Total deposits	2,217,477	2,329,887
Securities sold under agreements to repurchase	116,360	185,763
Interest payable	552	535
FHLB borrowings	87,052	40,094
Other borrowings	31,250	18,063
Junior subordinated debentures	23,980	23,917
Other liabilities	6,354	5,603
Total liabilities	2,483,025	2,603,862
Stockholders' Equity:		
Common stock, \$4 par value; authorized 18,000,000 shares; issued 13,167,769 and 13,020,742 shares in 2017 and 2016, respectively	54,671	54,083
Additional paid-in capital	163,067	158,671
Retained earnings	104,281	86,216

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Deferred compensation	2,987	3,201
Accumulated other comprehensive income (loss)	1,999	(5,761)
Less treasury stock at cost, 549,743 shares in 2017 and 2016	(15,574)	(15,737)
Total stockholders' equity	311,431	280,673
Total liabilities and stockholders' equity	\$ 2,794,456	\$ 2,884,535

See accompanying notes to unaudited condensed consolidated financial statements.

2

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

First Mid-Illinois Bancshares, Inc.
Condensed Consolidated Statements of Income (unaudited)

(In thousands, except per share data)	Three months		Nine months	
	ended September 30, 2017	2016	ended September 30, 2017	2016
Interest income:				
Interest and fees on loans	\$20,385	\$15,294	\$61,337	\$42,496
Interest on investment securities	4,179	3,229	12,585	9,622
Interest on certificates of deposit investments	9	78	41	234
Interest on federal funds sold	1	7	62	8
Interest on deposits with other financial institutions	40	15	217	125
Total interest income	24,614	18,623	74,242	52,485
Interest expense:				
Interest on deposits	1,028	623	2,840	1,777
Interest on securities sold under agreements to repurchase	51	23	137	62
Interest on FHLB borrowings	283	150	602	465
Interest on other borrowings	143	42	385	45
Interest on subordinated debentures	236	162	680	456
Total interest expense	1,741	1,000	4,644	2,805
Net interest income	22,873	17,623	69,598	49,680
Provision for loan losses	1,489	1,081	5,051	1,927
Net interest income after provision for loan losses	21,384	16,542	64,547	47,753
Other income:				
Trust revenues	925	774	2,696	2,549
Brokerage commissions	536	526	1,550	1,440
Insurance commissions	670	738	3,148	2,806
Service charges	1,758	1,824	5,160	4,977
Securities gains, net	254	466	589	1,130
Mortgage banking revenue, net	347	382	875	715
ATM / debit card revenue	1,595	1,457	4,828	4,418
Bank owned life insurance	792	201	1,355	384
Other	784	530	2,925	1,582
Total other income	7,661	6,898	23,126	20,001
Other expense:				
Salaries and employee benefits	9,648	7,844	29,685	23,293
Net occupancy and equipment expense	3,129	2,864	9,378	8,389
Net other real estate owned expense	385	32	530	23
FDIC insurance	210	294	679	841
Amortization of intangible assets	545	455	1,651	1,312
Stationery and supplies	168	221	539	612
Legal and professional	871	713	2,596	2,414
Marketing and donations	338	285	909	1,486
Other	2,618	2,612	9,102	6,264
Total other expense	17,912	15,320	55,069	44,634
Income before income taxes	11,133	8,120	32,604	23,120
Income taxes	3,538	2,812	10,545	8,077
Net income	7,595	5,308	22,059	15,043
Dividends on preferred shares	—	—	—	825

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Net income available to common stockholders	\$7,595	\$5,308	\$22,059	\$14,218
Per share data:				
Basic net income per common share available to common stockholders	\$0.61	\$0.51	\$1.76	\$1.52
Diluted net income per common share available to common stockholders	\$0.61	\$0.51	\$1.76	\$1.50
Cash dividends declared per common share	\$—	\$0.16	\$0.32	\$0.46

See accompanying notes to unaudited condensed consolidated financial statements.

3

First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Statements of Comprehensive Income (unaudited)

(in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Net income	\$7,595	\$5,308	\$22,059	\$15,043
Other Comprehensive Income				
Unrealized gains (losses) on available-for-sale securities, net of taxes of \$327 and \$(690) for three months ended September 30, 2017 and 2016, respectively and \$(5,154) and \$(3,698) for nine months ended September 30, 2017 and 2016, respectively.	(512)	1,082	8,068	5,792
Amortized holding losses on held-to-maturity securities transferred from available-for-sale, net of taxes of \$(11) for three months ended September 30, 2017 and 2016, and \$(32) and \$(161) for nine months ended September 30, 2017 and 2016, respectively.	16	16	51	251
Less: reclassification adjustment for realized gains included in net income, net of taxes of \$99 and \$182 for three months ended September 30, 2017 and 2016, respectively and \$230 and \$440 for nine months ended September 30, 2017 and 2016, respectively.	(155)	(284)	(359)	(690)
Other comprehensive income (loss), net of taxes	(651)	814	7,760	5,353
Comprehensive income	\$6,944	\$6,122	\$29,819	\$20,396

See accompanying notes to unaudited condensed consolidated financial statements.

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Statements of Cash Flows (unaudited)	Nine months ended	
	September 30, 2017	2016
(In thousands)		
Cash flows from operating activities:		
Net income	\$22,059	\$15,043
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	5,051	1,927
Depreciation, amortization and accretion, net	6,241	5,592
Change in cash surrender value of bank owned life insurance	(844)	(384)
Stock-based compensation expense	300	268
Gains on investment securities, net	(589)	(1,130)
Loss (gain) on sales of other real property owned, net	349	(5)
Donation of building	—	653
Loss on write down of fixed assets	337	26
Gains on sale of loans held for sale, net	(809)	(805)
Decrease in accrued interest receivable	(323)	(347)
Increase (decrease) in accrued interest payable	38	(36)
Origination of loans held for sale	(45,076)	(57,199)
Proceeds from sale of loans held for sale	44,981	55,388
Decrease (increase) in other assets	2,475	(2,713)
Decrease in other liabilities	(1,421)	(1,036)
Net cash provided by operating activities	32,769	15,242
Cash flows from investing activities:		
Proceeds from maturities of certificates of deposit investments	12,958	13,618
Purchases of certificates of deposit investments	—	(12,958)
Proceeds from sales of securities available-for-sale	96,184	68,726
Proceeds from maturities of securities available-for-sale	52,894	55,500
Proceeds from maturities of securities held-to-maturity	—	91,899
Purchases of securities available-for-sale	(134,807)	(84,102)
Purchases of securities held-to-maturity	—	(71,557)
Net increase in loans	(49,198)	(84,432)
Sale of premises and equipment	—	147
Purchases of premises and equipment	(1,304)	(449)
Proceeds from sales of other real property owned	5,356	488
Investment in bank owned life insurance	—	(25,000)
Cash received related to acquisition, net of cash and cash equivalents acquired	—	36,774
Net cash used in investing activities	(17,917)	(11,346)
Cash flows from financing activities:		
Net decrease in deposits	(112,410)	(3,996)
Increase in federal funds purchased	20,000	—
Decrease in repurchase agreements	(69,403)	(24,673)
Proceeds from FHLB advances	52,000	20,000
Repayment of FHLB advances	(5,000)	(5,000)
Proceeds from short-term debt	—	7,000
Proceeds from long-term debt	—	15,000
Repayment of other debt	(6,813)	—
Proceeds from issuance of common stock	4,195	97
Direct expenses related to capital transactions	(213)	(230)

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Dividends paid on preferred stock	—	(1,286)
Dividends paid on common stock	(3,467)	(3,555)
Net cash (used in) provided by financing activities	(121,111)	3,357
(Decrease) increase in cash and cash equivalents	(106,259)	7,253
Cash and cash equivalents at beginning of period	175,902	115,784
Cash and cash equivalents at end of period	\$69,643	\$123,037

5

First Mid-Illinois Bancshares, Inc.

Condensed Consolidated Statements of Cash Flows (unaudited)	Nine months ended September 30,	
(In thousands)	2017	2016
Supplemental disclosures of cash flow information		
Cash paid during the period for:		
Interest	\$4,627	\$2,568
Income taxes	7,969	9,335
Supplemental disclosures of noncash investing and financing activities		
Loans transferred to other real estate owned	5,317	115
Dividends reinvested in common stock	527	1,052
Net tax benefit related to option and deferred compensation plans	221	140
Supplemental disclosure of purchase of capital stock of First Clover Leaf		
Fair value of assets acquired		\$668,905
Consideration paid:		
Cash paid		22,545
Common stock issued		65,926
Total consideration paid		88,471
Fair value of liabilities assumed		\$580,434

See accompanying notes to unaudited condensed consolidated financial statements.

6

Notes to Condensed Consolidated Financial Statements
(unaudited)

Note 1 -- Basis of Accounting and Consolidation

The unaudited condensed consolidated financial statements include the accounts of First Mid-Illinois Bancshares, Inc. ("Company") and its wholly-owned subsidiaries: First Mid-Illinois Bank & Trust, N.A. ("First Mid Bank"), Mid-Illinois Data Services, Inc. ("MIDS") and The Checkley Agency, Inc. doing business as First Mid Insurance Group ("First Mid Insurance"). All significant intercompany balances and transactions have been eliminated in consolidation. The financial information reflects all adjustments which, in the opinion of management, are necessary for a fair presentation of the results of the interim periods ended September 30, 2017 and 2016, and all such adjustments are of a normal recurring nature. Certain amounts in the prior year's consolidated financial statements have been reclassified to conform to the September 30, 2017 presentation and there was no impact on net income or stockholders' equity. The results of the interim period ended September 30, 2017 are not necessarily indicative of the results expected for the year ending December 31, 2017. The Company operates as a one-segment entity for financial reporting purposes.

The 2016 year-end consolidated balance sheet data was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

The unaudited condensed consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X and do not include all of the information required by U.S. generally accepted accounting principles ("GAAP") for complete financial statements and related footnote disclosures although the Company believes that the disclosures made are adequate to make the information not misleading. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's 2016 Annual Report on Form 10-K.

Website

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

At-The-Market Program

On August 16, 2017, the Company entered into a Sales Agency Agreement, pursuant to which the Company may sell, from time to time, up to an aggregate of \$20 million of its common stock. Shares of common stock are offered pursuant to the Company's shelf registration statement filed within the SEC. During the three and nine months ended September 30, 2017, the company sold 95,310 shares of common stock at the weighted average price of approximately \$35.06, representing gross proceeds of \$3.34 million and net proceeds of \$3.28 million. As of September 30, 2017, approximately \$16.66 million of common stock remained available for issuance under the At The Market program.

Agreement and Plan of Merger

On April 26, 2016, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with First Clover Leaf Financial Corp., a Maryland corporation ("First Clover Leaf"), pursuant to which, amongst other things, the Company agreed to acquire 100% of the issued and outstanding shares of First Clover Leaf pursuant to a business combination whereby First Clover Leaf would merge with and into the Company, with the Company as the surviving

entity (the "Merger").

On September 8, 2016, the effective time of the Merger, 25% of the shares of First Clover Leaf common stock issued and outstanding immediately prior to the effective time of the Merger converted into the right to receive \$12.87 per share, for an approximate aggregate total of \$22,545,000, and 75% of the shares of First Clover Leaf common stock issued and outstanding immediately prior to the effective time of the Merger converted into the right to receive 0.495 shares of the Company's common stock, par value \$4.00 per share, for an approximate aggregate total of 2,600,616 shares of the Company's common stock. Cash in lieu of fractional shares of Company common stock were issued in connection with the Merger.

7

Bank Owned Life Insurance

First Mid Bank has purchased life insurance policies on certain senior management. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts that are probable at settlement.

Stock Plans

At the Annual Meeting of Stockholders held April 26, 2017, the stockholders approved the First Mid-Illinois Bancshares, Inc. 2017 Stock Incentive Plan (“SI Plan”). The SI Plan was implemented to succeed the Company’s 2007 Stock Incentive Plan, which had a ten-year term. The SI Plan is intended to provide a means whereby directors, employees, consultants and advisors of the Company and its subsidiaries may sustain a sense of proprietorship and personal involvement in the continued development and financial success of the Company and its subsidiaries, thereby advancing the interests of the Company and its stockholders. Accordingly, directors and selected employees, consultants and advisors may be provided the opportunity to acquire shares of common stock of the Company on the terms and conditions established in the SI Plan.

A maximum of 149,983 shares of common stock may be issued under the SI Plan. There have been no stock options awarded under any Company plan since 2008. The Company awarded 11,473 and 13,912 stock units during 2017 and 2016, respectively, under the 2007 Stock Incentive Plan.

Accumulated Other Comprehensive Income (Loss)

The components of accumulated other comprehensive income (loss) included in stockholders’ equity as of September 30, 2017 and December 31, 2016 are as follows (in thousands):

	Unrealized Gain (Loss) on Securities	Securities with Other-Than-Temporary Impairment Losses	Total
September 30, 2017			
Net unrealized gains on securities available-for-sale	\$ 3,817	\$ —	\$3,817
Unamortized losses on held-to-maturity securities transferred from available-for-sale	(310)	—	(310)
Securities with other-than-temporary impairment losses	—	(232)	(232)
Tax benefit (expense)	(1,366)	90	(1,276)
Balance at September 30, 2017	\$ 2,141	\$ (142)	\$ 1,999
December 31, 2016			
Net unrealized losses on securities available-for-sale		\$(7,649)	\$(7,649)
Unamortized losses on held-to-maturity securities transferred from available-for-sale	(394)	—	(394)
Securities with other-than-temporary impairment losses	—	(1,398)	(1,398)
Tax benefit	3,135	545	3,680
Balance at December 31, 2016	\$(4,908)	\$(853)	\$(5,761)

8

Amounts reclassified from accumulated other comprehensive income and the affected line items in the statements of income during the nine months ended September 30, 2017 and 2016, were as follows (in thousands):

	Amounts Reclassified from Other Comprehensive Income				Affected Line Item in the Statements of Income
	Three months ended September 30, 2017		Nine months ended September 30, 2016		
Realized gains on available-for-sale securities	\$254	\$466	\$589	\$1,130	Securities gains, net (Total reclassified amount before tax)
	(99)	(182)	(230)	(440)	Income taxes
Total reclassifications out of accumulated other comprehensive income	\$155	\$284	\$359	\$690	Net reclassified amount

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

Adoption of New Accounting Guidance

Accounting Standards Update 2017-09, Compensation-Stock Compensation (Topic 718): Scope of Modification ("ASU 2017-09"). In May 2017, FASB issued ASU 2017-09. This update provides guidance on determining which changes to the terms and conditions of share-based payment awards require the application of modification accounting under Topic 718. The guidance is effective for public companies for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. The amendments should be applied on a prospective basis to an award modified on or after adoption date. ASU 2017-09 is not expected to have a significant impact on the Company's consolidated financial statement.

Accounting Standards Update 2017-08, Receivables-Nonrefundable Fees and Other Costs ("ASU 2017-08"). In March 2017, FASB issued ASU 2017-08. This update amends the amortization period for certain purchased callable debt securities held at a premium. The update shortens the premium's amortization period to the earliest call date to more closely align the amortization period of premiums to expectations incorporated in market pricing on the underlying securities. For public companies, the update is effective for annual periods beginning after December 15, 2018, and is to be applied on a modified retrospective basis with a cumulative-effect adjustment directly to retained earnings as of the beginning of the adoption period. Early adoption is permitted, including adoption in an interim period. The Company has adopted ASU 2017-08 early and there was not a significant impact on the Company's consolidated financial statements.

Accounting Standards Update 2017-04, Intangibles--Goodwill and Other (Topic 350: Simplifying the Test for Goodwill Impairment ("ASU 2017-04"). In January 2017, FASB issued ASU 2017-04. The amendments in this update simplify the measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Under this guidance, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss should not exceed the total amount of goodwill allocated to that reporting unit. ASU 2017-04 is effective for public companies for the reporting periods beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Although the Company cannot anticipate future goodwill impairment, based on the most recent assessment, it is unlikely that an impairment amount would need to be calculated and, therefore, does not

anticipate a material impact on the Company's consolidated financial statements. The current accounting policies and procedures of the Company are not anticipated to change, except for the elimination of the Step 2 analysis.

Accounting Standards Update 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses of Financial Instruments ("ASU 2016-13"). In June 2016, FASB issued ASU 2016-13. The provisions of ASU 2016-13 requires an entity to utilize a new impairment model known as the current expected credit loss ("CECL") model to estimate its lifetime "expected credit loss" and record an allowance that, when deducted from the amortized cost basis of the financial asset, presents the net amount expected to be collected on the financial asset. The CECL model is expected to result in

9

more timely recognition of credit losses. ASU 2016-13 also requires new disclosures for financial assets measured at amortized cost, loans and available-for-sale debt securities. ASU 2016-13 is effective for annual periods beginning after December 15, 2019, including interim periods within those fiscal years. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is adopted. Management has formed an internal committee to evaluate implementation steps and assess the impact ASU 2016-13 will have on the Company's consolidated financial statements.

Accounting Standards Update 2016-08, Revenue from Contracts with Customers (Topic 606) ("ASU 2016-08"). In March 2016, the FASB issued ASU 2016-08 which amended the accounting guidance issued by the FASB in May 2014 that revised the criteria for determining when to recognize revenue from contracts with customers and expanded disclosure requirements. The amendment defers the effective date by one year. This accounting guidance can be implemented using either a retrospective method or a cumulative-effect approach. This new guidance will be effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted but only for interim and annual reporting periods beginning after December 15, 2016. There are many aspects of the new accounting guidance that are still being interpreted, and the FASB has recently issued and proposed updates to certain aspects of the guidance. Management continues to evaluate the impact ASU 2016-08 will have on the Company's consolidated financial statements.

Accounting Standards Update 2016-02, Leases (Topic 842) ("ASU 2016-02"). On February 25, 2016, FASB issued ASU 2016-02 which creates Topic 842, Leases and supersedes Topic 840, Leases. ASU 2016-02 is intended to improve financial reporting about leasing transactions, by increasing transparency and comparability among organizations. Under the new guidance, a lessee will be required to record all leases with lease terms of more than 12 months on their balance sheet as lease liabilities with a corresponding right-of-use asset. ASU 2016-02 maintains the dual model for lease accounting, requiring leases to be classified as either operating or finance, with lease classification determined in a manner similar to existing lease guidance. The new guidance will be effective for public companies for fiscal years beginning on or after December 15, 2018, and for private companies for fiscal years beginning on or after December 15, 2019. Early adoption is permitted for all entities. Management continues to evaluate the impact ASU 2016-02 will have on the Company's consolidated financial statements.

Accounting Standards Update 2016-01, Financial Instruments (Topic 825): Recognition and Measurement of Financial Assets and Financial Liabilities ("ASU 2016-01"). In January 2016, FASB issued ASU 2016-01 which amends prior guidance to require an entity to measure its equity investments (except those accounted for under the equity method of accounting) to be measured at fair value with changes in fair value recognized in net income. An entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or similar investment of same issuer. The new guidance simplifies the impairment assessment of equity investments without readily determinable fair values, requires public entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes, requires an entity to present separately in other comprehensive income the portion of the total change in fair value of a liability resulting from changes in the instrument-specific credit risk when the entity has selected fair value option for financial instruments and requires separate presentation of financial assets and liabilities by measurement category and form of financial asset. The new guidance will be effective for reporting periods after January 1, 2018 and is not expected to have a significant impact on the Company's consolidated financial statements.

