FIRST MERCHANTS CORP
Form 10-Q
November 09, 2016

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

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

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _______ to _______

Commission File Number 0-17071

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

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

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

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

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

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

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

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

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

As of October 31, 2016, there were 40,807,138 outstanding common shares of the registrant.

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GLOSSARY OF DEFINED TERMS

FIRST MERCHANTS CORPORATION

Ameriana	Ameriana Bancorp, Inc., which was acquired by the Corporation on December 31, 2015.
ASC	Accounting Standards Codification
Bank	First Merchants Bank, a wholly-owned subsidiary of the Corporation
C Financial	C Financial Corporation, which was acquired by the Corporation on April 17, 2015.
CFS	CFS Bancorp, Inc., which was acquired by the Corporation on November 12, 2013.
CMT	Constant Maturity Treasury
Community	Community Bancshares, Inc., which was acquired by the Corporation on November 7, 2014.
Corporation	First Merchants Corporation
DSU	Deferred stock units
ESPP	Employee Stock Purchase Plan
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FMIG	First Merchants Insurance Services, Inc., an Indiana corporation
FTE	Fully taxable equivalent
GAAP	Generally Accepted Accounting Principles
Indiana DFI	Indiana Department of Financial Institutions
RSA	Restricted Stock Awards
SCB	SCB Bank, of which the Bank assumed substantially all the deposits and certain other liabilities and acquired certain other assets from the FDIC as receiver on February 10, 2012.
TEFRA	Tax Equivalent and Fiscal Responsibility Act. The TEFRA disallowance reduces the amount of interest expense an entity may deduct for the purpose of carrying tax-free investment securities.

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CONSOLIDATED CONDENSED BALANCE SHEETS

	September 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
Cash and cash equivalents	$ 99,602	$ 102,170
Interest-bearing time deposits	33,803	32,315
Investment securities available for sale	675,813	658,400
Investment securities held to maturity (fair value of $647,046 and $632,380)	624,615	618,599
Loans held for sale	1,482	9,894
Loans, net of allowance for loan losses of $63,456 and $62,453	4,910,388	4,631,369
Premises and equipment	95,540	97,648
Federal Reserve and Federal Home Loan Bank stock	18,044	37,633
Interest receivable	23,652	24,415
Core deposit intangibles	15,844	16,635
Goodwill	244,000	243,129
Cash surrender value of life insurance	201,856	200,539
Other real estate owned	10,242	17,257
Tax asset, deferred and receivable	31,779	46,977
Other assets	35,692	24,023
TOTAL ASSETS	$ 7,022,352	$ 6,761,003
LIABILITIES		
Deposits:		
Noninterest-bearing	$ 1,307,886	$ 1,266,027
Interest-bearing	4,136,354	4,023,620
Total Deposits	5,444,240	5,289,647
Borrowings:		
Federal funds purchased	58,358	49,721
Securities sold under repurchase agreements	138,671	155,325
Federal Home Loan Bank advances	297,022	235,652
Subordinated debentures and term loans	128,288	127,846
Total Borrowings	622,339	568,544
Interest payable	3,733	3,092
Other liabilities	51,175	49,211
Total Liabilities	6,121,487	5,910,494
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY		
Cumulative Preferred Stock, $1,000 par value, $1,000 liquidation value:		
Authorized - 600 shares		
Issued and outstanding - 125 shares	125	125
Common Stock, $.125 stated value:		
Authorized - 50,000,000 shares		
Issued and outstanding - 40,799,025 and 40,664,259 shares	5,100	5,083
Additional paid-in capital	506,848	504,530

Retained earnings	384,868	342,133
Accumulated other comprehensive income (loss)	3,924	(1,362)
Total Stockholders' Equity	900,865	850,509
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 7,022,352	$ 6,761,003

