FIRST MERCHANTS CORP
Form 10-Q
November 06, 2014

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, 2014
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _______ to _______

Commission File Number 0-17071

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, 2014, there were 36,074,444 outstanding common shares of the registrant.

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CONSOLIDATED CONDENSED BALANCE SHEETS

	September 30, 2014 (Unaudited)	December 31, 2013
ASSETS		
Cash and cash equivalents	$74,237	$109,434
Interest-bearing time deposits	24,171	55,069
Investment securities available for sale	567,996	536,201
Investment securities held to maturity (fair value of $634,555 and $560,847)	621,818	559,378
Loans held for sale	6,423	5,331
Loans, net of allowance for loan losses of $65,596 and $67,870	3,706,871	3,564,539
Premises and equipment	74,105	74,454
Federal Reserve and Federal Home Loan Bank stock	43,127	38,990
Interest receivable	19,455	18,672
Core deposit intangibles	12,043	13,818
Goodwill	188,948	188,948
Cash surrender value of life insurance	165,423	164,571
Other real estate owned	14,540	22,246
Tax asset, deferred and receivable	41,131	56,614
Other assets	31,095	28,997
TOTAL ASSETS	$5,591,383	$5,437,262
LIABILITIES		
Deposits:		
Noninterest-bearing	$939,540	$930,772
Interest-bearing	3,370,583	3,300,696
Total Deposits	4,310,123	4,231,468
Borrowings:		
Federal funds purchased	61,428	125,645
Securities sold under repurchase agreements	117,892	148,672
Federal Home Loan Bank advances	255,423	122,140
Subordinated debentures and term loans	126,874	126,807
Total Borrowings	561,617	523,264
Interest payable	3,819	1,771
Other liabilities	31,271	45,836
Total Liabilities	4,906,830	4,802,339
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 - 36,074,246 and 35,921,761 shares	4,509	4,490
Additional paid-in capital	395,582	393,783

Retained earnings	280,187	242,935
Accumulated other comprehensive income (loss)	4,150	(6,410)
Total Stockholders' Equity	684,553	634,923
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$5,591,383	$5,437,262

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CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
INTEREST INCOME				
Loans receivable:				
Taxable	$43,981	$33,548	$128,329	$104,725
Tax exempt	61	85	180	315
Investment securities:				
Taxable	5,046	3,876	14,902	11,071
Tax exempt	3,683	2,840	10,691	7,809
Deposits with financial institutions	18	18	76	99
Federal Reserve and Federal Home Loan Bank stock	501	369	1,648	1,108
Total Interest Income	53,290	40,736	155,826	125,127
INTEREST EXPENSE				
Deposits	2,853	2,213	8,276	7,703
Federal funds purchased	102	72	174	84
Securities sold under repurchase agreements	74	192	457	594
Federal Home Loan Bank advances	734	506	2,092	1,427
Subordinated debentures and term loans	1,661	731	4,950	2,189
Total Interest Expense	5,424	3,714	15,949	11,997
NET INTEREST INCOME	47,866	37,022	139,877	113,130
Provision for loan losses	1,600	1,533	1,600	5,632
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	46,266	35,489	138,277	107,498
OTHER INCOME				
Service charges on deposit accounts	4,119	3,120	11,768	8,761
Fiduciary activities	2,152	1,986	6,724	6,357
Other customer fees	3,991	2,899	11,773	8,495
Commission income	1,723	1,636	5,877	5,556
Earnings on cash surrender value of life insurance	1,524	611	2,925	1,921
Net gains and fees on sales of loans	1,458	1,673	3,340	6,508
Net realized gains on sales of available for sale securities	910		2,335	487
Other income	2,417	(125)	4,671	1,651
Total Other Income	18,294	11,800	49,413	39,736
OTHER EXPENSES				
Salaries and employee benefits	24,173	20,616	72,904	61,943
Net occupancy	3,401	2,430	10,543	7,299
Equipment	2,187	1,852	7,022	5,368
Marketing	1,070	559	2,628	1,561
Outside data processing fees	1,853	1,515	5,723	4,386
Printing and office supplies	350	320	1,201	962

Core deposit amortization	592	383	1,776	1,153
FDIC assessments	920	677	2,843	2,095
Other real estate owned and credit-related expenses	2,618	1,648	6,988	4,993
Professional and other outside services	1,573	1,444	4,483	4,936
Other expenses	3,839	2,775	10,804	7,965
Total Other Expenses	42,576	34,219	126,915	102,661
INCOME BEFORE INCOME TAX	21,984	13,070	60,775	44,573
Income tax expense	5,862	2,667	15,873	11,490
NET INCOME	16,122	10,403	44,902	33,083
Preferred stock dividends		(430)		(2,139)
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	$16,122	$9,973	$44,902	$30,944
Per Share Data:				
Basic Net Income Available to Common Stockholders	$0.45	$0.35	$1.25	$1.08
Diluted Net Income Available to Common Stockholders	$0.45	$0.35	$1.24	$1.07
Cash Dividends Paid	$0.08	$0.05	$0.21	$0.13
Average Diluted Shares Outstanding (in thousands)	36,329	29,081	36,295	29,026

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CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Net income	$16,122	$10,403	$44,902	$33,083
Other comprehensive income net of tax:				
Unrealized holding gain (loss) on securities available for sale arising during the period, net of tax of $152, $470, $6,105 and $6,810	283	(873)	11,338	(12,646)
Unrealized gain (loss) on securities available for sale for which a portion of an other than temporary impairment has been recognized in income, net of tax of $103, $916 and $48	(1)	(192)	1,701	89
Unrealized gain (loss) on cash flow hedges arising during the period, net of tax of $10, $86, $885 and $543	18	(162)	(1,645)	1,007
Amortization of items previously recorded in accumulated other comprehensive income, net of tax of $39 and $423		73		786
Reclassification adjustment for losses included in net income, net of tax of $194, $72, $450 and $35	(360)	135	(834)	65
	(60)	(1,019)	10,560	(10,699)
Comprehensive income	$16,062	$9,384	$55,462	$22,384

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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, 2013	125	$125	35,921,761	$4,490	$393,783	$242,935	$ (6,410)	$634,923
Comprehensive Income								
Net Income						44,902		44,902
Other Comprehensive Income, net of tax							10,560	10,560
Cash Dividends on Common Stock ($.21 per Share)						(7,650)		(7,650)
Share-based Compensation			125,188	16	1,595			1,611
Stock Issued under Employee Benefit Plans			21,016	3	373			376
Stock Issued under Dividend Reinvestment and Stock Purchase Plan			18,139	2	378			380
Stock Options Exercised			38,650	5	505			510
Stock Redeemed			(50,508)	(7)	(1,052)			(1,059)
Balances, September 30, 2014	125	$125	36,074,246	$4,509	$395,582	$280,187	$ 4,150	$684,553

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Unaudited)

	September 30, 2014	2013
Cash Flow From Operating Activities:		
Net income	$44,902	$33,083
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,600	5,632
Depreciation and amortization	4,505	3,932
Change in deferred taxes	16,032	12,647
Share-based compensation	1,611	1,285
Tax benefit from stock options exercised	(60)	
Loans originated for sale	(149,001)	(242,014)
Proceeds from sales of loans	147,909	259,002
Gains on sales of securities available for sale	(2,335)	(487)
Change in interest receivable	(783)	196
Change in interest payable	2,048	(686)
Other adjustments	(14,015)	(6,329)
Net cash provided by operating activities	$52,413	$66,261
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	$30,898	$19,568
Purchases of:		
Securities available for sale	(114,563)	(216,731)
Securities held to maturity	(114,821)	(9,026)
Proceeds from sales of securities available for sale	47,722	25,222
Proceeds from maturities of:		
Securities available for sale	47,096	79,209
Securities held to maturity	51,029	59,642
Change in Federal Reserve and Federal Home Loan Bank stock	(4,137)	(5)
Net change in loans	(159,559)	(37,528)
Proceeds from the sale of other real estate owned	11,860	5,574
Other adjustments	7,367	(5,569)
Net cash used in investing activities	$(197,108)	$(79,644)
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	$(47,610)	$69,475
Certificates of deposit and other time deposits	126,265	(160,012)
Borrowings	386,643	215,923
Repayment of borrowings	(348,357)	(58,686)
Cash dividends on common stock	(7,650)	(3,795)
Cash dividends on preferred stock		(2,139)
Stock issued under employee benefit plans	376	389
Stock issued under dividend reinvestment and stock purchase plans	380	236

Stock options exercised	450	97
Tax benefit from stock options exercised	60	
Stock redeemed	(1,059)	(484)
Cumulative preferred stock redeemed (SBLF)		(56,740)
Net cash provided by financing activities	$109,498	$4,264
Net Change in Cash and Cash Equivalents	(35,197)	(9,119)
Cash and Cash Equivalents, January 1	109,434	101,460
Cash and Cash Equivalents, September 30	$74,237	$92,341
Additional cash flow information:		
Interest paid	$13,901	$12,683
Income tax paid	$4,409	$5,378
Loans transferred to other real estate owned	$3,807	$5,045
Fixed assets transferred to other real estate owned	$297	$461
Non-cash investing activities using trade date accounting	$6,502	$713

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

NOTE 1

GENERAL

Financial Statement Preparation

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

The consolidated condensed balance sheet of the Corporation as of December 31, 2013, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation’s annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation’s Form 10-K annual report filed with the Securities and Exchange Commission. The results of operations for the nine months ended September 30, 2014, are not necessarily indicative of the results to be expected for the year.

NOTE 2

BUSINESS COMBINATIONS

CFS Bancorp, Inc.