Accounting Standards Update 2014-09, Revenue from Contracts with Customers (Topic 606): ("ASU 2014-09"). In May 2014, FASB issued ASU 2014-09 which created a new topic in the FASB Accounting Standards Codification(R) ("ASC"), Topic 606. In addition to superseding and replacing nearly all existing U.S. GAAP revenue recognition guidance, including industry-specific guidance, ASU 2014-09 establishes a new control-based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and

more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, ASU 2014-09 adds a new Subtopic to the ASC, Other Assets and Deferred Costs: Contracts with Customers ("ASC 340-40"), to provide guidance on costs related to obtaining a contract with a customer and costs incurred in fulfilling a contract with a customer that are not in the scope of another ASC Topic. The new guidance does not apply to certain contracts within the scope of other ASC Topics, such as lease contracts, insurance contracts, financing arrangements, financial instruments, guarantee other than product or service warranties, and non-monetary exchanges between entities in the same line of business to facilitate sales to customers. See ASU 2016-08, above, for the effective dates.

Note 2 -- Earnings Per Share

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

The components of basic and diluted net income per common share available to common stockholders for the three and nine-month period ended September 30, 2017 and 2016 were as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Basic Net Income per Common Share				
Available to Common Stockholders:				
Net income	\$7,595,000	\$5,308,000	\$22,059,000	\$15,043,000
Preferred stock dividends	—	—	—	(825,000)
Net income available to common stockholders	7,595,000	5,308,000	22,059,000	14,218,000
Weighted average common shares outstanding	12,528,674	10,497,072	12,498,913	9,372,547
Basic earnings per common share	\$0.61	\$0.51	\$1.76	\$1.52
Diluted Net Income per Common Share				
Available to Common Stockholders:				
Net income available to common stockholders	\$7,595,000	\$5,308,000	\$22,059,000	\$14,218,000
Effect of assumed preferred stock conversion	—	—	—	825,000
Net income applicable to diluted earnings per share	7,595,000	5,308,000	22,059,000	15,043,000
Weighted average common shares outstanding	12,528,674	10,497,072	12,498,913	9,372,547
Dilutive potential common shares:				
Assumed conversion of stock options	6,299	1,742	6,827	1,945
Restricted stock awarded	836	5,232	836	5,232
Assumed conversion of preferred stock	—	—	—	677,674
Dilutive potential common shares	7,135	6,974	7,663	684,851
Diluted weighted average common shares outstanding	12,535,809	10,504,046	12,506,576	10,057,398
Diluted earnings per common share	\$0.61	\$0.51	\$1.76	\$1.50

The following shares were not considered in computing diluted earnings per share for the three and nine-month periods ended September 30, 2017 and 2016 because they were anti-dilutive:

	Three months ended September 30, 2016	Nine months ended September 30, 2016
Stock options to purchase shares of common stock	—24,500	—24,500

Note 3 -- Investment Securities

The amortized cost, gross unrealized gains and losses and estimated fair values for available-for-sale and held-to-maturity securities by major security type at September 30, 2017 and December 31, 2016 were as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
September 30, 2017				
Available-for-sale:				
U.S. Treasury securities and obligations of U.S. government corporations & agencies	\$ 126,931	\$ 484	\$(1,014)	\$ 126,401
Obligations of states and political subdivisions	169,526	3,486	(486)	172,526
Mortgage-backed securities: GSE residential	314,195	2,223	(1,061)	315,357
Trust preferred securities	2,933	—	(232)	2,701
Other securities	4,034	185	—	4,219
Total available-for-sale	\$ 617,619	\$ 6,378	\$(2,793)	\$ 621,204
Held-to-maturity:				
U.S. Treasury securities and obligations of U.S. government corporations & agencies	\$ 69,306	\$ 328	\$(497)	\$ 69,137
December 31, 2016				
Available-for-sale:				
U.S. Treasury securities and obligations of U.S. government corporations & agencies	\$ 138,819	\$ 13	\$(2,508)	\$ 136,324
Obligations of states and political subdivisions	164,163	1,346	(2,804)	162,705
Mortgage-backed securities: GSE residential	318,829	531	(4,369)	314,991
Trust preferred securities	3,050	—	(1,398)	1,652
Other securities	4,034	147	(5)	4,176
Total available-for-sale	\$ 628,895	\$ 2,037	\$(11,084)	\$ 619,848
Held-to-maturity:				
U.S. Treasury securities and obligations of U.S. government corporations & agencies	\$ 74,231	\$ 203	\$(1,338)	\$ 73,096

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

Realized gains and losses resulting from sales of securities were as follows during the nine months ended September 30, 2017 and 2016 (in thousands):

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
Gross gains	\$394	\$446	\$746	\$1,130

Gross losses (140) — (157) —

12

The following table indicates the expected maturities of investment securities classified as available-for-sale presented at fair value, and held-to-maturity presented at amortized cost, at September 30, 2017 and the weighted average yield for each range of maturities (dollars in thousands):

	One year or less	After 1 through 5 years	After 5 through 10 years	After ten years	Total	
Available-for-sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$75,846	\$39,439	\$11,116	\$—	\$126,401	
Obligations of state and political subdivisions	19,153	81,336	70,371	1,666	172,526	
Mortgage-backed securities: GSE residential	423	213,894	101,040	—	315,357	
Trust preferred securities	—	—	—	2,701	2,701	
Other securities	—	2,006	2,038	175	4,219	
Total available-for-sale investments	\$95,422	\$336,675	\$184,565	\$4,542	\$621,204	
Weighted average yield	2.23	% 2.56	% 2.68	% 2.57	% 2.55	%
Full tax-equivalent yield	2.65	% 3.02	% 3.47	% 3.41	% 3.10	%
Held to Maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$39,993	\$29,313	\$—	\$—	\$69,306	
Weighted average yield	1.76	% 2.08	% —	% —	% 1.90	%
Full tax-equivalent yield	1.76	% 2.08	% —	% —	% 1.90	%

The weighted average yields are calculated on the basis of the amortized cost and effective yields weighted for the scheduled maturity of each security. Tax-equivalent yields have been calculated using a 35% tax rate. With the exception of obligations of the U.S. Treasury and other U.S. government agencies and corporations, there were no investment securities of any single issuer, the book value of which exceeded 10% of stockholders' equity at September 30, 2017.

Investment securities carried at approximately \$463 million and \$509 million at September 30, 2017 and December 31, 2016, respectively, were pledged to secure public deposits and repurchase agreements and for other purposes as permitted or required by law.

The following table presents the aging of gross unrealized losses and fair value by investment category as of September 30, 2017 and December 31, 2016 (in thousands):

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2017						
Available-for-sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$73,135	\$(1,009)	\$1,003	\$(5)	\$74,138	\$(1,014)
Obligations of states and political subdivisions	25,250	(274)	9,339	(212)	34,589	(486)
Mortgage-backed securities: GSE residential	86,744	(810)	9,084	(251)	95,828	(1,061)
Trust preferred securities	—	—	2,701	(232)	2,701	(232)
Other securities	—	—	—	—	—	—
Total	\$185,129	\$(2,093)	\$22,127	\$(700)	\$207,256	\$(2,793)
Held-to-maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$29,336	\$(229)	\$14,725	\$(268)	\$44,061	\$(497)
December 31, 2016						
Available-for-sale:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$125,257	\$(2,508)	\$—	\$—	\$125,257	\$(2,508)
Obligations of states and political subdivisions	93,405	(2,804)	—	—	93,405	(2,804)
Mortgage-backed securities: GSE residential	266,319	(4,099)	5,878	(270)	272,197	(4,369)
Trust preferred securities	—	—	1,652	(1,398)	1,652	(1,398)
Other securities	—	—	1,995	(5)	1,995	(5)
Total	\$484,981	\$(9,411)	\$9,525	\$(1,673)	\$494,506	\$(11,084)
Held-to-maturity:						
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$53,295	\$(1,338)	\$—	\$—	\$53,295	\$(1,338)

U.S. Treasury Securities and Obligations of U.S. Government Corporations and Agencies. At September 30, 2017 there was one available-for sale U.S. Treasury securities and obligations of U.S. government corporations and agencies with a fair value of \$1,003,000 and unrealized losses of \$5,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2016, there were no available-for sale U.S. Treasury securities and obligations of U.S. government corporations and agencies in a continuous unrealized loss position for twelve months or more. At September 30, 2017 there were three held-to-maturity U.S. Treasury securities and obligations of U.S. government corporations and agencies with a fair value of \$14,725,000 and unrealized losses of \$268,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2016 there were also no held-to-maturity U.S. Treasury securities and obligations of U.S. government corporations and agencies in a continuous unrealized loss position for twelve months or more.

Obligations of states and political subdivisions. At September 30, 2017 there were twenty-two obligations of states and political subdivisions with a fair value of \$9,339,000 and unrealized losses of \$212,000 in a continuous loss position for twelve months or more. At December 31, 2016, there were no obligations of states and political subdivisions in a continuous unrealized loss position for twelve months or more.

Mortgage-backed Securities: GSE Residential. At September 30, 2017 there were five mortgage-backed securities with a fair value of \$9,084,000 and unrealized losses of \$251,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2016, there were two mortgage-backed securities with a fair value of \$5,878,000

and unrealized losses of \$270,000 in a continuous unrealized loss position for twelve months or more.

14

Trust Preferred Securities. At September 30, 2017, there was one trust preferred security with a fair value of \$2,701,000 and unrealized loss of \$232,000 in a continuous unrealized loss position for twelve months or more. At December 31, 2016, there was one trust preferred security with a fair value of \$1,652,000 and unrealized loss of \$1,398,000 in a continuous unrealized loss position for twelve months or more. The unrealized loss was primarily due to the long-term nature of the trust preferred security, a lack of demand or inactive market for the security, the impending change to the regulatory treatment of these securities, and concerns regarding the underlying financial institutions that have issued the trust preferred securities.

The Company recorded no other-than-temporary impairment (OTTI) for these securities during 2017 or 2016. Because it is not more-likely-than-not that the Company will be required to sell the remaining security before recovery of its new, lower amortized cost basis, which may be maturity, the Company does not consider the remainder of the investment to be other-than-temporarily impaired at September 30, 2017. However, future downgrades or additional deferrals and defaults in this security, could result in additional OTTI and consequently, have a material impact on future earnings.

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

Book Value	Fair Value	Unrealized Gains (Losses)	Other-than-temporary Impairment Recorded To-date
PreTSL XXVIII	\$2,933	\$2,701	\$ (232) \$ (1,111)

Other securities. At September 30, 2017 there were no other securities in a continuous unrealized loss position for twelve months or more. At December 31, 2016, there was one other security with a fair value of \$1,995,000 and unrealized losses of \$5,000 in a continuous unrealized loss position for twelve months or more.

The Company does not believe any other individual unrealized loss as of September 30, 2017 represents OTTI. However, given the continued disruption in the financial markets, the Company may be required to recognize OTTI losses in future periods with respect to its available for sale investment securities portfolio. The amount and timing of any additional OTTI will depend on the decline in the underlying cash flows of the securities. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in the period the other-than-temporary impairment is identified.

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

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

if there has been an adverse change which could indicate additional OTTI.

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

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

15

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

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

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

Credit Losses Recognized on Investments. As described above, the Company's investment in trust preferred security has experienced fair value deterioration due to credit losses but is not otherwise other-than-temporarily impaired. The following table provides information about the trust preferred security for which only a credit loss was recognized in income and other losses are recorded in other comprehensive income (loss) for the nine months ended September 30, 2017 and 2016 (in thousands).

	Accumulated Credit Losses	
	September 30, 2017	September 30, 2016
Credit losses on trust preferred securities held		
Beginning of period	\$1,111	\$ 1,111
Additions related to OTTI losses not previously recognized	—	—
Reductions due to sales / (recoveries)	—	—
Reductions due to change in intent or likelihood of sale	—	—
Additions related to increases in previously recognized OTTI losses	—	—
Reductions due to increases in expected cash flows	—	—
End of period	\$1,111	\$ 1,111

Note 4 – Loans and Allowance for Loan Losses

Loans are stated at the principal amount outstanding net of unearned discounts, unearned income and allowance for loan losses. Unearned income includes deferred loan origination fees reduced by loan origination costs and is amortized to interest income over the life of the related loan using methods that approximated the effective interest rate method. Interest on substantially all loans is credited to income based on the principal amount outstanding. A summary of loans at September 30, 2017 and December 31, 2016 follows (in thousands):

	September 30, December 31,	
	2017	2016
Construction and land development	\$ 77,325	\$ 49,366
Agricultural real estate	126,164	126,216
1-4 Family residential properties	302,889	328,119
Multifamily residential properties	72,491	83,478
Commercial real estate	650,059	633,694
Loans secured by real estate	1,228,928	1,220,873
Agricultural loans	81,367	86,735
Commercial and industrial loans	444,836	412,637
Consumer loans	30,394	38,404
All other loans	89,117	77,602
Total Gross loans	1,874,642	1,836,251
Less: Loans held for sale	2,079	1,175
	1,872,563	1,835,076
Less:		
Net deferred loan fees, premiums and discounts	7,080	10,259
Allowance for loan losses	18,589	16,753
Net loans	\$ 1,846,894	\$ 1,808,064

Net loans increased \$38.8 million as of September 30, 2017 compared to December 31, 2016. The increase was primarily due to increases in construction and land development and commercial and industrial loans offset by decreases in 1-4 family and multifamily residential properties. Loans expected to be sold are classified as held for sale in the consolidated financial statements and are recorded at the lower of aggregate cost or market value, taking into consideration future commitments to sell the loans. These loans are primarily for 1-4 family residential properties.

Most of the Company's business activities are with customers located near the Company's branch locations in Illinois and Missouri. At September 30, 2017, the Company's loan portfolio included \$207.5 million of loans to borrowers whose businesses are directly related to agriculture. Of this amount, \$166.4 million was concentrated in other grain farming. Total loans to borrowers whose businesses are directly related to agriculture decreased \$5.5 million from \$213.0 million at December 31, 2016 due to seasonal paydowns based upon timing of cash flow requirements. Loans concentrated in other grain farming decreased \$4.9 million from \$171.3 million at December 31, 2016. While the Company adheres to sound underwriting practices, including collateralization of loans, any extended period of low commodity prices, drought conditions, significantly reduced yields on crops and/or reduced levels of government assistance to the agricultural industry could result in an increase in the level of problem agriculture loans and potentially result in loan losses within the agricultural portfolio.

In addition, the Company has \$120.3 million of loans to motels and hotels. The performance of these loans is dependent on borrower specific issues as well as the general level of business and personal travel within the region. While the Company adheres to sound underwriting standards, a prolonged period of reduced business or personal travel could result in an increase in nonperforming loans to this business segment and potentially in loan losses. The Company also has \$168.3 million of loans to lessors of non-residential buildings, \$129.4 million of loans

to lessors of residential buildings and dwellings, and \$81.4 million of loans to other gambling industries.

17

The structure of the Company's loan approval process is based on progressively larger lending authorities granted to individual loan officers, loan committees, and ultimately the board of directors. Outstanding balances to one borrower or affiliated borrowers are limited by federal regulation and the vast majority of borrowers are below regulatory thresholds. The Company can occasionally have outstanding balances to one borrower up to but not exceeding the regulatory threshold should underwriting guidelines warrant. The vast majority of the Company's loans are to businesses located in the geographic market areas served by the Company's branch bank system. Additionally, a significant portion of the collateral securing the loans in the portfolio is located within the Company's primary geographic footprint. In general, the Company adheres to loan underwriting standards consistent with industry guidelines for all loan segments.

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

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

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

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

Residential Real Estate Loans. Residential real estate loans generally include loans for the purchase or refinance of residential real estate properties consisting of one-to-four units and home equity loans and lines of credit. The Company sells the vast majority of its long-term fixed rate residential real estate loans to secondary market

investors. The Company also releases the servicing of these loans upon sale. The Company retains all residential real estate loans with balloon payment features. Balloon periods are limited to five years. Residential real estate loans are typically underwritten to conform to industry standards including criteria for maximum debt-to-income and loan-to-value ratios as well as minimum credit scores. Loans secured by first liens on residential real estate held in the portfolio typically do not exceed 80% of the value of the collateral and have amortization periods of twenty five years or less. The Company does not originate subprime mortgage loans.

Consumer Loans. Consumer loans are primarily comprised of loans to individuals for personal and household purposes such as the purchase of an automobile or other living expenses. Minimum underwriting criteria have been established that consider credit score, debt-to-income ratio, employment history, and collateral coverage. Typically, consumer loans are set up on monthly payments with amortization periods based on the type and age of the collateral.

18

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

Purchase Credit-Impaired Loans. Loans acquired with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be credit impaired. Evidence of credit quality deterioration as of the purchase date may include information such as past-due and nonaccrual status, borrower credit scores and recent loan to value percentages. Purchase credit-impaired ("PCI") loans are accounted for under ASC 310-30, Receivables--Loans and Debt Securities Acquired with Deteriorated Credit Quality ("ASC 310-30"), and are initially measured at fair value, which includes the estimated future credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for credit losses related to these loans is not carried over and recorded at the acquisition date. The cash flows expected to be collected were estimated using current key assumptions, such as default rates, value of underlying collateral, severity and prepayment speeds.

Allowance for Loan Losses

The allowance for loan losses represents the Company's best estimate of the reserve necessary to adequately account for probable losses existing in the current portfolio. The provision for loan losses is the charge against current earnings that is determined by the Company as the amount needed to maintain an adequate allowance for loan losses. In determining the adequacy of the allowance for loan losses, and therefore the provision to be charged to current earnings, the Company relies predominantly on a disciplined credit review and approval process that extends to the full range of the Company's credit exposure. The review process is directed by the overall lending policy and is intended to identify, at the earliest possible stage, borrowers who might be facing financial difficulty. Factors considered by the Company in evaluating the overall adequacy of the allowance include historical net loan losses, the level and composition of nonaccrual, past due and troubled debt restructurings, trends in volumes and terms of loans, effects of changes in risk selection and underwriting standards or lending practices, lending staff changes, concentrations of credit, industry conditions and the current economic conditions in the region where the Company operates. The Company estimates the appropriate level of allowance for loan losses by separately evaluating large impaired loans and nonimpaired loans.

The Company has loans acquired from business combinations with uncollected principal balances. These loans are carried net of a fair value adjustment for credit risk and interest rates and are only included in the allowance calculation to the extent that the reserve requirement exceeds the fair value adjustment. However, as the acquired loans renew, it is necessary to establish an allowance which represents an amount that, in management's opinion, will be adequate to absorb probable credit losses inherent in such loans.

Impaired loans

The Company individually evaluates certain loans for impairment. In general, these loans have been internally identified via the Company's loan grading system as credits requiring management's attention due to underlying problems in the borrower's business or collateral concerns. This evaluation considers expected future cash flows, the value of collateral and also other factors that may impact the borrower's ability to make payments when due. For loans greater than \$250,000, impairment is individually measured each quarter using one of three alternatives: (1) the present value of expected future cash flows discounted at the loan's effective interest rate; (2) the loan's observable market price, if available; or (3) the fair value of the collateral less costs to sell for collateral dependent loans and loans for which foreclosure is deemed to be probable. A specific allowance is assigned when expected cash flows or collateral do not justify the carrying amount of the loan. The carrying value of the loan reflects reductions from prior charge-offs.

