

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

---

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

For the quarterly period ended June 30, 2019  
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)

<u>Indiana</u> (State or other jurisdiction of incorporation or organization)	<u>35-1544218</u> (I.R.S. Employer Identification No.)
<u>200 East Jackson Street, Muncie, IN</u> (Address of principal executive offices)	<u>47305-2814</u> (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)

Title of Each Class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, \$0.125 state value per share	FRME	NASDAQ

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

Indicate by check mark whether the registrant has submitted electronically every interactive data file required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes ☒ No ☐

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

Large Accelerated Filer	<input checked="" type="checkbox"/>	Accelerated Filer	<input type="checkbox"/>	Non-Accelerated Filer	<input type="checkbox"/>
Smaller Reporting Company	<input type="checkbox"/>	Emerging Growth Company	<input type="checkbox"/>		

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

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

As of July 31, 2019, there were 49,696,573 outstanding common shares of the registrant.

# TABLE OF CONTENTS

## FIRST MERCHANTS CORPORATION

---

	Page No.
<a href="#">Glossary of Defined Terms</a>	<a href="#">3</a>
 <a href="#">Part I. Financial Information</a>	
Item 1.	<a href="#">Financial Statements:</a>
	<a href="#">Consolidated Condensed Balance Sheets</a>
	<a href="#">Consolidated Condensed Statements of Income</a>
	<a href="#">Consolidated Condensed Statements of Comprehensive Income</a>
	<a href="#">Consolidated Condensed Statements of Stockholders' Equity</a>
	<a href="#">Consolidated Condensed Statements of Cash Flows</a>
	<a href="#">Notes to Consolidated Condensed Financial Statements</a>
Item 2.	<a href="#">Management's Discussion and Analysis of Financial Condition and Results of Operations</a>
Item 3.	<a href="#">Quantitative and Qualitative Disclosures About Market Risk</a>
Item 4.	<a href="#">Controls and Procedures</a>
 <a href="#">Part II. Other Information</a>	
Item 1.	<a href="#">Legal Proceedings</a>
Item 1A.	<a href="#">Risk Factors</a>
Item 2.	<a href="#">Unregistered Sales of Equity Securities and Use of Proceeds</a>
Item 3.	<a href="#">Defaults Upon Senior Securities</a>
Item 4.	<a href="#">Mine Safety Disclosures</a>
Item 5.	<a href="#">Other Information</a>
Item 6.	<a href="#">Exhibits</a>
 <a href="#">Signatures</a>	 <a href="#">60</a>

***GLOSSARY OF DEFINED TERMS***

**FIRST MERCHANTS CORPORATION**

---

ASC	Accounting Standards Codification
Bank	First Merchants Bank, a wholly-owned subsidiary of the Corporation
CET1	Common Equity Tier 1
CMT	Constant Maturity Treasury
Corporation	First Merchants Corporation
ESPP	Employee Stock Purchase Plan
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FTE	Fully taxable equivalent
GAAP	Generally Accepted Accounting Principles
OREO	Other real estate owned
RSA	Restricted Stock Awards
TEFRA	Tax Equity and Fiscal Responsibility Act

***PART I. FINANCIAL INFORMATION***  
***ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS***  
*(table dollar amounts in thousands, except share data)*

**CONSOLIDATED CONDENSED BALANCE SHEETS**

	June 30, 2019 (Unaudited)	December 31, 2018
<b>ASSETS</b>		
Cash and cash equivalents	\$ 128,185	\$ 139,247
Interest-bearing time deposits	129,614	36,963
Investment securities available for sale	1,399,959	1,142,195
Investment securities held to maturity (fair value of \$708,915 and \$489,217)	692,965	490,387
Loans held for sale	5,854	4,778
Loans, net of allowance for loan losses of \$81,274 and \$80,552	7,430,096	7,143,915
Premises and equipment	91,767	93,420
Federal Home Loan Bank stock	24,588	24,588
Interest receivable	45,150	40,881
Goodwill	445,355	445,355
Other intangibles	21,381	24,429
Cash surrender value of life insurance	226,241	224,939
Other real estate owned	1,131	2,179
Tax asset, deferred and receivable	12,340	23,668
Other assets	83,231	47,772
<b>TOTAL ASSETS</b>	<b>\$ 10,737,857</b>	<b>\$ 9,884,716</b>
<b>LIABILITIES</b>		
Deposits:		
Noninterest-bearing	\$ 1,353,165	\$ 1,447,907
Interest-bearing	6,966,163	6,306,686
<b>Total Deposits</b>	<b>8,319,328</b>	<b>7,754,593</b>
Borrowings:		
Federal funds purchased	75,000	104,000
Securities sold under repurchase agreements	119,674	113,512
Federal Home Loan Bank advances	460,042	314,986
Subordinated debentures and term loans	138,574	138,463
<b>Total Borrowings</b>	<b>793,290</b>	<b>670,961</b>
Interest payable	6,740	5,607
Other liabilities	116,863	45,295
<b>Total Liabilities</b>	<b>9,236,221</b>	<b>8,476,456</b>
<b>COMMITMENTS AND CONTINGENT LIABILITIES</b>		
<b>STOCKHOLDERS' EQUITY</b>		
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 - 100,000,000 shares		
Issued and outstanding - 49,456,594 and 49,349,800 shares	6,182	6,169
Additional paid-in capital	841,365	840,052
Retained earnings	639,362	583,336
Accumulated other comprehensive income (loss)	14,602	(21,422)
<b>Total Stockholders' Equity</b>	<b>1,501,636</b>	<b>1,408,260</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$ 10,737,857</b>	<b>\$ 9,884,716</b>

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

***PART I. FINANCIAL INFORMATION***  
***ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS***  
*(table dollar amounts in thousands, except share data)*

**CONSOLIDATED CONDENSED STATEMENTS OF INCOME**  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<b>INTEREST INCOME</b>				
Loans receivable:				
Taxable	\$ 92,824	\$ 84,663	\$ 183,305	\$ 162,930
Tax exempt	4,244	3,632	8,397	7,228
Investment securities:				
Taxable	6,998	5,434	13,093	10,530
Tax exempt	7,454	6,246	14,325	12,372
Deposits with financial institutions	784	633	1,659	764
Federal Home Loan Bank stock	335	263	673	667
<b>Total Interest Income</b>	<b>112,639</b>	<b>100,871</b>	<b>221,452</b>	<b>194,491</b>
<b>INTEREST EXPENSE</b>				
Deposits	23,087	12,165	42,681	21,167
Federal funds purchased	117	61	210	441
Securities sold under repurchase agreements	342	172	672	345
Federal Home Loan Bank advances	1,692	1,845	3,506	4,004
Subordinated debentures and term loans	2,123	2,057	4,239	4,047
<b>Total Interest Expense</b>	<b>27,361</b>	<b>16,300</b>	<b>51,308</b>	<b>30,004</b>
<b>NET INTEREST INCOME</b>	<b>85,278</b>	<b>84,571</b>	<b>170,144</b>	<b>164,487</b>
Provision for loan losses	500	1,663	1,700	4,163
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>84,778</b>	<b>82,908</b>	<b>168,444</b>	<b>160,324</b>
<b>OTHER INCOME</b>				
Service charges on deposit accounts	5,437	5,038	10,532	9,815
Fiduciary and wealth management fees	3,931	3,595	7,749	7,391
Card payment fees	4,829	4,462	9,655	9,056
Other customer fees	341	455	780	897
Increase in cash surrender value of life insurance	927	907	1,916	1,985
Gains on life insurance benefits	19	100	19	198
Net gains and fees on sales of loans	1,736	1,600	3,031	3,421
Net realized gains on sales of available for sale securities	1,843	1,122	2,983	2,731
Derivative hedge fees	1,487	231	2,268	1,073
Other income	1,064	681	1,394	1,185
<b>Total Other Income</b>	<b>21,614</b>	<b>18,191</b>	<b>40,327</b>	<b>37,752</b>
<b>OTHER EXPENSES</b>				
Salaries and employee benefits	32,709	32,192	65,737	64,418
Net occupancy	4,469	4,348	9,496	9,018
Equipment	4,117	3,556	7,759	7,224
Marketing	2,752	1,474	3,826	2,358
Outside data processing fees	3,929	3,462	7,613	6,426
Printing and office supplies	334	324	649	658
Intangible asset amortization	1,520	1,718	3,048	3,444
FDIC assessments	678	711	1,385	1,430
Other real estate owned and foreclosure expenses	903	362	2,068	764
Professional and other outside services	2,376	1,789	4,260	3,330
Other expenses	3,800	3,568	8,367	8,121
<b>Total Other Expenses</b>	<b>57,587</b>	<b>53,504</b>	<b>114,208</b>	<b>107,191</b>
<b>INCOME BEFORE INCOME TAX</b>	<b>48,805</b>	<b>47,595</b>	<b>94,563</b>	<b>90,885</b>
Income tax expense	7,749	7,961	14,690	14,572
<b>NET INCOME AVAILABLE TO COMMON STOCKHOLDERS</b>	<b>\$ 41,056</b>	<b>\$ 39,634</b>	<b>\$ 79,873</b>	<b>\$ 76,313</b>
Per Share Data:				
Basic Net Income Available to Common Stockholders	\$ 0.83	\$ 0.80	\$ 1.62	\$ 1.55

Diluted Net Income Available to Common Stockholders	\$	0.83	\$	0.80	\$	1.61	\$	1.54
Cash Dividends Paid	\$	0.26	\$	0.22	\$	0.48	\$	0.40
Average Diluted Shares Outstanding (in thousands)		49,550		49,451		49,545		49,440

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

***PART I. FINANCIAL INFORMATION***  
***ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS***  
*(table dollar amounts in thousands, except share data)*

**CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME**  
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Net income	\$ 41,056	\$ 39,634	\$ 79,873	\$ 76,313
Other comprehensive income (loss), net of tax:				
Unrealized holding gain (loss) on securities available for sale arising during the period, net of tax of \$4,822, \$683, \$10,402, and \$4,874	18,140	(2,570)	39,130	(20,268)
Unrealized gain (loss) on cash flow hedges arising during the period, net of tax of \$148, \$61, \$230 and \$167	(553)	230	(862)	874
Reclassification adjustment for net gains included in net income, net of tax of \$369, \$214, \$596 and \$516	(1,390)	(803)	(2,244)	(1,940)
Total other comprehensive income (loss), net of tax	16,197	(3,143)	36,024	(21,334)
Comprehensive income	<u>\$ 57,253</u>	<u>\$ 36,491</u>	<u>\$ 115,897</u>	<u>\$ 54,979</u>