On November 12, 2013, the Corporation acquired 100 percent of CFS Bancorp, Inc. ("CFS") in an all stock transaction. CFS was headquartered in Munster, Indiana and had 20 full-service banking centers serving the northwestern Indiana and northeastern Illinois areas. Pursuant to the merger agreement, the shareholders of CFS received 0.65 percent of a share of the Corporation's common stock for each share of CFS common stock held. The Corporation issued approximately 7.1 million shares of common stock, which was valued at approximately $135.6 million.

The Corporation engaged in this transaction with the expectation that it would be accretive and add a new market area with a demographic profile consistent with many of the current Indiana markets served by the Bank. Goodwill resulted from this transaction due to the expected synergies from combining operations.

Under the acquisition method of accounting, the total purchase price is allocated to CFS's net tangible and intangible assets based on their current estimated fair values on the date of the acquisition. Based on valuations of the fair value of tangible and intangible assets acquired and liabilities assumed, the purchase price for the CFS acquisition was allocated as follows:

	Fair Value
Cash and cash equivalents	$10,992
Interest-bearing time deposits	213,379
Investment securities available for sale	15,913
Investment securities held to maturity	14,372
Mortgage loans held for sale	189
Loans	603,114
Premises and equipment	19,643
Federal Home Loan Bank stock	6,188
Interest receivable	1,770
Cash surrender value of life insurance	36,555
Other real estate owned	12,857
Tax asset, deferred and receivable	30,717
Other assets	111,656
Deposits	(955,432)
Securities sold under repurchase agreements	(9,830)
Federal Home Loan Bank advances	(15,000)
Interest payable	(294)
Other liabilities	(16,033)
Net tangible assets acquired	80,756
Core deposit intangible	7,313
Goodwill	47,573
Purchase price	$135,642

(table dollar amounts in thousands, except share data)

Of the total purchase price, $7,313,000 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.

The Corporation had one-time expenses related to the CFS acquisition and the integration of their core system of $1.6 million for the nine months ended September 30, 2014. The majority of expense was in salary and employee benefits related to employees retained through integration of $521,000, equipment and processing expenses of $619,000 primarily related to running CFS' core system prior to integration and marketing expenses of $125,000 due to mailings to current CFS customers during the integration time frame.

Community Bancshares, Inc.

On July 21, 2014, First Merchants Corporation, an Indiana corporation ("First Merchants"), and Community Bancshares, Inc., an Indiana corporation (“Community Bancshares”), entered into an Agreement and Plan of Reorganization and Merger (the “Merger Agreement”), pursuant to which, Community Bancshares will, subject to the terms and conditions of the Merger Agreement, merge with and into First Merchants (the “Merger”) whereupon the separate corporate existence of Community Bancshares will cease and First Merchants will survive. Immediately following the Merger, Community Bank, an Indiana state bank and wholly-owned subsidiary of Community Bancshares, will be merged with and into First Merchants Bank, National Association, a national bank and wholly-owned subsidiary of First Merchants, with First Merchants Bank, National Association continuing as the surviving bank. As a result of this merger, First Merchants ($5.6 billion) and Community Bancshares ($259 million) will have combined assets of approximately $5.9 billion. The Corporation had $256,000 of one-time expenses related to the Community Bancshares acquisition for the nine months ended September 30, 2014. These expenses were primarily for legal and professional services. All regulatory and shareholder approvals required in connection with the Merger have been obtained. Consummation of the Merger is expected to occur on November 7, 2014.

NOTE 3

INVESTMENT SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at September 30, 2014				
U.S. Treasury				
U.S. Government-sponsored agency securities	$100	$9		$109
State and municipal	225,402	10,601	$206	235,797
U.S. Government-sponsored mortgage-backed securities	323,254	6,560	283	329,531

Corporate obligations	1,570		717	853
Equity securities	1,706			1,706
Total available for sale	552,032	17,170	1,206	567,996
Held to maturity at September 30, 2014				
State and municipal	191,660	4,935	64	196,531
U.S. Government-sponsored mortgage-backed securities	430,158	8,847	981	438,024
Total held to maturity	621,818	13,782	1,045	634,555
Total Investment Securities	$1,173,850	$30,952	$2,251	$1,202,551

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2013				
U.S. Treasury	$15,914	$80	$21	$15,973
U.S. Government-sponsored agency securities	3,550	12	17	3,545
State and municipal	231,005	3,878	3,896	230,987
U.S. Government-sponsored mortgage-backed securities	279,299	3,926	1,973	281,252
Corporate obligations	6,374		3,636	2,738
Equity securities	1,706			1,706
Total available for sale	537,848	7,896	9,543	536,201
Held to maturity at December 31, 2013				
State and municipal	145,941	62	91	145,912
U.S. Government-sponsored mortgage-backed securities	413,437	5,220	3,722	414,935
Total held to maturity	559,378	5,282	3,813	560,847
Total Investment Securities	$1,097,226	$13,178	$13,356	$1,097,048

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The amortized cost and fair value of available for sale securities and held to maturity securities at September 30, 2014, 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, 2014:				
Due in one year or less	$5,184	$5,214	$5,167	$5,195
Due after one through five years	9,676	9,989	18,087	18,429
Due after five through ten years	47,127	49,113	83,138	85,034
Due after ten years	165,085	172,443	85,268	87,873
	$227,072	$236,759	$191,660	$196,531
U.S. Government-sponsored mortgage-backed securities	323,254	329,531	430,158	438,024
Equity securities	1,706	1,706		
Total Investment Securities	$552,032	$567,996	$621,818	$634,555

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was $461,303,000 at September 30, 2014, and $373,533,000 at December 31, 2013.

The book value of securities sold under agreements to repurchase amounted to $114,070,000 at September 30, 2014, and $126,900,000 at December 31, 2013.

Gross gains and losses on the sales and redemptions of available for sale securities, and other-than-temporary impairment ("OTTI") losses recognized for the three and nine months ended September 30, 2014 and 2013 are shown below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Sales and Redemptions of Available for Sale Securities:				
Gross gains	$909	$—	$2,335	$487
Gross losses				
Other-than-temporary impairment losses				

The following table shows the Corporation's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2014, and December 31, 2013:

	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, 2014						
State and municipal	$3,239	$ 5	$13,678	$ 201	$16,917	$ 206
U.S. Government-sponsored mortgage-backed securities	18,096	100	5,615	183	23,711	283
Corporate obligations			821	717	821	717
Total Temporarily Impaired Available for Sale Securities	21,335	105	20,114	1,101	41,449	1,206
Temporarily Impaired Held to Maturity Securities at September 30, 2014						
State and municipal	8,475	64			8,475	64
U.S. Government-sponsored mortgage-backed securities	58,004	687	18,639	294	76,643	981
Total Temporarily Impaired Held to Maturity Securities	66,479	751	18,639	294	85,118	1,045
Total Temporarily Impaired Investment Securities	$87,814	$ 856	$38,753	$ 1,395	$126,567	$ 2,251

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	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, 2013						
U.S. Treasury	$4,875	$ 21			$4,875	$ 21
U.S. Government-sponsored agency securities	3,433	17			3,433	17
State and municipal	111,791	3,840	$583	$ 56	$112,374	$ 3,896
U.S. Government-sponsored mortgage-backed securities	117,866	1,701	2,683	272	120,549	1,973
Corporate obligations			2,711	3,636	2,711	3,636
Total Temporarily Impaired Available for Sale Securities	237,965	5,579	5,977	3,964	243,942	9,543
Temporarily Impaired Held to Maturity Securities at December 31, 2013						
State and municipal	17,318	91	184		17,502	91
U.S. Government-sponsored mortgage-backed securities	213,048	3,462	2,640	260	215,688	3,722
Total Temporarily Impaired Held to Maturity Securities	230,366	3,553	2,824	260	233,190	3,813
Total Temporarily Impaired Investment Securities	$468,331	$ 9,132	$8,801	$ 4,224	$477,132	$ 13,356

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, 2014	December 31, 2013
Investments reported at less than historical cost:		
Historical cost	$128,819	$490,488
Fair value	$126,567	$477,132
Percent of the Corporation's available for sale and held to maturity portfolio	10.6 %	43.6 %

The Corporation’s management has evaluated all securities with unrealized losses for other-than-temporary impairment ("OTTI") as of September 30, 2014. 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 the second quarter of 2014, the Corporation sold four of its six trust preferred securities with an amortized cost of $4.8 million, which resulted in a net gain of $641,000. The Corporation has two remaining trust preferred securities. Such investments have an amortized cost of $1.5 million and a fair value of $821,000, which is less than 1 percent of the Corporation’s entire investment portfolio. The Corporation utilized Standard and Poor's to determine the fair value of the two remaining trust preferred securities.

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

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

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

U.S. Government-Sponsored Mortgage-Backed Securities

The unrealized losses on the Corporation’s investment in U.S. Government-sponsored mortgage-backed securities were a result of changes in interest rates. The Corporation expects to recover the amortized cost basis over the term of the securities as the decline in market value is attributable to changes in interest rates and not credit quality. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2014.

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State and Municipal

The unrealized losses on the Corporation's investments in securities of state and political subdivisions were caused by changes in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2014.

Corporate Obligations

The Corporation's unrealized losses on Corporate Obligations were due to the decline in value related to the pooled trust preferred securities, and is attributable to temporary illiquidity and the financial crisis affecting these markets, coupled with the potential credit loss resulting from the adverse change in expected cash flows. Due to the illiquidity in the market, it is unlikely that the Corporation would be able to recover its investment in these securities if the Corporation sold the securities at this time. Management has analyzed the cash flow characteristics of the securities and this analysis included utilizing the most recent trustee reports and any other relevant market information, including announcements of deferrals or defaults of trust preferred securities. The Corporation compared expected discounted cash flows, based on performance indicators of the underlying assets in the security, to the carrying value of the investment to determine if OTTI existed. The Corporation does not intend to sell the investment, and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the remainder of the investment securities, which are classified as Level 3 inputs in the fair value hierarchy, to be other-than-temporarily impaired at September 30, 2014.