Non-Impaired loans

Non-impaired loans comprise the vast majority of the Company's total loan portfolio and include loans in accrual status and those credits not identified as troubled debt restructurings. A small portion of these loans are considered "criticized" due to the risk rating assigned reflecting elevated credit risk due to characteristics, such as a strained cash flow position, associated with the individual borrowers. Criticized loans are those assigned risk ratings of Special Mention, Substandard, or Doubtful. Determining the appropriate level of the allowance for loan losses for all non-impaired loans is based on a migration analysis of net losses over a rolling twelve quarter period by loan segment. A weighted average of the net losses is determined by assigning more weight to the most recent quarters in order to recognize current risk factors influencing the various segments of the loan portfolio more prominently than past periods. Environmental factors including changes in economic conditions, changes in

credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets are evaluated each quarter to determine if adjustments to the weighted average historical net losses is appropriate given these current influences on the risk profile of each loan segment. Because the economic and business climate in any given industry or market, and its impact on any given borrower, can change rapidly, the risk profile of the loan portfolio is periodically assessed and adjusted when appropriate. Consumer loans are evaluated for adverse classification based primarily on the Uniform Retail Credit Classification and Account Management Policy established by the federal banking regulators. Classification standards are generally based on delinquency status, collateral coverage, bankruptcy and the presence of fraud.

Due to weakened economic conditions during prior years, the Company established qualitative factor adjustments for each of the loan segments at levels above the historical net loss averages. Some of the economic factors included the potential for reduced cash flow for commercial operating loans from reduction in sales or increased operating costs, decreased occupancy rates for commercial buildings, reduced levels of home sales for commercial land developments, the uncertainty regarding grain prices and increased operating costs for farmers, and increased levels of unemployment and bankruptcy impacting consumer's ability to pay. Each of these economic uncertainties was taken into consideration in developing the level of the allowance for loan losses.

The Company has not materially changed any aspect of its overall approach in the determination of the allowance for loan losses. However, on an on-going basis the Company continues to refine the methods used in determining management's best estimate of the allowance for loan losses.

The following tables present the balance in the allowance for loan losses and the recorded investment in loans based on portfolio segment and impairment method for the three and nine-months ended September 30, 2017 and 2016 and for the year ended December 31, 2016 (in thousands):

	Commercial/ Commercial Real Estate	Agricultural/ Agricultural Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Three months ended September 30, 2017						
Allowance for loan losses:						
Balance, beginning of period	\$ 14,747	\$ 1,743	\$ 969	\$ 716	\$ 34	\$18,209
Provision charged to expense	1,440	(57)	(2)	72	36	1,489
Losses charged off	(1,242)	—	(7)	(160)	—	(1,409)
Recoveries	158	1	78	63	—	300
Balance, end of period	\$ 15,103	\$ 1,687	\$ 1,038	\$ 691	\$ 70	\$18,589
Ending balance:						
Individually evaluated for impairment	\$ 168	\$ —	\$ 125	\$ 2	\$ —	\$295
Collectively evaluated for impairment	\$ 14,935	\$ 1,687	\$ 913	\$ 689	\$ 70	\$18,294
Acquired with deteriorated credit quality	\$ —	\$ —	\$ —	\$ —	\$ —	\$—

	Commercial/ Commercial Real Estate	Agricultural/ Agricultural Real Estate	Residential Real Estate	Consumer	Unallocated	Total	
Three months ended September 30, 2016							
Allowance for loan losses:							
Balance, beginning of period	\$ 12,025	\$ 1,419	\$ 924	\$ 733	\$ 63	\$ 15,164	
Provision charged to expense	445	476	(36	) 248	(52	) 1,081
Losses charged off	—	—	—	(271) —	(271)
Recoveries	128	2	1	56	—	187	
Balance, end of period	\$ 12,598	\$ 1,897	\$ 889	\$ 766	\$ 11	\$ 16,161	
Ending balance:							
Individually evaluated for impairment	\$ 272	\$ 329	\$ —	\$ —	\$ —	\$ 601	
Collectively evaluated for impairment	\$ 12,326	\$ 1,568	\$ 889	\$ 766	\$ 11	\$ 15,560	
Acquired with deteriorated credit quality	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	
Nine months ended September 30, 2017							
Allowance for loan losses:							
Balance, beginning of year	\$ 12,901	\$ 2,249	\$ 874	\$ 693	\$ 36	\$ 16,753	
Provision charged to expense	4,573	98	167	179	34	5,051	
Losses charged off	(2,725) (662) (106) (397) —	(3,890)
Recoveries	354	2	103	216	—	675	
Balance, end of period	\$ 15,103	\$ 1,687	\$ 1,038	\$ 691	\$ 70	\$ 18,589	
Ending balance:							
Individually evaluated for impairment	\$ 168	\$ —	\$ 125	\$ 2	\$ —	\$ 295	
Collectively evaluated for impairment	\$ 14,935	\$ 1,687	\$ 913	\$ 689	\$ 70	\$ 18,294	
Acquired with deteriorated credit quality	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	
Loans:							
Individually evaluated for impairment	\$ 7,635	\$ 513	\$ 1,418	\$ 210	\$ —	\$ 9,776	
Collectively evaluated for impairment	1,287,821	206,669	324,920	32,892	\$ —	1,852,302	
Acquired with deteriorated credit quality	5,484	—	—	—	\$ —	5,484	
Ending balance	\$ 1,300,940	\$ 207,182	\$ 326,338	\$ 33,102	\$ —	\$ 1,867,562	

	Commercial/ Commercial Real Estate	Agricultural/ Agricultural Real Estate	Residential Real Estate	Consumer	Unallocated	Total
Nine months ended September 30, 2016						
Allowance for loan losses:						
Balance, beginning of year	\$ 11,379	\$ 1,337	\$ 994	\$ 642	\$ 224	\$ 14,576
Provision charged to expense	1,058	587	36	459	(213)	1,927
Losses charged off	(582)	(30)	(142)	(493)	—	(1,247)
Recoveries	743	3	1	158	—	905
Balance, end of period	\$ 12,598	\$ 1,897	\$ 889	\$ 766	\$ 11	\$ 16,161
Ending balance:						
Individually evaluated for impairment	\$ 272	\$ 329	\$ —	\$ —	\$ —	\$ 601
Collectively evaluated for impairment	\$ 12,326	\$ 1,568	\$ 889	\$ 766	\$ 11	\$ 15,560
Acquired with deteriorated credit quality	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Loans:						
Individually evaluated for impairment	\$ 1,753	\$ 1,170	\$ 471	\$ 20	\$ —	\$ 3,414
Collectively evaluated for impairment	1,162,386	208,775	378,742	44,740	—	1,794,643
Acquired with deteriorated credit quality	3,942	—	4,746	—	—	8,688
Ending balance	\$ 1,168,081	\$ 209,945	\$ 383,959	\$ 44,760	\$ —	\$ 1,806,745
Year ended December 31, 2016						
Allowance for loan losses:						
Balance, beginning of year	\$ 11,379	\$ 1,337	\$ 994	\$ 642	\$ 224	\$ 14,576
Provision charged to expense	1,467	933	113	501	(188)	2,826
Losses charged off	(747)	(30)	(234)	(664)	—	(1,675)
Recoveries	802	9	1	214	—	1,026
Balance, end of year	\$ 12,901	\$ 2,249	\$ 874	\$ 693	\$ 36	\$ 16,753
Ending balance:						
Individually evaluated for impairment	\$ 192	\$ 660	\$ 6	\$ —	\$ —	\$ 858
Collectively evaluated for impairment	\$ 12,695	\$ 1,589	\$ 868	\$ 693	\$ 36	\$ 15,881
Acquired with deteriorated credit quality	\$ 14	\$ —	\$ —	\$ —	\$ —	\$ 14
Loans:						
Individually evaluated for impairment	\$ 1,956	\$ 1,345	\$ 1,752	\$ 213	\$ —	\$ 5,266
Collectively evaluated for impairment	1,199,003	211,168	360,825	41,644	—	1,812,640
Acquired with deteriorated credit quality	3,840	—	4,246	—	—	8,086
Ending balance	\$ 1,204,799	\$ 212,513	\$ 366,823	\$ 41,857	\$ —	\$ 1,825,992

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

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

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

Credit Quality

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, collateral support, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a continuous basis. The Company uses the following definitions for risk ratings which are commensurate with a loan considered "criticized":

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

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

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

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

The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of September 30, 2017 and December 31, 2016 (in thousands):

	Construction & Land Development		Agricultural Real Estate		1-4 Family Residential Properties		Multifamily Residential Properties	
	2017	2016	2017	2016	2017	2016	2017	2016
Pass	\$76,913	\$48,877	\$119,958	\$118,934	\$290,989	\$318,921	\$64,938	\$81,018
Special Mention	—	—	4,862	5,190	2,359	918	89	1,651
Substandard	266	227	1,276	1,984	8,549	6,576	7,296	531
Doubtful	—	—	—	—	—	—	—	—
Total	\$77,179	\$49,104	\$126,096	\$126,108	\$301,897	\$326,415	\$72,323	\$83,200

	Commercial Real Estate (Nonfarm/Nonresidential)		Agricultural Loans		Commercial & Industrial Loans		Consumer Loans	
	2017	2016	2017	2016	2017	2016	2017	2016
Pass	\$ 609,203	\$ 610,025	\$78,356	\$81,922	\$424,306	\$397,762	\$29,669	\$37,624
Special Mention	20,082	5,229	2,128	3,271	17,560	8,485	13	17
Substandard	17,899	14,881	899	1,492	1,607	2,786	392	387
Doubtful	—	—	—	—	—	—	—	—
Total	\$ 647,184	\$ 630,135	\$81,383	\$86,685	\$443,473	\$409,033	\$30,074	\$38,028

	All Other Loans		Total Loans	
	2017	2016	2017	2016
Pass	\$85,239	\$74,377	\$1,779,571	\$1,769,460
Special Mention	2,714	2,892	49,807	27,653
Substandard	—	15	38,184	28,879
Doubtful	—	—	—	—
Total	\$87,953	\$77,284	\$1,867,562	\$1,825,992

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

The following table presents the Company's loan portfolio aging analysis at September 30, 2017 and December 31, 2016 (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Total Loans > 90 Days & Accruing
September 30, 2017							
Construction and land development	\$—	\$—	\$267	\$267	\$76,912	\$77,179	\$ —
Agricultural real estate	—	—	396	396	125,700	126,096	—
1-4 Family residential properties	1,542	282	2,146	3,970	297,927	301,897	—
Multifamily residential properties	—	4,494	56	4,550	67,773	72,323	—
Commercial real estate	968	1,129	1,130	3,227	643,957	647,184	—
Loans secured by real estate	2,510	5,905	3,995	12,410	1,212,269	1,224,679	—
Agricultural loans	14	41	178	233	81,150	81,383	—
Commercial and industrial loans	613	407	592	1,612	441,861	443,473	—
Consumer loans	188	6	3	197	29,877	30,074	—
All other loans	—	—	—	—	87,953	87,953	—
Total loans	\$3,325	\$6,359	\$4,768	\$14,452	\$1,853,110	\$1,867,562	\$ —
December 31, 2016							
Construction and land development	\$—	\$—	\$—	\$—	\$49,104	\$49,104	\$ —
Agricultural real estate	—	131	293	424	125,684	126,108	—
1-4 Family residential properties	1,854	713	1,008	3,575	322,840	326,415	105
Multifamily residential properties	—	—	240	240	82,960	83,200	—
Commercial real estate	1,662	716	43	2,421	627,714	630,135	—
Loans secured by real estate	3,516	1,560	1,584	6,660	1,208,302	1,214,962	105
Agricultural loans	365	84	37	486	86,199	86,685	—
Commercial and industrial loans	395	155	249	799	408,234	409,033	—
Consumer loans	192	37	11	240	37,788	38,028	—
All other loans	—	—	—	—	77,284	77,284	—
Total loans	\$4,468	\$1,836	\$1,881	\$8,185	\$1,817,807	\$1,825,992	\$ 105

Impaired Loans

Within all loan portfolio segments, loans are considered impaired when, based on current information and events, it is probable the Company will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified due date. Impaired loans, excluding certain troubled debt restructured loans, are placed on nonaccrual status. Impaired loans include nonaccrual loans and loans modified in troubled debt restructurings where concessions have been granted to borrowers experiencing financial difficulties. These concessions could include a reduction in the interest rate on the loan, payment extensions, forgiveness of principal, forbearance or other actions intended to maximize collection. It is the Company's policy to have any restructured loans which are on nonaccrual status prior to being modified remain on nonaccrual status until, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal. If the restructured loan is on accrual status prior to being modified, the loan is reviewed to determine if the modified loan should remain on accrual status.

The Company's policy is to discontinue the accrual of interest income on all loans for which principal or interest is ninety days past due. The accrual of interest is discontinued earlier when, in the opinion of management, there is reasonable doubt as to the timely collection of interest or principal. Once interest accruals are discontinued, accrued but uncollected interest is charged against current year income. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Interest on loans determined to be troubled debt restructurings is recognized on an accrual basis in accordance with the restructured terms if the loan is in compliance with the modified terms. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal. The Company requires a period of satisfactory performance of not less than six months before returning a nonaccrual loan to accrual status.

The following tables present impaired loans as of September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017			December 31, 2016		
	Recorded Balance	Unpaid Principal Balance	Specific Allowance	Recorded Balance	Unpaid Principal Balance	Specific Allowance
Loans with a specific allowance:						
Construction and land development	\$266	\$ 607	\$ —	\$227	\$ 227	\$ —
Agricultural real estate	276	276	—	—	—	—
1-4 Family residential properties	1,417	1,738	125	997	997	6
Multifamily residential properties	7,425	7,425	11	528	528	—
Commercial real estate	4,391	4,547	29	863	884	—
Loans secured by real estate	13,775	14,593	165	2,615	2,636	6
Agricultural loans	237	1,080	—	1,345	1,345	660
Commercial and industrial loans	1,038	1,456	128	1,093	1,191	192
Consumer loans	210	210	2	213	213	—
All other loans	—	—	—	—	—	—
Total loans	\$15,260	\$17,339	\$ 295	\$5,266	\$5,385	\$ 858
Loans without a specific allowance:						
Construction and land development	\$—	\$—	\$ —	\$—	\$—	\$ —
Agricultural real estate	15	15	—	205	207	—
1-4 Family residential properties	1,623	2,106	—	2,497	3,207	—
Multifamily residential properties	—	—	—	3,419	3,547	—
Commercial real estate	1,297	1,474	—	6,224	6,802	—
Loans secured by real estate	2,935	3,595	—	12,345	13,763	—
Agricultural loans	597	7	—	43	66	—
Commercial and industrial loans	911	1,218	—	378	572	—
Consumer loans	85	95	—	206	211	—
All other loans	—	—	—	—	—	—
Total loans	\$4,528	\$4,915	\$ —	\$12,972	\$14,612	\$ —
Total loans:						
Construction and land development	\$266	\$ 607	\$ —	\$227	\$ 227	\$ —
Agricultural real estate	291	291	—	205	207	—
1-4 Family residential properties	3,040	3,844	125	3,494	4,204	6
Multifamily residential properties	7,425	7,425	11	3,947	4,075	—
Commercial real estate	5,688	6,021	29	7,087	7,686	—
Loans secured by real estate	16,710	18,188	165	14,960	16,399	6
Agricultural loans	834	1,087	—	1,388	1,411	660

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Commercial and industrial loans	1,949	2,674	128	1,471	1,763	192
Consumer loans	295	305	2	419	424	—
All other loans	—	—	—	—	—	—
Total loans	\$19,788	\$22,254	\$ 295	\$18,238	\$19,997	\$ 858

26

The following tables present average recorded investment and interest income recognized on impaired loans for the three and nine-month periods ended September 30, 2017 and 2016 (in thousands):

	For the three months ended			
	September 30, 2017		September 30, 2016	
	Average		Average	
	Investment	Interest	Investment	Interest
	in	Income	in	Income
	Impaired	Recognized	Impaired	Recognized
	Loans		Loans	
Construction and land development	\$267	\$ —	\$ 231	\$ —
Agricultural real estate	291	—	474	—
1-4 Family residential properties	3,047	5	1,572	3
Multifamily residential properties	8,017	80	535	—
Commercial real estate	5,762	6	1,097	1
Loans secured by real estate	17,384	91	3,909	4
Agricultural loans	834	—	755	—
Commercial and industrial loans	2,075	2	744	1
Consumer loans	296	—	306	—
All other loans	—	—	10	—
Total loans	\$20,589	\$ 93	\$ 5,724	\$ 5
	For the nine months ended			
	September 30, 2017		September 30, 2016	
	Average		Average	
	Investment	Interest	Investment	Interest
	in	Income	in	Income
	Impaired	Recognized	Impaired	Recognized
	Loans		Loans	
Construction and land development	\$98	\$ —	\$ 231	\$ —
Agricultural real estate	293	—	476	—
1-4 Family residential properties	3,003	16	1,344	10
Multifamily residential properties	10,839	229	539	—
Commercial real estate	4,638	14	1,064	2
Loans secured by real estate	18,871	259	3,654	12
Agricultural loans	900	—	696	—
Commercial and industrial loans	2,216	6	777	1
Consumer loans	307	—	388	—
Total loans	\$22,294	\$ 265	\$ 5,515	\$ 13

The amount of interest income recognized by the Company within the periods stated above was due to loans modified in troubled debt restructurings that remained on accrual status. The balance of loans modified in troubled debt restructurings included in the impaired loans at September 30, 2017 stated above that were still accruing was \$410,000 of 1-4 Family residential properties, \$5,217,000 of multifamily residential properties, \$347,000 of commercial real estate, \$29,000 of commercial & industrial loans and \$1,000 of consumer loans. The balance of loans modified in a troubled debt restructurings at September 30, 2016 included in the impaired loans stated above that were still accruing was \$514,000 of 1-4 family residential properties, \$3,430,000 of multifamily residential properties, \$2,152,000 commercial real estate, \$46,000 commercial and industrial loans, and \$9,000 of consumer loans. For the nine months ended September 30, 2017 and 2016, the amount of interest income recognized using a cash-basis method of accounting during the period that the loans were impaired was not material.

Non Accrual Loans

The following table presents the Company's recorded balance of nonaccrual loans as September 30, 2017 and December 31, 2016 (in thousands). This table excludes purchased impaired loans and performing troubled debt restructurings.

	September 30, December 31,	
	2017	2016
Construction and land development	\$ 266	\$ 227
Agricultural real estate	291	205
1-4 Family residential properties	2,630	2,890
Multifamily residential properties	2,208	528
Commercial real estate	5,341	4,971
Loans secured by real estate	10,736	8,821
Agricultural loans	834	1,388
Commercial and industrial loans	1,920	1,430
Consumer loans	294	414
Total loans	\$ 13,784	\$ 12,053

Interest income that would have been recorded under the original terms of such nonaccrual loans totaled \$366,000 and \$99,000 for the nine months ended September 30, 2017 and 2016, respectively.