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*

**CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY**  
(Unaudited)

	Three Months Ended June 30, 2019							
	Preferred		Common Stock		Additional	Retained	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount	Paid in Capital			
<b>Balances, March 31, 2019</b>	125	\$ 125	49,428,468	\$ 6,179	\$ 839,919	\$ 611,220	\$ (1,595)	\$ 1,455,848
Comprehensive income:								
Net income	—	—	—	—	—	41,056	—	41,056
Other comprehensive income, net of tax	—	—	—	—	—	—	16,197	16,197
Cash dividends on common stock (\$0.26 per share)	—	—	—	—	—	(12,914)	—	(12,914)
Share-based compensation	—	—	4,978	1	843	—	—	844
Stock issued under employee benefit plans	—	—	5,908	—	188	—	—	188
Stock issued under dividend reinvestment and stock purchase plan	—	—	10,178	1	368	—	—	369
Stock options exercised	—	—	7,500	1	64	—	—	65
Stock redeemed	—	—	(438)	—	(17)	—	—	(17)
<b>Balances, June 30, 2019</b>	125	\$ 125	49,456,594	\$ 6,182	\$ 841,365	\$ 639,362	\$ 14,602	\$ 1,501,636

	Three Months Ended June 30, 2018							
	Preferred		Common Stock		Additional	Retained	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount	Paid in Capital			
<b>Balances, March 31, 2018</b>	125	\$ 125	49,243,096	\$ 6,155	\$ 834,894	\$ 493,624	\$ (21,725)	\$ 1,313,073
Comprehensive income:								
Net income	—	—	—	—	—	39,634	—	39,634
Other comprehensive loss, net of tax	—	—	—	—	—	—	(3,143)	(3,143)
Cash dividends on common stock (\$0.22 per share)	—	—	—	—	—	(10,896)	—	(10,896)
Share-based compensation	—	—	4,945	—	776	—	—	776
Stock issued under employee benefit plans	—	—	4,842	—	187	—	—	187
Stock issued under dividend reinvestment and stock purchase plan	—	—	6,497	1	304	—	—	305
Stock options exercised	—	—	21,375	3	415	—	—	418
Stock redeemed	—	—	(567)	1	(27)	—	—	(26)
<b>Balances, June 30, 2018</b>	125	\$ 125	49,280,188	\$ 6,160	\$ 836,549	\$ 522,362	\$ (24,868)	\$ 1,340,328



**PART I. FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*

**CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY - CONTINUED**  
(Unaudited)

	Six Months Ended June 30, 2019							
	Preferred		Common Stock		Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount				
<b>Balances, December 31, 2018</b>	125	\$ 125	49,349,800	\$ 6,169	\$ 840,052	\$ 583,336	\$ (21,422)	\$ 1,408,260
Comprehensive income:								
Net income	—	—	—	—	—	79,873	—	79,873
Other comprehensive income, net of tax	—	—	—	—	—	—	36,024	36,024
Cash dividends on common stock (\$.48 per share)	—	—	—	—	—	(23,847)	—	(23,847)
Share-based compensation	—	—	108,638	14	1,811	—	—	1,825
Stock issued under employee benefit plans	—	—	11,247	1	361	—	—	362
Stock issued under dividend reinvestment and stock purchase plan	—	—	18,686	2	707	—	—	709
Stock options exercised	—	—	11,200	1	104	—	—	105
Stock redeemed	—	—	(42,977)	(5)	(1,670)	—	—	(1,675)
<b>Balances, June 30, 2019</b>	125	\$ 125	49,456,594	\$ 6,182	\$ 841,365	\$ 639,362	\$ 14,602	\$ 1,501,636

	Six Months Ended June 30, 2018							
	Preferred		Common Stock		Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
	Shares	Amount	Shares	Amount				
<b>Balances, December 31, 2017</b>	125	\$ 125	49,158,238	\$ 6,145	\$ 834,870	\$ 465,231	\$ (2,908)	\$ 1,303,463
Comprehensive income:								
Net income	—	—	—	—	—	76,313	—	76,313
Other comprehensive loss, net of tax	—	—	—	—	—	—	(21,334)	(21,334)
Cash dividends on common stock (\$.40 per share)	—	—	—	—	—	(19,808)	—	(19,808)
Reclassification adjustment under ASU 2018-02	—	—	—	—	—	626	(626)	—
Share-based compensation	—	—	98,021	12	1,641	—	—	1,653
Stock issued under employee benefit plans	—	—	9,205	1	343	—	—	344
Stock issued under dividend reinvestment and stock purchase plan	—	—	12,111	2	553	—	—	555
Stock options exercised	—	—	44,932	6	947	—	—	953
Stock redeemed	—	—	(42,319)	(6)	(1,805)	—	—	(1,811)
<b>Balances, June 30, 2018</b>	125	\$ 125	49,280,188	\$ 6,160	\$ 836,549	\$ 522,362	\$ (24,868)	\$ 1,340,328

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*

**CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS**  
(Unaudited)

	Six Months ended	
	June 30, 2019	June 30, 2018
Cash Flow From Operating Activities:		
Net income	\$ 79,873	\$ 76,313
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,700	4,163
Depreciation and amortization	4,379	4,409
Change in deferred taxes	(398)	3,043
Share-based compensation	1,825	1,653
Loans originated for sale	(183,498)	(178,913)
Proceeds from sales of loans held for sale	184,667	186,556
Gains on sales of loans held for sale	(2,245)	(2,473)
Gains on sales of securities available for sale	(2,983)	(2,731)
Increase in cash surrender of life insurance	(1,916)	(1,985)
Gains on life insurance benefits	(19)	(198)
Change in interest receivable	(4,269)	(1,400)
Change in interest payable	1,133	417
Other adjustments	4,759	(7,132)
Net cash provided by operating activities	83,008	81,722
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	(92,651)	(1,572)
Purchases of:		
Securities available for sale	(306,291)	(260,786)
Securities held to maturity	(238,559)	—
Proceeds from sales of securities available for sale	82,052	100,293
Proceeds from maturities of:		
Securities available for sale	53,910	36,124
Securities held to maturity	35,185	36,750
Change in Federal Home Loan Bank stock	—	(763)
Net change in loans	(288,195)	(337,800)
Proceeds from the sale of other real estate owned	827	1,746
Proceeds from life insurance benefits	633	2,835
Other adjustments	(3,691)	3,082
Net cash used in investing activities	(756,780)	(420,091)
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	400,314	291,984
Certificates of deposit and other time deposits	164,421	39,301
Borrowings	533,010	901,407
Repayment of borrowings	(410,689)	(895,568)
Cash dividends on common stock	(23,847)	(19,808)
Stock issued under employee benefit plans	362	344
Stock issued under dividend reinvestment and stock purchase plans	709	555
Stock options exercised	105	953
Stock redeemed	(1,675)	(1,811)
Net cash provided by financing activities	662,710	317,357
Net Change in Cash and Cash Equivalents	(11,062)	(21,012)
Cash and Cash Equivalents, January 1	139,247	154,905
Cash and Cash Equivalents, June 30	\$ 128,185	\$ 133,893
Additional cash flow information:		
Interest paid	\$ 50,175	\$ 29,587
Income tax paid (refunded)	11,499	8,019
Loans transferred to other real estate owned	314	252
Fixed assets transferred to other real estate owned	965	—
Non-cash investing activities using trade date accounting	40,618	210
ROU assets obtained in exchange for new operating lease liabilities	23,384	—

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

**NOTE 1****GENERAL****Financial Statement Preparation**

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

The Consolidated Condensed Balance Sheet of the Corporation as of December 31, 2018, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation's annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2018 filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2019, are not necessarily indicative of the results to be expected for the year. Reclassifications have been made to prior financial statements to conform to the current financial statement presentation. These reclassifications had no effect on net income.

**Recent Accounting Changes Adopted in 2019**

**FASB Accounting Standards Updates No. 2018-11 - Leases (Topic 842): Targeted Improvements** - The FASB issued Accounting Standards Update (ASU) No. 2018-11, *Leases (Topic 842): Targeted Improvements*. This ASU was intended to reduce costs and ease implementation of the leases standard for financial statement preparers. ASU 2018-11 provided a new transition method and a practical expedient for separating components of a contract. ASU 2018-11 provided entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applied the new leases standard at the adoption date and recognized a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, the Corporation's reporting for the comparative periods presented in the financial statements in the period of adoption is in accordance with GAAP in Topic 840, Leases. The Corporation must provide the required Topic 840 disclosures for all periods that continue to be in accordance with Topic 840. The amendments did not change the existing disclosure requirements in Topic 840 (for example, they did not create interim disclosure requirements that the Corporation previously was not required to provide). The Corporation adopted this new transition method on January 1, 2019, but did not recognize a cumulative-effect adjustment to the opening balance of retained earnings at adoption. Lease disclosures are included in NOTE 7. LEASES, in the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

The amendments in ASU 2018-11 provided lessors with a practical expedient, by class of underlying asset, to not separate non-lease components from the associated lease component and, instead, to account for those components as a single component if the non-lease components otherwise would be accounted for under the new revenue guidance (Topic 606) and both of the following are met:

- \* The timing and pattern of transfer of the non-lease component(s) and associated lease component are the same.
- \* The lease component, if accounted for separately, would be classified as an operating lease.

An entity electing this practical expedient (including an entity that accounts for the combined component entirely in Topic 606) is required to disclose certain information, by class of underlying asset, as specified in the ASU. The Corporation elected the practical expedient to not separate non-lease components from the associated lease component at adoption, which was January 1, 2019.