Credit Losses Recognized on Investments

Certain corporate obligations have 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 2014	Accumulated Credit Losses in 2013
Credit losses on debt securities held:		
Balance, January 1	$11,355	$11,355
Additions related to other-than-temporary losses not previously recognized		
Balance, September 30	$11,355	$11,355

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 lending, which results in portfolio diversification. The following tables show the composition of the loan portfolio, the allowance for loan losses and certain credit quality elements, all excluding loans held for sale. Loans held for sale as of September 30, 2014, and December 31, 2013, were $6,423,000 and $5,331,000, respectively.

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

	September 30, 2014	December 31, 2013
Commercial and industrial loans	$900,970	$761,705
Agricultural production financing and other loans to farmers	99,649	114,348
Real estate loans:		
Construction	178,213	177,082
Commercial and farmland	1,603,698	1,611,809
Residential	625,609	616,385
Home Equity	269,952	255,223
Individuals' loans for household and other personal expenditures	66,832	69,783
Lease financing receivables, net of unearned income	1,208	1,545
Other loans	26,336	24,529
Loans	$3,772,467	$3,632,409
Allowance for loan losses	(65,596)	(67,870)
Net Loans	$3,706,871	$3,564,539

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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 appropriate to cover probable losses inherent in the loan portfolio at September 30, 2014. 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 the allowance remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values.

The allowance is increased by the provision for loan losses and decreased by charge offs less recoveries. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off. The Bank charges off a loan when a determination is made that all or a portion of the loan is uncollectible. The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The amount provided for loan losses in a given period may be greater than or less than net loan losses 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 in a given period 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.

In conformance with ASC 805 and ASC 820, loans purchased after December 31, 2008 are recorded at the acquisition date fair value. Such loans are only included in the allowance 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 allowance consists of specific impairment reserves as required by ASC 310-10-35, a component for historical losses in accordance with ASC 450 and the consideration of current environmental factors in accordance with ASC 450. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected.

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

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

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At September 30, 2014, the allowance for loan losses was $65,596,000, a decrease of $628,000 from the September 30, 2013 balance of $66,224,000. Specific reserves on impaired loans increased $1,895,000 to $3,370,000, from $1,475,000 at September 30, 2013. Net charge offs for the three months ended September 30, 2014, were $4,371,000, an increase of $860,000 from the same period in 2013. The provision for loan losses for the three months ended September 30, 2014 was $1,600,000, an increase of $67,000 for the same period in in 2013. The determination of the provision for loan losses in any period is based on management's continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio.

The following tables summarize changes in the allowance for loan losses by loan segment for the three and nine months ended September 30, 2014, and September 30, 2013:

	Three Months Ended September 30, 2014					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, July 1	$28,614	$22,582	$2,243	$14,928		$68,367
Provision for losses	1,385	528	113	(424)	$(2)	1,600
Recoveries on loans	1,987	1,215	86	431	3	3,722
Loans charged off	(4,444)	(2,707)	(214)	(728)		(8,093)
Balances, September 30, 2014	$27,542	$21,618	$2,228	$14,207	$1	$65,596

	Nine Months Ended September 30, 2014					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, January 1	$27,176	$23,102	$2,515	$15,077		$67,870
Provision for losses	1,736	(177)	(39)	100	$(20)	1,600
Recoveries on loans	4,485	2,356	303	1,360	23	8,527
Loans charged off	(5,855)	(3,663)	(551)	(2,330)	(2)	(12,401)
Balances, September 30, 2014	$27,542	$21,618	$2,228	$14,207	$1	$65,596

	Three Months Ended September 30, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, July 1	$26,563	$23,605	$2,885	$15,113	$36	$68,202
Provision for losses	(346)	1,560	(31)	333	17	1,533

Recoveries on loans	1,494	258	110	311	3	2,176
Loans charged off	(1,680)	(2,795)	(161)	(1,051)		(5,687)
Balances, September 30, 2013	$26,031	$22,628	$2,803	$14,706	$56	$66,224

	Nine Months Ended September 30, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, January 1	$25,913	$26,703	$2,593	$14,157		$69,366
Provision for losses	1,929	132	267	3,236	$68	5,632
Recoveries on loans	4,050	3,023	426	946	3	8,448
Loans charged off	(5,861)	(7,230)	(483)	(3,633)	(15)	(17,222)
Balances, September 30, 2013	$26,031	$22,628	$2,803	$14,706	$56	$66,224

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

	September 30, 2014					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance Balances:						
Individually evaluated for impairment	$1,818	$609		$484		$2,911
Collectively evaluated for impairment	25,669	20,605	$2,228	13,723	$1	62,226
Loans Acquired with Deteriorated Credit Quality	55	404				459
Total Allowance for Loan Losses	$27,542	$21,618	$2,228	$14,207	$1	$65,596
Loan Balances:						
Individually evaluated for impairment	$18,284	$22,502		$3,644		$44,430
Collectively evaluated for impairment	1,001,354	1,707,966	$66,832	890,676	$1,208	3,668,036
Loans Acquired with Deteriorated Credit Quality	7,317	51,443		1,241		60,001
Loans	$1,026,955	$1,781,911	$66,832	$895,561	$1,208	$3,772,467

	December 31, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance Balances:						
Individually evaluated for impairment	$585	$763		$6		$1,354
Collectively evaluated for impairment	26,493	22,208	$2,515	15,071		66,287
Loans Acquired with Deteriorated Credit Quality	98	131				229
Total Allowance for Loan Losses	$27,176	$23,102	$2,515	$15,077		$67,870
Loan Balances:						
Individually evaluated for impairment	$10,240	$29,007		$2,820		$42,067
Collectively evaluated for impairment	882,794	1,690,285	$69,783	867,094	$1,545	3,511,501
Loans Acquired with Deteriorated Credit Quality	7,548	69,599		1,694		78,841
Loans	$900,582	$1,788,891	$69,783	$871,608	$1,545	$3,632,409

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.

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Residential and Consumer

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

Loans are reclassified to a non-accruing status when, in management’s judgment, the collateral value and financial condition of the borrower do not justify accruing interest. Interest previously recorded, but not deemed collectible, is reversed and charged against current income. Payments subsequently received on 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, 2014	December 31, 2013
Commercial and industrial loans	$7,139	$9,283
Agriculture production financing and other loans to farmers	10,669	30
Real estate Loans:		
Construction	951	4,978
Commercial and farmland	14,680	28,095
Residential	13,546	12,068
Home Equity	1,896	1,667
Individuals' loans for household and other personal expenditures	223	117
Other Loans		164
Total	$49,104	$56,402

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

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

	September 30, 2014		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance:			
Commercial and industrial loans	$30,525	$13,122	
Agriculture production financing and other loans to farmers	28	25	
Real estate Loans:			
Construction	11,455	8,168	
Commercial and farmland	82,625	60,605	
Residential	4,826	2,986	
Home equity	3,272	118	
Other loans	33		
Total	$132,764	$85,024	
Impaired loans with related allowance:			
Commercial and industrial loans	$2,027	$1,810	$773
Agriculture production financing and other loans to farmers	10,645	10,645	1,100
Real estate Loans:			
Commercial and farmland	7,159	4,478	1,013
Residential	1,460	1,460	484
Total	$21,291	$18,393	$3,370
Total Impaired Loans	$154,055	$103,417	$3,370

	December 31, 2013		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance:			
Commercial and industrial loans	$35,066	$16,371	
Agriculture production financing and other loans to farmers	32	30	
Real estate Loans:			
Construction	16,109	10,625	
Commercial and farmland	128,073	83,033	
Residential	6,746	3,910	
Home equity	3,299	112	
Other loans	454	172	
Total	$189,779	$114,253	

Impaired loans with related allowance:			
Commercial and industrial loans	$1,390	$1,216	$683
Real estate Loans:			
Commercial and farmland	4,657	4,215	894
Residential	74	71	6
Total	$6,121	$5,502	$1,583
Total Impaired Loans	$195,900	$119,755	$1,583

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	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial loans	$13,406	$86	$13,820	$263
Agriculture production financing and other loans to farmers	25		27	
Real estate Loans:				
Construction	8,026	112	8,197	331
Commercial and farmland	61,356	895	62,367	2,663
Residential	3,018	40	3,164	93
Home equity	118		147	
Total	$85,949	$1,133	$87,722	$3,350
Impaired loans with related allowance:				
Commercial and industrial loans	$1,814	$10	$1,864	$30
Agriculture production financing and other loans to farmers	10,645		10,645	
Real estate Loans:				
Commercial and farmland	4,484		4,528	23
Residential	1,460		1,460	
Total	$18,403	$10	$18,497	$53
Total Impaired Loans	$104,352	$1,143	$106,219	$3,403

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial loans	$8,352	$110	$9,553	$184
Agriculture production financing and other loans to farmers	32		33	

Real estate Loans:				
Construction	4,115	29	4,262	85
Commercial and farmland	34,298	620	35,198	1,642
Residential	2,687	82	3,028	114
Home equity	217		236	
Other loans	174		184	1
Total	$49,875	$841	$52,494	$2,026
Impaired loans with related allowance:				
Commercial and industrial loans	$865		$889	$7
Real estate Loans:				
Commercial and farmland	5,742	$5	5,844	5
Residential	74		78	
Total	$6,681	$5	$6,811	$12
Total Impaired Loans	$56,556	$846	$59,305	$2,038