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CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
INTEREST INCOME				
Loans receivable:				
Taxable	$53,819	$46,037	$156,407	$134,908
Tax exempt	1,649	1,190	4,429	2,174
Investment securities:				
Taxable	3,992	4,374	12,522	13,522
Tax exempt	4,668	4,412	13,760	12,478
Deposits with financial institutions	55	25	283	93
Federal Reserve and Federal Home Loan Bank stock	193	500	906	1,509
Total Interest Income	64,376	56,538	188,307	164,684
INTEREST EXPENSE				
Deposits	3,926	3,715	12,028	10,917
Federal funds purchased	27	27	62	69
Securities sold under repurchase agreements	91	96	283	264
Federal Home Loan Bank advances	853	711	2,467	2,108
Subordinated debentures and term loans	1,797	1,666	5,368	4,996
Total Interest Expense	6,694	6,215	20,208	18,354
NET INTEREST INCOME	57,682	50,323	168,099	146,330
Provision for loan losses	1,900		3,240	417
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	55,782	50,323	164,859	145,913
OTHER INCOME				
Service charges on deposit accounts	4,667	4,445	13,228	12,083
Fiduciary activities	2,448	2,242	7,318	7,058
Other customer fees	4,777	4,156	14,531	12,425
Commission income		4		4,147
Earnings on cash surrender value of life insurance	614	710	3,387	2,097
Net gains and fees on sales of loans	1,989	1,905	5,166	5,175
Net realized gains on sales of available for sale securities	839	1,115	2,542	2,047
Gain on sale of insurance subsidiary				8,265
Other income	1,527	1,755	2,911	2,540
Total Other Income	16,861	16,332	49,083	55,837
OTHER EXPENSES				
Salaries and employee benefits	26,651	25,137	79,558	76,112
Net occupancy	4,348	3,726	12,429	11,019
Equipment	2,947	2,698	9,428	8,104
Marketing	630	847	2,218	2,578
Outside data processing fees	2,382	1,992	6,476	5,477

Printing and office supplies	314	343	1,047	1,010
Core deposit amortization	978	693	2,933	2,143
FDIC assessments	534	958	2,486	2,716
Other real estate owned and foreclosure expenses	637	1,675	2,303	2,917
Professional and other outside services	1,242	1,686	4,882	6,311
Other expenses	3,452	3,276	11,665	10,909
Total Other Expenses	44,115	43,031	135,425	129,296
INCOME BEFORE INCOME TAX	28,528	23,624	78,517	72,454
Income tax expense	7,469	6,557	19,759	21,247
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	$21,059	$17,067	$58,758	$51,207
Per Share Data:				
Basic Net Income Available to Common Stockholders	$0.51	$0.46	$1.44	$1.36
Diluted Net Income Available to Common Stockholders	$0.51	$0.45	$1.43	$1.35
Cash Dividends Paid	$0.14	$0.11	$0.39	$0.30
Average Diluted Shares Outstanding (in thousands)	41,026	38,118	40,970	38,054

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CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	$21,059	$17,067	$58,758	$51,207
Other comprehensive income net of tax:				
Unrealized holding gain (loss) on securities available for sale arising during the period, net of tax of $1,627, $2,439, $4,234 and $63	(3,022)	4,530	7,863	117
Unrealized gain (loss) on cash flow hedges arising during the period, net of tax of $134, $627, $835 and $792	250	(1,164)	(1,548)	(1,468)
Reclassification adjustment for net gains included in net income, net of tax of $183, $263, $554 and $340	(339)	(490)	(1,029)	(633)
	(3,111)	2,876	5,286	(1,984)
Comprehensive income	$17,948	$19,943	$64,044	$49,223

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CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
(Unaudited)

	Preferred		Common Stock		Additional		Accumulated Other	
	Shares	Amount	Shares	Amount	Paid in Capital	Retained Earnings	Comprehensive Income (Loss)	Total
Balances, December 31, 2015	125	$ 125	40,664,259	$5,083	$504,530	$342,133	$ (1,362)	$850,509
Comprehensive income								
Net income						58,758		58,758
Other comprehensive income, net of tax							5,286	5,286
Cash dividends on common stock ($.39 per share)						(16,023)		(16,023)
Share-based compensation			110,251	14	1,869			1,883
Stock issued under employee benefit plans			15,968	2	336			338
Stock issued under dividend reinvestment and stock purchase plan			23,882	3	602			605
Stock options exercised			22,385	3	347			350
Stock redeemed			(37,720)	(5)	(836)			(841)
Balances,September 30, 2016	125	$ 125	40,799,025	$5,100	$506,848	$384,868	$ 3,924	$900,865