**FASB Accounting Standards Update No. 2018-07 - Compensation - Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting** - The FASB issued an Accounting Standards Update (ASU) intended to reduce cost and complexity and to improve financial reporting for non-employee share-based payments. The ASU expanded the scope of Topic 718, *Compensation-Stock Compensation* (which currently only includes share-based payments to employees) to include share-based payments issued to non-employees for goods or services. Consequently, the accounting for share-based payments to non-employees and employees is substantially aligned. The ASU supersedes Subtopic 505-50, *Equity-Equity-Based Payments to Non-Employees*. The Corporation adopted the standard in the first quarter of 2019 and adoption of the standard did not have a significant effect on the Corporation's consolidated financial statements.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

**FASB Accounting Standards Update No. 2017-08 - Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities** - The FASB issued Accounting Standards Update (ASU) No. 2017-08, *Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The ASU shortened the amortization period for certain callable debt securities held at a premium to the earliest call date. Under previous GAAP, entities normally amortized the premium as an adjustment of yield over the contractual life of the instrument. Stakeholders expressed concerns with the approach on the basis that GAAP excluded certain callable debt securities from consideration of early repayment of principal even if the holder was certain the call would be exercised. As a result, upon the exercise of a call on a callable debt security held at a premium, the unamortized premium was recorded as a loss in earnings. Further, there was diversity in practice (1) in the amortization period for premiums of callable debt securities, and (2) in how the potential for exercise of a call was factored into current impairment assessments. Another issue was that the practice in the United States was to quote, price, and trade callable debt securities using a model that incorporated consideration of calls (also referred to as "yield-to-worst" pricing). The ASU shortened the amortization period for certain callable debt securities held at a premium and required the premium to be amortized to the earliest call date. However, the amendments did not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity.

The Corporation was required to apply the amendments on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings at adoption. The Corporation adopted ASU 2017-08 on January 1, 2019 and adoption of the standard did not have a significant effect on the Corporation's consolidated financial statements.

**FASB Accounting Standards Update No. 2016-02 - Leases (Topic 842)** - The FASB issued new lease accounting guidance in Accounting Standards Update (ASU) No. 2016-02, *Leases (Topic 842)*. Under the new guidance, lessees recognize the following for all leases (with the exception of short-term leases) at the commencement date:

- A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and
- A right-of-use ("ROU") asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, *Revenue from Contracts with Customers*. The new lease guidance simplified the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees are no longer provided with a source of off-balance sheet financing.

The Corporation elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allowed the Corporation to carry forward the historical lease classification. The Corporation elected to not apply ASC 842 to short-term leases (leases with a term of 12 months or less). Leases with an initial term of 12 months or less are not recorded on the balance sheet as the Corporation expenses the lease on a straight-line basis over the lease term. The Corporation also elected the practical expedient to not separate nonlease components from lease components. Variable payments are not included as part of the consideration of a lease contract and all of the Corporation's nonlease components contain variable payments; therefore, this election will not have any impact on the ROU asset or lease liability.

The Corporation adopted this ASU on January 1, 2019 and recorded a ROU asset of \$23.3 million and a lease liability of \$23.8 million at adoption. Lease disclosures are included in NOTE 7. LEASES, in the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

#### **Revenue Recognition**

Revenue recognition guidance establishes principles for reporting information about the nature, amount, timing and uncertainty of revenue and cash flows arising from the entity's contracts to provide goods or services to customers. The core principle requires an entity to recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The majority of the Corporation's revenue-generating transactions are not subject to revenue recognition guidance, including revenue generated from financial instruments, such as loans, letters of credit, derivatives and investment securities, as well as revenue related to mortgage servicing activities, as these activities are subject to other GAAP discussed elsewhere within the disclosures. The Corporation has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Condensed Statements of Income was not necessary. Descriptions of revenue-generating activities that are within the scope of the guidance, which are presented in our income statements are as follows:

**Service charges on deposit accounts:** The Corporation earns fees from its deposit customers for transaction-based, account maintenance and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering and ACH fees, are recognized at the time the transaction is executed, which is the point in time the Corporation fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned monthly, representing the period which the Corporation satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

**PART I. FINANCIAL INFORMATION**

**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

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

*(Unaudited)*

**Fiduciary activities:** This represents monthly fees due from wealth management customers as consideration for managing the customers' assets. Wealth management and trust services include custody of assets, investment management, fees for trust services and similar fiduciary activities. These fees are primarily earned over time as the Corporation provides the contracted monthly or quarterly services and are generally assessed based on the market value of assets under management at month-end. Fees that are transaction-based are recognized at the point in time that the transaction is executed.

**Investment Brokerage Fees:** The Corporation earns fees from investment brokerage services provided to its customers by a third-party service provider. The Corporation receives commissions from the third-party provider on a monthly basis based upon customer activity for the month. The fees are paid to us by the third party on a monthly basis and are recognized when received.

**Interchange income:** The Corporation earns interchange fees from debit and credit cardholder transactions conducted through the Visa and MasterCard payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized concurrent with the transaction processing services provided to the cardholder.

**Gains (Losses) on Sales of OREO:** The Corporation records a gain or loss from the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Corporation finances the sale of OREO to the buyer, the Corporation assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Corporation adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

**New Accounting Pronouncements Not Yet Adopted**

The Corporation continually monitors potential accounting changes and pronouncements. The following pronouncements have been deemed to have the most applicability to the Corporation's financial statements:

**FASB Accounting Standards Updates No. 2018-15 - *Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract***

**Summary** - The FASB has issued Accounting Standards Update (ASU) No. 2018-15, *Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract*, which reduces complexity for the accounting for costs of implementing a cloud computing service arrangement. This standard aligns the accounting for implementation costs of hosting arrangements, regardless of whether they convey a license to the hosted software.

The ASU aligns the following requirements for capitalizing implementation costs:

- \* Those incurred in a hosting arrangement that is a service contract, and
- \* Those incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license).

For calendar-year public companies, the changes will be effective for fiscal years ending after December 15, 2019. For all other calendar-year companies and organizations, the changes will be effective for fiscal years ending after December 15, 2020. The Corporation plans to adopt the standard in the first quarter of 2020, but adoption of the standard is not expected to have a significant impact on the Corporation's consolidated financial statements.

**FASB Accounting Standards Updates No. 2018-14 - *Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20): Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans***

**Summary** - The FASB has issued ASU No. 2018-14, *Compensation - Retirement Benefits - Defined Benefit Plans - General (Subtopic 715-20): Disclosure Framework - Changes to the Disclosure Requirements for Defined Benefit Plans*, that applies to all employers that sponsor defined benefit pension or other postretirement plans. The amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans.

**Disclosure Requirements Deleted**

- \* The amounts in accumulated other comprehensive income expected to be recognized as components of net periodic benefit cost over the next fiscal year.
- \* The amount and timing of plan assets expected to be returned to the employer.
- \* Related party disclosures about the amount of future annual benefits covered by insurance and annuity contracts and significant transactions between the employer or related parties and the plan.
- \* For public entities, the effects of a one-percentage-point change in assumed health care cost trend rates on the (a) aggregate of the service and interest cost components of net periodic benefit costs and (b) benefit obligation for postretirement health care benefits.

**PART I. FINANCIAL INFORMATION**

**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

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

*(Unaudited)*

Disclosure Requirements Added

- \* An explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period.

The amendments also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed:

- \* The projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets.
- \* The accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets.

ASU No. 2018-14 is effective for fiscal years ending after December 15, 2020, for public business entities and for fiscal years ending after December 15, 2021, for all other entities. Early adoption is permitted for all entities. The Corporation plans to adopt the standard in the first quarter of 2020, but adoption of the standard is not expected to have a significant impact on the Corporation's disclosures.

**FASB Accounting Standards Updates No. 2018-13 - Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement**

**Summary** - The FASB has issued ASU No. 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. ASU No. 2018-13 modifies the disclosure requirements on fair value measurements in Topic 820. Certain disclosure requirements related to transfers between Level 1 and Level 2 of the fair value hierarchy and Level 3 valuation process were removed from Topic 820. Disclosures were also added to Topic 820 for changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements.

In addition, the amendments eliminate at a minimum from the phrase "an entity shall disclose at a minimum" to promote the appropriate exercise of discretion by entities when considering fair value measurement disclosures and to clarify that materiality is an appropriate consideration of entities and their auditors when evaluating disclosure requirements.

The amendments in ASU No. 2018-13 are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The amendments on changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements, and the narrative description of measurement uncertainty should be applied prospectively for only the most recent interim or annual period presented in the initial fiscal year of adoption. All other amendments should be applied retrospectively to all periods presented upon their effective date. Early adoption is permitted. An entity is permitted to early adopt any removed or modified disclosures upon issuance of ASU No. 2018-13 and delay adoption of the additional disclosures until their effective date. The Corporation plans to adopt the standard in the first quarter of 2020, but adoption of the standard is not expected to have a significant impact on the Corporation's disclosures.

**FASB Accounting Standards Update No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments**

**Summary** - The FASB has issued Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. This new guidance was issued to address concerns that current generally accepted accounting principles (GAAP) restricts the ability to record credit losses that are expected, but do not yet meet the "probable" threshold by replacing the current "incurred loss" model for recognizing credit losses with an "expected life of loan loss" model referred to as the Current Expected Credit Loss (CECL) model.

Under the CECL model, certain financial assets carried at amortized cost, such as loans held for investment and held-to-maturity debt securities, are required to be presented at the net amount expected to be collected. The measurement of expected credit losses is to be based on information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. This measurement will take place at the time the financial asset is first added to the balance sheet and periodically thereafter. This differs significantly from the "incurred loss" model required under current GAAP, which delays recognition until it is probable a loss has been incurred. The change could materially affect how the allowance for loan losses is determined and cause a charge to earnings through the provision for loan losses. Such would adversely affect the financial condition of the Corporation.

The ASU is effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Corporation plans to adopt this ASU in the first quarter of 2020.