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

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

- Pass - Loans that are considered to be of acceptable credit quality.
- Special Mention - Loans which possess some credit deficiency or potential weakness, which deserves close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Corporation's credit position at some future date. Special mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification. The key distinctions of this category's classification are that it is indicative of an unwarranted level of risk; and weaknesses are considered “potential”, not “defined”, impairments to the primary source of repayment. Examples include businesses that may be suffering from inadequate management, loss of key personnel or significant customer or litigation.
- Substandard - A substandard loan is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness that jeopardizes the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Other characteristics may include:
    - the likelihood that a loan will be paid from the primary source of repayment is uncertain or financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss,
    - the primary source of repayment is gone, and the Corporation is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees,
    - loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
    - unusual courses of action are needed to maintain a high probability of repayment,
    - the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
    - the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
    - loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
    - the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
    - there is significant deterioration in market conditions to which the borrower is highly vulnerable.
- Doubtful - Loans that have all of the weaknesses of those classified as Substandard. However, based on currently existing facts, conditions and values, these weaknesses make full collection of principal highly questionable and improbable. Other credit characteristics may include the primary source of repayment is gone or there is considerable doubt as to the quality of the secondary sources of repayment. The possibility of loss is high, but because of certain important pending factors that may strengthen the loan, loss classification is deferred until the exact status of repayment is known.
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Loss – Loans that are considered uncollectible and of such little value that continuing to carry them as an asset is not warranted. Loans will be classified as Loss when it is neither practical not desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

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The following tables summarize the credit quality of the Corporation's loan portfolio, by loan class for the periods indicated. Consumer non-performing loans include accruing consumer loans 90 plus days delinquent and consumer non-accrual loans. The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified date. Loans that evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected are included in the applicable categories below.

	September 30, 2014							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	$835,214	$ 15,803	$ 49,658	$ 295				$900,970
Agriculture production financing and other loans to farmers	83,753	1,957	13,939					99,649
Real estate Loans:								
Construction	153,293	1,584	8,606			$ 14,581	$ 149	178,213
Commercial and farmland	1,480,054	40,232	83,177				235	1,603,698
Residential	139,702	2,181	7,227			464,912	11,587	625,609
Home equity	6,068	266	447			261,316	1,855	269,952
Individuals' loans for household and other personal expenditures						66,589	243	66,832
Lease financing receivables, net of unearned income	1,095		113					1,208
Other loans	26,333	3						26,336
Loans	$2,725,512	$ 62,026	$ 163,167	$ 295		$ 807,398	$ 14,069	$3,772,467

	December 31, 2013							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	$708,835	$ 11,332	$ 41,013	$ 525				$761,705
Agriculture production financing and other loans to farmers	114,318		30					114,348
Real estate Loans:								

Construction	162,976	1,132	12,029			$ 945	177,082
Commercial and farmland	1,473,714	57,676	80,184			235	1,611,809
Residential	143,657	2,232	11,494	136	$ 448,494	10,372	616,385
Home equity	6,194	35	1,184		246,101	1,709	255,223
Individuals' loans for household and other personal expenditures					69,666	117	69,783
Lease financing receivables, net of unearned income	1,420		125				1,545
Other loans	24,334		195				24,529
Loans	$ 2,635,448	$ 72,407	$ 146,254	$ 661	$ 764,261	$ 13,378	$ 3,632,409

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The following table shows a past due aging of the Corporation's loan portfolio, by loan class as of September 30, 2014, and December 31, 2013:

	September 30, 2014						
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total
Commercial and industrial loans	$887,365	$2,522	$3,758	$186	$ 7,139	$ 13,605	$900,970
Agriculture production financing and other loans to farmers	88,526	174	280		10,669	11,123	99,649
Real estate Loans:							
Construction	176,229	1,033			951	1,984	178,213
Commercial and farmland	1,583,226	4,044	1,748		14,680	20,472	1,603,698
Residential	607,204	3,841	469	549	13,546	18,405	625,609
Home equity	266,566	710	703	77	1,896	3,386	269,952
Individuals' loans for household and other personal expenditures	66,366	217	7	19	223	466	66,832
Lease financing receivables, net of unearned income	1,208						1,208
Other loans	26,336						26,336
Loans	$3,703,026	$12,541	$6,965	$831	$ 49,104	$ 69,441	$3,772,467

	December 31, 2013						
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total
Commercial and industrial loans	$749,020	$2,628	$774		$ 9,283	$ 12,685	$761,705
Agriculture production financing and other loans to farmers	114,305	13			30	43	114,348
Real estate Loans:							
Construction	171,046	1,058			4,978	6,036	177,082
Commercial and farmland	1,573,403	3,807	5,801	$703	28,095	38,406	1,611,809
Residential	595,192	7,156	1,475	494	12,068	21,193	616,385
Home equity	251,188	1,652	563	153	1,667	4,035	255,223
Individuals' loans for household and other personal expenditures	69,061	550	55		117	722	69,783
Lease financing receivables, net of unearned income	1,545						1,545
Other loans	24,365				164	164	24,529

Loans	$3,549,125	$16,864	$8,668	$1,350	$ 56,402	$ 83,284	$3,632,409

See the information regarding the analysis of loan loss experience in the "LOAN QUALITY/PROVISION FOR LOAN LOSSES" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as ITEM 2 of this Form 10-Q.

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

The following tables summarize troubled debt restructurings in the Corporation's loan portfolio that occurred during the periods indicated:

	Three Months Ended September 30, 2014			Nine Months Ended September 30, 2014		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Real estate Loans:						
Commercial and farmland				$259	$ 259	1
Residential	$256	$ 245	5	448	428	7
Home Equity	229	247	7	314	343	10
Individuals' loans for household and other personal expenditures				26	26	2
Total	$485	$ 492	12	$1,047	$ 1,056	20

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	Three Months Ended September 30, 2013			Nine Months Ended September 30, 2013		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and industrial loans	$162	$ 183	1	$294	$ 315	5
Real estate Loans:						
Commercial and farmland	1,464	1,469	6	6,449	5,450	10
Residential	190	191	2	658	649	8
Individuals' loans for household and other personal expenditures				44	45	2
Total	$1,816	$ 1,843	9	$7,445	$ 6,459	25

The following tables show the recorded investment of troubled debt restructurings, by modification type, that occurred during the periods indicated:

	Three Months Ended September 30, 2014			
	Term Modification	Rate Modification	Combination	Total Modification
Real estate Loans:				
Residential			$241	$241
Home Equity			245	245
Total			$486	$486

	Nine Months Ended September 30, 2014			
	Term Modification	Rate Modification	Combination	Total Modification
Real estate Loans:				
Commercial and farmland	$283			$283
Residential		$60	$361	421
Home Equity		95	245	340
Individuals' loans for household and other personal expenditures			24	24
Total	$283	$155	$630	$1,068

	Three Months Ended September 30, 2013			
	Term Modification	Rate Modification	Combination	Total Modification

Commercial and industrial loans	$175			$175
Real estate Loans:				
Commercial and farmland	1,399			1,399
Residential	158	$34		192
Total	$1,732	$34		$1,766

	Nine Months Ended September 30, 2013			
	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans	$228		$63	$291
Real estate Loans:				
Commercial and farmland	1,399		1,950	3,349
Residential	158	$94	353	605
Individuals' loans for household and other personal expenditures			26	26
Total	$1,785	$94	$2,392	$4,271

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Loans secured by residential real estate made up 73 percent of the post-modification balance of troubled debt restructured loans made in the nine months ended September 30, 2014.

The following tables summarize the troubled debt restructures that occurred during the twelve months ended September 30, 2014 and September 30, 2013, that subsequently defaulted during the period indicated and remained in default at period end. For purposes of this schedule, a loan is considered in default if it is 30 or more days past due.

	Three Months Ended September 30, 2014		Nine Months Ended September 30, 2014	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Real estate Loans:				
Residential	1	$71	1	$71
Total	1	$71	1	$71

	Three Months Ended September 30, 2013		Nine Months Ended September 30, 2013	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Commercial and industrial loans	1	$18	1	$18
Real estate Loans:				
Commercial and farmland			1	223
Residential	2	166	2	166
Total	3	$184	4	$407

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

NOTE 5

ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE

On February 10, 2012, First Merchants Bank, National Association (the "Bank") assumed $113.0 million in loans as part of a Purchase and Assumption Agreement of SCB Bank. This loan portfolio was acquired at a fair value discount of $19.2 million.

On November 12, 2013, the Corporation acquired all of the assets of CFS Bancorp, Inc. as discussed in NOTE 2. BUSINESS COMBINATIONS included in the Notes to Consolidated Condensed Financial Statements of this Form 10-Q. The acquired assets included $639.6 million in loans which were acquired at a fair value discount of $36.5 million.

Loans acquired in the transactions described above are included in NOTE 4. LOANS AND ALLOWANCE included in the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

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

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The following table includes the outstanding balance and carrying amount of loans acquired during the years ended December 31, 2012 and 2013, which are included in the balance sheet amounts of loans receivable at September 30, 2014 and December 31, 2013.

	September 30, 2014			December 31, 2013		
	CFS	SCB	Total	CFS	SCB	Total
Commercial and industrial loans	$77,186	$6,406	$83,592	$81,303	$8,184	$89,487
Agricultural production financing and other loans to farmers		959	959		1,161	1,161
Real estate loans:						
Construction	11,099		11,099	17,962		17,962
Commercial and farmland	264,241	16,482	280,723	311,631	23,418	335,049
Residential	150,454	7,717	158,171	166,754	9,359	176,113
Home Equity	40,864	16,381	57,245	49,042	18,236	67,278
Individuals' loans for household and other personal expenditures	1,054	140	1,194	2,360	269	2,629
Other Loans	87		87	132	407	539
Total	$544,985	$48,085	$593,070	$629,184	$61,034	$690,218
Carrying Amount	$519,516	$41,292	$560,808	$585,913	$50,269	$636,182
Allowance	398	61	459		229	229
Carrying Amount Net of Allowance	$519,118	$41,231	$560,349	$585,913	$50,040	$635,953

The balance of the allowance for loan losses for loans acquired and accounted for under ASC 310-30 was $459,000 and $229,000 at September 30, 2014 and December 31, 2013, respectively.