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended	
	September 30, 2016	September 30, 2015
Cash Flow From Operating Activities:		
Net income	$58,758	$ 51,207
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,240	417
Depreciation and amortization	5,363	4,707
Change in deferred taxes	6,889	3,363
Share-based compensation	1,883	1,687
Tax benefit from stock options exercised	(41)	(70)
Loans originated for sale	(280,769)	(286,414)
Proceeds from sales of loans held for sale	293,519	296,302
Gains on sales of loans held for sale	(4,338)	(4,596)
Gain on sale of insurance subsidiary		(8,265)
Gain on cancellation of subordinated debentures		(1,250)
Gains on sales of securities available for sale	(2,542)	(2,047)
Change in interest receivable	763	(1,772)
Change in interest payable	641	480
Other adjustments	(501)	301
Net cash provided by operating activities	82,865	54,050
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	(1,488)	21,331
Purchases of:		
Securities available for sale	(161,962)	(166,645)
Securities held to maturity	(94,309)	(55,415)
Proceeds from sales of securities available for sale	104,821	70,114
Proceeds from maturities of:		
Securities available for sale	52,019	47,664
Securities held to maturity	86,281	69,629
Change in Federal Reserve and Federal Home Loan Bank stock	19,589	7,710
Net change in loans	(286,125)	(296,602)
Net cash and cash equivalents paid in acquisition		(12,004)
Net cash received from sale of insurance subsidiary		15,155
Proceeds from the sale of other real estate owned	8,105	8,294
Other adjustments	(3,800)	1,264
Net cash used in investing activities	(276,869)	(289,505)
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	195,395	106,597
Certificates of deposit and other time deposits	(41,973)	(38,028)
Borrowings	647,935	414,197
Repayment of borrowings	(594,350)	(270,497)

Cash dividends on common stock	(16,023)	(11,448)
Stock issued under employee benefit plans	338	351
Stock issued under dividend reinvestment and stock purchase plans	605	487
Stock options exercised	309	1,422
Tax benefit from stock options exercised	41	70
Stock redeemed	(841)	(1,635)
Net cash provided by financing activities	191,436	201,516
Net Change in Cash and Cash Equivalents	(2,568)	(33,939)
Cash and Cash Equivalents, January 1	102,170	118,616
Cash and Cash Equivalents, September 30	$99,602	$ 84,677
Additional cash flow information:		
Interest paid	$19,567	$ 17,845
Income tax paid	4,499	15,000
Loans transferred to other real estate owned	665	3,244
Fixed assets transferred to other real estate owned	360	1,166
Non-cash investing activities using trade date accounting	1,341	3,332
In conjunction with the acquisition, liabilities were assumed as follows:		
Fair value of assets acquired		$ 141,724
Cash received (paid) in acquisition		(14,500)
Less: Common stock issued		
Liabilities assumed	$—	$ 127,224

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NOTE 1

GENERAL

Financial Statement Preparation

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

The Consolidated Condensed Balance Sheet of the Corporation as of December 31, 2015, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation's annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission. The results of operations for the three and nine months ended September 30, 2016, are not necessarily indicative of the results to be expected for the year. Reclassifications have been made to prior financial statements to conform to the current financial statement presentation. These reclassifications had no effect on net income.

NOTE 2

ACQUISITIONS AND DIVESTITURES

Acquisition - Ameriana Bancorp, Inc.

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

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

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

(table dollar amounts in thousands, except share data)

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

Acquisition - C Financial Corporation

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

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

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

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

Subsidiary Divestiture - First Merchants Insurance Services, Inc.

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

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NOTE 3

INVESTMENT SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at September 30, 2016				
U.S. Government-sponsored agency securities	$100	$ 1		$101
State and municipal	348,557	20,852	$ 324	369,085
U.S. Government-sponsored mortgage-backed securities	297,557	7,040	17	304,580
Corporate obligations	31			31
Equity securities	2,016			2,016
Total available for sale	648,261	27,893	341	675,813
Held to maturity at September 30, 2016				
Federal agencies	29,499	10	51	29,458
State and municipal	209,857	9,682	14	219,525
U.S. Government-sponsored mortgage-backed securities	385,259	12,804		398,063
Total held to maturity	624,615	22,496	65	647,046
Total Investment Securities	$1,272,876	$ 50,389	$ 406	$1,322,859

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

The amortized cost and fair value of available for sale and held to maturity securities at September 30, 2016 and December 31, 2015, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Maturity Distribution at September 30, 2016:				
Due in one year or less	$2,336	$2,353	$2,512	$2,533
Due after one through five years	22,195	23,463	53,530	55,764
Due after five through ten years	66,314	70,278	76,023	77,338
Due after ten years	257,843	273,123	107,291	113,348
	$348,688	$369,217	$239,356	$248,983
U.S. Government-sponsored mortgage-backed securities	297,557	304,580	385,259	398,063
Equity securities	2,016	2,016		
Total Investment Securities	$648,261	$675,813	$624,615	$647,046

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

The carrying value of securities pledged as collateral, to secure borrowings and for other purposes, was $587,806,000 at September 30, 2016, and $637,358,000 at December 31, 2015.