The Corporation expects a one-time cumulative-effect adjustment to the allowance for loan losses will be recognized in retained earnings on the consolidated balance sheet as of the beginning of the first reporting period in which the new standard is effective, as is consistent with regulatory expectations set forth in interagency guidance issued at the end of 2016. The Corporation established an implementation team that meets on a regular basis to oversee activities and monitor progress. Third party software has been implemented and initial models have been developed. The implementation team is testing the models by conducting limited parallel runs and testing the sensitivity of assumptions. Forecasting methodologies continue to be refined and outputs from those models challenged. The magnitude of any such adjustment or the overall impact of the new standard on the financial condition or results of operations cannot yet be determined.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

**NOTE 2**  
**PENDING MERGER**

*MBT Financial Corp.*

On October 9, 2018, the Corporation and MBT Financial Corp., a Michigan corporation ("MBT"), entered into an Agreement and Plan of Reorganization and Merger (the "Merger Agreement"), pursuant to which MBT will, subject to the terms and conditions of the Merger Agreement, merge with and into the Corporation (the "Holding Company Merger"), whereupon the separate corporate existence of MBT will cease and the Corporation will survive. Immediately following the Holding Company Merger, MBT's wholly-owned subsidiary, Monroe Bank & Trust, will be merged with and into the Bank (the "Bank Merger" and, together with the Holding Company Merger, the "Mergers"), with the Bank continuing as the surviving bank. Based on the closing price of the Corporation's common stock on October 9, 2018 of \$45.71 per share, the transaction value is estimated at approximately \$290.9 million. The transaction is expected to be a tax-free exchange for MBT's shareholders who will be receiving the Corporation's common stock pursuant to the Holding Company Merger. MBT's total assets as of June 30, 2019 were \$1.3 billion.

At a special meeting held on February 14, 2019, the shareholders of MBT approved the Merger Agreement and the transactions contemplated by the Merger Agreement. In addition, on January 3, 2019, the FDIC issued its order approving the Bank Merger, subject to certain customary conditions. On June 27, 2019, the FDIC reconfirmed its approval and extended the time for consummation until September 30, 2019. On February 18, 2019, the Indiana DFI approved the Bank Merger. On June 20, 2019, the DFI reconfirmed its approval. On June 13, 2019, the Corporation filed an application with the Federal Reserve Bank of Chicago seeking its approval of the merger. Consummation of the Mergers remain subject to satisfaction of other customary closing conditions contained in the Merger Agreement. The Mergers are expected to close during the third quarter of 2019.

**NOTE 3**

**INVESTMENT SECURITIES**

The amortized cost, gross unrealized gains, gross unrealized losses and approximate market value of the Corporation's investment securities at the dates indicated were:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at June 30, 2019				
U.S. Government-sponsored agency securities	\$ 33,494	\$ 453	\$ —	\$ 33,947
State and municipal	685,123	30,835	200	715,758
U.S. Government-sponsored mortgage-backed securities	642,298	8,532	607	650,223
Corporate obligations	31	—	—	31
Total available for sale	1,360,946	39,820	807	1,399,959
Held to maturity at June 30, 2019				
U.S. Government-sponsored agency securities	33,865	20	66	33,819
State and municipal	310,076	10,987	22	321,041
U.S. Government-sponsored mortgage-backed securities	347,524	5,257	226	352,555
Foreign investment	1,500	—	—	1,500
Total held to maturity	692,965	16,264	314	708,915
Total Investment Securities	\$ 2,053,911	\$ 56,084	\$ 1,121	\$ 2,108,874
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2018				
U.S. Government-sponsored agency securities	\$ 13,493	\$ 92	\$ 3	\$ 13,582
State and municipal	605,994	5,995	5,854	606,135
U.S. Government-sponsored mortgage-backed securities	530,209	634	8,396	522,447
Corporate obligations	31	—	—	31
Total available for sale	1,149,727	6,721	14,253	1,142,195
Held to maturity at December 31, 2018				
U.S. Government-sponsored agency securities	22,618	—	545	22,073
State and municipal	197,909	2,858	872	199,895
U.S. Government-sponsored mortgage-backed securities	268,860	713	3,323	266,250
Foreign investment	1,000	—	1	999
Total held to maturity	490,387	3,571	4,741	489,217
Total Investment Securities	\$ 1,640,114	\$ 10,292	\$ 18,994	\$ 1,631,412

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

The change in unrealized gains/losses from December 31, 2018 to June 30, 2019 is primarily due to the changes in interest rates. The longer term points on the yield curve have declined since year-end which increases the fair value of securities held in the portfolio.

The amortized cost and fair value of available for sale and held to maturity securities at June 30, 2019 and December 31, 2018, 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
<b>Maturity Distribution at June 30, 2019:</b>				
Due in one year or less	\$ 1,131	\$ 1,138	\$ 3,784	\$ 3,782
Due after one through five years	3,752	3,851	46,941	46,914
Due after five through ten years	74,311	76,604	78,716	81,769
Due after ten years	639,454	668,143	216,000	223,895
	718,648	749,736	345,441	356,360
U.S. Government-sponsored mortgage-backed securities	642,298	650,223	347,524	352,555
Total Investment Securities	<u>\$ 1,360,946</u>	<u>\$ 1,399,959</u>	<u>\$ 692,965</u>	<u>\$ 708,915</u>

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
<b>Maturity Distribution at December 31, 2018</b>				
Due in one year or less	\$ 13,092	\$ 13,144	\$ 4,732	\$ 4,730
Due after one through five years	5,311	5,378	49,054	48,473
Due after five through ten years	73,280	74,411	62,873	64,163
Due after ten years	527,835	526,815	104,868	105,601
	619,518	619,748	221,527	222,967
U.S. Government-sponsored mortgage-backed securities	530,209	522,447	268,860	266,250
Total Investment Securities	<u>\$ 1,149,727</u>	<u>\$ 1,142,195</u>	<u>\$ 490,387</u>	<u>\$ 489,217</u>

The carrying value of securities pledged as collateral, to secure borrowings and for other purposes, was \$483,230,000 at June 30, 2019, and \$416,155,000 at December 31, 2018.

The book value of securities sold under agreements to repurchase amounted to \$119,266,000 at June 30, 2019, and \$116,691,000 at December 31, 2018.

Gross gains on the sales and redemptions of available for sale securities for the three and six months ended June 30, 2019 and 2018 are shown below.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<b>Sales and Redemptions of Available for Sale Securities:</b>				
Gross gains	\$ 1,843	\$ 1,122	\$ 2,983	\$ 2,731
Gross losses	—	—	—	—



# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

The following tables show the Corporation's gross unrealized losses and fair value, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position at June 30, 2019, and December 31, 2018:

	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 June 30, 2019						
State and municipal	\$ 7,699	\$ 16	\$ 7,080	\$ 184	\$ 14,779	\$ 200
U.S. Government-sponsored mortgage-backed securities	7,791	15	75,152	592	82,943	607
Total Temporarily Impaired Available for Sale Securities	15,490	31	82,232	776	97,722	807
Temporarily Impaired Held to Maturity Securities at June 30, 2019						
U.S. Government-sponsored agency securities	—	—	15,454	66	15,454	66
State and municipal	6,421	22	—	—	6,421	22
U.S. Government-sponsored mortgage-backed securities	74	—	36,614	226	36,688	226
Total Temporarily Impaired Held to Maturity Securities	6,495	22	52,068	292	58,563	314
Total Temporarily Impaired Investment Securities	<u>\$ 21,985</u>	<u>\$ 53</u>	<u>\$ 134,300</u>	<u>\$ 1,068</u>	<u>\$ 156,285</u>	<u>\$ 1,121</u>
	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, 2018						
U.S. Government-sponsored agency securities	\$ 1,490	\$ 3	\$ —	\$ —	\$ 1,490	\$ 3
State and municipal	234,431	3,958	38,028	1,896	272,459	5,854
U.S. Government-sponsored mortgage-backed securities	196,601	2,400	217,121	5,996	413,722	8,396
Total Temporarily Impaired Available for Sale Securities	432,522	6,361	255,149	7,892	687,671	14,253
Temporarily Impaired Held to Maturity Securities at December 31, 2018						
U.S. Government-sponsored agency securities	—	—	22,073	545	22,073	545
State and municipal	14,952	369	16,786	503	31,738	872
U.S. Government-sponsored mortgage-backed securities	102,828	876	87,268	2,447	190,096	3,323
Foreign investment	—	—	999	1	999	1
Total Temporarily Impaired Held to Maturity Securities	117,780	1,245	127,126	3,496	244,906	4,741
Total Temporarily Impaired Investment Securities	<u>\$ 550,302</u>	<u>\$ 7,606</u>	<u>\$ 382,275</u>	<u>\$ 11,388</u>	<u>\$ 932,577</u>	<u>\$ 18,994</u>

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.

	June 30, 2019	December 31, 2018
Investments reported at less than historical cost:		
Historical cost	\$ 157,406	\$ 951,571
Fair value	156,285	932,577
Gross unrealized losses	<u>\$ 1,121</u>	<u>\$ 18,994</u>
Percent of the Corporation's investment portfolio	7.5%	57.1%

The Corporation's management believes the decline in fair value for these securities was temporary. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income during the period the other-than-temporary-impairment ("OTTI") is identified. The Corporation's management has evaluated all securities with unrealized losses for OTTI and concluded no OTTI existed at June 30, 2019.

In determining the fair value of the investment securities portfolio, the Corporation utilizes a third party for portfolio accounting services, including market value input, for those securities classified as Level 1 and Level 2 in the fair value hierarchy. The Corporation has obtained an understanding of what inputs are being used by the vendor in pricing the portfolio and how the vendor classified 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. Fair value of securities classified as Level 3 in the valuation hierarchy was determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

### State and Municipal and U.S. Government-Sponsored Agency Securities

The unrealized losses on the Corporation's investments in securities of state and political subdivisions and U.S. Government-Sponsored Agency securities were caused by interest rate increases. 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. Because the Corporation does not intend to sell the investments and it is not more likely than not that the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Corporation does not consider those investments to be other-than-temporarily impaired at June 30, 2019. The state and municipal securities portfolio contains unrealized losses of \$200,000 on seven securities and \$22,000 on two securities in the available for sale and held to maturity portfolios, respectively. The U.S. Government-Sponsored Agency securities portfolio contains no unrealized losses in the available for sale portfolio and \$66,000 on three securities in the held to maturity portfolio.

### U.S. Government-Sponsored Mortgage-Backed Securities

The unrealized losses on the Corporation's investment in mortgage-backed securities were a result of interest rate changes. The Corporation expects to recover the amortized cost basis over the term of the securities. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Corporation does not intend to sell the investments and it is not more likely than not that the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Corporation does not consider those investments to be other-than-temporarily impaired at June 30, 2019. The mortgage-backed securities portfolio contains unrealized losses of \$607,000 on twenty-nine securities and \$226,000 on fourteen securities in the available for sale and held to maturity portfolios, respectively. All these securities are issued by a U.S. government-sponsored entity.