As customer cash flow expectations have improved, nonaccretable yield was reclassified to accretable yield. The accretable yield, or income expected to be collected, and reclassifications from nonaccretable yield, are identified in the table below.

	Three Months Ended September 30, 2014			Three Months Ended September 30, 2013
	CFS	SCB	Total	SCB
Beginning balance	$12,085	$5,069	$17,154	$3,959
Additions				
Accretion	(2,791)	(693)	(3,484)	(413)
Reclassification from nonaccretable	2,601	329	2,930	
Disposals	(1,345)	(363)	(1,708)	
Ending balance	$10,550	$4,342	$14,892	$3,546

	Nine Months Ended September 30, 2014			Nine Months Ended September 30, 2013
	CFS	SCB	Total	SCB
Beginning balance	$13,435	$5,864	$19,299	$5,142
Additions				
Accretion	(5,677)	(1,749)	(7,426)	(1,596)
Reclassification from nonaccretable	4,382	718	5,100	
Disposals	(1,590)	(491)	(2,081)	
Ending balance	$10,550	$4,342	$14,892	$3,546

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NOTE 6

DERIVATIVE FINANCIAL INSTRUMENTS

Risk Management Objective of Using Derivatives

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

Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish these objectives, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. As of September 30, 2014 and 2013, the Corporation had five interest rate swaps with a notional amount of $56.0 million and one interest rate cap with a notional amount of $13.0 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2014, $26.0 million of the interest rate swaps and the $13.0 million interest rate cap were used to hedge the variable cash outflows (LIBOR-based) associated with existing trust preferred securities when the outflows converted from a fixed rate to variable rate in September of 2012. In addition, the remaining $30.0 million of interest rate swaps were used to hedge the variable cash outflows (LIBOR-based) associated with three Federal Home Loan Bank advances. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the three and nine months ended September 30, 2014, and 2013, the Corporation did not recognize any ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation expects to reclassify $1,369,000 from accumulated other comprehensive income to interest expense.

Non-designated Hedges

The Corporation does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Corporation provides to certain customers. The Corporation executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Corporation executes with a third party, such that the Corporation minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of September 30, 2014, the notional amount of customer-facing swaps was approximately $145,055,000. This amount is offset with third party counterparties, as described above.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Corporation's derivative financial instruments, as well as their classification on the Balance Sheet, as of September 30, 2014, and December 31, 2013.

	Asset Derivatives				Liability Derivatives			
	September 30, 2014		December 31, 2013		September 30, 2014		December 31, 2013	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:								
Interest rate contracts	Other Assets	$236	Other Assets	$1,162	Other Liabilities	$1,620	Other Liabilities	$1,021
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	$2,873	Other Assets	$2,847	Other Liabilities	$2,927	Other Liabilities	$2,932

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Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Corporation's derivative financial instruments on the Income Statement for three and nine months ended September 30, 2014, and 2013.

Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative
		Three Months Ended September 30, 2014	Nine Months Ended September 30, 2014
Interest rate contracts	Other income	$43	$31

Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative
		Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013
Interest rate contracts	Other income	$(16)	$249

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

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Other Comprehensive Income on Derivative (Effective Portion)			
	Three Months ended		Nine Months ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013
Interest Rate Products	$28	$(248)	$(2,530)	$1,550

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

Location of Loss Reclassified from Accumulated Other Comprehensive Income (Effective Portion)	Amount of Gain (Loss) Reclassified from Other Comprehensive Income into Income (Effective Portion)			
	Three Months ended		Nine Months ended	
	September 30, 2014	September 30, 2013	September 30, 2014	September 30, 2013

Interest Expense	$(356)	$(207)	$(1,051)	(587)

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

Credit-risk-related Contingent Features

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

The Corporation also has agreements with certain of its derivative counterparties that contain a provision where if the Corporation defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, the Corporation could also be declared in default on its derivative obligations. As of September 30, 2014, the termination value of derivatives in a net liability position related to these agreements was $4,277,000. As of September 30, 2014, the Corporation had minimum collateral posting thresholds with certain of its derivative counterparties and had posted collateral of $4,581,000. If the Corporation had breached any of these provisions at September 30, 2014, it could have been required to settle its obligations under the agreements at their termination value.

NOTE 7

DISCLOSURES ABOUT FAIR VALUE OF ASSETS AND LIABILITIES

The Corporation used fair value measurements to record fair value adjustments, to certain assets, and liabilities and to determine fair value disclosures. The accounting guidance defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. ASC 820 applies only when other guidance requires or permits assets or liabilities to be measured at fair value; it does not expand the use of fair value in any new circumstances.

As defined in ASC 820, fair value is the price to sell an asset or transfer a liability in an orderly transaction between market participants. It represents an exit price at the measurement date. Market participants are buyers and sellers, who are independent, knowledgeable, and willing and able to transact in the principal (or most advantageous) market for the asset or liability being measured. Current market conditions, including imbalances between supply and demand, are considered in determining fair value. The Corporation values its assets and liabilities in the principal market where it sells the particular asset or transfers the liability with the greatest volume and level of activity. In the absence of a principal market, the valuation is based on the most advantageous market for the asset or liability (i.e., the market where the asset could be sold or the liability transferred at a price that maximizes the amount to be received for the asset or minimizes the amount to be paid to transfer the liability).

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability. Inputs can be observable or unobservable. Observable inputs are those assumptions which market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of the Corporation. Unobservable inputs are assumptions based on the Corporation’s own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date. All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy which gives the highest ranking to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest ranking to unobservable inputs for which there is little or no market activity (Level 3). Fair values for assets or liabilities classified as Level 2 are based on one or a combination of the following factors: (i) quoted prices for similar assets; (ii) observable inputs for the asset or liability, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation considers an input to be significant if it drives 10 percent or more of the total fair value of a particular asset or liability.

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Recurring Measurements

The following table presents the fair value measurements of assets and liabilities recognized in the Consolidated Condensed Balance Sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2014, and December 31, 2013.

		Fair Value Measurements Using:		
September 30, 2014	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	109		109	
State and municipal	235,797		229,167	$6,630
U.S. Government-sponsored mortgage-backed securities	329,531		329,531	
Corporate obligations	853			853
Equity securities	1,706		1,702	4
Interest rate swap asset	2,911		2,911	
Interest rate cap	198		198	
Interest rate swap liability	4,547		4,547	

		Fair Value Measurements Using:		
December 31, 2013	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Treasury	$15,973		$15,973	
U.S. Government-sponsored agency securities	3,545		3,545	
State and municipal	230,987		223,752	$7,235
U.S. Government-sponsored mortgage-backed securities	281,252		281,252	
Corporate obligations	2,738			2,738
Equity securities	1,706		1,702	4
Interest rate swap asset	3,619		3,619	

Interest rate cap	390	390
Interest rate swap liability	3,953	3,953

Following is a description of the valuation methodologies and inputs used for instruments measured at fair value on a recurring basis and recognized in the accompanying Consolidated Condensed Balance Sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques as of September 30, 2014.

Available for Sale Investment Securities

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

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

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Corporate Obligations

Corporate obligations are primarily comprised of pooled trust preferred securities and are classified as Level 3 inputs in the fair value hierarchy. These securities were rated A or better at inception, but at September 30, 2014, Moody's ratings on these securities ranged from Ca to C. The issuers in these securities are primarily banks, but some of the pools do include a limited number of insurance companies. On a quarterly basis, the Corporation uses an other-than-temporary impairment ("OTTI") evaluation process to compare the present value of expected cash flows to determine whether an adverse change in cash flows has occurred. The OTTI evaluation process considers the structure and term of the collateralized debt obligation ("CDO"), interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. Assumptions used in the evaluation process include expected future default rates and prepayments as well as recovery assumptions on defaults and deferrals. In addition, the process is used to "stress" each CDO, or make assumptions more severe than expected activity, to determine the degree to which assumptions could deteriorate before the CDO could no longer fully support repayment of the Corporation's note class. Upon completion of the September 30, 2014 quarterly evaluation process, the conclusion was no OTTI for the three months ending September 30, 2014, or for the three months ended September 30, 2013.

In the second quarter of 2014, the Corporation sold four of its six trust preferred securities with an amortized cost of $4.8 million, which resulted in a net gain of $641,000. The Corporation has two remaining trust preferred securities. Such investments have an amortized cost of $1.5 million and a fair value of $821,000.

Interest Rate Derivative Agreements

See information regarding the Corporation's interest rate derivative products in NOTE 6. DERIVATIVE FINANCIAL INSTRUMENTS, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

Level 3 Reconciliation

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the Consolidated Condensed Balance Sheets using significant unobservable (Level 3) inputs for three and nine months ended September 30, 2014, and 2013.

	Available for Sale Securities			
	Three Months Ended September 30, 2014	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2014	Nine Months Ended September 30, 2013
Balance at beginning of the period	$7,533	$17,915	$9,977	$18,328
Total realized and unrealized gains and losses:				

Included in net income				
Included in other comprehensive income	68	(486)	2,960	(521)
Purchases, issuances and settlements				
Transfers in/(out) of Level 3		3,905		3,905
Principal payments	(114)	(336)	(5,450)	(714)
Ending balance	$7,487	$20,998	$7,487	$20,998

There were no gains or losses for the period included in earnings that were attributable to the changes in unrealized gains or losses related to assets or liabilities held at September 30, 2014 or December 31, 2013.