The book value of securities sold under agreements to repurchase amounted to $134,248,000 at September 30, 2016, and $153,789,000 at December 31, 2015.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Sales and Redemptions of Available for Sale Securities:				
Gross gains	$839	$1,115	$2,542	$2,147
Gross losses				100

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

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

Temporarily Impaired Available for Sale Securities at September 30, 2016						
State and municipal	$22,468	$ 324			$22,468	$ 324
U.S. Government-sponsored mortgage-backed securities	9,543	17			9,543	17
Total Temporarily Impaired Available for Sale Securities	32,011	341	—	—	32,011	341
Temporarily Impaired Held to Maturity Securities at September 30, 2016						
Federal agencies	15,469	51			15,469	51
State and municipal	6,941	14			6,941	14
Total Temporarily Impaired Held to Maturity Securities	22,410	65			22,410	65
Total Temporarily Impaired Investment Securities	$54,421	$ 406	$ —	$ —	$54,421	$ 406

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

(table dollar amounts in thousands, except share data)

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

	September 30, 2016	December 31, 2015
Investments reported at less than historical cost:		
Historical cost	$ 54,826	$ 178,964
Fair value	$ 54,421	$ 177,584
Percent of the Corporation's available for sale and held to maturity portfolio	4.2 %	13.9 %

Management believes the decline in fair value for these securities was temporary. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income during the period the other-than-temporary impairment is identified.

The Corporation's management has evaluated all securities with unrealized losses for other-than temporary impairment as of September 30, 2016. The evaluations are based on the nature of the securities, the extent and duration of the loss and the intent and ability of the Corporation to hold these securities either to maturity or through the expected recovery period.

In determining the fair value of the investment securities portfolio, the Corporation utilizes a third party for portfolio accounting services, including market value input, for those securities classified as Level 1 and Level 2 in the fair value hierarchy. The Corporation has obtained an understanding of what inputs are being used by the vendor in pricing the portfolio and how the vendor was classifying these securities based upon these inputs. From these discussions, the Corporation's management is comfortable that the classifications are proper. The Corporation has gained trust in the data for two reasons: (a) independent spot testing of the data is conducted by the Corporation through obtaining market quotes from various brokers on a periodic basis and (b) actual gains or losses resulting from the sale of certain securities has proven the data to be accurate over time. The fair value of securities classified as Level 3 in the valuation hierarchy was determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

State and Municipal and U.S. Government-Sponsored Mortgage-Backed Securities

The unrealized losses on the Corporation's investments in securities of state and political subdivisions and U.S. Government-sponsored mortgage-backed securities were caused by changes in interest rates and not credit quality. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Corporation does not intend to sell the investments and more likely than not the Corporation won't be required to sell the investments before recovery of its lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2016.

Credit Losses Recognized on Investments

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

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

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

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NOTE 4

LOANS AND ALLOWANCE

The Corporation's primary lending focus is small business and middle market commercial, commercial real estate, residential real estate and consumer, which results in portfolio diversification. The following tables show the composition of the loan portfolio, the allowance for loan losses and certain credit quality aspects, all excluding loans held for sale. Loans held for sale as of September 30, 2016, and December 31, 2015, were $1,482,000 and $9,894,000, respectively.

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

	September 30, 2016	December 31, 2015
Commercial and industrial loans	$ 1,146,538	$ 1,057,075
Agricultural production financing and other loans to farmers	93,169	97,711
Real estate loans:		
Construction	368,241	366,704
Commercial and farmland	1,941,739	1,802,921
Residential	739,855	786,105
Home Equity	398,837	348,613
Individuals' loans for household and other personal expenditures	76,497	74,717
Lease financing receivables, net of unearned income	380	588
Other commercial loans	208,588	159,388
Loans	$ 4,973,844	$ 4,693,822
Allowance for loan losses	(63,456)	(62,453)
Net Loans	$ 4,910,388	$ 4,631,369

Allowance, Credit Quality and Loan Portfolio

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. Management believes the allowance for loan losses is adequate to cover probable losses inherent in the loan portfolio at September 30, 2016. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments, to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examinations, and will increase or decrease as deemed necessary to ensure it remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, portfolio mix and collateral values.