## NOTE 4

### LOANS AND ALLOWANCE

The Corporation's primary lending focus is small business and middle market commercial, commercial real estate and residential real estate, which results in portfolio diversification. The following tables show the composition of the loan portfolio, the allowance for loan losses and credit quality characteristics by collateral classification, excluding loans held for sale. Loans held for sale as of June 30, 2019, and December 31, 2018, were \$5,854,000 and \$4,778,000, respectively.

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

	June 30, 2019	December 31, 2018
Commercial and industrial loans	\$ 1,877,042	\$ 1,726,664
Agricultural production financing and other loans to farmers	83,452	92,404
Real estate loans:		
Construction	624,548	545,729
Commercial and farmland	2,821,689	2,832,102
Residential	993,802	966,421
Home equity	548,006	528,157
Individuals' loans for household and other personal expenditures	98,384	99,788
Public finance and other commercial loans	464,447	433,202
Loans	\$ 7,511,370	\$ 7,224,467
Allowance for loan losses	(81,274)	(80,552)
Net Loans	\$ 7,430,096	\$ 7,143,915

### Allowance, Credit Quality and Loan Portfolio

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. Management believes the allowance for loan losses is adequate to cover probable losses inherent in the loan portfolio at June 30, 2019. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examinations, and will increase or decrease as deemed necessary to ensure it remains adequate. In addition, the allowance as a percentage of charge-offs and nonperforming loans will change at different points in time based on credit performance, portfolio mix and collateral values.

# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

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

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

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

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

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

The following tables summarize changes in the allowance for loan losses by loan segment for the three and six months ended June 30, 2019 and June 30, 2018:

Three Months Ended June 30, 2019						
	Commercial	Commercial Real Estate	Consumer	Residential	Total	
<b>Allowance for loan losses:</b>						
Balances, March 31, 2019	\$ 33,069	\$ 29,434	\$ 4,026	\$ 14,373	\$	80,902
Provision for losses	100	320	36	44		500
Recoveries on loans	344	778	100	212		1,434
Loans charged off	(311)	(1,001)	(92)	(158)		(1,562)
Balances, June 30, 2019	<u>\$ 33,202</u>	<u>\$ 29,531</u>	<u>\$ 4,070</u>	<u>\$ 14,471</u>	<u>\$</u>	<u>81,274</u>

Six Months Ended June 30, 2019						
	Commercial	Commercial Real Estate	Consumer	Residential	Total	
<b>Allowance for loan losses:</b>						
Balances, December 31, 2018	\$ 32,657	\$ 29,609	\$ 3,964	\$ 14,322	\$	80,552
Provision for losses	336	1,089	141	134		1,700
Recoveries on loans	886	1,023	218	312		2,439
Loans charged off	(677)	(2,190)	(253)	(297)		(3,417)
Balances, June 30, 2019	<u>\$ 33,202</u>	<u>\$ 29,531</u>	<u>\$ 4,070</u>	<u>\$ 14,471</u>	<u>\$</u>	<u>81,274</u>

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
**(Unaudited)**

Three Months Ended June 30, 2018						
	Commercial	Commercial Real Estate	Consumer	Residential	Total	
<b>Allowance for loan losses:</b>						
Balances, March 31, 2018	\$ 30,770	\$ 27,705	\$ 3,896	\$ 14,049	\$	76,420
Provision for losses	471	954	60	178		1,663
Recoveries on loans	1,283	1,213	98	596		3,190
Loans charged off	(1,057)	(2,141)	(133)	(399)		(3,730)
Balances, June 30, 2018	<u>\$ 31,467</u>	<u>\$ 27,731</u>	<u>\$ 3,921</u>	<u>\$ 14,424</u>	<u>\$</u>	<u>77,543</u>

Six Months Ended June 30, 2018						
	Commercial	Commercial Real Estate	Consumer	Residential	Total	
<b>Allowance for loan losses:</b>						
Balances, December 31, 2017	\$ 30,420	\$ 27,343	\$ 3,732	\$ 13,537	\$	75,032
Provision for losses	1,311	1,038	334	1,480		4,163
Recoveries on loans	1,402	1,552	187	750		3,891
Loans charged off	(1,666)	(2,202)	(332)	(1,343)		(5,543)
Balances, June 30, 2018	<u>\$ 31,467</u>	<u>\$ 27,731</u>	<u>\$ 3,921</u>	<u>\$ 14,424</u>	<u>\$</u>	<u>77,543</u>

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

June 30, 2019						
	Commercial	Commercial Real Estate	Consumer	Residential	Total	
<b>Allowance Balances:</b>						
Individually evaluated for impairment	\$ 1,849	\$ 14	\$ 1	\$ 432	\$	2,296
Collectively evaluated for impairment	31,353	29,517	4,069	14,039		78,978
Total Allowance for Loan Losses	<u>\$ 33,202</u>	<u>\$ 29,531</u>	<u>\$ 4,070</u>	<u>\$ 14,471</u>	<u>\$</u>	<u>81,274</u>
<b>Loan Balances:</b>						
Individually evaluated for impairment	\$ 5,090	\$ 14,419	\$ 14	\$ 2,450	\$	21,973
Collectively evaluated for impairment	2,418,481	3,419,930	98,370	1,538,533		7,475,314
Loans acquired with deteriorated credit quality	1,370	11,888	—	825		14,083
Loans	<u>\$ 2,424,941</u>	<u>\$ 3,446,237</u>	<u>\$ 98,384</u>	<u>\$ 1,541,808</u>	<u>\$</u>	<u>7,511,370</u>

December 31, 2018						
	Commercial	Commercial Real Estate	Consumer	Residential	Total	
<b>Allowance Balances:</b>						
Individually evaluated for impairment	\$ —	\$ 1,435	\$ 1	\$ 436	\$	1,872
Collectively evaluated for impairment	32,657	28,174	3,963	13,886		78,680
Total Allowance for Loan Losses	<u>\$ 32,657</u>	<u>\$ 29,609</u>	<u>\$ 3,964</u>	<u>\$ 14,322</u>	<u>\$</u>	<u>80,552</u>
<b>Loan Balances:</b>						
Individually evaluated for impairment	\$ 1,838	\$ 17,756	\$ 18	\$ 2,413	\$	22,025
Collectively evaluated for impairment	2,248,330	3,347,686	99,770	1,490,872		7,186,658
Loans acquired with deteriorated credit quality	2,102	12,389	—	1,293		15,784
Loans	<u>\$ 2,252,270</u>	<u>\$ 3,377,831</u>	<u>\$ 99,788</u>	<u>\$ 1,494,578</u>	<u>\$</u>	<u>7,224,467</u>

# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

Loans individually evaluated for impairment are comprised of commercial and consumer loans deemed impaired in accordance with ASC 310-10. This includes loans acquired with deteriorated credit quality totaling \$1,824,000 with \$329,000 of related allowance for loan losses at June 30, 2019 and \$1,541,000 with no related allowance for loan losses at December 31, 2018.

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

### *Commercial*

Commercial lending is 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 tangible assets being financed such as equipment or real estate or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee. Other loans may be unsecured, secured but under-collateralized or otherwise made on the basis of the enterprise value of an organization. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

### *Commercial real estate*

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

### *Consumer and Residential*

With respect to residential loans that are secured by 1-4 family residences and are typically owner occupied, the Corporation generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Home equity loans are 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 on loans secured by 1-4 family residences can be impacted by changes in property values. 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. When the interest accrual is discontinued, all unpaid accrued interest is reversed against earnings when considered uncollectable. 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:

	June 30, 2019	December 31, 2018
Commercial and industrial loans	\$ 2,770	\$ 1,803
Agriculture production financing and other loans to farmers	2,785	679
Real estate loans:		
Construction	6,918	8,667
Commercial and farmland	6,340	8,156
Residential	4,579	4,966
Home equity	1,826	1,481
Individuals' loans for household and other personal expenditures	64	42
Public finance and other commercial loans	353	354
Total	<u>\$ 25,635</u>	<u>\$ 26,148</u>

Impaired loans include loans deemed impaired according to the guidance set forth in ASC 310-10. Commercial loans under \$500,000 and consumer loans, with the exception of troubled debt restructures, are not individually evaluated for impairment.

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 for measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor, which includes selling costs if applicable, 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.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

The following tables show the composition of the Corporation's impaired loans, related allowance and interest income recognized while impaired by loan class as of the periods indicated:

	June 30, 2019		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
<b>Impaired loans with no related allowance:</b>			
Commercial and industrial loans	\$ 1,048	\$ 1,012	\$ —
Agriculture production financing and other loans to farmers	679	668	—
Real estate Loans:			
Construction	7,978	6,909	—
Commercial and farmland	10,160	7,381	—
Residential	117	99	—
Home equity	49	49	—
Public finance and other commercial loans	353	353	—
Total	\$ 20,384	\$ 16,471	\$ —
<b>Impaired loans with related allowance:</b>			
Commercial and industrial loans	\$ 1,185	\$ 940	\$ 455
Agriculture production financing and other loans to farmers	\$ 2,167	\$ 2,117	\$ 1,394
Real estate Loans:			
Commercial and farmland	134	129	14
Residential	1,976	1,953	362
Home equity	366	349	70
Individuals' loans for household and other personal expenditures	14	14	1
Total	\$ 5,842	\$ 5,502	\$ 2,296
Total Impaired Loans	\$ 26,226	\$ 21,973	\$ 2,296

	December 31, 2018		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
<b>Impaired loans with no related allowance:</b>			
Commercial and industrial loans	\$ 828	\$ 806	\$ —
Agriculture production financing and other loans to farmers	679	679	—
Real estate Loans:			
Construction	1,352	614	—
Commercial and farmland	11,176	8,994	—
Residential	118	100	—
Home equity	49	48	—
Public finance and other commercial loans	353	353	—
Total	\$ 14,555	\$ 11,594	\$ —
<b>Impaired loans with related allowance:</b>			
Real estate Loans:			
Construction	\$ 7,978	\$ 7,977	\$ 1,429
Commercial and farmland	171	171	6
Residential	1,958	1,907	362
Home equity	376	358	74
Individuals' loans for household and other personal expenditures	18	18	1
Total	\$ 10,501	\$ 10,431	\$ 1,872
Total Impaired Loans	\$ 25,056	\$ 22,025	\$ 1,872