Purchased Credit-Impaired Loans

The Company acquired certain loans considered to be credit-impaired ("PCI") in its business combination with First Clover Leaf during the third quarter of 2016. At acquisition, these loans evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of these loans is included in the consolidated balance sheet amounts for Loans. The Company had no PCI loans prior to the First Clover Leaf acquisition. The amount of these loans at September 30, 2017 and December 31, 2016 are as follows (in thousands):

	September 30, December 31,	
	2017	2016
1-4 Family residential properties	\$ —	\$ 827
Multifamily residential properties	3,387	3,419
Commercial real estate	2,085	3,816
Loans secured by real estate	5,472	8,062
Commercial and industrial loans	12	24
Carrying amount	5,484	8,086
Allowance for loan losses	—	14
Carrying amount, net of allowance	\$ 5,484	\$ 8,072

As of September 8, 2016, the acquisition date, the principal outstanding of PCI loans totaled \$10,650,000 and the fair value of PCI loans totaled \$8,688,000. For PCI loans, the difference between contractually required payments at acquisition and the cash flow expected to be collected is referred to as the non-accretable difference. Any excess of expected cash flows over the fair value is referred to as the accretable yield. As of September 30, 2017 there is no accretable yield on the PCI loans acquired. Subsequent decreases to the expected cash flows will result in a provision for loan and lease losses. Subsequent increases in expected cash flows will result in a reversal of the provision for loan

and lease losses to the extent of prior charges and then an adjustment to accretable yield, which would have a positive impact on interest income. As of December 31, 2016, there was one loan with a change in expected cash flows and as a result, approximately \$14,000 of provision was recorded. Subsequently, expected cash flows improved due to paydown of the loan balance and the provision was reversed. There was no provision recorded for the remaining PCI loans at September 30, 2017.

28

Troubled Debt Restructuring

The balance of troubled debt restructurings ("TDRs") at September 30, 2017 and December 31, 2016 was \$8.6 million and \$10.9 million, respectively. There was \$99,000 and \$196,000 in specific reserves established with respect to these loans as of September 30, 2017 and December 31, 2016, respectively. As troubled debt restructurings, these loans are included in nonperforming loans and are classified as impaired which requires that they be individually measured for impairment. The modification of the terms of these loans included one or a combination of the following: a reduction of stated interest rate of the loan; an extension of the maturity date and change in payment terms; or a permanent reduction of the recorded investment in the loan. The following table presents the Company's recorded balance of troubled debt restructurings at September 30, 2017 and December 31, 2016 (in thousands).

Troubled debt restructurings:	September 30, December 31,	
	2017	2016
Construction and land development	\$ —	\$ 227
1-4 Family residential properties	843	1,753
Multifamily residential properties	5,217	3,419
Commercial real estate	671	4,125
Loans secured by real estate	6,731	9,524
Agricultural loans	828	—
Commercial and industrial loans	849	1,040
Consumer loans	210	325
Total	\$ 8,618	\$ 10,889
Performing troubled debt restructurings:		
1-4 Family residential properties	410	\$ 603
Multifamily residential properties	5,217	3,419
Commercial real estate	347	2,116
Loans secured by real estate	5,974	6,138
Commercial and industrial loans	29	41
Consumer loans	1	6
Total	\$ 6,004	\$ 6,185

The decrease in TDRs during the period was primarily due to loans that paid off. The following table presents loans modified as TDRs during the nine months ended September 30, 2017 and 2016, as a result of various modified loan factors (in thousands):

	September 30, 2017		September 30, 2016	
	Number of Recorded Investment Modifications	Type of Modifications	Number of Recorded Investment Modifications	Type of Modifications
Construction and land development	—	\$ —	1	\$ 231 (b)(c)
1-4 Family residential properties	1	17 (c)	1	47 (c)
Commercial real estate	—		1	43 (b)(c)
Loans secured by real estate	1	17	3	321
Agricultural loans	4	828 (b)(c)(d)	—	—
Commercial and industrial loans	1	27 (c)	6	405 (b)(c)
Consumer Loans	—		1	20 (c)
Total	6	\$ 872	10	\$ 746

Type of modifications:

- (a) Reduction of stated interest rate of loan
- (b) Change in payment terms
- (c) Extension of maturity date

(d) Permanent reduction of the recorded investment

29

A loan is considered to be in payment default once it is 90 days past due under the modified terms. There were no loans modified as troubled debt restructurings during the prior twelve months that experienced defaults for nine months ended September 30, 2017. There was one loan modified as troubled debt restructuring during the prior twelve months that experienced defaults as of December 31, 2016.

The balance of real estate owned includes \$2,229,000 and \$1,982,000 of foreclosed real estate properties recorded as a result of obtaining physical possession of the property at September 30, 2017 and December 31, 2016, respectively. The Company also held \$35,000 of repossessed collateral, consisting of machinery and equipment, acquired with foreclosed real estate. The recorded investment of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceeds are in process was \$429,000 and \$661,000 at September 30, 2017 and December 31, 2016, respectively.

Note 5 -- Goodwill and Intangible Assets

The Company has goodwill from business combinations, intangible assets from branch acquisitions, identifiable intangible assets assigned to core deposit relationships and customer lists of First Mid Insurance. The following table presents gross carrying value and accumulated amortization by major intangible asset class as of September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017		December 31, 2016	
	Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Goodwill not subject to amortization (effective 1/1/02)	\$63,910	\$ 3,760	\$61,551	\$ 3,760
Intangibles from branch acquisition	3,015	3,015	3,015	3,015
Core deposit intangibles	19,862	11,053	19,862	9,644
Other intangibles	3,731	2,239	3,731	2,102
	\$90,518	\$ 20,067	\$88,159	\$ 18,521

During the third quarter of 2016, goodwill of \$16.8 million was provisionally recorded for the acquisition of First Clover Leaf. Goodwill was adjusted to \$19.1 million within the twelve month measurement period to reflect information collected through that period to record goodwill. The measurement period adjustment also increased other liabilities by \$2 million and decreased other assets by \$.3 million. The goodwill consists largely of the synergies and economies of scale expected from combining the operations of First Clover Leaf Bank with First Mid Bank. All of the goodwill was assigned to the banking segment of the Company. The Company expects this goodwill will not be deductible for tax purposes. The following table provides a reconciliation of the purchase price paid for First Clover Leaf and the amount of goodwill recorded (in thousands):

Purchase price (in excess of net book value)	\$8,741
Purchase accounting adjustments:	
Fair value of securities	737
Fair value of loans, net	3,475
Fair value of OREO	754
Fair value of premises and equipment	(1,963)
Fair value of time deposits	1,994
Fair value of FHLB advances	113
Fair value of subordinated debentures	(731)
Core deposit intangible	(4,660)
Other assets	10,683

	10,402
Resulting goodwill from acquisition	\$ 19,143

30

As part of the acquisition of First Clover Leaf Bank, the Company acquired mortgage servicing rights valued at \$1,069,000. The following table summarizes the activity pertaining to mortgage servicing rights included in intangible assets as of September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017	December 31, 2016
Beginning Balance	\$ 985	\$ —
Mortgage servicing rights acquired during period	—	1,069
Mortgage servicing rights capitalized	—	14
Mortgage servicing rights amortized	(105	) (98
Ending Balance	\$ 880	\$ 985

Total amortization expense for the nine months ended September 30, 2017 and 2016 was as follows (in thousands):

	Three months ended September 30, 2017		Nine months ended September 30, 2016	
Core deposit intangibles	466	395	\$1,409	\$1,161
Other intangibles	46	46	137	137
Mortgage servicing rights	33	14	105	14
	\$545	\$455	\$1,651	\$1,312

Aggregate amortization expense for the current year and estimated amortization expense for each of the five succeeding years is shown in the table below (in thousands):

Aggregate amortization expense:	
For period 01/01/17-09/30/17	\$1,651
Estimated amortization expense:	
For period 10/01/17-12/31/17	501
For year ended 12/31/18	1,954
For year ended 12/31/19	1,778
For year ended 12/31/20	1,576
For year ended 12/31/21	1,304
For year ended 12/31/22	1,195

In accordance with the provisions of SFAS No. 142, "Goodwill and Other Intangible Assets," codified within ASC 350, the Company performed testing of goodwill for impairment as of September 30, 2017 and determined that, as of that date, goodwill was not impaired. Management also concluded that the remaining amounts and amortization periods were appropriate for all intangible assets.

Note 6 -- Repurchase Agreements and Other Borrowings

Securities sold under agreements to repurchase were \$116.4 million at September 30, 2017, a decrease of \$69.4 million from \$185.8 million at December 31, 2016. The decrease during the first nine months of 2017 was primarily

due to decreases in balances of customers due to changes in cash flow needs for their businesses. All of the transactions have overnight maturities with a weighted average rate of 0.09%.

31

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral pledged by the Company would be used to settle the fair value of the repurchase agreement should the Company be in default (e.g., declare bankruptcy), the Company could cancel the repurchase agreement (i.e., cease payment of principal and interest), and attempt collection on the amount of collateral value in excess of the repurchase agreement fair value.

The collateral is held by a third party financial institution in the counterparty's custodial account. The counterparty has the right to sell or repledge the investment securities. For government entity repurchase agreements, the collateral is held by the Company in a segregated custodial account under a tri-party agreement. The Company is required by the counterparty to maintain adequate collateral levels. In the event the collateral fair value falls below stipulated levels, the Company will pledge additional securities. The Company closely monitors collateral levels to ensure adequate levels are maintained, while mitigating the potential of over-collateralization in the event of counterparty default.

Collateral pledged by class for repurchase agreements are as follows (in thousands):

	September 30, 2017	December 31, 2016
US Treasury securities and obligations of U.S. government corporations & agencies	\$ 88,435	\$ 100,526
Obligations of states and political subdivisions	—	1,173
Mortgage-backed securities: GSE: residential	27,925	84,064
Total	\$ 116,360	\$ 185,763

FHLB borrowings increased to \$87 million at September 30, 2017 compared to \$40 million December 31, 2016. At September 30, 2017 the advances were as follows:

- \$20 million overnight advance at 1.20%
- \$5 million advance with a 3-year maturity, at 1.30%, due May 7, 2018
- \$5 million advance with a 2-year maturity, at 0.99%, due June 21, 2018
- \$10 million advance with a 3-year maturity, at 1.42%, due November 5, 2018
- \$5 million advance with a 1.5-year maturity, at 1.49%, due December 28, 2018
- \$5 million advance with a 2-year maturity, at 1.56%, due June, 28, 2019
- \$5 million advance with a 2.5-year maturity, at 1.67%, due January 31, 2020
- \$5 million advance with a 3-year maturity, at 1.75%, due July 31, 2020
- \$5 million advance with a 6-year maturity, at 2.30%, due August 24, 2020
- \$5 million advance with a 3.5-year maturity, at 1.83%, due February 1, 2021
- \$5 million advance with a 7-year maturity, at 2.55%, due October 1, 2021
- \$5 million advance with a 8-year maturity, at 2.40%, due January 9, 2023

Note 7 -- Fair Value of Assets and Liabilities

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

- Level 1 Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2 Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities which use observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

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

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

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

The trust preferred securities are collateralized debt obligation securities that are backed by trust preferred securities issued by banks, thrifts, and insurance companies. The market for these securities at September 30, 2017 is not active and markets for similar securities are also not active. The inactivity was evidenced first by a significant widening of the bid-ask spread in the brokered markets in which trust preferred securities trade and then by a significant decrease in the volume of trades relative to historical levels. The new issue market is also inactive and will continue to be, as a result of the Dodd-Frank Act's elimination of trust preferred securities from Tier 1 capital for certain holding companies. There are currently very few market participants who are willing and or able to transact for these securities. The market values for these securities are very depressed relative to historical levels. Given conditions in the debt markets today and the absence of observable transactions in the secondary and new issue markets, we

determined:

• The few observable transactions and market quotations that are available are not reliable for purposes of determining fair value at September 30, 2017,

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

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

33

The following table presents the Company's assets that are measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall as of September 30, 2017 and December 31, 2016 (in thousands):

	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)
September 30, 2017				
Available-for-sale securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 126,401	\$ —	\$ 126,401	\$ —
Obligations of states and political subdivisions	172,526	—	172,526	—
Mortgage-backed securities	315,357	—	315,357	—
Trust preferred securities	2,701	—	—	2,701
Other securities	4,219	175	4,044	—
Total available-for-sale securities	\$ 621,204	\$ 175	\$ 618,328	\$ 2,701
December 31, 2016				
Available-for-sale securities:				
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 136,324	\$ —	\$ 136,324	\$ —
Obligations of states and political subdivisions	162,705	—	162,705	—
Mortgage-backed securities	314,991	—	314,991	—
Trust preferred securities	1,652	—	—	1,652
Other securities	4,176	144	4,032	—
Total available-for-sale securities	\$ 619,848	\$ 144	\$ 618,052	\$ 1,652

The change in fair value of assets measured on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2017 and 2016 is summarized as follows (in thousands):

	Trust Preferred Securities			
	Three months ended September 30, 2017	Three months ended September 30, 2016	Nine months ended September 30, 2017	Nine months ended September 30, 2016
Beginning balance	\$ 2,424	\$ 1,746	\$ 1,652	\$ 1,906
Transfers into Level 3	—	—	—	—
Transfers out of Level 3	—	—	—	—
Total gains or losses:				
Included in net income	—	—	—	—
Included in other comprehensive income (loss)	318	(66)	1,166	(190)
Purchases, issuances, sales and settlements:				
Purchases	—	—	—	—
Issuances	—	—	—	—
Sales	—	—	—	—
Settlements	(41)	(19)	(117)	(55)

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Ending balance	\$2,701	\$ 1,661	\$2,701	\$ 1,661
Total gains or losses for the period included in net income attributable to the change in unrealized gains or losses related to assets and liabilities still held at the reporting date	\$—	\$ —	\$—	\$ —

34

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

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

If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. Impaired loans that are collateral dependent are classified within Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

Management establishes a specific allowance for impaired loans that have an estimated fair value that is below the carrying value. The total carrying amount of loans for which a change in specific allowance has occurred as of September 30, 2017 was \$7,092,000 and a fair value of \$6,793,000 resulting in specific loss exposures of \$299,000.

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

Foreclosed Assets Held For Sale. Other real estate owned acquired through loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. The adjustment at the time of foreclosure is recorded through the allowance for loan losses. Due to the subjective nature of establishing the fair value when the asset is acquired, the actual fair value of the other real estate owned or foreclosed asset could differ from the original estimate. If it is determined that fair value declines subsequent to foreclosure, a valuation allowance is recorded through noninterest expense. Operating costs associated with the assets after acquisition are also recorded as noninterest expense. Gains and losses on the disposition of other real estate owned and foreclosed assets are netted and posted to other noninterest expense. The total carrying amount of other real estate owned as of September 30, 2017 was \$2,229,000. Other real estate owned included in the total carrying amount and measured at fair value on a nonrecurring basis during the period amounted to \$307,000.

The following table presents the fair value measurement of assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2017 and December 31, 2016 (in thousands):

	Fair Value Measurements Using			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2017				
Impaired loans (collateral dependent)	\$6,793	\$ —	—\$	\$ 6,793
Foreclosed assets held for sale	307	—	—	307

December 31, 2016

Impaired loans (collateral dependent)	\$6,938	\$	—\$	—\$	6,938
Foreclosed assets held for sale	173	—	—	—	173

35

Sensitivity of Significant Unobservable Inputs

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

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

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements other than goodwill at June 30, 2017 and December 31, 2016 (in thousands).

September 30, 2017	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
			Discount rate	13.3%
			Constant prepayment rate (1)	1.3%
Trust Preferred Securities	\$2,701	Discounted cash flow	Cumulative projected prepayments	21.9%
			Probability of default	0.6%
			Projected cures given deferral	0.0%
			Loss severity	97.7%
Impaired loans (collateral dependent)	\$6,793	Third party valuations	Discount to reflect realizable value	0% - 40% (20%)
Foreclosed assets held for sale	\$307	Third party valuations	Discount to reflect realizable value less estimated selling costs	0% - 40% (35%)
December 31, 2016	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted Average)
			Discount rate	13.6%
			Constant prepayment rate (1)	1.3%
Trust Preferred Securities	\$1,652	Discounted cash flow	Cumulative projected prepayments	22.4%
			Probability of default	0.5%
			Projected cures given deferral	0.0%
			Loss severity	97.6%
Impaired loans (collateral dependent)	\$6,938	Third party valuations	Discount to reflect realizable value	0% - 40% (20%)
Foreclosed assets held for sale	\$173	Third party valuations	Discount to reflect realizable value less estimated selling costs	0% - 40% (35%)

(1) Every five years

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

Cash and Cash Equivalents, Federal Funds Sold, Interest Receivable and Federal Reserve and Federal Home Loan Bank Stock. The carrying amount approximates fair value.

Certificates of Deposit Investments. The fair value of certificates of deposit investments is estimated using a discounted cash flow calculation that applies the rates currently offered for deposits of similar remaining maturities.

Held-to-Maturity 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.

Loans Held for Sale. Loans expected to be sold are classified as held for sale and are recorded at the lower of aggregate cost or market value.

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

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

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

Interest Payable. The carrying amount approximates fair value.

Junior Subordinated Debentures, Federal Home Loan Bank Borrowings and Other Borrowings. Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing debt.

The following tables present estimated fair values of the Company's financial instruments at September 30, 2017 and December 31, 2016 in accordance with FAS 107-1 and APB 28-1, codified with ASC 805 (in thousands):

	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
September 30, 2017					
Financial Assets					
Cash and due from banks	\$69,153	\$69,153	\$69,153	\$—	\$—
Federal funds sold	490	490	490	—	—
Certificates of deposit investments	1,685	1,708	—	1,708	—
Available-for-sale securities	621,204	621,204	175	618,328	2,701
Held-to-maturity securities	69,306	69,137	—	69,137	—
Loans held for sale	2,079	2,079	—	2,079	—
Loans net of allowance for loan losses	1,846,894	1,842,343	—	—	1,842,343
Interest receivable	10,876	10,876	—	10,876	—
Federal Reserve Bank stock	5,160	5,160	—	5,160	—
Federal Home Loan Bank stock	3,302	3,302	—	3,302	—
Financial Liabilities					
Deposits	\$2,217,477	\$2,217,528	\$—	\$1,897,161	\$320,367
Securities sold under agreements to repurchase	116,360	116,348	—	116,348	—
Interest payable	552	552	—	552	—
Federal Home Loan Bank borrowings	87,052	87,396	—	87,396	—
Other borrowings	31,250	31,250	20,000	11,250	—
Junior subordinated debentures	23,980	17,640	—	17,640	—

	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
December 31, 2016					
Financial Assets					
Cash and due from banks	\$137,002	\$137,002	\$137,002	\$—	\$—
Federal funds sold	38,900	38,900	38,900	—	—
Certificates of deposit investments	14,643	14,651	—	14,651	—
Available-for-sale securities	619,848	619,848	144	618,052	1,652
Held-to-maturity securities	74,231	73,096	—	73,096	—
Loans held for sale	1,175	1,175	—	1,175	—
Loans net of allowance for loan losses	1,808,064	1,795,764	—	—	1,795,764
Interest receivable	10,553	10,553	—	10,553	—
Federal Reserve Bank stock	3,949	3,949	—	3,949	—
Federal Home Loan Bank stock	4,389	4,389	—	4,389	—
Financial Liabilities					
Deposits	\$2,329,887	\$2,331,725	\$—	\$1,976,806	\$354,919
Securities sold under agreements to repurchase	185,763	185,766	—	185,766	—
Interest payable	535	535	—	535	—
Federal Home Loan Bank borrowings	40,094	40,318	—	40,318	—
Other borrowings	18,063	18,063	—	18,063	—
Junior subordinated debentures	23,917	17,068	—	17,068	—

Note 8 -- Business Combinations

First Clover Leaf Financial Corp

On April 26, 2016, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with First Clover Leaf Financial Corp., a Maryland corporation ("First Clover Leaf"), pursuant to which, amongst other things, the Company agreed to acquire 100% of the issued and outstanding shares of First Clover Leaf pursuant to a business combination whereby First Clover Leaf would merge with and into the Company, with the Company as the surviving entity (the "Merger").