Transfers Between Levels

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

	Three and Nine Months Ended September 30, 2013			
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Reason for Transfer
Transfers to/(from) Level:				
Available for sale securities		$(3,905)	$3,905	Selected state and municipal securities were transferred from Level 2 to Level 3 due to limited availability of similar securities in active markets.
		$(3,905)	$3,905	

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Nonrecurring Measurements

The following table presents the fair value measurement of assets and liabilities measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2014, and December 31, 2013.

		Fair Value Measurements Using		
September 30, 2014	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans (collateral dependent)	$19,830			$19,830
Other real estate owned	$5,638			$5,638

		Fair Value Measurements Using		
December 31, 2013	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans (collateral dependent)	$12,117			$12,117
Other real estate owned	$6,877			$6,877

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

Impaired Loans (collateral dependent)

Loans for which it is probable that the Corporation will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. During 2014, certain impaired loans were partially charged off or re-evaluated. Impaired loans that are collateral dependent are classified within Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

Other Real Estate Owned

The fair value for impaired loans and other real estate owned is measured based on the value of the collateral securing those loans or real estate and is determined using several methods. The fair value of real estate is generally determined based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically ascertained by assessing, either singularly or some combination of, asset appraisals, accounts receivable aging reports, inventory listings and/or customer financial statements. Both appraised values and values based on borrower's financial information are discounted as considered appropriate based on age and quality of the information and current market conditions.

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Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements, other than goodwill, at September 30, 2014 and December 31, 2013.

September 30, 2014	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
State and municipal securities	$6,630	Discounted cash flow	Maturity/Call date	1 month to 18 yrs
			Blend of US Muni BQ curve Discount rate	A- to BBB- 1% - 6.25%
Corporate obligations/Equity securities	$857	Discounted cash flow	Risk free rate	3 month LIBOR
			plus Premium for illiquidity	plus 200bps
Impaired loans (collateral dependent)	$19,830	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 50% (2%)
Other real estate owned	$5,638	Appraisals	Discount to reflect current market conditions	0% - 20% (4%)

December 31, 2013	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
State and municipal securities	$7,235	Discounted cash flow	Maturity/Call date	1 month to 15 yrs
			Blend of US Muni BQ curve Discount rate	A- to BBB- 1% - 5%
Corporate obligations/Equity securities	$2,742	Discounted cash flow	Risk free rate	3 month LIBOR
			plus Premium for illiquidity	plus 200bps
Impaired loans (collateral dependent)	$12,117	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 50% (3%)
Other real estate owned	$6,877	Appraisals	Discount to reflect current market conditions	0% - 20% (2%)

Sensitivity of Significant Unobservable Inputs

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

State and Municipal Securities

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

Corporate Obligations/Equity Securities

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

(table dollar amounts in thousands, except share data)

Fair Value of Financial Instruments

The following table presents estimated fair values of the Corporation's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2014, and December 31, 2013.

		September 30, 2014 (unaudited)		
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and due from banks	$74,237	$74,237		
Interest-bearing time deposits	24,171	24,171		
Investment securities available for sale	567,996		$560,509	$7,487
Investment securities held to maturity	621,818		595,817	38,738
Loans held for sale	6,423		6,423	
Loans	3,706,871			3,667,454
Federal Reserve Bank and Federal Home Loan Bank stock	43,127		43,127	
Interest rate swap and cap asset	3,109		3,109	
Interest receivable	19,455		19,455	
Liabilities:				
Deposits	$4,310,123	$3,229,034	$1,073,638	
Borrowings:				
Federal funds purchased	61,428		61,428	
Securities sold under repurchase agreements	117,892		117,903	
Federal Home Loan Bank advances	255,423		255,569	
Subordinated debentures and term loans	126,874		101,257	
Interest rate swap liability	4,547		4,547	
Interest payable	3,819		3,819	

		December 31, 2013		
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and due from banks	$109,434	$109,434		

Interest-bearing time deposits	55,069	55,069		
Investment securities available for sale	536,201		$526,224	$9,977
Investment securities held to maturity	559,378		525,998	34,849
Loans held for sale	5,331		5,331	
Loans	3,564,539			3,506,615
Federal Reserve Bank and Federal Home Loan Bank stock	38,990		38,990	
Interest rate swap and cap asset	4,009		4,009	
Interest receivable	18,672		18,672	
Liabilities:				
Deposits	$4,231,468	$3,082,117	$934,937	
Borrowings:				
Federal funds purchased	125,645		125,645	
Securities sold under repurchase agreements	148,672		148,852	
Federal Home Loan Bank advances	122,140		122,962	
Subordinated debentures and term loans	126,807		82,607	
Interest rate swap liability	3,953		3,953	
Interest payable	1,771		1,771	

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 8

ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table summarizes the changes in the balances of each component of accumulated other comprehensive income (loss), net of tax, as of September 30, 2014 and 2013:

	Accumulated Other Comprehensive Income (Loss)				
	Unrealized Gains (Losses) on Securities Available for Sale	Unrealized Gains (Losses) on Securities Available for Sale for which a Portion of Other-Than-Temporary Impairment has been Recognized in Income	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total
Balance at December 31, 2013	$1,566	$ (1,847)	$(501)	$(5,628)	$(6,410)
Other comprehensive income before reclassifications	11,338	1,701	(1,645)		11,394
Amounts reclassified from accumulated other comprehensive income	(1,518)		684		(834)
Period change	9,820	1,701	(961)	—	10,560
Balance at September 30, 2014	$11,386	$ (146)	$(1,462)	$(5,628)	$4,150
Balance at December 31, 2012	$17,904	$ (3,272)	$(2,652)	$(17,479)	$(5,499)
Other comprehensive income before reclassifications	(12,646)	89	1,007		(11,550)
Amounts reclassified from accumulated other comprehensive income	(317)		382	786	851
Period change	(12,963)	89	1,389	786	(10,699)
Balance at September 30, 2013	$4,941	$ (3,183)	$(1,263)	$(16,693)	$(16,198)

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The following table presents the reclassification adjustments out of accumulated other comprehensive income (loss) that were included in net income in the Consolidated Condensed Statements of Income for the three and nine months ended September 30, 2014 and 2013:

	Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Three Months Ended September 30,		
Details about Accumulated Other Comprehensive Income (Loss)Components	2014	2013	Affected Line Item in the Statements of Income
Unrealized gains (losses) on available for sale securities [1]			
Realized securities gains reclassified into income	$910		Other income - net realized gains on sales of available for sale securities
Related income tax expense	(318)		Income tax expense
	$592	$—	
Unrealized gains (losses) on cash flow hedges [2]			
Interest rate contracts	$(356)	$(207)	Interest expense - subordinated debentures and term loans
Related income tax benefit	124	72	Income tax expense
	$(232)	$(135)	
Unrealized gains (losses) on defined benefit plans			
Amortization of net loss and prior service costs		$(112)	Other expenses - salaries and employee benefits
Related income tax benefit		39	Income tax expense
	$—	$(73)	
Total reclassifications for the period, net of tax	$360	$(208)	

Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Nine Months Ended

Details about Accumulated Other Comprehensive Income (Loss)Components	September 30, 2014	2013	Affected Line Item in the Statements of Income
Unrealized gains (losses) on available for sale securities [1]			
Realized securities gains reclassified into income	$2,335	$487	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(817)	(170)	Income tax expense
	$1,518	$317	
Unrealized gains (losses) on cash flow hedges [2]			
Interest rate contracts	$(1,051)	$(587)	Interest expense - subordinated debentures and term loans
Related income tax benefit	367	205	Income tax expense
	$(684)	$(382)	
Unrealized gains (losses) on defined benefit plans			
Amortization of net loss and prior service costs		$(1,209)	Other expenses - salaries and employee benefits
Related income tax benefit		423	Income tax expense
	$—	$(786)	
Total reclassifications for the period, net of tax	$834	$(851)	

[1] For additional detail related to unrealized gains (losses) on available for sale securities and related amounts reclassified from accumulated other comprehensive income see NOTE 3. INVESTMENT SECURITIES.

[2] For additional detail related to unrealized gains (losses) on cash flow hedges and related amounts reclassified from accumulated other comprehensive income see NOTE 6. DERIVATIVE FINANCIAL INSTRUMENTS.

(table dollar amounts in thousands, except share data)

NOTE 9

SHARE-BASED COMPENSATION

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten year life, become 100 percent vested ranging from six months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. RSAs for employees retired from the Corporation continue to vest after retirement. Deferred stock units ("DSUs") can be credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of September 30, 2014, there were no outstanding DSUs.

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

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA’s and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three and nine months ended September 30, 2014 was $552,000 and $1,611,000 compared to $475,000 and $1,285,000 for the three and nine months ended September 30, 2013. Share-based compensation has been recognized as a component of salaries and benefits expense in the accompanying CONSOLIDATED CONDENSED STATEMENTS OF INCOME.

The estimated fair value of the stock options granted during 2014 and in prior years was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2014 Black Scholes model:

Risk-free interest rate	2.41	%
Expected price volatility	45.05	%
Dividend yield	2.73	%
Forfeiture rate	5.46	%

Weighted-average expected life, until exercise	7.7 years

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

Share-based compensation expense recognized in the CONSOLIDATED CONDENSED STATEMENTS OF INCOME is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately 5.5 percent for the nine months ended September 30, 2014, based on historical experience.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Stock and ESPP Options				
Pre-tax compensation expense	$81	$89	$156	$177
Income tax expense (benefit)	(21)	(17)	(26)	1
Stock and ESPP option expense, net of income taxes	$60	$72	$130	$178
Restricted Stock Awards				
Pre-tax compensation expense	$471	$386	$1,455	$1,108
Income tax benefit	(165)	(135)	(509)	(387)
Restricted stock awards expense, net of income taxes	$306	$251	$946	$721
Total Share-Based Compensation				
Pre-tax compensation expense	$552	$475	$1,611	$1,285
Income tax benefit	(186)	(152)	(535)	(386)
Total share-based compensation expense, net of income taxes	$366	$323	$1,076	$899

As of September 30, 2014, unrecognized compensation expense related to stock options and RSAs totaling $65,000 and $3,014,000, respectively, is expected to be recognized over weighted-average periods of 0.31 and 1.36 years, respectively.