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

	Three Months Ended June 30, 2019		Six Months Ended June 30, 2019	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>Impaired loans with no related allowance:</b>				
Commercial and industrial loans	\$ 1,013	\$ —	\$ 1,021	\$ —
Agriculture production financing and other loans to farmers	668	—	672	—
Real estate Loans:				
Construction	7,314	—	7,792	—
Commercial and farmland	7,998	39	8,187	78
Residential	38	1	38	2
Home equity	49	—	49	—
Public finance and other commercial loans	353	—	353	—
Total	\$ 17,433	\$ 40	\$ 18,112	\$ 80
<b>Impaired loans with related allowance:</b>				
Commercial and industrial loans	\$ 940	\$ —	\$ 940	\$ —
Agriculture production financing and other loans to farmers	2,117	—	2,134	—
Real estate Loans:				
Commercial and farmland	157	—	164	—
Residential	2,021	16	2,029	32
Home equity	351	3	352	6
Individuals' loans for household and other personal expenditures	14	—	15	—
Total	\$ 5,600	\$ 19	\$ 5,634	\$ 38
Total Impaired Loans	\$ 23,033	\$ 59	\$ 23,746	\$ 118

	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
<b>Impaired loans with no related allowance:</b>				
Commercial and industrial loans	\$ 1,004	\$ —	\$ 1,006	\$ —
Agriculture production financing and other loans to farmers	640	—	640	—
Real estate Loans:				
Construction	1,106	—	1,167	—
Commercial and farmland	9,935	40	10,241	87
Residential	63	1	63	2
Individuals' loans for household and other personal expenditures	10	—	11	—
Public finance and other commercial loans	—	—	—	—
Total	\$ 12,758	\$ 41	\$ 13,128	\$ 89
<b>Impaired loans with related allowance:</b>				
Commercial and industrial loans	\$ 108	\$ —	\$ 108	\$ —
Real estate Loans:				
Residential	1,714	12	1,726	24
Home equity	302	2	303	5
Total	\$ 2,124	\$ 14	\$ 2,137	\$ 29
Total Impaired Loans	\$ 14,882	\$ 55	\$ 15,265	\$ 118

Impaired loans in the above tables do not include loans accounted for under ASC 310-30, or any other loan, unless deemed impaired in accordance with ASC 310-10.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

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, (iv) covenant failures and (v) 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:
  - o the likelihood that a loan will be paid from the primary source of repayment is uncertain or financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss,
  - o the primary source of repayment is gone, and the Corporation is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees,
  - o loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
  - o unusual courses of action are needed to maintain a high probability of repayment,
  - o the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
  - o the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
  - o loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
  - o the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
  - o there is significant deterioration in market conditions to which the borrower is highly vulnerable.
- Doubtful - Loans that have all of the weaknesses of those classified as Substandard. However, based on currently existing facts, conditions and values, these weaknesses make full collection of principal highly questionable and improbable. Other credit characteristics may include considerable doubt as to the quality of the secondary sources of repayment. The possibility of loss is high, but because of certain important pending factors that may strengthen the loan, loss classification is deferred until the exact status of repayment is known.
- Loss – Loans that are considered uncollectable and of such little value that continuing to carry them as an asset is not warranted. Loans will be classified as Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.



**PART I. FINANCIAL INFORMATION**

**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

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

*(Unaudited)*

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-days or more 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.

June 30, 2019								
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$ 1,781,040	\$ 53,407	\$ 42,266	\$ 329	\$ —	\$ —	\$ —	\$ 1,877,042
Agriculture production financing and other loans to farmers	67,837	5,478	10,137	—	—	—	—	83,452
Real estate Loans:								
Construction	591,962	1,444	7,712	—	—	23,430		624,548
Commercial and farmland	2,645,338	79,586	94,179	450	—	2,136	—	2,821,689
Residential	156,622	5,833	3,425	—	—	823,309	4,613	993,802
Home equity	27,324	585	758	—	—	517,620	1,719	548,006
Individuals' loans for household and other personal expenditures	—	—	—	—	—	98,320	64	98,384
Public finance and other commercial loans	464,094	—	353	—	—	—	—	464,447
Loans	<u>\$ 5,734,217</u>	<u>\$ 146,333</u>	<u>\$ 158,830</u>	<u>\$ 779</u>	<u>\$ —</u>	<u>\$ 1,464,815</u>	<u>\$ 6,396</u>	<u>\$ 7,511,370</u>

December 31, 2018								
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$ 1,660,879	\$ 23,246	\$ 42,539	\$ —	\$ —	\$ —	\$ —	\$ 1,726,664
Agriculture production financing and other loans to farmers	78,446	5,966	7,992	—	—	—	—	92,404
Real estate Loans:								
Construction	492,358	2,185	24,224	—	—	25,419	1,543	545,729
Commercial and farmland	2,669,491	76,037	84,288	—	—	2,285	1	2,832,102
Residential	170,075	7,373	2,076	—	—	782,080	4,817	966,421
Home equity	24,653	535	457	—	—	500,996	1,516	528,157
Individuals' loans for household and other personal expenditures	—	—	—	—	—	99,741	47	99,788
Public finance and other commercial loans	432,849	—	353	—	—	—	—	433,202
Loans	<u>\$ 5,528,751</u>	<u>\$ 115,342</u>	<u>\$ 161,929</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 1,410,521</u>	<u>\$ 7,924</u>	<u>\$ 7,224,467</u>

The tables below show a past due aging of the Corporation's loan portfolio, by loan class, as of June 30, 2019, and December 31, 2018:

June 30, 2019							
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans 90 Days or More Past Due And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total
Commercial and industrial loans	\$ 1,874,004	\$ 248	\$ 20	\$ —	\$ 2,770	\$ 3,038	\$ 1,877,042
Agriculture production financing and other loans to farmers	80,634	33	—	—	2,785	2,818	83,452
Real estate loans:							
Construction	617,519	111	—	—	6,918	7,029	624,548
Commercial and farmland	2,808,422	6,751	176	—	6,340	13,267	2,821,689
Residential	984,086	4,540	422	175	4,579	9,716	993,802
Home equity	544,338	1,308	500	34	1,826	3,668	548,006
Individuals' loans for household and other personal expenditures	97,826	407	87	—	64	558	98,384
Public finance and other commercial loans	464,094	—	—	—	353	353	464,447
Loans	<u>\$ 7,470,923</u>	<u>\$ 13,398</u>	<u>\$ 1,205</u>	<u>\$ 209</u>	<u>\$ 25,635</u>	<u>\$ 40,447</u>	<u>\$ 7,511,370</u>

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
**(Unaudited)**

December 31, 2018							
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans 90 Days or More Past Due And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total
Commercial and industrial loans	\$ 1,723,337	\$ 1,093	\$ 182	\$ 249	\$ 1,803	\$ 3,327	\$ 1,726,664
Agriculture production financing and other loans to farmers	89,440	2,285	—	—	679	2,964	92,404
Real estate loans:							
Construction	535,520	64	—	1,478	8,667	10,209	545,729
Commercial and farmland	2,822,515	1,253	178	—	8,156	9,587	2,832,102
Residential	959,252	1,756	430	17	4,966	7,169	966,421
Home equity	524,198	2,164	207	107	1,481	3,959	528,157
Individuals' loans for household and other personal expenditures	99,499	179	64	4	42	289	99,788
Public finance and other commercial loans	432,848	—	—	—	354	354	433,202
Loans	<u>\$ 7,186,609</u>	<u>\$ 8,794</u>	<u>\$ 1,061</u>	<u>\$ 1,855</u>	<u>\$ 26,148</u>	<u>\$ 37,858</u>	<u>\$ 7,224,467</u>

On occasion, borrowers 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 works 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 original 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 restructures in the Corporation's loan portfolio that occurred during the periods indicated:

Three Months Ended June 30, 2019				Six Months Ended June 30, 2019		
	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:						
Residential	\$ 171	\$ 164	4	\$ 261	\$ 254	5
Total	<u>\$ 171</u>	<u>\$ 164</u>	<u>4</u>	<u>\$ 261</u>	<u>\$ 254</u>	<u>5</u>
Three Months Ended June 30, 2018				Six Months Ended June 30, 2018		
	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:						
Residential	\$ 122	\$ 125	2	\$ 336	\$ 347	7
Home equity	—	—	—	16	16	2
Individuals' loans for household and other personal expenditures	—	—	—	7	8	1
Total	<u>\$ 122</u>	<u>\$ 125</u>	<u>2</u>	<u>\$ 359</u>	<u>\$ 371</u>	<u>10</u>

The following tables summarize the recorded investment of troubled debt restructures as of June 30, 2019 and 2018, by modification type, that occurred during the periods indicated:

Three Months Ended June 30, 2019				
	Term Modification	Rate Modification	Combination	Total Modification
Real estate loans:				
Residential	\$ —	\$ —	\$ 164	\$ 164
Total	<u>\$ —</u>	<u>\$ —</u>	<u>\$ 164</u>	<u>\$ 164</u>
Six Months Ended June 30, 2019				
	Term Modification	Rate Modification	Combination	Total Modification
Real estate loans:				
Residential	\$ —	\$ 89	\$ 164	\$ 253
Total	<u>\$ —</u>	<u>\$ 89</u>	<u>\$ 164</u>	<u>\$ 253</u>

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
**(Unaudited)**

Three Months Ended June 30, 2018				
	Term Modification	Rate Modification	Combination	Total Modification
Real estate loans:				
Residential	\$ —	\$ 91	\$ 34	\$ 125
Total	\$ —	\$ 91	\$ 34	\$ 125

Six Months Ended June 30, 2018				
	Term Modification	Rate Modification	Combination	Total Modification
Real estate loans:				
Residential	\$ 37	\$ 163	\$ 139	\$ 339
Home equity	60	10	—	70
Individuals' loans for household and other personal expenditures	—	7	—	7
Total	\$ 97	\$ 180	\$ 139	\$ 416

Loans secured by residential real estate made up 100 percent of the post-modification balance of troubled debt restructured loans made in the three and six months ended June 30, 2019. The same loan classification made up 100 percent of the post-modification balance of troubled debt restructured loans made in the three months ended June 30, 2018.