At the effective time of the Merger, 25% of the shares of First Clover Leaf common stock issued and outstanding immediately prior to the effective time of the Merger converted into the right to receive \$12.87 per share, for an approximate aggregate total of \$22,545,000, and 75% of the shares of First Clover Leaf common stock issued and outstanding immediately prior to the effective time of the Merger converted into the right to receive 0.495 shares of the Company's common stock, par value \$4.00 per share, for an approximate aggregate total of 2,600,616 shares of the Company's common stock. Cash in lieu of fractional shares of Company common stock were issued in connection with the Merger.

First Clover Leaf had \$659 million in assets at book value including \$449 million in loans and \$535 million in deposits. As a result of the acquisition, the Company increased its deposit base and reduced transaction costs. The Company also expects to reduce costs through economies of scale.

The acquisition was accounted for under the acquisition method of accounting in accordance with ASC 805, "Business Combinations ("ASC 805")," and accordingly the assets and liabilities were recorded at their estimated fair values on the date of acquisition. Fair values are subject to refinement for up to one year after the closing date of September 8, 2016 as additional information regarding the closing date fair values become available. The total consideration paid

was used to determine the amount of goodwill resulting from the transaction. As the total consideration paid exceeded the net assets acquired, goodwill of \$19.1 million was recorded for the acquisition. Goodwill recorded in the transaction, which reflects the synergies and economies of scale expected from combining operations and the enhanced revenue opportunities from the Company's service capabilities in the St. Louis market, is not tax deductible, and was all assigned to the banking segment of the Company.

The following table summarizes the estimated fair values of assets acquired and liabilities assumed at the date of the First Clover Leaf acquisition (in thousands).

	Acquired Book Value	Fair Value Adjustments	As Recorded by First Clover Leaf Bank
Assets			
Cash	\$59,320	\$ —	\$59,320
Investment Securities	109,911	(737	) 109,174
Loans	448,668	(10,403	) 438,265
Allowance for loan losses	(6,928	)6,928	—
Other real estate owned	2,741	(754	) 1,987
Premises and equipment	9,618	1,963	11,581
Goodwill	11,385	7,758	19,143
Core deposit intangible	99	4,561	4,660
Other assets	23,974	2,875	26,849
Total assets acquired	\$658,788	\$ 12,191	\$ 670,979
Liabilities and Stockholders' Equity			
Deposits	\$534,692	\$ 1,994	\$ 536,686
Securities sold under agreements to repurchase	23,263	—	23,263
FHLB advances	15,000	113	15,113
Subordinated debentures	4,000	(731	) 3,269
Other liabilities	2,103	2,074	4,177
Total liabilities assumed	579,058	3,450	582,508
Net assets acquired	\$79,730	\$ 8,741	\$ 88,471
Consideration Paid			
Cash			\$ 22,545
Common stock			65,926
Total consideration paid			\$ 88,471

The Company has recognized approximately \$3,302,000, pre-tax, of acquisition costs for the First Clover Leaf acquisition of which \$1,962,000 was recorded for 2017. These costs are included in legal and professional and other expense. Of the \$10.4 million difference between the fair value and acquired value of the purchased loans, approximately \$8.4 million is being accreted to interest income over the remaining term of the loans. The differences between fair value and acquired value of the assumed time deposits of \$1.99 million, of the assumed FHLB advances of \$113,000 and of the assumed subordinated debentures of \$(731,000), are being amortized to interest expense over the remaining life of the liabilities. The core deposit intangible asset, with a fair value of \$4.7 million, will be amortized on an accelerated basis over its estimated life of 10 years.

The following unaudited pro forma condensed combined financial information presents the results of operations of the Company, including the effects of the purchase accounting adjustments and acquisition expenses, had the First Clover Leaf acquisition taken place at the beginning of the period (dollars in thousands):

	Three months ended September 30, 2016	Nine months ended September 30, 2016
Net interest income	\$ 21,255	\$ 63,727
Provision for loan losses	1,363	2,209
Non-interest income	7,322	21,640
Non-interest expense	20,039	57,145
Income before income taxes	7,175	26,013
Income tax expense	2,481	9,079
Net income	\$ 4,694	\$ 16,934
Earnings per share		
Basic	\$ 0.45	\$ 1.72
Diluted	\$ 0.45	\$ 1.68

Basic weighted average shares outstanding	10,497,072	9,372,547
Diluted weighted average shares outstanding	10,504,046	10,057,398

The unaudited pro forma condensed combined financial statements do not reflect any anticipated cost savings and revenue enhancements. Accordingly, the pro forma results of operations of the Company as of and after the First Clover Leaf business combination may not be indicative of the results that actually would have occurred if the combination had been in effect during the periods presented or of the results that may be attained in the future.

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

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of the Company and its subsidiaries as of, and for the three and nine-month periods ended September 30, 2017 and 2016. This discussion and analysis should be read in conjunction with the consolidated financial statements, related notes and selected financial data appearing elsewhere in this report.

Forward-Looking Statements

This report may contain certain forward-looking statements, such as discussions of the Company’s pricing and fee trends, credit quality and outlook, liquidity, new business results, expansion plans, anticipated expenses and planned schedules. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are identified by use of the words “believe,” “expect,” “intend,” “anticipate,” “estimate,” “project,” or similar expressions. Actual results could differ materially from the results indicated by these statements because the realization of those results is subject to many risks and uncertainties, including those described in Item 1A-“Risk Factors” and other sections of the Company’s Annual Report on Form 10-K and the Company’s other filings with the SEC, and changes in interest rates, general economic conditions and those in the Company’s market area, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios and the valuation of the investment portfolio, the Company’s success in raising capital and effecting and integrating acquisitions, demand for loan products, deposit flows, competition, demand for financial services in the Company’s market area and accounting principles, policies and guidelines. Furthermore, forward-looking statements speak only as of the date they are made. Except as required under the federal securities laws or the rules and regulations of the SEC, we do not undertake any obligation to update or review any forward-looking information, whether as a result of new information, future events or otherwise. Further information concerning the Company and its business, including a discussion of these and additional factors that could materially affect the Company’s financial results, is included in the Company’s 2016 Annual Report on Form 10-K under the headings “Item 1. Business” and “Item 1A. Risk Factors.”

Overview

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

Net income was \$22,059,000 and \$15,043,000 for the nine months ended September 30, 2017 and 2016, respectively. Diluted net income per common share available to common stockholders was \$1.76 and \$1.50 for the nine months ended September 30, 2017 and 2016.

The following table shows the Company’s annualized performance ratios for the nine months ended September 30, 2017 and 2016, compared to the performance ratios for the year ended December 31, 2016:

	Nine months ended		Year ended	
	September 30,		December 31,	
	2017	2016	2016	
Return on average assets	1.04 %	0.92 %	0.94 %	%

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Return on average common equity	9.96	%	9.34	%	9.30	%
Average equity to average assets	10.42	%	10.10	%	10.12	%

Total assets were \$2.79 billion at September 30, 2017, compared to \$2.88 billion as of December 31, 2016. From December 31, 2016 to September 30, 2017, cash and interest bearing deposits decreased \$106.2 million, net loan balances increased \$38.8 million and investment securities decreased \$3.6 million. Net loan balances were \$1.85 billion at September 30, 2017 compared to \$1.81 billion at December 31, 2016.

41

Net interest margin, defined as net interest income divided by average interest-earning assets, was 3.55% for the nine months ended September 30, 2017, up from 3.27% for the same period in 2016. This increase was primarily due to an increase in earning assets and net accretion income from the acquisition of First Clover Leaf. Net interest income before the provision for loan losses was \$69.6 million compared to net interest income of \$49.7 million for the same period in 2016. The increase in net interest income was primarily due to growth in average earning assets including loans and investments primarily due to the acquisition of First Clover Leaf. Income from Bank Owned Life Insurance increased \$971,000 compared to the same period in 2016 due to a death benefit of \$511,000 and nine months of cash surrender value increases for 2017 versus six months for 2016.

Total non-interest income of \$23.1 million increased \$3.1 million or 15.6% from \$20.0 million for the same period last year. Insurance commissions were \$342,000 higher than last year primarily due to growth in senior care policies underwritten through the Illiana Insurance Agency branch of First Mid Insurance. Electronic Services revenues were \$410,000 greater than last year and deposit service charges increased by \$183,000 primarily due to the addition of First Clover Leaf.

Total non-interest expense of \$55.1 million increased \$10.4 million or 23.4% from \$44.6 million for the same period last year. The increase is primarily attributable to the First Clover Leaf acquisition. Salaries and benefits expense increased to \$29.7 million compared to \$23.3 million for the same period last year. Occupancy expenses have also increased to \$9.4 million from \$8.4 million for the first nine months of last year primarily due to the additional locations from First Clover Leaf.

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

	Change in Net Income 2017 versus 2016	
	Three months ended September 30,	Nine months ended September 30,
Net interest income	\$5,250	\$ 19,918
Provision for loan losses	(408)	(3,124)
Other income, including securities transactions	763	3,125
Other expenses	(2,592)	(10,435)
Income taxes	(726)	(2,468)
Increase in net income	\$2,287	\$ 7,016

Credit quality is an area of importance to the Company. Total nonperforming loans were \$19.8 million at September 30, 2017, compared to \$15.8 million at September 30, 2016 and \$18.2 million at December 31, 2016. See the discussion under the heading "Loan Quality and Allowance for Loan Losses" for a detailed explanation of these balances. Repossessed asset balances totaled \$2.3 million at September 30, 2017 compared to \$2.1 million at September 30, 2016 and \$2 million at December 31, 2016. The Company's provision for loan losses for the nine months ended September 30, 2017 and 2016 was \$5,051,000 and \$1,927,000, respectively. Total loans past due 30 days or more were 0.77% of loans at September 30, 2017 compared to 0.38% at September 30, 2016, and 0.45% of loans at December 31, 2016. At September 30, 2017, the composition of the loan portfolio remained similar to the same period last year. Loans secured by both commercial and residential real estate comprised approximately 65.6% of the loan portfolio as of September 30, 2017 and 66.6% as of December 31, 2016.

The Company's capital position remains strong and the Company has consistently maintained regulatory capital ratios above the "well-capitalized" standards. The Company's Tier 1 capital to risk weighted assets ratio calculated under the regulatory risk-based capital requirements at September 30, 2017 and 2016 and December 31, 2016 was 12.41%, 12.03% and 11.99%, respectively. The Company's total capital to risk weighted assets ratio calculated under the regulatory risk-based capital requirements at September 30, 2017 and 2016 and December 31, 2016 was 13.26%, 12.79% and 12.79%, respectively. The increase in these ratios from December 31, 2016 was primarily due to net income added to retained earnings.

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

The Company enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include lines of credit, letters of credit and other commitments to extend credit. The total outstanding commitments at September 30, 2017 and 2016 were \$440 million and \$455 million, respectively.

Federal Deposit Insurance Corporation Insurance Coverage. As an FDIC-insured institution, First Mid Bank is required to pay deposit insurance premium assessments to the FDIC. A number of requirements with respect to the FDIC insurance system have affect results, including insurance assessment rates. The Company expensed \$582,000 and \$758,000 for this assessment during the first nine months of 2017 and 2016, respectively.

In addition to its insurance assessment, each insured bank is subject to quarterly debt service assessments in connection with bonds issued by a government corporation that financed the federal savings and loan bailout. The Company expensed \$97,000 and \$83,000 during the first nine months of 2017 and 2016 for this assessment, respectively.

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

As included in the proposed rule of June 2012, the final rule includes new risk-based capital and leverage ratios, which will be phased in from 2015 to 2019, and refines the definition of what constitutes “capital” for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Company and First Mid Bank beginning in 2015 are: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6%; (iii) a total capital ratio of 8%; and (iv) a Tier 1 leverage ratio of 4%. The rule also establishes a “capital conservation buffer” of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement is being phased in beginning in January 2016 at 0.625% of risk weighted assets and will increase by that amount each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if its capital level falls below the buffer amount.

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

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

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

See discussion under the heading "Capital Resources" for a description of the Company's and First Mid Bank's risk-based capital.

Critical Accounting Policies and Use of Significant Estimates

The Company has established various accounting policies that govern the application of U.S. generally accepted accounting principles in the preparation of the Company's financial statements. The significant accounting policies of the Company are described in the footnotes to the consolidated financial statements included in the Company's 2016 Annual Report on Form 10-K. Certain accounting policies involve significant judgments and assumptions by management that have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and assumptions, which could have a material impact on the carrying values of assets and liabilities and the results of operations of the Company.

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

The Company estimates the appropriate level of allowance for loan losses by separately evaluating impaired and non-impaired loans. A specific allowance is assigned to an impaired loan when expected cash flows or collateral do not justify the carrying amount of the loan. The methodology used to assign an allowance to a non-impaired loan is more subjective. Generally, the allowance assigned to non-impaired loans is determined based on migration analysis of historical net losses on each loan segment with similar risk characteristics, adjusted for qualitative factors including the volume and severity of identified classified loans, changes in economic conditions, changes in credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets. Because the economic and business climate in any given industry or market, and its impact on any given borrower, can change rapidly, the risk profile of the loan portfolio is continually assessed and adjusted when appropriate. Notwithstanding these procedures, there still exists the possibility that the assessment could prove to be significantly incorrect and that an immediate adjustment to the allowance for loan losses would be required.

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

Investment in Debt and Equity Securities. The Company classifies its investments in debt and equity securities as either held-to-maturity or available-for-sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities," which was codified into ASC 320. Securities classified as held-to-maturity are recorded at cost or amortized cost. Available-for-sale securities are carried

at fair value. Fair value calculations are based on quoted market prices when such prices are available. If quoted market prices are not available, estimates of fair value are computed using a variety of techniques, including extrapolation from the quoted prices of similar instruments or recent trades for thinly traded securities, fundamental analysis, or through obtaining purchase quotes. Due to the subjective nature of the valuation process, it is possible that the actual fair values of these investments could differ from the estimated amounts, thereby affecting the financial position, results of operations and cash flows of the Company. If the estimated value of investments is less than the cost or amortized cost, the Company evaluates whether an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of the investment. If such an event or change has occurred and the Company determines that the impairment is other-than-temporary, a further determination is made as to the portion of impairment that is related to credit loss. The impairment of the investment that is related to the credit loss is expensed in the period in which the event or change occurred. The remainder of the impairment is recorded in other comprehensive income.

44

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

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

Impairment of Goodwill and Intangible Assets. Core deposit and customer relationships, which are intangible assets with a finite life, are recorded on the Company's balance sheets. These intangible assets were capitalized as a result of past acquisitions and are being amortized over their estimated useful lives of up to 15 years. Core deposit intangible assets, with finite lives will be tested for impairment when changes in events or circumstances indicate that its carrying amount may not be recoverable. Core deposit intangible assets were tested for impairment as of September 30, 2017 as part of the goodwill impairment test and no impairment was identified.

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

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

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

The three levels are defined as follows:

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

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

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

45

At the end of each quarter, the Company assesses the valuation hierarchy for each asset or liability measured. From time to time, assets or liabilities may be transferred within hierarchy levels due to changes in availability of observable market inputs to measure fair value at the measurement date. Transfers into or out of hierarchy levels are based upon the fair value at the beginning of the reporting period. A more detailed description of the fair values measured at each level of the fair value hierarchy can be found in Note 7 – Fair Value of Assets and Liabilities.

Results of Operations

Net Interest Income

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

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

The Company's average balances, interest income and expense and rates earned or paid for major balance sheet categories are set forth for the three and nine months ended September 30, 2017 and 2016 in the following table (dollars in thousands):

	Three months ended September 30, 2017			Three months ended September 30, 2016		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
ASSETS						
Interest-bearing deposits with other financial institutions	\$ 11,265	\$ 40	1.44 %	\$ 9,662	\$ 15	0.62 %
Federal funds sold	490	1	0.83 %	6,718	7	0.41 %
Certificates of deposit investments	1,685	9	2.17 %	29,490	78	1.05 %
Investment securities						
Taxable	579,025	2,984	2.06 %	522,841	2,304	1.76 %
Tax-exempt (1)	172,617	1,195	2.77 %	119,986	925	3.08 %
Loans (2)	1,840,570	20,385	4.49 %	1,445,774	15,294	4.21 %
Total earning assets	2,605,652	24,614	3.83 %	2,134,471	18,623	3.47 %
Cash and due from banks	52,458			47,417		
Premises and equipment	38,877			32,249		
Other assets	140,768			100,546		
Allowance for loan losses	(18,595)			(15,520)		
Total assets	\$ 2,819,160			\$ 2,299,163		
LIABILITIES AND STOCKHOLDERS' EQUITY						
Interest-bearing deposits						
Demand deposits	\$ 1,131,699	\$ 500	0.18 %	\$ 851,425	\$ 217	0.10 %
Savings deposits	366,541	119	0.13 %	338,583	112	0.13 %
Time deposits	325,070	409	0.51 %	294,598	294	0.40 %
Securities sold under agreements to repurchase	135,327	51	0.15 %	130,999	23	0.07 %
FHLB advances	73,051	283	1.57 %	51,453	150	1.16 %
Fed Funds Purchased	9,467	37	1.59 %	5,914	12	0.81 %
Junior subordinated debt	23,966	236	3.99 %	21,437	162	3.01 %
Other debt	12,177	106	3.53 %	4,728	30	2.50 %
Total interest-bearing liabilities	2,077,298	1,741	0.34 %	1,699,137	1,000	0.23 %
Non interest-bearing demand deposits	425,077			357,160		
Other liabilities	11,472			7,502		
Stockholders' equity	305,313			235,364		
Total liabilities & equity	\$ 2,819,160			\$ 2,299,163		
Net interest income		\$ 22,873			\$ 17,623	
Net interest spread			3.49 %			3.24 %
Impact of non-interest bearing funds			0.06 %			0.05 %
Net yield on interest-earning assets			3.55 %			3.29 %

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

(2) Nonaccrual loans and loans held for sale are included in the average balances. Balances are net of unaccreted discount related to loans acquired.