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The allowance is increased by provision expense and decreased by charge offs less recoveries. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off. The Bank charges off a loan when a determination is made that all or a portion of the loan is uncollectible. The amount provided for loan losses in a given period may be greater than or less than net loan losses experienced during the period, and is based on management's judgment as to the appropriate level of the allowance for loan losses. The determination of the provision amount is based on management's ongoing review and evaluation of the loan portfolio, including an internally administered loan "watch" list and independent loan reviews. The evaluation takes into consideration identified credit problems, the possibility of losses inherent in the loan portfolio that are not specifically identified and management's judgment as to the impact of the current environment and economic conditions on the portfolio.

The allowance consists of specific impairment reserves as required by ASC 310-10-35, a component for historical losses in accordance with ASC 450 and the consideration of current environmental factors in accordance with ASC 450. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected.

The historical loss allocation for loans not deemed impaired according to ASC 450 is the product of the volume of loans within the non-impaired criticized and non-criticized risk grade classifications, each segmented by call code, and the historical loss factor for each respective classification and call code segment. The historical loss factors are based upon actual loss experience within each risk and call code classification. The historical look back period for non-criticized loans looks to the most recent rolling-four-quarter average and aligns with the look back period for non-impaired criticized loans. Each of the rolling four quarter periods used to obtain the average, include all charge offs for the previous twelve-month period, therefore the historical look back period includes seven quarters. The resulting allocation is reflective of current conditions. Criticized loans are grouped based on the risk grade assigned to the loan. Loans with a special mention grade are assigned a loss factor, and loans with a classified grade but not impaired are assigned a separate loss factor. The loss factor computation for this allocation includes a segmented historical loss migration analysis of risk grades to charge off.

(table dollar amounts in thousands, except share data)

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

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

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

	Three Months Ended September 30, 2016					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, June 30, 2016	$26,321	$ 22,280	$ 2,684	$ 10,899	$ 2	$62,186
Provision for losses	727	578	115	480		1,900
Recoveries on loans	175	651	101	324		1,251
Loans charged off	(720)	(572)	(114)	(475)		(1,881)
Balances, September 30, 2016	$26,503	$ 22,937	$ 2,786	$ 11,228	$ 2	$63,456

	Nine Months Ended September 30, 2016					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, December 31, 2015	$26,478	$ 22,145	$ 2,689	$ 11,139	$ 2	$62,453
Provision for losses	1,266	992	192	790		3,240
Recoveries on loans	1,150	1,879	286	909		4,224
Loans charged off	(2,391)	(2,079)	(381)	(1,610)		(6,461)
Balances, September 30, 2016	$26,503	$ 22,937	$ 2,786	$ 11,228	$ 2	$63,456

	Three Months Ended September 30, 2015					
	Commercial		Consumer	Residential		Total

		Commercial Real Estate			Finance Leases	
Allowance for loan losses:						
Balances, June 30, 2015	$31,479	$ 15,828	$ 2,927	$ 12,311	$ 5	$62,550
Provision for losses	3,202	(2,966)	(102)	(132)	(2)	
Recoveries on loans	281	1,510	67	513		2,371
Loans charged off	(1,026)	(386)	(169)	(479)		(2,060)
Balances, September 30, 2015	$33,936	$ 13,986	$ 2,723	$ 12,213	$ 3	$62,861

	Nine Months Ended September 30, 2015					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, December 31, 2014	$28,824	$ 19,327	$ 2,658	$ 13,152	$ 3	$63,964
Provision for losses	6,226	(6,364)	225	330		417
Recoveries on loans	1,168	2,069	246	1,392		4,875
Loans charged off	(2,282)	(1,046)	(406)	(2,661)		(6,395)
Balances, September 30, 2015	$33,936	$ 13,986	$ 2,723	$ 12,213	$ 3	$62,861

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

	September 30, 2016					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance Balances:						
Individually evaluated for impairment	$555	$760		$312		$1,627
Collectively evaluated for impairment	25,948	22,177	$ 2,786	10,916	$ 2	61,829
Loans Acquired with Deteriorated Credit Quality						
Total Allowance for Loan Losses	$26,503	$22,937	$ 2,786	$11,228	$ 2	$63,456
Loan Balances:						
Individually evaluated for impairment	$5,764	$23,904		$4,158		$33,826
Collectively evaluated for impairment	1,436,065	2,242,862	$ 76,497	1,132,385	$ 380	4,888,189
Loans Acquired with Deteriorated Credit Quality	6,466	43,214		2,149		51,829
Loans	$1,448,295	$2,309,980	$ 76,497	$1,138,692	$ 380	$4,973,844

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

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

Commercial

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

Commercial real estate

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

Consumer and Residential

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

(table dollar amounts in thousands, except share data)

Loans are reclassified to a non-accruing status when, in management's judgment, the collateral value and financial condition of the borrower do not justify accruing interest. Uncollected interest previously recorded, but not deemed collectible, is reversed and charged against current income. Payments subsequently received on non-accrual loans are applied to principal. A loan is returned to accrual status when principal and interest are no longer past due and collectability is probable, typically after a minimum of six consecutive months of performance. Payments received on impaired accruing or delinquent loans are applied to interest income as accrued.