Stock option activity under the Corporation's stock option plans as of September 30, 2014 and changes during the nine months ended September 30, 2014, were as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2014	958,786	$ 21.32		
Granted	13,500	$ 21.65		
Exercised	(38,650)	$ 11.64		
Canceled	(193,106)	$ 24.42		
Outstanding September 30, 2014	740,530	$ 20.99	3.32	1,929,297
Vested and Expected to Vest at September 30, 2014	740,530	$ 20.99	3.32	1,929,297
Exercisable at September 30, 2014	718,030	$ 21.05	3.14	1,885,287

The weighted-average grant date fair value was $8.13 and $5.73 for stock options granted during the nine months ended September 30, 2014 and 2013, respectively.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of the first nine months of 2014 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their stock options on September 30, 2014. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock. The aggregate intrinsic value of stock options exercised during the nine months ended September 30, 2014 and 2013 was $388,000 and $106,000, respectively. Cash receipts of stock options exercised during this same period were $450,000 and $97,000, respectively.

The following table summarizes information on unvested RSAs outstanding as of September 30, 2014:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2014	429,002	$12.51
Granted	93,715	$20.46
Vested	(125,188)	$9.18
Forfeited	(8,111)	$16.03
Unvested RSAs at September 30, 2014	389,418	$15.44

The grant date fair value of ESPP options was estimated at the beginning of the July 1, 2014 quarterly offering period of approximately $21,000. The ESPP options vested during the three months ending September 30, 2014, leaving no unrecognized compensation expense related to unvested ESPP options at September 30, 2014.

(table dollar amounts in thousands, except share data)

NOTE 10

Income Tax

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Income Tax Expense :				
Currently Payable:				
Federal	$(969)	$(1,897)	$(541)	$(1,157)
State	137		382	
Deferred:				
Federal	6,694	4,564	16,032	12,647
State				
Total Income Tax Expense	$5,862	$2,667	$15,873	$11,490
Reconciliation of Federal Statutory to Actual Tax Expense:				
Federal statutory income tax at 35%	$7,694	$4,575	$21,271	$15,601
Tax-exempt interest income	(1,310)	(1,024)	(3,805)	(2,842)
Stock compensation	8	14	29	40
Earnings on life insurance	(534)	(213)	(1,024)	(672)
Tax credits	(158)	(375)	(753)	(411)
Other	162	(310)	155	(226)
Actual Tax Expense	$5,862	$2,667	$15,873	$11,490

NOTE 11

Net Income Per Share

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

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

The following table reconciles basic and diluted net income per share for the three and nine months ended September 30, 2014 and 2013.

	Three Months Ended September 30,					
	2014			2013		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	$16,122			$10,403		
Less: Preferred Stock dividends and discount accretion				(430)		
Net income available to common stockholders	16,122	36,054,867	$0.45	9,973	28,806,809	$0.35
Effect of dilutive stock options and warrants		274,114			274,663	
Diluted net income per share:						
Net income available to common stockholders	$16,122	36,328,981	$0.45	$9,973	29,081,472	$0.35

	Nine Months Ended September 30,					
	2014			2013		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	$44,902			$33,083		
Less: Preferred Stock dividends and discount accretion				(2,139)		
Net income available to common stockholders	44,902	36,013,049	$1.25	30,944	28,769,206	$1.08
Effect of dilutive stock options and warrants		282,337			257,260	
Diluted net income per share:						
Net income available to common stockholders	$44,902	36,295,386	$1.24	$30,944	29,026,466	$1.07

Stock options to purchase 531,872 and 615,151 shares for the three months ended September 30, 2014, and 2013, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

Stock options to purchase 569,061 and 667,382 shares for the nine months ended September 30, 2014 and 2013, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

NOTE 12

IMPACT OF ACCOUNTING CHANGES

Accounting Standards Update (“ASU” or “Update”) 2014-01, Investments - Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects (January 2014). This Update permits entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. The ASU modifies the conditions that an entity must meet to be eligible to use a method other than the equity or cost methods to account for qualified affordable housing project investments. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. The amendments in this Update should be applied retrospectively to all periods presented. Adoption of the ASU is not expected to have a significant effect on the Corporation’s consolidated financial statements.

ASU 2014-04, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure (January 2014). The objective of this Update is to reduce diversity by clarifying when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The ASU is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. The amendments in this Update may be adopted using either a modified retrospective transition method or a prospective transition method. Adoption of the ASU is not expected to have a significant effect on the Corporation’s consolidated financial statements.

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity (April 2014). This Update seeks to better define the groups of assets which qualify for discontinued operations, in order to ease the burden and cost for preparers and stakeholders. This issue changed “the criteria for reporting discontinued operations” and related reporting requirements, including the provision for disclosures about the “disposal of an individually significant component of an entity that does not qualify for discontinued operations presentation.” The amendments in this Update are effective for fiscal years beginning after December 15, 2014. Early adoption is permitted only for disposals or classifications as held for sale. The Company will adopt the methodologies prescribed by this ASU by the date required. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

ASU 2014-09, Revenue from Contracts with Customers (Topic 606) (May 2014).
•Section A - Summary and Amendments That Create Revenue from Contracts with Customers (Topic 606) and Other Assets and
Deferred Costs - Contracts with Customers (Subtopic 340-40)
•Section B - Conforming Amendments to Other Topics and Subtopics in the Codification and Status Tables
•Section C - Background Information and Basis for Conclusions

The topic of Revenue Recognition had become broad with several other regulatory agencies issuing standards, which lacked cohesion. The new guidance establishes a "comprehensive framework" and "reduces the number of requirements to which an entity must consider in recognizing revenue" and yet provides improved disclosures to assist stakeholders reviewing financial statements. The amendments in this Update are effective for annual reporting periods beginning after December 15, 2016. Early adoption is not permitted. The Company will adopt the methodologies prescribed by this ASU by the date required. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

ASU 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures (June 2014). This Update addresses the concerns of stakeholders' by changing the accounting practices surrounding repurchase agreements. The new guidance changes the "accounting for repurchase-to-maturity transactions and linked repurchase financings to secured borrowing accounting, which is consistent with the accounting for other repurchase agreements." The amendments in this Update are effective for annual reporting periods beginning after December 15, 2014. Early adoption is prohibited. The Company will adopt the methodologies prescribed by this ASU by the date required. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

ASU 2014-12, Compensation - Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period (June 2014). This Update defines the accounting treatment for share-based payments and "resolves the diverse accounting treatment of those awards in practice." The new requirement mandates that "a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition." Compensation cost will now be recognized in the period in which it becomes likely that the performance target will be met. The amendments in this Update are effective for annual reporting periods beginning after December 15, 2015. Early adoption is permitted. The Company will adopt the methodologies prescribed by this ASU by the date required. Adoption of the ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

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NOTE 13

CONSUMMATION OF MERGER

On July 21, 2014, First Merchants and Community Bancshares entered into an Agreement and Plan of Reorganization and Merger (the “Merger Agreement”), pursuant to which, Community Bancshares will, subject to the terms and conditions of the Merger Agreement, merge with and into First Merchants (the “Merger”) whereupon the separate corporate existence of Community Bancshares will cease and First Merchants will survive. Immediately following the Merger, Community Bank, an Indiana state bank and wholly-owned subsidiary of Community Bancshares, will be merged with and into First Merchants Bank, National Association, a national bank and wholly-owned subsidiary of First Merchants, with First Merchants Bank, National Association continuing as the surviving bank. As a result of this merger, First Merchants ($5.6 billion) and Community Bancshares ($259 million) will have combined assets of approximately $5.9 billion. All regulatory and shareholder approvals required in connection with the Merger have been obtained. Consummation of the Merger is expected to occur on November 7, 2014.

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

FORWARD-LOOKING STATEMENTS

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

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

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

- fluctuations in market rates of interest and loan and deposit pricing, which could negatively affect our net interest margin, asset valuations and expense expectations;
- adverse changes in the economy, which might affect our business prospects and could cause credit-related losses and expenses;
- adverse developments in our loan and investment portfolios;
- competitive factors in the banking industry, such as the trend towards consolidation in our market;
- changes in the banking legislation or the regulatory requirements of federal and state agencies applicable to bank holding companies and banks like our affiliate bank;
- acquisitions of other businesses by us and integration of such acquired businesses;
- changes in market, economic, operational, liquidity, credit and interest rate risks associated with our business; and
- the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends.

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

CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles are complex and require us to apply significant judgments to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply those principles where actual measurement is not possible or practical. For a complete discussion of our significant accounting policies, see

“Notes to the Consolidated Financial Statements” in our Annual Report on Form 10-K for the year ended December 31, 2013. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

We believe there have been no significant changes during the nine months ended September 30, 2014, to the items that we disclosed as our critical accounting policies and estimates in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2013.

BUSINESS SUMMARY

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

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

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

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RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported net income available to common stockholders of $16.1 million, or $0.45 per fully diluted common share for the three months ended September 30, 2014, an increase of $6.1 million, compared to net income available to common stockholders of $10.0 million, or $0.35 per fully diluted common share for the three months ended September 30, 2013. Net income available to common stockholders for the nine months ended September 30, 2014 was $44.9 million, or $1.24 per fully diluted common share, compared to net income available to common stockholders of $30.9 million, or $1.07 per fully diluted common share for the same period in 2013.