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

	Nine months ended September 30, 2017			Nine months ended September 30, 2016		
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate
Assets						
Interest-bearing deposits with other financial institutions	\$30,200	\$217	0.96 %	\$30,618	\$125	0.54 %
Federal funds sold	11,901	62	0.69 %	2,582	8	0.42 %
Certificates of deposit investments	3,867	41	1.42 %	31,166	234	1.00 %
Investment securities:						
Taxable	579,444	8,999	2.07 %	513,562	6,981	1.81 %
Tax-exempt (1)	172,447	3,586	2.77 %	111,322	2,641	3.16 %
Loans (2)	1,820,264	61,337	4.51 %	1,335,898	42,496	4.25 %
Total earning assets	2,618,123	74,242	3.79 %	2,025,148	52,485	3.45 %
Cash and due from banks	54,011			46,092		
Premises and equipment	39,448			31,008		
Other assets	141,180			85,451		
Allowance for loan losses	(17,993)			(15,078)		
Total assets	\$2,834,769			\$2,172,621		
Liabilities and Stockholders' Equity						
Interest-bearing deposits						
Demand deposits	\$1,129,427	\$1,289	0.15 %	\$818,397	\$613	0.10 %
Savings deposits	368,291	353	0.13 %	335,518	328	0.13 %
Time deposits	353,191	1,198	0.45 %	257,733	836	0.43 %
Securities sold under agreements to repurchase	149,970	137	0.12 %	127,534	62	0.07 %
FHLB advances	53,076	602	1.52 %	32,459	465	1.91 %
Fed Funds Purchased	4,334	49	1.50 %	2,401	14	0.77 %
Junior subordinated debt	23,945	680	3.80 %	20,894	456	2.91 %
Other debt	13,987	336	3.22 %	1,624	31	2.54 %
Total interest-bearing liabilities	2,096,221	4,644	0.30 %	1,596,560	2,805	0.23 %
Non interest-bearing demand deposits	434,201			348,476		
Other liabilities	8,912			8,043		
Stockholders' equity	295,435			219,542		
Total liabilities & equity	\$2,834,769			\$2,172,621		
Net interest income		\$69,598			\$49,680	
Net interest spread			3.49 %			3.22 %
Impact of non-interest bearing funds			0.06 %			0.05 %
Net yield on interest- earning assets			3.55 %			3.27 %

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

(2) Nonaccrual loans and loans held for sale are included in the average balances. Balances are net of unaccreted discount related to loans acquired.

Changes in net interest income may also be analyzed by segregating the volume and rate components of interest income and interest expense. The following table summarizes the approximate relative contribution of changes in average volume and interest rates to changes in net interest income for the three and nine-months ended September 30, 2017, compared to the same periods in 2016 (in thousands):

	Three months ended September 30, 2017 compared to 2016 Increase / (Decrease)			Nine months ended September 30, 2017 compared to 2016 Increase / (Decrease)		
	Total Change	Volume (1)	Rate (1)	Total Change	Volume (1)	Rate (1)
Earning Assets:						
Interest-bearing deposits	\$25	\$3	\$22	\$92	\$(3)	\$95
Federal funds sold	(6)	(30)	24	54	46	8
Certificates of deposit investments	(69)	(342)	273	(193)	(307)	114
Investment securities:						
Taxable	680	263	417	2,018	952	1,066
Tax-exempt (2)	270	372	(102)	945	1,304	(359)
Loans (3)	5,091	4,094	997	18,841	16,121	2,720
Total interest income	5,991	4,360	1,631	21,757	18,113	3,644
Interest-Bearing Liabilities:						
Interest-bearing deposits						
Demand deposits	283	82	201	676	292	384
Savings deposits	7	7	—	25	25	—
Time deposits	115	31	84	362	321	41
Securities sold under agreements to repurchase	28	1	27	75	15	60
FHLB advances	133	72	61	137	296	(159)
Federal Funds Purchased	25	10	15	35	16	19
Junior subordinated debt	74	20	54	224	72	152
Other debt	76	61	15	305	295	10
Total interest expense	741	284	457	1,839	1,332	507
Net interest income	\$5,250	\$4,076	\$1,174	\$19,918	\$16,781	\$3,137

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

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

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

Net interest income increased \$19.9 million, or 40.1%, to \$69.6 million for the nine months ended September 30, 2017, from \$49.7 million for the same period in 2016. Net interest income increased due to the growth in average earning assets including loans and investments acquired from First Clover Leaf. The net interest margin increased primarily due to the growth in earning assets, an increase in investment yields and accretion income related to the acquisition of First Clover Leaf.

For the nine months ended September 30, 2017, average earning assets increased by \$593.0 million, or 29.3%, and average interest-bearing liabilities increased \$499.7 million or 31.3%, compared with average balances for the same period in 2016.

The changes in average balances for these periods are shown below:

- ▲Average interest-bearing deposits held by the Company decreased \$0.4 million or 1.4%.
- ▲Average federal funds sold increased \$9.3 million or 360.9%.
- ▲Average certificates of deposits investments decreased \$27.3 million or 87.6%
- ▲Average loans increased by \$484.4 million or 36.3%.
- ▲Average securities increased by \$127.0 million or 20.3%.
- ▲Average deposits increased by \$439.3 million or 31.1%.
- ▲Average securities sold under agreements to repurchase increased by \$22.4 million or 17.6%.
- ▲Average borrowings and other debt increased by \$38.0 million or 66.2%.
- ▲Net interest margin increased to 3.55% for the first nine months of 2017 from 3.27% for the first nine months of 2016.

To compare the tax-exempt yields on interest-earning assets to taxable yields, the Company also computes non-GAAP net interest income on a tax equivalent basis (TE) where the interest earned on tax-exempt loans and securities is adjusted to an amount comparable to interest subject to normal income taxes assuming a federal tax rate of 35% (referred to as the tax equivalent adjustment). The year-to-date net yield on interest-earning assets (TE) was 3.68% and 3.38% for the first nine months of 2017 and 2016, respectively. The TE adjustments to net interest income for the nine months ended September 30, 2017 and 2016 were \$2,547,000 and \$1,628,000, respectively.

Provision for Loan Losses

The provision for loan losses for the nine months ended September 30, 2017 and 2016 was \$5,051,000 and \$1,927,000, respectively. The increase in provision expense was primarily due to an increase in non-performing loans and net charge-offs. Net charge-offs were \$3,215,000 for the nine months ended September 30, 2017, compared to net charge offs of \$343,000 for September 30, 2016. Nonperforming loans were \$19.8 million and \$15.8 million as of September 30, 2017 and 2016, respectively. For information on loan loss experience and nonperforming loans, see discussion under the “Nonperforming Loans” and “Loan Quality and Allowance for Loan Losses” sections below.

Other Income

An important source of the Company’s revenue is other income. The following table sets forth the major components of other income for the three and nine-months ended September 30, 2017 and 2016 (in thousands):

	Three months ended			Nine months ended		
	September 30,		\$ Change	September 30,		\$ Change
	2017	2016		2017	2016	
Trust revenues	\$925	\$774	\$ 151	\$2,696	\$2,549	\$ 147
Brokerage commissions	536	526	10	1,550	1,440	110
Insurance commissions	670	738	(68)	3,148	2,806	342
Service charges	1,758	1,824	(66)	5,160	4,977	183
Security gains, net	254	466	(212)	589	1,130	(541)
Mortgage banking revenue, net	347	382	(35)	875	715	160
ATM / debit card revenue	1,595	1,457	138	4,828	4,418	410
Bank Owned Life Insurance	792	201	591	1,355	384	971
Other	784	530	254	2,925	1,582	1,343
Total other income	\$7,661	\$6,898	\$ 763	\$23,126	\$20,001	\$3,125

Following are explanations of the changes in these other income categories for the three months ended September 30, 2017 compared to the same period in 2016:

Trust revenues increased \$151,000 or 19.5% to \$925,000 from \$774,000 due to an increase in revenue from defined contribution and other retirement accounts. Trust assets, at market value, were \$895.6 million at September 30, 2017 compared to \$829.6 million at September 30, 2016.

Revenues from brokerage increased \$10,000 or 1.9% to \$536,000 from \$526,000 primarily due to an increase in the number of brokerage accounts from new business development efforts.

Insurance commissions decreased \$68,000 or 9.2% to \$670,000 from \$738,000 primarily due to the timing of policy commissions receipts.

Fees from service charges decreased \$66,000 or 3.6% to \$1,758,000 from \$1,824,000 primarily due to a decrease in commercial transaction account fees.

The sale of securities during the three months ended September 30, 2017 resulted in net securities gains of \$254,000 compared to \$466,000 during the three months ended September 30, 2016.

Mortgage banking income decreased \$35,000 or 9.2% to \$347,000 from \$382,000. Loans sold balances were as follows:

\$12.7 million (representing 124 loans) for the three months ended September 30, 2017

\$25.9 million (representing 215 loans) for the three months ended of September 30, 2016

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

Revenue from ATMs and debit cards increased \$138,000 or 9.5% to \$1,595,000 from \$1,457,000 due to an increase in electronic transactions primarily from First Clover Leaf acquired in the third quarter of 2016.

- Bank owned life insurance income increased \$591,000 or 294.0%. The increase is primarily due to a death benefit of \$511,000 received on a single policy. The Company invested \$25 million in bank owned life insurance during the first quarter of 2016 and acquired \$15.6 million in bank owned life insurance in the First Clover Leaf acquisition during the third quarter of 2016.

Other income increased \$254,000 or 47.9% to \$784,000 from \$530,000 primarily due to income from tax refunds resulting from overpayment of taxes in 2016 by First Clover Leaf.

Following are explanations of the changes in these other income categories for the nine months ended September 30, 2017 compared to the same period in 2016:

- Trust revenues increased \$147,000 or 5.8% to \$2,696,000 from \$2,549,000 due to an increase in revenue from defined contribution and other retirement accounts. Trust assets, at market value, were \$895.6 million at September 30, 2017 compared to \$829.6 million at September 30, 2016.

Revenues from brokerage increased \$110,000 or 7.6% to \$1,550,000 from \$1,440,000 primarily due to an increase in the number of brokerage accounts from new business development efforts.

Insurance commissions increased \$342,000 or 12.2% to \$3,148,000 from \$2,806,000 primarily due to growth in senior care policies underwritten through the Illiana Insurance Agency branch of First Mid Insurance.

Fees from service charges increased \$183,000 or 3.7% to \$5,160,000 from \$4,977,000 primarily due to the acquisition of First Clover Leaf.

The sale of securities during the nine months ended September 30, 2017 resulted in net securities gains of \$589,000 compared to \$1,130,000 during the nine months ended September 30, 2016.

Mortgage banking income increased \$160,000 or 22.4% to \$875,000 from \$715,000. Loans sold balances were as follows:

\$44.2 million (representing 365 loans) for the nine months ended September 30, 2017

\$54.6 million (representing 452 loans) for the nine months ended September 30, 2016

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

Revenue from ATMs and debit cards increased \$410,000 or 9.3% to \$4,828,000 from \$4,418,000 due to an increase in electronic transactions primarily from First Clover Leaf acquired in the third quarter of 2016 and incentives received from VISA.

Bank owned life insurance income increased \$971,000 or 252.9%. The increase is primarily due to a death benefit of \$511,000 and nine months of cash surrender value increases for 2017 versus six months for 2016. The Company invested \$25 million in bank owned life insurance during the first quarter of 2016 and acquired \$15.6 million in bank owned life insurance in the First Clover Leaf acquisition during the third quarter of 2016.

Other income increased \$1,343,000 or 84.9% to \$2,925,000 from \$1,582,000 primarily due to income from First Clover Leaf acquired during the third quarter of 2016 and income tax refunds resulting from overpayment of taxes in 2016 by First Clover Leaf.

Other Expense

The major categories of other expense include salaries and employee benefits, occupancy and equipment expenses and other operating expenses associated with day-to-day operations. The following table sets forth the major components of other expense for the three and nine-months ended September 30, 2017 and 2016 (in thousands):

	Three months ended			Nine months ended		
	September 30,			September 30,		
	2017	2016	\$ Change	2017	2016	\$ Change
Salaries and employee benefits	\$9,648	\$7,844	\$1,804	\$29,685	\$23,293	\$6,392
Net occupancy and equipment expense	3,129	2,864	265	9,378	8,389	989
Net other real estate owned expense (income)	385	32	353	530	23	507
FDIC insurance	210	294	(84)	679	841	(162)
Amortization of intangible assets	545	455	90	1,651	1,312	339
Stationery and supplies	168	221	(53)	539	612	(73)
Legal and professional	871	713	158	2,596	2,414	182
Marketing and donations	338	285	53	909	1,486	(577)
Other operating expenses	2,618	2,612	6	9,102	6,264	2,838
Total other expense	\$17,912	\$15,320	\$2,592	\$55,069	\$44,634	\$10,435

Following are explanations for the changes in these other expense categories for the three months ended September 30, 2017 compared to the same period in 2016:

Salaries and employee benefits, the largest component of other expense, increased \$1,804,000 or 23.0% to \$9,648,000 from \$7,844,000. The increase is primarily due to merit increases in 2017 for continuing employees. There were 584 and 596 full-time equivalent employees at September 30, 2017 and 2016, respectively.

Occupancy and equipment expense increased \$265,000 or 9.3% to \$3,129,000 from \$2,864,000. The increase was primarily due to increases in rent and depreciation expenses related to the acquisition of six First Clover Leaf locations during the third quarter of 2016.

Net other real estate owned expense increased \$353,000 or 1,103.1% to \$385,000 from \$32,000. The increase in 2017 was primarily due to a write down of one property to the now appraised value and real estate taxes and maintenance expenses on properties owned in 2017.

Expense for amortization of intangible assets increased \$90,000 or 19.8% to \$545,000 from \$455,000 for the nine months ended September 30, 2017 and 2016, respectively. The increase in 2017 was due to the core deposit intangible amortization from First Clover Leaf.

Other operating expenses increased \$6,000 or 0.2% to \$2,618,000 in 2017 from \$2,612,000 in 2016 primarily due to the additional expenses from the First Clover Leaf locations and costs associated with the merger of First Clover Leaf Bank into First Mid Bank during the first quarter of 2017.

On a net basis, all other categories of operating expenses increased \$74,000 or 4.9% to \$1,587,000 in 2017 from \$1,513,000 in 2016. The increase from 2016 to 2017 was primarily due to an increase in legal, marketing and donation expenses, primarily due to First Clover Leaf and a decline in FDIC Insurance rates.

Following are explanations for the changes in these other expense categories for the nine months ended September 30, 2017 compared to the same period in 2016:

Salaries and employee benefits, the largest component of other expense, increased \$6,392,000 or 27.4% to \$29,685,000 from \$23,293,000. The increase is primarily due to the addition of 88 employees in the acquisition of the First Clover Leaf and merit increases in 2017 for continuing employees. There were 584 and 596 full-time equivalent employees at September 30, 2017 and 2016, respectively.

52

Occupancy and equipment expense increased \$989,000 or 11.8% to \$9,378,000 from \$8,389,000. The increase was primarily due to increases in rent and depreciation expenses related to the acquisition of six First Clover Leaf locations during the third quarter of 2016.

Net other real estate owned expense increased \$507,000 or 2,204.3% to \$530,000 from \$23,000. The increase in 2017 was primarily due to a write down of one property to the now appraised value, real estate taxes and maintenance expenses on properties owned and losses on properties sold during 2017.

Expense for amortization of intangible assets increased \$339,000 or 25.8% to \$1,651,000 from \$1,312,000 for the nine months ended September 30, 2017 and 2016, respectively. The increase in 2017 was due to the core deposit intangible amortization from First Clover Leaf, net of intangibles that were fully amortized during 2016.

Other operating expenses increased \$2,838,000 or 45.3% to \$9,102,000 in 2017 from \$6,264,000 in 2016 primarily due to the additional expenses from the First Clover Leaf locations and costs associated with the merger of First Clover Leaf Bank into First Mid Bank during the first quarter of 2017.

On a net basis, all other categories of operating expenses decreased \$630,000 or 11.8% to \$4,723,000 in 2017 from \$5,353,000 in 2016. The decrease from 2016 to 2017 was primarily due to the donation of a building located in Monticello, Illinois with a book value of \$653,000 and a decline in FDIC Insurance rates, during 2016, net of increases in other expenses from the addition of First Clover Leaf.

Income Taxes

Total income tax expense amounted to \$10.5 million (32.3% effective tax rate) for the nine months ended September 30, 2017, compared to \$8.1 million (34.9% effective tax rate) for the same period in 2016. The decline in effective tax rate for the nine months ended September 30, 2017 compared to the same period in 2016 is primarily due to an increase in tax-exempt municipal investments and income from bank owned life insurance, net of an increase in State of Illinois tax rate from 7.75% to 9.50% beginning July 1, 2017.

The Company files U.S. federal and state of Illinois income tax returns. The Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2014.

Analysis of Balance Sheets

Securities

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

The following table sets forth the amortized cost of the available-for-sale and held-to-maturity securities as of September 30, 2017 and December 31, 2016 (dollars in thousands):

	September 30, 2017			December 31, 2016		
	Amortized Cost	Weighted Average Yield		Amortized Cost	Weighted Average Yield	
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$196,237	1.98 %		\$213,050	1.83 %	
Obligations of states and political subdivisions	169,526	2.86 %		164,163	2.80 %	
Mortgage-backed securities: GSE residential	314,195	2.59 %		318,829	2.57 %	
Trust preferred securities	2,933	2.15 %		3,050	1.86 %	
Other securities	4,034	2.50 %		4,034	2.14 %	
Total securities	\$686,925	2.55 %		\$703,126	2.39 %	

At September 30, 2017, the Company's investment portfolio decreased by \$16.2 million from December 31, 2016 primarily due to securities that were sold to provide cash flow to fund loans. When purchasing investment securities, the Company considers its overall liquidity and interest rate risk profile, as well as the adequacy of expected returns relative to the risks assumed. The table below presents the credit ratings as of September 30, 2017 for certain investment securities (in thousands):

	Amortized Cost	Estimated Fair Value	Average Credit Rating of Fair Value at September 30, 2017 (1)					
			AAA	AA +/-	A +/-	BBB +/-	< BBB -	Not rated
Available-for-sale:								
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$126,931	\$126,401	\$—	\$126,401	\$—	\$—	\$—	\$—
Obligations of state and political subdivisions	169,526	172,526	13,173	103,705	54,771	—	—	877
Mortgage-backed securities (2)	314,195	315,357	—	—	—	—	—	315,357
Trust preferred securities	2,933	2,701	—	—	—	—	2,701	—
Other securities	4,034	4,219	—	—	2,038	2,006	—	175
Total available-for-sale	\$617,619	\$621,204	\$13,173	\$230,106	\$56,809	\$2,006	\$2,701	\$316,409
Held-to-maturity:								
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$69,306	\$69,137	\$—	\$69,137	\$—	\$—	\$—	\$—

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

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

54

The trust preferred securities is one trust preferred pooled security issued by FTN Financial Securities Corp. (“FTN”). The following table contains information regarding the trust preferred security as of September 30, 2017:

Deal name	PreTSL XXVIII
Class	Mezzanine C-1
Book value	\$2,933,000
Fair value	\$2,701,000
Unrealized gains/(losses)	\$(232,000)
Other-than-temporary impairment recorded in earnings	\$1,111,000
Lowest credit rating assigned	CCC
Number of performing banks	35
Number of issuers in default	8
Number of issuers in deferral	1
Original collateral	\$360,850,000
Actual defaults & deferrals as a % of original collateral	13.7 %
Remaining collateral	\$334,542,000
Actual defaults & deferrals as a % of remaining collateral	14.8 %
Expected defaults & deferrals as a % of remaining collateral	40.7 %
Estimated incremental defaults required to break yield	\$61,062,000
Performing collateral	\$286,342,000
Current balance of class	\$34,357,000
Subordination	\$257,584,000
Excess subordination	\$21,123,000
Excess subordination as a % of remaining performing collateral	7.4 %
Discount rate (1)	2.51%-3.99%
Expected defaults & deferrals as a % of remaining collateral (2)	2% / .36
Recovery assumption (3)	10 %
Prepayment assumption (4)	1 %

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

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

(3) With 2 year lag

(4) Additional assumptions regarding prepayments:

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

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

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

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

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

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

The trust preferred pooled security is a Collateralized Debt Obligation (“CDOs”) backed by a pool of debt securities issued by financial institutions. The collateral consists of trust-preferred securities and subordinated debt securities issued by banks, bank holding companies and insurance companies. Performing collateral is the amount of remaining

collateral less the balances of collateral in deferral or default. Subordination is the amount of performing collateral in excess of the current balance of a specified class and all classes senior to the specified class. Excess subordination is the amount that the performing collateral balance exceeds the current outstanding balance of the specific class, plus all senior classes. It is a static measure of credit enhancement, but does not incorporate all of the structural elements of the security deal. This amount can also be impacted by future defaults and deferrals, deferring balances that cure or redemptions of securities by issuers. A negative excess subordination indicates that the current performing collateral of the security would be insufficient to pay the current principal balance of the class notes after all of the senior classes' notes were paid. However, the performing collateral balance excludes

55

the collateral of issuers currently deferring their interest payments. Because these issuers are expected to resume payment in the future (within five years of the first deferred interest period), a negative excess subordination does not necessarily mean a class note holder will not receive a greater than projected or even full payment of cash flow at maturity.