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

	September 30, 2016	December 31, 2015
Commercial and industrial loans	$ 2,381	$ 4,634
Agriculture production financing and other loans to farmers	1,530	827
Real estate Loans:		
Construction	271	736
Commercial and farmland	16,983	11,277
Residential	10,608	11,818
Home Equity	2,216	1,952
Individuals' loans for household and other personal expenditures	116	145
Total	$ 34,105	$ 31,389

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

Allowable methods for determining the amount of impairment include estimating fair value using the fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. The fair value of real estate is generally based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

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

	September 30, 2016		
	Unpaid Principal	Recorded Investment	Related Allowance

	Balance		
Impaired loans with no related allowance:			
Commercial and industrial loans	$18,096	$ 9,996	
Agriculture production financing and other loans to farmers	649	611	
Real estate Loans:			
Construction	6,492	3,545	
Commercial and farmland	82,551	61,536	
Residential	8,252	4,934	
Home equity	82	44	
Other commercial loans	13		
Total	$116,135	$ 80,666	
Impaired loans with related allowance:			
Commercial and industrial loans	$779	$ 467	$ 379
Agriculture production financing and other loans to farmers	1,186	1,156	175
Real estate Loans:			
Commercial and farmland	2,070	1,835	760
Residential	65	34	22
Total	$4,100	$ 3,492	$ 1,336
Total Impaired Loans	$120,235	$ 84,158	$ 1,336

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	December 31, 2015		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance:			
Commercial and industrial loans	$22,151	$ 11,669	
Agriculture production financing and other loans to farmers	370	361	
Real estate Loans:			
Construction	4,551	2,336	
Commercial and farmland	95,930	69,024	
Residential	11,262	7,338	
Home equity	297	247	
Other commercial loans	20		
Total	$134,581	$ 90,975	
Impaired loans with related allowance:			
Commercial and industrial loans	$3,043	$ 2,690	$ 1,247
Agriculture production financing and other loans to farmers	466	466	30
Real estate Loans:			
Commercial and farmland	2,144	1,933	392
Residential	2,300	1,463	173
Total	$7,953	$ 6,552	$ 1,842
Total Impaired Loans	$142,534	$ 97,527	$ 1,842

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2016	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial loans	$10,025	$ 89	$10,436	$ 261
Agriculture production financing and other loans to farmers	636	3	644	3
Real estate Loans:				
Construction	3,526	72	3,572	215
Commercial and farmland	61,903	854	63,722	2,576
Residential	5,081	40	5,453	118
Home equity	44		57	
Total	$81,215	$ 1,058	$83,884	$ 3,173
Impaired loans with related allowance:				
Commercial and industrial loans	$469		$471	
Agriculture production financing and other loans to farmers	1,164	6	1,236	6
Real estate Loans:				
Commercial and farmland	1,850		1,894	
Residential	34		39	
Total	$3,517	$ 6	$3,640	$ 6

Total Impaired Loans	$84,732	$ 1,064	$87,524	$ 3,179
	Three Months Ended September 30, 2015		Nine Months Ended September 30, 2015	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial loans	$11,863	$ 137	$12,676	$ 368
Agriculture production financing and other loans to farmers	675		699	
Real estate Loans:				
Construction	2,855	41	3,407	123
Commercial and farmland	64,186	932	65,310	2,661
Residential	9,028	47	9,272	177
Home equity	194		197	
Total	$88,801	$ 1,157	$91,561	$ 3,329
Impaired loans with related allowance:				
Commercial and industrial loans	$2,731	$ 10	$2,774	$ 29
Agriculture production financing and other loans to farmers	547		547	
Real estate Loans:				
Commercial and farmland	2,459		2,613	
Residential	625		626	
Total	$6,362	$ 10	$6,560	$ 29
Total Impaired Loans	$95,163	$ 1,167	$98,121	$ 3,358

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As part of the ongoing monitoring of the credit quality of the Corporation's loan portfolio, management tracks certain credit quality indicators including trends related to: (i) the level of criticized commercial loans, (ii) net charge offs, (iii) no