On November 12, 2013, the Corporation acquired 100 percent of CFS Bancorp, Inc. ("CFS") in an all stock transaction. CFS was headquartered in Munster, Indiana and had 20 full-service banking centers serving the northwestern Indiana and northeastern Illinois areas. Pursuant to the merger agreement, the shareholders of CFS received 0.65 percent of a share of the Corporation's common stock for each share of CFS common stock held. The Corporation issued approximately 7.1 million shares of common stock, which was valued at approximately $135.6 million. Additional details of the merger are discussed within NOTE 2. BUSINESS COMBINATIONS, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

As of September 30, 2014, total assets equaled $5.6 billion, an increase of $154.1 million from December 31, 2013. Investment securities increased $94.2 million and total loans of $3.8 billion increased $141.2 million from December 31, 2013. Additional details of the changes in the Corporation's loans and other earning assets are discussed within NOTE 4. LOANS AND ALLOWANCE, included within the Notes to Consolidated Condensed Financial Statements, and the "EARNING ASSETS" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

The Corporation’s allowance for loan losses totaled $65.6 million as of September 30, 2014. The allowance provides 133.6 percent coverage of all non-accrual loans and 1.74 percent of total loans. The Corporation had provision expense of $1.6 million for the three and nine months ended September 30, 2014, compared to $1.5 million and $5.6 million, respectively, for the same periods of 2013. Net charge-offs totaled $4.4 million and $3.9 million for the three and nine months ended September 30, 2014, compared to $3.5 million and $8.8 million for the same periods of 2013. Additional details are discussed within the “LOAN QUALITY/PROVISION FOR LOAN LOSSES” section of Management’s Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

Total deposits of $4.3 billion increased from December 31, 2013 by $78.7 million. The largest increase was in brokered deposits, which increased $249.9 million. This increase was offset by a decrease in maturity deposits of $123.6 million compared to December 31, 2013.

Total borrowings increased $38.4 million from December 31, 2013 as Federal Home Loan Bank advances increased $133.3 million. This increase was offset by decreases in Federal Funds purchased and securities sold under repurchase agreements, which decreased $64.2 million and $30.8 million, respectively.

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

NET INTEREST INCOME

Net interest income is the primary source of the Corporation’s earnings. Net interest margin is a function of net interest income and the level of average earning assets. Net interest income and net interest margin are presented in the following table on a fully taxable equivalent basis (“FTE”), which adjusts tax-exempt or nontaxable interest income to an amount that would be comparable to interest subject to income taxes using the federal statutory tax rate of 35 percent in effect for all periods. Net interest margin for the third quarter of 2014 remained stable at 4.0 percent compared to the third quarter of 2013, while earning assets increased by $1.1 billion. During the nine months ended September 30, 2014, asset yields and interest costs remained stable at 4.4 percent and 0.4 percent, respectively, compared to the same period in 2013.

The increases in net interest income and average earning assets during the three and nine months ended September 30, 2014 compared with the same periods in 2013, were driven primarily due to the Corporation acquiring 100 percent of CFS Bancorp, Inc. ("CFS") in November 2013. Due to this transaction, the Bank acquired all the assets, deposits and liabilities of CFS. Additional details can be found in NOTE 2. BUSINESS COMBINATION, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

As a result of the acquisitions in prior periods, the Corporation recognized fair value accretion, which is included in interest income in the periods presented. Interest income included $3,484,000 and $413,000 of fair value accretion for the three months ended September 30, 2014 and 2013, respectively. Fair value accretion of $7,426,000 and $1,596,000 was included in interest income for the nine months ended September 30, 2014 and 2013, respectively. Additional details of the Corporation's remaining loan fair value discount, accretable and nonaccretable yield related to acquisitions can be found in NOTE 5. ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

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The following table presents the Corporation's average balance sheet, interest income/interest expense, and the average rate as a percent of average earning assets for the three and nine months ended September 30, 2014, and 2013.

	For the Three Months Ended					
	September 30, 2014			September 30, 2013		
	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate
Assets:						
Federal Funds Sold						
Interest-bearing time deposits	$28,549	$18	0.3 %	$24,497	$18	0.3 %
Federal Reserve and Federal Home Loan Bank stock	43,127	501	4.6	32,790	369	4.5
Investment Securities: (1)						
Taxable	776,270	5,046	2.6	615,878	3,876	2.5
Tax-Exempt (2)	409,241	5,665	5.5	297,274	4,368	5.9
Total Investment Securities	1,185,511	10,711	3.6	913,152	8,244	3.6
Loans held for sale	9,393	152	6.5	11,063	158	5.7
Loans: (3)						
Commercial	2,905,920	34,344	4.7	2,309,226	26,417	4.6
Real Estate Mortgage	455,714	5,025	4.4	274,345	3,049	4.4
Installment	369,797	4,460	4.8	308,520	3,924	5.1
Tax-Exempt (2)	12,866	94	2.9	15,053	131	3.5
Total Loans	3,753,690	44,075	4.7	2,918,207	33,679	4.6
Total Earning Assets	5,010,877	55,305	4.4 %	3,888,646	42,310	4.4 %
Net unrealized gain on securities available for sale	11,247			(4,733)		
Allowance for loan losses	(68,123)			(69,117)		
Cash and cash equivalents	74,773			69,974		
Premises and equipment	74,696			54,757		
Other assets	475,234			347,455		
Total Assets	$5,578,704			$4,286,982		
Liabilities:						
Interest-bearing deposits:						
Interest-bearing NOW deposits	$1,059,163	$279	0.1 %	$847,009	$224	0.1 %
Money market deposits	736,339	372	0.2	576,135	290	0.2
Savings deposits	528,746	154	0.1	357,267	93	0.1
Certificates and other time deposits	1,032,274	2,048	0.8	739,413	1,606	0.9
Total Interest-bearing Deposits	3,356,522	2,853	0.3	2,519,824	2,213	0.4
Borrowings	572,923	2,571	1.8	446,894	1,501	1.3
Total Interest-bearing Liabilities	3,929,445	5,424	0.6	2,966,718	3,714	0.5
Noninterest-bearing deposits	932,266			775,545		
Other liabilities	37,687			36,685		
Total Liabilities	4,899,398			3,778,948		
Stockholders' Equity	679,306			508,034		

Total Liabilities and Stockholders' Equity	$5,578,704	5,424	0.4		$4,286,982	3,714	0.4	
Net Interest Income		$49,881				$38,596		
Net Interest Margin			4.0	%			4.0	%

(1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments.
(2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2014 and 2013. These totals equal $2,015 and $1,574 for the three months ended September 30, 2014 and 2013, respectively.
(3) Non accruing loans have been included in the average balances.

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	For the Nine Months Ended							
	September 30, 2014				September 30, 2013			
	Average Balance	Interest Income / Expense	Average Rate		Average Balance	Interest Income / Expense	Average Rate	
Assets:								
Federal Funds Sold								
Interest-bearing time deposits	$43,906	$76	0.2	%	$60,853	$99	0.2	%
Federal Reserve and Federal Home Loan Bank stock	41,657	1,648	5.3		32,787	1,108	4.5	
Investment Securities: (1)								
Taxable	761,924	14,902	2.6		608,343	11,071	2.4	
Tax-Exempt (2)	389,682	16,447	5.6		270,378	12,013	5.9	
Total Investment Securities	1,151,606	31,349	3.6		878,721	23,084	3.5	
Loans held for sale	6,653	322	6.5		19,866	691	4.6	
Loans: (3)								
Commercial	2,893,922	99,685	4.6		2,290,938	82,691	4.8	
Real Estate Mortgage	417,899	14,650	4.7		277,666	9,259	4.4	
Installment	353,134	13,672	5.2		308,240	12,084	5.2	
Tax-Exempt (2)	12,328	277	3.0		15,990	484	4.0	
Total Loans	3,683,936	128,606	4.7		2,912,700	105,209	4.8	
Total Earning Assets	4,921,105	161,679	4.4	%	3,885,061	129,500	4.4	%
Net unrealized gain on securities available for sale	7,929				6,076			
Allowance for loan losses	(68,703)				(69,432)			
Cash and cash equivalents	83,259				67,109			
Premises and equipment	74,732				54,142			
Other assets	481,959				345,689			
Total Assets	$5,500,281				$4,288,645			
Liabilities:								
Interest-bearing deposits:								
Interest-bearing NOW deposits	$1,061,762	$827	0.1	%	$850,125	$683	0.1	%
Money market deposits	755,097	1,136	0.2		563,863	911	0.2	
Savings deposits	527,147	461	0.1		354,941	292	0.1	
Certificates and other time deposits	1,021,044	5,852	0.8		795,074	5,817	1.0	
Total Interest-bearing Deposits	3,365,050	8,276	0.3		2,564,003	7,703	0.4	
Borrowings	508,992	7,673	2.0		391,294	4,294	1.5	
Total Interest-bearing Liabilities	3,874,042	15,949	0.5		2,955,297	11,997	0.5	
Noninterest-bearing deposits	925,107				768,586			
Other liabilities	38,724				36,606			
Total Liabilities	4,837,873				3,760,489			
Stockholders' Equity	662,408				528,156			
Total Liabilities and Stockholders' Equity	$5,500,281	15,949	0.4		$4,288,645	11,997	0.4	
Net Interest Income		$145,730				$117,503		
Net Interest Margin			4.0	%			4.0	%

(1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments.
(2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2014 and 2013. These totals equal $5,853 and $4,373 for the nine months ended September 30, 2014 and 2013, respectively.
(3) Non accruing loans have been included in the average balances.