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

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

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

See discussion below and Note 3 – Investment Securities in the notes to the financial statements for more detail regarding this analysis. Based on this analysis, the Company believes the amortized costs recorded for the trust preferred security investment accurately reflects the position of the security at September 30, 2017 and December 31, 2016.

Other-than-temporary Impairment of Securities

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

56

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

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

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

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

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

Loans

The loan portfolio (net of unearned interest) is the largest category of the Company's earning assets. The following table summarizes the composition of the loan portfolio, including loans held for sale, as of September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017	% Outstanding Loans		December 31, 2016	% Outstanding Loans	
Construction and land development	\$ 77,179	4.1	%	\$ 49,104	2.7	%
Agricultural real estate	126,096	6.8	%	126,108	6.9	%
1-4 Family residential properties	301,897	16.2	%	326,415	17.9	%
Multifamily residential properties	72,323	3.9	%	83,200	4.6	%
Commercial real estate	647,184	34.6	%	630,135	34.5	%
Loans secured by real estate	1,224,679	65.6	%	1,214,962	66.6	%
Agricultural loans	81,383	4.4	%	86,685	4.7	%

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Commercial and industrial loans	443,473	23.7	%	409,033	22.4	%
Consumer loans	30,074	1.6	%	38,028	2.1	%
All other loans	87,953	4.7	%	77,284	4.2	%
Total loans	\$ 1,867,562	100.0	%	\$ 1,825,992	100.0	%

57

Overall loan balances increased \$41,570,000, or 2.28%. The balance of real estate loans held for sale, included in the balances shown above, amounted to \$2,079,000 and \$1,175,000 as of September 30, 2017 and December 31, 2016, respectively.

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

The following table summarizes the loan portfolio geographically by branch region as of September 30, 2017 and December 31, 2016 (dollars in thousands):

	September 30, 2017			December 31, 2016		
	Principal balance	% Outstanding Loans	%	Principal balance	% Outstanding loans	%
Central region	486,267	26.0	%	465,458	25.5	%
Sullivan region	163,329	8.7	%	170,463	9.3	%
Decatur region	355,564	19.0	%	313,459	17.2	%
Peoria region	186,356	10.0	%	204,514	11.2	%
Highland region	542,189	29.1	%	538,325	29.5	%
Southern region	133,857	7.2	%	133,773	7.3	%
Total all regions	\$1,867,562	100.0	%	\$1,825,992	100.0	%

Loans are geographically dispersed among these regions located in central and southwestern Illinois. While these regions have experienced some economic stress during 2017 and 2016, the Company does not consider these locations high risk areas since these regions have not experienced the significant declines in real estate values seen in some other areas in the United States.

The Company does not have a concentration, as defined by the regulatory agencies, in construction and land development loans or commercial real estate loans as a percentage of total risk-based capital for the periods shown above. At September 30, 2017 and December 31, 2016, the Company did have industry loan concentrations in excess of 25% of total risk-based capital in the following industries (dollars in thousands):

	September 30, 2017			December 31, 2016		
	Principal balance	% Outstanding Loans	%	Principal balance	% Outstanding Loans	%
Other grain farming	\$166,432	8.91	%	\$171,336	9.38	%
Lessors of non-residential buildings	168,254	9.01	%	134,019	7.34	%
Lessors of residential buildings & dwellings	129,378	6.93	%	139,584	7.64	%
Hotels and motels	120,330	6.44	%	103,843	5.69	%
Other Gambling Industries	81,434	4.36	%	48,973	2.68	%
Automobile Dealers	49,874	2.67	%	54,261	2.97	%

Balances of other gambling industries were not a concentration December 31, 2016, but is shown here for comparative purposes. Balances of automobile dealers were not a concentration September 30, 2017, but is shown here for comparative purposes. The Company had no further industry loan concentrations in excess of 25% of total risk-based capital.

The following table presents the balance of loans outstanding as of September 30, 2017, by contractual maturities (in thousands):

	Maturity (1)			Total
	One year or less(2)	Over 1 through 5 years	Over 5 years	
Construction and land development	\$54,002	\$15,391	\$7,786	\$77,179
Agricultural real estate	14,370	44,405	67,321	126,096
1-4 Family residential properties	29,474	78,604	193,819	301,897
Multifamily residential properties	9,873	53,001	9,449	72,323
Commercial real estate	73,847	293,995	279,342	647,184
Loans secured by real estate	181,566	485,396	557,717	1,224,679
Agricultural loans	64,404	15,120	1,859	81,383
Commercial and industrial loans	176,715	225,657	41,101	443,473
Consumer loans	3,482	25,125	1,467	30,074
All other loans	19,136	23,058	45,759	87,953
Total loans	\$445,303	\$774,356	\$647,903	\$1,867,562

(1) Based upon remaining contractual maturity.

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

As of September 30, 2017, loans with maturities over one year consisted of approximately \$1.2 billion in fixed rate loans and approximately \$259 million in variable rate loans. The loan maturities noted above are based on the contractual provisions of the individual loans. The Company has no general policy regarding renewals and borrower requests, which are handled on a case-by-case basis.

Nonperforming Loans and Nonperforming Other Assets

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

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

Restructured loans are loans on which, due to deterioration in the borrower’s financial condition, the original terms have been modified in favor of the borrower or either principal or interest has been forgiven. Repossessed assets represent property acquired as the result of borrower defaults on loans. These assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure or repossession. Write-downs occurring at foreclosure are charged against the allowance for loan losses. On an ongoing basis, properties are appraised as required by market indications and applicable regulations. Write-downs for subsequent declines in value are recorded in non-interest expense in other real estate owned along with other expenses related to maintaining the properties.



Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

The following table presents information concerning the aggregate amount of nonperforming loans and repossessed assets at September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017		December 31, 2016	
Nonaccrual loans	\$	13,784	\$	12,053
Restructured loans which are performing in accordance with revised terms		6,004		6,185
Total nonperforming loans		19,788		18,238
Repossessed assets		2,264		1,985
Total nonperforming loans and repossessed assets	\$	22,052	\$	20,223
Nonperforming loans to loans, before allowance for loan losses		1.06	%	1.00
Nonperforming loans and repossessed assets to loans, before allowance for loan losses		1.18	%	1.11

The \$1,731,000 increase in nonaccrual loans during 2017 resulted from the net of \$8,720,000 of loans put on nonaccrual status offset by \$5,491,000 of loans becoming current or paid-off, \$517,000 of loans transferred to other real estate and \$981,000 of loans charged off.

The following table summarizes the composition of nonaccrual loans (in thousands):

	September 30, 2017			December 31, 2016		
	Balance	% of Total	%	Balance	% of Total	%
Construction and land development	\$266	1.9	%	\$227	1.9	%
Agricultural real estate	291	2.1	%	205	1.7	%
1-4 Family residential properties	2,630	19.1	%	2,890	24.0	%
Multifamily Residential properties	2,208	16.0	%	528	4.4	%
Commercial real estate	5,341	38.8	%	4,971	41.2	%
Loans secured by real estate	10,736	77.9	%	8,821	73.2	%
Agricultural loans	834	6.1	%	1,388	11.5	%
Commercial and industrial loans	1,920	13.9	%	1,430	11.9	%
Consumer loans	294	2.1	%	414	3.4	%
Total loans	\$13,784	100.0	%	\$12,053	100.0	%

Interest income that would have been reported if nonaccrual and restructured loans had been performing totaled \$366,000 and \$99,000 for the nine months ended September 30, 2017 and 2016, respectively.

The \$279,000 increase in repossessed assets during the first nine months of 2017 resulted from the net of \$7,760,000 of additional assets repossessed, \$327,000 of assets written down to appraised value and \$7,154,000 of repossessed assets sold. The following table summarizes the composition of repossessed assets (in thousands):

	September 30, 2017			December 31, 2016		
	Balance	% of Total	%	Balance	% of Total	%
Construction and land development	\$1,799	79.5	%	\$1,711	86.2	%
Farm Loans	—	—	%	40	2.0	%
1-4 family residential properties	430	19.0	%	231	11.6	%
Total real estate	2,229	98.5	%	1,982	99.8	%
Consumer loans	35	1.5	%	3	0.2	%
Total repossessed collateral	\$2,264	100.0	%	\$1,985	100.0	%

Repossessed assets sold during the first nine months of 2017 resulted in net losses of \$354,000, of which \$21,000 of net losses was related to real estate asset sales and \$333,000 of net losses was related to other repossessed assets. Repossessed assets sold during the same period in 2016 resulted in net losses of \$5,000, all of which was related to other repossessed assets.

Loan Quality and Allowance for Loan Losses

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

Given the current state of the economy, management did assess the impact of the recession on each category of loans and adjusted historical loss factors to reflect the prolonged weakened economic conditions. Some of the economic factors include the potential for reduced cash flow for commercial operating loans from reduction in sales or increased operating costs, decreased occupancy rates for commercial buildings, reduced levels of home sales for commercial land developments, the uncertainty regarding grain prices, increased operating costs for farmers, and increased levels of unemployment and bankruptcy impacting consumer's ability to pay. Each of these economic uncertainties was taken into consideration in developing the level of the reserve. Management considers the allowance for loan losses a critical accounting policy.

Management recognizes there are risk factors that are inherent in the Company's loan portfolio. All financial institutions face risk factors in their loan portfolios because risk exposure is a function of the business. The Company's operations (and therefore its loans) are concentrated in east central Illinois, an area where agriculture is the dominant industry. Accordingly, lending and other business relationships with agriculture-based businesses are critical to the Company's success. At September 30, 2017, the Company's loan portfolio included \$207.5 million of loans to borrowers whose businesses are directly related to agriculture. Of this amount, \$166.4 million was concentrated in other grain farming. Total loans to borrowers whose businesses are directly related to agriculture decreased \$5.47 million from \$213.0 million at December 31, 2016 while loans concentrated in other grain farming decreased \$4.9 million from \$171.3 million at December 31, 2016.

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

In addition, the Company has \$120.3 million of loans to motels and hotels. The performance of these loans is dependent on borrower specific issues as well as the general level of business and personal travel within the region. While the Company adheres to sound underwriting standards, a prolonged period of reduced business or personal travel could result in an increase in nonperforming loans to this business segment and potentially in loan losses. The Company also has \$168.3 million of loans to lessors of non-residential buildings, \$129.4 million of loans to lessors of residential buildings and dwellings, and \$81.4 million of loans to other gambling industries.

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

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

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

Analysis of the allowance for loan losses as of September 30, 2017 and 2016, and of changes in the allowance for the three and nine month periods ended September 30, 2017 and 2016, is as follows (dollars in thousands):

	Three months ended		Nine months ended		
	September 30,		September 30,		
	2017	2016	2017	2016	
Average loans outstanding, net of unearned income	\$ 1,840,570	\$ 1,445,774	\$ 1,820,264	\$ 1,335,898	
Allowance-beginning of period	18,209	15,164	16,753	14,576	
Charge-offs:					
Real estate-mortgage	563	—	914	221	
Commercial, financial & agricultural	686	—	2,579	533	
Installment	18	148	90	226	
Other	142	123	307	267	
Total charge-offs	1,409	271	3,890	1,247	
Recoveries:					
Real estate-mortgage	85	108	256	523	
Commercial, financial & agricultural	152	23	203	224	
Installment	11	7	21	19	
Other	52	49	195	139	
Total recoveries	300	187	675	905	
Net charge-offs (recoveries)	1,109	84	3,215	342	
Provision for loan losses	1,489	1,081	5,051	1,927	
Allowance-end of period	\$ 18,589	\$ 16,161	\$ 18,589	\$ 16,161	
Ratio of annualized net charge-offs to average loans	0.24	% 0.02	% 0.24	% 0.03	%
Ratio of allowance for loan losses to loans outstanding (less unearned interest at end of period)	1.00	% 0.89	% 1.00	% 0.89	%
Ratio of allowance for loan losses to nonperforming loans	94	% 102	% 94	% 102	%

The ratio of allowance for loan losses to loans outstanding was 1.00% as of September 30, 2017 compared to 0.89% as of September 30, 2016. The ratio of the allowance for loan losses to nonperforming loans is 94% as of September 30, 2017 compared to 102% as of September 30, 2016. The decrease in this ratio is primarily due to the increase in nonperforming loans to \$19.8 million at September 30, 2017 from \$15.8 million at September 30, 2016. The ratios also decreased as acquired First Clover Leaf loans were recorded at fair value and First Clover Leaf's allowance for loan loss was not carried over in accordance with ASC 805.

During the first nine months of 2017, the Company had net charge-offs of \$3,215,000 compared to net charge-offs of \$342,000 in 2016. During the first nine months of 2017 there were charge offs of commercial real estate loans to three borrowers of \$619,000, charge offs of two agricultural loans to one borrower of \$662,000, and charge offs of nine commercial operating loans to four borrowers of \$1,674,000. During the first nine months of 2016, there was one significant charge off of a residential real estate loan to a single borrower of \$83,000, charge offs of four commercial operating loans to a single borrower of \$437,000, and a significant charge off of two consumer loans to a single borrower of \$108,000.

Deposits

Funding of the Company's earning assets is substantially provided by a combination of consumer, commercial and public fund deposits. The Company continues to focus its strategies and emphasis on retail core deposits, the major component of funding sources. The following table sets forth the average deposits and weighted average rates for the nine months ended September 30, 2017 and 2016 and for the year ended December 31, 2016 (dollars in thousands):

	Nine months ended September 30, 2017		Nine months ended September 30, 2016		Year ended December 31, 2016	
	Average Balance	Weighted Average Rate	Average Balance	Weighted Average Rate	Average Balance	Weighted Average Rate
Demand deposits:						
Non-interest-bearing	\$434,201	— %	\$348,476	— %	\$372,339	— %
Interest-bearing	1,129,427	0.15 %	818,397	0.10 %	881,994	0.11 %
Savings	368,291	0.13 %	335,518	0.13 %	340,746	0.13 %
Time deposits	353,191	0.45 %	257,733	0.43 %	298,124	0.43 %
Total average deposits	\$2,285,110	0.17 %	\$1,760,124	0.13 %	\$1,893,203	0.14 %

The following table sets forth the high and low month-end balances for the nine months ended September 30, 2017 and 2016 and for the year ended December 31, 2016 (in thousands):

	Nine months ended September 30, 2017	Nine months ended September 30, 2016	Year ended December 31, 2016
High month-end balances of total deposits	\$2,331,084	\$2,265,259	\$2,329,887
Low month-end balances of total deposits	2,217,477	1,699,770	1,699,770

During the first nine months of 2017, the average balance of deposits increased by \$391.9 million from the average balance for the year ended December 31, 2016. Average non-interest bearing deposits increased by \$61.9 million, average interest bearing balances increased by \$247.4 million, savings account balances increased \$27.5 million and balances of time deposits increased \$55.1 million. These increases were primarily the result of average deposit balances acquired in the acquisition of First Clover Leaf during the third quarter of 2016 included in balances for the full nine months of 2017.

Balances of time deposits of \$100,000 or more include time deposits maintained for public fund entities and consumer time deposits. The following table sets forth the maturity of time deposits of \$100,000 or more at September 30, 2017 and December 31, 2016 (in thousands):

	September 30, 2017	December 31, 2016
3 months or less	\$ 28,203	\$ 23,796

Over 3 through 6 months	26,949	20,352
Over 6 through 12 months	37,215	37,094
Over 12 months	45,878	70,020
Total	\$ 138,245	\$ 151,262

Repurchase Agreements and Other Borrowings

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

Information relating to securities sold under agreements to repurchase and other borrowings as of September 30, 2017 and December 31, 2016 is presented below (dollars in thousands):

	September 30, December 31,	
	2017	2016
Securities sold under agreements to repurchase	\$ 116,360	\$ 185,763
Fed funds	20,000	—
Federal Home Loan Bank advances:		
FHLB-Overnight	27,000	—
Fixed term – due in one year or less	—	5,000
Fixed term – due after one year	60,052	35,094
Debt:		
Debt due in one year or less	—	4,000
Debt due after one year	11,250	14,063
Junior subordinated debentures	23,980	23,917
Total	\$ 258,642	\$ 267,837
Average interest rate at end of period	0.90	% 0.52 %
Maximum outstanding at any month-end:		
Securities sold under agreements to repurchase	\$ 163,626	\$ 185,763
Federal funds purchased	20,000	12,500
Federal Home Loan Bank advances:		
FHLB-Overnight	30,000	10,000
Fixed term – due in one year or less	5,000	20,000
Fixed term – due after one year	60,061	35,109
Debt:		
Debt due in one year or less	4,000	7,000
Debt due after one year	14,063	15,000
Junior subordinated debentures	23,980	23,917
Averages for the period (YTD):		
Securities sold under agreements to repurchase	\$ 149,970	\$ 129,734
Federal funds purchased	4,334	1,795
Federal Home Loan Bank advances:		
FHLB-overnight	8,055	3,992
Fixed term – due in one year or less	3,150	10,260
Fixed term – due after one year	41,871	22,396
Debt:		
Loans due in one year or less	879	1,454
Loans due after one year	13,108	4,749

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

Junior subordinated debentures	23,945	21,650		
Total	\$ 245,312	\$ 196,030		
Average interest rate during the period	0.98	%	0.81	%

Securities sold under agreements to repurchase decreased \$69.4 million during the first nine months of 2017 primarily due to the seasonal declines in balances and cash flow needs of various customers. FHLB advances represent borrowings by First Mid Bank to economically fund loan demand.

At September 30, 2017 the fixed term advances consisted of \$60 million as follows:

- \$5 million advance with a 3-year maturity, at 1.30%, due May 7, 2018
- \$5 million advance with a 2-year maturity, at 0.99%, due June 21, 2018
- \$10 million advance with a 3-year maturity, at 1.42%, due November 5, 2018
- \$5 million advance with a 1.5-year maturity, at 1.49%, due December 28, 2018
- \$5 million advance with a 2-year maturity, at 1.56%, due June 28, 2019
- \$5 million advance with a 2.5-year maturity, at 1.67%, due January 31, 2020
- \$5 million advance with a 3-year maturity, at 1.75%, due July 31, 2020
- \$5 million advance with a 6-year maturity, at 2.30%, due August 24, 2020
- \$5 million advance with a 3.5-year maturity, at 1.83%, due February 1, 2021
- \$5 million advance with a 7-year maturity, at 2.55%, due October 1, 2021
- \$5 million advance with a 8-year maturity, at 2.40%, due January 9, 2023

The Company is party to a revolving credit agreement with The Northern Trust Company in the amount of \$10 million. The balance on this line of credit was \$0 as of September 30, 2017. This loan was renewed on April 14, 2017 for one year as a revolving credit agreement with a maximum available balance of \$10 million. The interest rate is floating at 2.25% over the federal funds rate (3.41% at September 30, 2017). The loan is secured by all of the stock of First Mid Bank. The Company and its subsidiary bank were in compliance with the then existing covenants at September 30, 2017 and 2016 and December 31, 2016.

On September 7, 2016, the Company entered into a credit agreement with The Northern Trust Company in the amount of \$15 million as a fixed-rate note with a maturity date of September 7, 2020. The interest rate is floating at 2.25% over the federal funds rate (3.41% at September 30, 2017) and interest and principle payments are due quarterly. As of September 30, 2017, the balance due was \$11.3 million. The loan is secured by all of the stock of First Mid Bank. The Company used the proceeds of this note to fund the cash portion of the acquisition price of First Clover Leaf. The Company and its subsidiary bank were in compliance with the then existing covenants at September 30, 2017 and December 31, 2016.

On February 27, 2004, the Company completed the issuance and sale of \$10 million of floating rate trust preferred securities through First Mid-Illinois Statutory Trust I (“Trust I”), a statutory business trust and wholly-owned unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust I for the purpose of issuing the trust preferred securities. The \$10 million in proceeds from the trust preferred issuance and an additional \$310,000 for the Company’s investment in common equity of Trust I, a total of \$10,310,000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust I mature in 2034, bear interest at three-month London Interbank Offered Rate (“LIBOR”) plus 280 basis points (4.15% and 3.17% at September 30, 2017 and December 31, 2016), reset quarterly, and are callable at par, at the option of the Company, quarterly. The Company used the proceeds of the offering for general corporate purposes.

On April 26, 2006, the Company completed the issuance and sale of \$10 million of fixed/floating rate trust preferred securities through First Mid-Illinois Statutory Trust II (“Trust II”), a statutory business trust and wholly-owned

unconsolidated subsidiary of the Company, as part of a pooled offering. The Company established Trust II for the purpose of issuing the trust preferred securities. The \$10 million in proceeds from the trust preferred issuance and an additional \$310,000 for the Company's investment in common equity of Trust II, a total of \$10,310,000, was invested in junior subordinated debentures of the Company. The underlying junior subordinated debentures issued by the Company to Trust II mature in 2036, bore interest at a fixed rate of 6.98% paid quarterly until June 15, 2011 and then converted to floating rate (LIBOR plus 160 basis points, 2.92% and 2.56% at September 30, 2017 and December 31, 2016, respectively). The net proceeds to the Company were used for general corporate purposes, including the Company's acquisition of Mansfield Bancorp, Inc. in 2006.

On September 8, 2016, the Company assumed the trust preferred securities of Clover Leaf Statutory Trust I ("CLST I"), a statutory business trust that was a wholly owned unconsolidated subsidiary of First Clover Financial. The \$4,000,000 of trust preferred securities and an additional \$124,000 additional investment in common equity of CLST I, is invested in junior subordinated debentures issued to CLST I. The subordinated debentures mature in 2025, bear interest at three-month LIBOR plus 185 basis points (3.17% and 2.81% at September 30, 2017 and December 31, 2016, respectively) and resets quarterly.

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

In addition to requirements of the Dodd-Frank Act discussed above, the act also required the federal banking agencies to adopt rules that prohibit banks and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds). This rule is generally referred to as the "Volcker Rule." On December 10, 2013, the federal banking agencies issued final rules to implement the prohibitions required by the Volcker Rule. Following the publication of the final rule, and in reaction to concerns in the banking industry regarding the adverse impact the final rule's treatment of certain collateralized debt instruments has on community banks, the federal banking agencies approved an interim final rule to permit banking entities to retain interests in certain collateralized debt obligations backed primarily by trust preferred securities. Under the interim final rule, the agencies permit the retention of an interest in or sponsorship of covered funds by banking entities under \$15 billion in assets if (1) the collateralized debt obligation was established and issued prior to May 19, 2010, (2) the banking entity reasonably believes that the offering proceeds received by the collateralized debt obligation were invested primarily in qualifying trust preferred collateral, and (3) the banking entity's interests in the collateralized debt obligation was acquired on or prior to December 10, 2013. Although the Volcker Rule impacts many large banking entities, the Company does not currently anticipate that the Volcker Rule will have a material effect on the operations of the Company or First Mid Bank.

Interest Rate Sensitivity

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

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

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

The following table sets forth the Company's interest rate repricing GAP for selected maturity periods at September 30, 2017 (dollars in thousands):

	Rate Sensitive Within						Total	Fair Value
	1 year	1-2 years	2-3 years	3-4 years	4-5 years	Thereafter		
Interest-earning assets:								
Federal funds sold and other interest-bearing deposits								
	\$7,052	\$—	\$—	\$—	\$—	\$—	\$7,052	\$7,052
Certificates of deposit investments								
	\$—	\$735	\$950	\$—	\$—	\$—	\$1,685	\$1,708
Taxable investment securities								
	175	5,027	3,002	22,327	38,320	449,133	517,984	517,815
Nontaxable investment securities								
	—	664	1,369	2,345	7,272	160,876	172,526	172,526
Loans								
	807,352	268,193	201,007	277,925	201,122	111,963	1,867,562	1,863,011
Total	\$814,579	\$274,619	\$206,328	\$302,597	\$246,714	\$721,972	\$2,566,809	\$2,562,112
Interest-bearing liabilities:								
Savings and NOW accounts								
	\$260,620	\$89,962	\$89,962	\$89,962	\$89,962	\$422,111	\$1,042,579	\$1,042,579
Money market accounts								
	309,888	17,939	17,939	17,939	17,939	41,842	423,486	423,486
Other time deposits								
	205,597	49,415	34,226	18,518	12,447	1,173	321,376	321,427
Short-term borrowings/debt								
	163,360	—	—	—	—	—	163,360	163,348
Long-term borrowings/debt								
	45,282	20,000	15,000	5,000	5,000	5,000	95,282	89,286
Total	\$984,747	\$177,316	\$157,127	\$131,419	\$125,348	\$470,126	\$2,046,083	\$2,040,126
Rate sensitive assets – rate sensitive liabilities								
	\$(170,168)	\$97,303	\$49,201	\$171,178	\$121,366	\$251,846	\$520,726	
Cumulative GAP								
	\$(170,168)	\$(72,865)	\$(23,664)	\$147,514	\$268,880	\$520,726		
Cumulative amounts as % of total Rate sensitive assets								
	(6.6)	)% 3.8	% 1.9	% 6.7	% 4.7	% 9.8	%	
Cumulative Ratio								
	(6.6)	)% (2.8)	)% (0.9)	)% 5.7	% 10.5	% 20.3	%	

The static GAP analysis shows that at September 30, 2017, the Company was liability sensitive, on a cumulative basis, through the twelve-month time horizon. This indicates that future increases in interest rates could have an adverse effect on net interest income. There are several ways the Company measures and manages the exposure to interest rate sensitivity, including static GAP analysis. The Company's ALCO also uses other financial models to

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

Capital Resources

At September 30, 2017, the Company's stockholders' equity increased \$31 million, or 11%, to \$311 million from \$281 million as of December 31, 2016. During the first nine months of 2017, net income contributed \$22.1 million to equity before the payment of dividends to stockholders. The change in market value of available-for-sale investment securities increased stockholders' equity by \$7.8 million, net of tax.

The Company is subject to various regulatory capital requirements administered by the federal banking agencies. Bank holding companies follow minimum regulatory requirements established by the Board of Governors of the Federal Reserve System ("Federal Reserve System"), and First Mid Bank follows similar minimum regulatory requirements established for national banks by the Office of the Comptroller of the Currency ("OCC"). Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary action by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Quantitative measures established by regulatory capital standards to ensure capital adequacy require the the Company and its subsidiary bank to maintain a minimum capital amounts and ratios (set forth in the table below). Management believes that, as of September 30, 2017 and December 31, 2016, the Company and First Mid Bank met all capital adequacy requirements.

Edgar Filing: FIRST MID ILLINOIS BANCSHARES INC - Form 10-Q

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

	Actual		Required Minimum For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2017						
Total Capital (to risk-weighted assets)						
Company	\$289,666	13.26%	\$174,785	> 8.00%	N/A	N/A
First Mid Bank	281,678	12.94	174,210	> 8.00	\$217,763	> 10.00%
Tier 1 Capital (to risk-weighted assets)						
Company	271,077	12.41	131,089	> 6.00	N/A	N/A
First Mid Bank	263,089	12.08	130,658	> 6.00	174,210	> 8.00
Common Equity Tier 1 Capital (to risk-weighted assets)						
Company	247,104	11.31	98,317	> 4.50	N/A	N/A
First Mid Bank	263,089	12.08	97,993	> 4.50	141,546	> 6.50
Tier 1 Capital (to average assets)						
Company	271,077	9.84	110,225	> 4.00	N/A	N/A
First Mid Bank	263,089	9.57	109,968	> 4.00	137,460	> 5.00
December 31, 2016						
Total Capital (to risk-weighted assets)						
Company	\$270,062	12.79%	\$168,902	> 8.00%	N/A	N/A
First Mid Bank	197,552	12.44	127,054	> 8.00	\$158,817	> 10.00%
First Clover Leaf Bank	78,145	15.08	41,459	> 8.00	51,824	> 10.00%
Tier 1 Capital (to risk-weighted assets)						
Company	253,258	11.99	126,677	> 6.00	N/A	N/A
First Mid Bank	180,826	11.39	95,290	> 6.00	127,054	> 8.00
First Clover Leaf Bank	78,145	15.08	31,094	> 6.00	41,459	> 8.00
Common Equity Tier 1 Capital (to risk-weighted assets)						
Company	229,341	10.86	95,008	> 4.50	N/A	N/A
First Mid Bank	180,826	11.39	71,468	> 4.50	103,231	> 6.50
First Clover Leaf Bank	78,145	15.08	23,321	> 4.50	33,685	> 6.50
Tier 1 Capital (to average assets)						
Company	253,258	9.19	110,242	> 4.00	N/A	N/A
First Mid Bank	180,826	8.62	83,938	> 4.00	104,922	> 5.00
First Clover Leaf Bank	78,145	12.04	25,963	> 4.00	32,453	> 5.00

The Company's risk-weighted assets, capital and capital ratios for September 30, 2017 are computed in accordance with Basel III capital rules which were effective January 1, 2015. Prior periods are computed following previous rules. See heading "Basel III" in the Overview section of this report for a more detailed description of the Basel III rules. As of September 30, 2017, both the Company and First Mid Bank had capital ratios above the required minimums for regulatory capital adequacy, and First Mid Bank had capital ratios that qualified it for treatment as well-capitalized under the regulatory framework for prompt corrective action with respect to banks. First Clover Leaf Bank merged into First Mid Bank during the first quarter of 2017.

Stock Plans

Participants may purchase Company stock under the following four plans of the Company: the Deferred Compensation Plan, the First Retirement and Savings Plan, the Dividend Reinvestment Plan, and the Stock Incentive Plan. For more detailed information on these plans, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

At the Annual Meeting of Stockholders held April 26, 2017, the stockholders approved the 2017 Stock Incentive Plan ("SI Plan"). The SI Plan was implemented to succeed the Company's 2007 Stock Incentive Plan, which had a ten-year term. The SI Plan is intended to provide a means whereby directors, employees, consultants and advisors of the Company and its Subsidiaries may sustain a sense of proprietorship and personal involvement in the continued development and financial success of the Company and its Subsidiaries, thereby advancing the interests of the Company and its stockholders. Accordingly, directors and selected employees, consultants and advisors may be provided the opportunity to acquire shares of Common Stock of the Company on the terms and conditions established in the SI Plan.

A maximum of 149,983 shares of common stock may be issued under the SI Plan. There were no stock options granted in 2017 or 2016. The Company awarded 11,473 and 13,912 stock unit awards during 2017 and 2016, respectively, under the 2007 Stock Incentive Plan.

Stock Repurchase Program

Since August 5, 1998, the Board of Directors has approved repurchase programs pursuant to which the Company may repurchase a total of approximately \$76.7 million of the Company's common stock. The repurchase programs approved by the Board of Directors are as follows:

- On August 5, 1998, repurchases of up to 3%, or \$2 million, of the Company's common stock.
- In March 2000, repurchases up to an additional 5%, or \$4.2 million of the Company's common stock.
- In September 2001, repurchases of \$3 million of additional shares of the Company's common stock.
- In August 2002, repurchases of \$5 million of additional shares of the Company's common stock.
- In September 2003, repurchases of \$10 million of additional shares of the Company's common stock.
- On April 27, 2004, repurchases of \$5 million of additional shares of the Company's common stock.
- On August 23, 2005, repurchases of \$5 million of additional shares of the Company's common stock.
- On August 22, 2006, repurchases of \$5 million of additional shares of the Company's common stock.
- On February 27, 2007, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 13, 2007, repurchases of \$5 million of additional shares of the Company's common stock.
- On December 16, 2008, repurchases of \$2.5 million of additional shares of the Company's common stock.
- On May 26, 2009, repurchases of \$5 million of additional shares of the Company's common stock.
- On February 22, 2011, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 13, 2012, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 19, 2013, repurchases of \$5 million additional shares of the Company's common stock.
- On October 28, 2014, repurchases of \$5 million additional shares of the Company's common stock.

During the nine months ended September 30, 2017, the Company did not repurchase any shares. Since 1998, the Company has repurchased a total of 2,042,993 shares at a total price of approximately \$69.5 million. As of September 30, 2017, the Company is authorized per all repurchase programs to purchase \$7.2 million in additional shares.

64

Liquidity

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

First Mid Bank has \$35 million available in overnight federal fund lines, including \$10 million from U.S. Bank, N.A., \$10 million from Wells Fargo Bank, N.A. and \$15 million from The Northern Trust Company. Availability of the funds is subject to First Mid Bank meeting minimum regulatory capital requirements for total capital to risk-weighted assets and Tier 1 capital to total average assets. As of September 30, 2017, First Mid Bank met these regulatory requirements.

First Mid Bank can borrow from the Federal Home Loan Bank as a source of liquidity. Availability of the funds is subject to the pledging of collateral to the Federal Home Loan Bank. Collateral that can be pledged includes one-to-four family residential real estate loans and securities. At September 30, 2017, the excess collateral at the FHLB would support approximately \$109.0 million of additional advances for First Mid Bank.

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

In addition, as of September 30, 2017, the Company had a revolving credit agreement in the amount of \$10 million with The Northern Trust Company with an outstanding balance of \$0 and \$10 million in available funds. This loan was renewed on April 14, 2017 for one year as a revolving credit agreement. The interest rate is floating at 2.25% over the federal funds rate. The loan is secured by all of the stock of First Mid Bank, including requirements for operating and capital ratios. The Company and its subsidiary bank were in compliance with the then existing covenants at September 30, 2017 and 2016 and December 31, 2016.

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

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

The following table summarizes significant contractual obligations and other commitments at September 30, 2017 (in thousands):

	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Time deposits	\$321,376	\$205,597	\$83,641	\$30,965	\$1,173
Debt	35,870	3,750	7,500	—	24,620
Other borrowings	203,360	153,360	35,000	10,000	5,000
Operating leases	43,921	2,517	4,383	3,520	33,501

Supplemental retirement 597	100	142	100	255
	\$605,124	\$365,324	\$130,666	\$44,585
				\$64,549

For the nine months ended September 30, 2017, net cash of \$32.8 million was provided from operating activities and \$17.9 million and \$121.1 million was used in investing activities and financing activities, respectively. In total, cash and cash equivalents decreased by \$106.2 million since year-end 2016.

65

Off-Balance Sheet Arrangements

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

The off-balance sheet financial instruments whose contract amounts represent credit risk at September 30, 2017 and December 31, 2016 were as follows (in thousands):

	September 30, December 31,	
	2017	2016
Unused commitments and lines of credit:		
Commercial real estate	\$ 71,719	\$ 128,576
Commercial operating	259,104	236,182
Home equity	38,811	40,896
Other	58,927	70,092
Total	\$ 428,561	\$ 475,746
Standby letters of credit	\$ 11,431	\$ 9,339

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

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There has been no material change in the market risk faced by the Company since December 31, 2016. For information regarding the Company's market risk, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

ITEM 4. CONTROLS AND PROCEDURES

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

PART II

ITEM 1. LEGAL PROCEEDINGS

The Company as successor to First Clover Leaf, certain former executive officers of First Clover Leaf, and certain former members of First Clover Leaf's board of directors, and the Company were named as defendants in one purported class action lawsuit brought by an alleged individual First Clover Leaf stockholder challenging the merger of First Clover Leaf into the Company (the "Lawsuit"). The Lawsuit was captioned Raul v. Highlander, et al, Case No. 16- L-703, and was filed on May 20, 2016, in the Circuit Court of Madison County, Illinois, Third Judicial District. On July 12, 2017, the defendants' motion to dismiss was granted and all claims were dismissed with prejudice. The plaintiff did not appeal this decision prior to August 11, 2017 deadline for such an appeal to be filed.

From time to time the Company and its subsidiaries may be involved in litigation that the Company believes is of a type common to our industry. None of any such existing claims are believed to be individually material at this time to the Company, although the outcome of any such existing claims cannot be predicted with certainty.

ITEM 1A. RISK FACTORS

Various risks and uncertainties, some of which are difficult to predict and beyond the Company's control, could negatively impact the Company. As a financial institution, the Company is exposed to interest rate risk, liquidity risk, credit risk, operational risk, risks from economic or market conditions, and general business risks among others. Adverse experience with these or other risks could have a material impact on the Company's financial condition and results of operations, as well as the value of its common stock. See the risk factors and "Supervision and Regulation" described in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

SIGNATURES

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

FIRST MID-ILLINOIS BANCSHARES, INC.
(Registrant)

Date: November 6, 2017

Joseph R. Dively
President and Chief Executive Officer

Matthew K. Smith
Chief Financial Officer

Exhibit Index to Quarterly Report on Form 10-Q

Exhibit Number	Description and Filing or Incorporation Reference
4.1	The Registrant agrees to furnish to the Commission, upon request, a copy of each instrument with respect to issues of long-term debt involving a total amount which does not exceed 10% of the total assets of the Registrant and its subsidiaries on a consolidated basis
<u>10.1</u>	<u>Sales Agency Agreement, dated August 16, 2017, by and among the Company, Sander O'Neill & Partners, and FIG Partners, LLC (incorporated by reference to Exhibit 10.1 to First Mid-Illinois Bancshares, Inc's current report on Form 8-K filed with the SEC on August 17, 2017)</u>
<u>11.1</u>	<u>Statement re: Computation of Earnings Per Share (Filed herewith on page 11)</u>
<u>31.1</u>	<u>Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002</u>
<u>31.2</u>	<u>Certification pursuant to section 302 of the Sarbanes-Oxley Act of 2002</u>
<u>32.1</u>	<u>Certification pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002</u>
<u>32.2</u>	<u>Certification pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002</u>
101	The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2017, formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheets at September 30, 2017 and December 31, 2016, (ii) the Consolidated Statements of Income for the three and nine months ended September 30, 2017 and 2016, (iii) the Consolidated Statements of Cash Flows for the nine months ended September, 2017 and 2016, and (iv) the Notes to Consolidated Financial Statements.
70	