The following tables summarize troubled debt restructures that occurred during the twelve months ended June 30, 2019 and 2018, that subsequently defaulted during the period indicated and remained in default at period end. A loan is considered in default if it is 30-days or more past due.

Three Months Ended June 30, 2019			Six Months Ended June 30, 2019	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Real estate loans:				
Residential	1	\$ 62	1	\$ 62
Total	1	\$ 62	1	\$ 62

  

Three Months Ended June 30, 2018			Six Months Ended June 30, 2018	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Real estate loans:				
Commercial and farmland	—	—	1	\$ 272
Residential	2	\$ 132	3	190
Total	2	\$ 132	4	\$ 462

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 loan restructures are generally included in the general historical allowance for loan loss at the post modification balance. Consumer non-accrual and delinquent troubled debt loan restructures are also considered in the calculation of the non-accrual and delinquency trend environmental allowance allocation. Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process totaled \$777,000 and \$800,000 at June 30, 2019 and December 31, 2018, respectively.

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 troubled debt loan restructures 30-89 days delinquent are included in the calculation of the delinquency trend environmental allocation in the allowance for loan losses. With the exception of the acquired loans excluded from the allowance for loan losses, all commercial non-impaired loans, including non-accrual and 90-days or more delinquent, are included in the ASC 450 loss estimate.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
**(Unaudited)**

**NOTE 5**
**PURCHASED CREDIT IMPAIRED LOANS**

Purchased Credit Impaired Loans are included in NOTE 4. LOANS AND ALLOWANCE, in the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q. As described in NOTE 4, purchased loans 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 for 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 nonaccretable difference. 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.

The carrying amount of Purchased Credit Impaired Loans as of June 30, 2019 and December 31, 2018 was \$15.9 million and \$17.3 million, respectively; with no required allowance for loan losses. As customer cash flow expectations improve, nonaccretable yield can be reclassified to accretable yield. The accretable yield, or income expected to be collected, and reclassifications from nonaccretable, are identified in the table below.

	Three Months Ended June 30, 2019	Six Months Ended June 30, 2019
Accretable yield beginning balance	\$ 2,064	\$ 2,143
Additions	—	—
Accretion	(638)	(1,218)
Reclassification from nonaccretable	488	989
Disposals	—	—
Accretable yield ending balance	<u>\$ 1,914</u>	<u>\$ 1,914</u>

  

	Three Months Ended June 30, 2018	Six Months Ended June 30, 2018
Accretable yield beginning balance	\$ 2,675	\$ 2,890
Additions	—	—
Accretion	(927)	(1,437)
Reclassification from nonaccretable	675	970
Disposals	—	—
Accretable yield ending balance	<u>\$ 2,423</u>	<u>\$ 2,423</u>

There were no loans acquired during the six months ended June 30, 2019 and 2018, for which it was probable that all contractually required payments would not be collected.

**NOTE 6**
**OTHER INTANGIBLES**

Core deposit intangibles and other intangibles are recorded on the acquisition date of an entity. The carrying basis and accumulated amortization of recognized core deposit intangibles and other intangibles are noted below.

	June 30, 2019	December 31, 2018
Gross carrying amount	\$ 85,869	\$ 85,869
Accumulated amortization	(64,488)	(61,440)
Total other intangibles	<u>\$ 21,381</u>	<u>\$ 24,429</u>

The core deposit intangibles and other intangibles are being amortized primarily on an accelerated basis over their estimated useful lives, generally over a period of two to ten years. Estimated future amortization expense is summarized as follows:

	Amortization Expense
2019	\$ 2,121
2020	3,632
2021	3,427
2022	3,325
2023	3,175
After 2023	5,701
	<u>\$ 21,381</u>

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

**NOTE 7**
**LEASES**

The Corporation adopted ASU No. 2016-02 - *Leases (Topic 842)*, as amended, as of January 1, 2019 for certain retail branches, office space, land and equipment. The Corporation elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allowed the Corporation to carry forward the historical lease classification. Operating leases are included in the operating lease right-of use ("ROU") asset, which is included in other assets and the lease liability is included in other liabilities in our condensed balance sheets. The Corporation does not have any finance leases.

ROU assets represent the Corporation's right to use an underlying asset for the lease term and lease liabilities represent the Corporation's obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. As most of the Corporation's leases do not provide an implicit rate, the Corporation typically uses its incremental borrowing rate based on information available at commencement date in determining the present value of lease payments. Lease terms may include options to extend or terminate the lease. The exercise of such lease renewal options is at the Corporation's sole discretion and is not included in the present value of lease obligations unless it is reasonably certain that the option will be exercised. The depreciable life of assets and leasehold improvements are limited by the expected lease term, unless there is a transfer of title or purchase option reasonably certain of exercise. Certain of the Corporation's lease agreements include rental payments adjusted periodically for inflation. The Corporation's lease agreements do not contain any material residual value guarantees or material restrictive covenants.

Supplemental balance sheet information related to leases is presented in the table below as of June 30, 2019.

	June 30, 2019
Operating lease assets	\$ 21,968
Total lease assets	\$ 21,968
Operating lease liabilities	\$ 22,603
Total Lease liabilities	\$ 22,603
Weighted average remaining lease term (years)	
Operating leases	9.5
Weighted average discount rate	
Operating leases	3.40%

The table below presents the components of lease expense for the periods indicated.

	Three Months Ended June 30, 2019	Six Months Ended June 30, 2019
Lease Cost:		
Operating lease cost	\$ 911	\$ 1,806
Short-term lease cost	30	73
Variable lease cost	253	511
Total lease cost	\$ 1,194	\$ 2,390

Supplemental cash flow information related to leases is presented in the tables below.

Maturity of lease liabilities	Operating Leases
Remaining 2019	\$ 1,774
2020	3,388
2021	3,114
2022	2,999
2023	2,628
2024 and after	12,771
Total lease payments	\$ 26,674
Less: Present value discount	4,071
Present value of lease liabilities	\$ 22,603
Other Information	Six Months Ended June 30, 2019
Cash paid for amounts included in the measurement of lease liabilities	
Operating cash flows from operating leases	\$ 1,634
ROU assets obtained in exchange for new operating lease liabilities	\$ 23,384

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

**NOTE 8****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 June 30, 2019, the Corporation had four interest rate swaps with a notional amount of \$46.0 million and one interest rate cap with a notional amount of \$13.0 million that were designated as cash flow hedges. As of December 31, 2018, the Corporation had four interest rate swaps with a notional amount of \$46.0 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 2019, \$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 \$20.0 million of interest rate swaps were used to hedge the variable cash outflows (LIBOR-based) associated with two Federal Home Loan Bank advances. During the six months ended June 30, 2019 and 2018, 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 \$438,000 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 June 30, 2019, the notional amount of customer-facing swaps was approximately \$548,951,000. This amount is offset with third party counterparties, as described above.

# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

### 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 June 30, 2019, and December 31, 2018.

	Asset Derivatives				Liability Derivatives			
	June 30, 2019		December 31, 2018		June 30, 2019		December 31, 2018	
	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	\$ —	Other Assets	\$ 135	Other Liabilities	\$ 1,609	Other Liabilities	\$ 688
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	\$ 25,059	Other Assets	\$ 11,948	Other Liabilities	\$ 25,059	Other Liabilities	\$ 11,948

The Corporation's derivative hedge asset and derivative hedge liability increased \$13.1 million and \$14.0 million, respectively from December 31, 2018. The increases are primarily due to a \$71.2 million increase in outstanding notional balance. Additionally, yield curve rates used for valuation purposes were lower at each term point as of June 30, 2019 compared to December 31, 2018.

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

	Amount of Gain (Loss) Recognized in Other Comprehensive Income on Derivative (Effective Portion)			
	Three Months Ended		Six Months Ended	
	June 30, 2019	June 30, 2018	June 30, 2019	June 30, 2018
Derivatives in Cash Flow Hedging Relationships				
Interest Rate Products	\$ (701)	\$ 291	\$ (1,092)	\$ 799

### Effect of Derivative Instruments on the Income Statement

The Corporation did not recognize any gains or losses from derivative financial instruments in the Consolidated Condensed Statements of Income for the three and six months ended June 30, 2019 and 2018.

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

Derivatives Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Reclassified from Other Comprehensive Income into Income (Effective Portion)	
		Three Months Ended June 30, 2019	Three Months Ended June 30, 2018
Interest rate contracts	Interest Expense	\$ (84)	\$ (105)

  

Derivatives Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Reclassified from Other Comprehensive Income into Income (Effective Portion)	
		Six Months Ended June 30, 2019	Six Months Ended June 30, 2018
Interest rate contracts	Interest Expense	\$ (143)	\$ (275)

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-market 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 adequately capitalized institution, then the Corporation could be required to terminate or fully collateralize all outstanding derivative contracts. Additionally, the Corporation has agreements with certain of its derivative counterparties that contain a provision where if the Corporation defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, then the Corporation could also be declared in default on its derivative obligations. As of June 30, 2019, the termination value of derivatives in a net liability position related to these agreements was \$26,045,000. As of June 30, 2019, the Corporation has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$28,405,000. The Corporation did not breach any of these provisions as of June 30, 2019, but if the Corporation had breached these provisions, it could have been required to settle its obligations under the agreements at their termination value.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

**NOTE 9****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.

**RECURRING MEASUREMENTS**

Assets and liabilities are considered to be measured at fair value on a recurring basis if fair value is measured regularly (i.e., daily, weekly, monthly or quarterly). Recurring valuation occurs at a minimum on the measurement date. Assets and liabilities are considered to be measured at fair value on a nonrecurring basis if the fair value measurement of the instrument does not necessarily result in a change in the amount recorded on the balance sheet. Generally, nonrecurring valuation is the result of the application of other accounting pronouncements which require assets or liabilities to be assessed for impairment or recorded at the lower of cost or fair value. The fair value of assets or liabilities transferred in or out of Level 3 is measured on the transfer date, with any additional changes in fair value subsequent to the transfer considered to be realized or unrealized gains or losses.

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

*Investment Securities*

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. The Corporation currently has no securities classified within Level 1 of the hierarchy. Where significant observable inputs, other than Level 1 quoted prices, are available, securities are classified within Level 2 of the valuation hierarchy. Level 2 securities include government-sponsored agency and mortgage backs and state and municipal securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy and include state and municipal, government-sponsored mortgage backs and corporate obligations securities. Level 3 fair value for 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 (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.



# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

### Interest Rate Derivative Agreements

See information regarding the Corporation's interest rate derivative products in NOTE 8. DERIVATIVE FINANCIAL INSTRUMENTS of these Notes to Consolidated Condensed Financial Statements. The following table presents the fair value measurements of assets and liabilities recognized in the accompanying balance sheets measured at fair value on a recurring basis and the level within the ASC 820-10 fair value hierarchy in which the fair value measurements fall at June 30, 2019, and December 31, 2018.

June 30, 2019	Fair Value Measurements Using:			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$ 33,947	\$ —	\$ 33,947	\$ —
State and municipal	715,758	—	712,818	2,940
U.S. Government-sponsored mortgage-backed securities	650,223	—	650,219	4
Corporate obligations	31	—	—	31
Interest rate swap asset	25,059	—	25,059	—
Interest rate swap liability	26,668	—	26,668	—

December 31, 2018	Fair Value Measurements Using:			
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$ 13,582	\$ —	\$ 13,582	\$ —
State and municipal	606,135	—	602,842	3,293
U.S. Government-sponsored mortgage-backed securities	522,447	—	522,443	4
Corporate obligations	31	—	—	31
Interest rate swap and cap asset	12,083	—	12,083	—
Interest rate swap liability	12,636	—	12,636	—

There were no gains or losses included in earnings that were attributable to the changes in unrealized gains or losses related to assets or liabilities held at June 30, 2019 or December 31, 2018.

### Level 3 Reconciliation

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the accompanying balance sheets using significant unobservable Level 3 inputs for the three and six months ended June 30, 2019 and 2018.

	Available for Sale Securities			
	Three Months Ended		Six Months Ended	
	June 30, 2019	June 30, 2018	June 30, 2019	June 30, 2018
Balance at beginning of the period	\$ 2,936	\$ 3,966	\$ 3,328	\$ 3,978
Included in other comprehensive income	37	1	80	(24)
Principal payments	2	3	(433)	16
Ending balance	<u>\$ 2,975</u>	<u>\$ 3,970</u>	<u>\$ 2,975</u>	<u>\$ 3,970</u>

### Transfers Between Levels

There were no transfers in or out of Level 3 for the three and six months ended June 30, 2019 and 2018.

# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

### Nonrecurring Measurements

Following is a description of valuation methodologies used for instruments measured at fair value on a non-recurring basis and recognized in the accompanying balance sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy for June 30, 2019, and December 31, 2018.

		Fair Value Measurements Using			
June 30, 2019	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)	\$ 12,966	\$ —	\$ —	\$ —	12,966
Other real estate owned	174	—	—	—	174

		Fair Value Measurements Using			
December 31, 2018	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)	\$ 11,866	\$ —	\$ —	\$ —	11,866
Other real estate owned	657	—	—	—	657

#### 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 2018 and 2019, 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 discounted 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.

### 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 June 30, 2019 and December 31, 2018.

June 30, 2019	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
State and municipal securities	\$ 2,940	Discounted cash flow	Maturity/Call date US Muni BQ curve Discount rate	1 month to 15 yrs A- to BBB- 2% - 5%
Corporate obligations and U.S. Government-sponsored mortgage backed securities	\$ 35	Discounted cash flow	Risk free rate plus premium for illiquidity	3 month LIBOR plus 200bps
Impaired loans (collateral dependent)	\$ 12,966	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 10% (4%)
Other real estate owned	\$ 174	Appraisals	Discount to reflect current market conditions	0% - 51% (30%)

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

December 31, 2018	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
State and municipal securities	\$ 3,293	Discounted cash flow	Maturity/Call date US Muni BQ curve Discount rate	1 month to 20 yrs A- to BBB- .69% - 5%
Corporate obligations and equity securities	\$ 35	Discounted cash flow	Risk free rate plus premium for illiquidity	3 month LIBOR plus 200bps
Impaired loans (collateral dependent)	\$ 11,866	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 10% (6%)
Other real estate owned	\$ 657	Appraisals	Discount to reflect current market conditions	0% - 10% (4%)

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 how those inputs might magnify or mitigate the effect of changes in the unobservable inputs on the fair value measurement.

*State and Municipal Securities, Corporate Obligations and U.S. Government-sponsored Mortgage Backed Securities*

The significant unobservable inputs used in the fair value measurement of the Corporation's state and municipal securities, corporate obligations and U.S. Government-sponsored mortgage backed 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.

**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 June 30, 2019, and December 31, 2018.

June 30, 2019					
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	Carrying Amount	(Level 1)	(Level 2)	(Level 3)	
Assets:					
Cash and cash equivalents	\$ 128,185	\$ 128,185	\$ —	\$ —	
Interest-bearing time deposits	129,614	129,614	—	—	
Investment securities available for sale	1,399,959	—	1,396,984	2,975	
Investment securities held to maturity	692,965	—	701,905	7,010	
Loans held for sale	5,854	—	5,854	—	
Loans	7,430,096	—	—	7,408,511	
Federal Home Loan Bank stock	24,588	—	24,588	—	
Interest rate swap asset	25,059	—	25,059	—	
Interest receivable	45,150	—	45,150	—	
Liabilities:					
Deposits	\$ 8,319,328	\$ 6,688,194	\$ 1,627,381	\$ —	
Borrowings:					
Federal funds purchased	75,000	—	75,000	—	
Securities sold under repurchase agreements	119,674	—	119,488	—	
Federal Home Loan Bank advances	460,042	—	461,582	—	
Subordinated debentures and term loans	138,574	—	127,594	—	
Interest rate swap liability	26,668	—	26,668	—	
Interest payable	6,740	—	6,740	—	

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

December 31, 2018					
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	Carrying Amount	(Level 1)	(Level 2)	(Level 3)	
Assets:					
Cash and cash equivalents	\$ 139,247	\$ 139,247	\$ —	\$ —	
Interest-bearing time deposits	36,963	36,963	—	—	
Investment securities available for sale	1,142,195	—	1,138,867	3,328	
Investment securities held to maturity	490,387	—	481,377	7,840	
Loans held for sale	4,778	—	4,778	—	
Loans	7,143,915	—	—	7,004,193	
Federal Home Loan Bank stock	24,588	—	24,588	—	
Interest rate swap and cap asset	12,083	—	12,083	—	
Interest receivable	40,881	—	40,881	—	
Liabilities:					
Deposits	\$ 7,754,593	\$ 6,267,879	\$ 1,464,129	\$ —	
Borrowings:					
Federal funds purchased	104,000	—	104,000	—	
Securities sold under repurchase agreements	113,512	—	113,437	—	
Federal Home Loan Bank advances	314,986	—	318,728	—	
Subordinated debentures and term loans	138,463	—	127,298	—	
Interest rate swap liability	12,636	—	12,636	—	
Interest payable	5,607	—	5,607	—	

**NOTE 10**

**TRANSFERS ACCOUNTED FOR AS SECURED BORROWINGS**

The collateral pledged for all repurchase agreements that are accounted for as secured borrowings as of June 30, 2019 and December 31, 2018 were:

June 30, 2019					
	Remaining Contractual Maturity of the Agreements				
	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
U.S. Government-sponsored mortgage-backed securities	\$ 110,233	\$ —	\$ —	\$ 9,441	\$ 119,674

  

December 31, 2018					
	Remaining Contractual Maturity of the Agreements				
	Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
U.S. Government-sponsored mortgage-backed securities	\$ 104,883	\$ 1,014	\$ 7,615	\$ —	\$ 113,512

# PART I. FINANCIAL INFORMATION

## ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

### NOTE 11

#### 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 June 30, 2019 and 2018:

	Accumulated Other Comprehensive Income (Loss)			
	Unrealized Gains (Losses) on Securities Available for Sale	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total
Balance at December 31, 2018	\$ (6,343)	\$ (559)	\$ (14,520)	\$ (21,422)
Other comprehensive income before reclassifications	39,130	(862)	—	38,268
Amounts reclassified from accumulated other comprehensive income	(2,357)	113	—	(2,244)
Period change	36,773	(749)	—	36,024
Balance at June 30, 2019	<u>\$ 30,430</u>	<u>\$ (1,308)</u>	<u>\$ (14,520)</u>	<u>\$ 14,602</u>
Balance at December 31, 2017	\$ 8,970	\$ (1,125)	\$ (10,753)	\$ (2,908)
Other comprehensive income before reclassifications	(20,268)	874	—	(19,394)
Amounts reclassified from accumulated other comprehensive income	(2,157)	217	—	(1,940)
Period change	(22,425)	1,091	—	(21,334)
Reclassification adjustment under ASU 2018-02	1,932	(242)	(2,316)	(626)
Balance at June 30, 2018	<u>\$ (11,523)</u>	<u>\$ (276)</u>	<u>\$ (13,069)</u>	<u>\$ (24,868)</u>

The following tables present 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 six months ended June 30, 2019 and 2018.

Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Three Months Ended June 30,			
Details about Accumulated Other Comprehensive Income (Loss) Components	2019	2018	Affected Line Item in the Statements of Income
Unrealized gains (losses) on available for sale securities <sup>(1)</sup>			
Realized securities gains reclassified into income	\$ 1,843	\$ 1,122	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(387)	(236)	Income tax expense
	<u>\$ 1,456</u>	<u>\$ 886</u>	
Unrealized gains (losses) on cash flow hedges <sup>(2)</sup>			
Interest rate contracts	\$ (84)	\$ (105)	Interest expense - subordinated debentures and term loans
Related income tax benefit	18	22	Income tax expense
	<u>\$ (66)</u>	<u>\$ (83)</u>	
Total reclassifications for the period, net of tax	<u>\$ 1,390</u>	<u>\$ 803</u>	
Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Six Months Ended June 30,			
Details about Accumulated Other Comprehensive Income (Loss) Components	2019	2018	Affected Line Item in the Statements of Income
Unrealized gains (losses) on available for sale securities <sup>(1)</sup>			
Realized securities gains reclassified into income	\$ 2,983	\$ 2,731	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(626)	(574)	Income tax expense
	<u>\$ 2,357</u>	<u>\$ 2,157</u>	
Unrealized gains (losses) on cash flow hedges <sup>(2)</sup>			
Interest rate contracts	\$ (143)	\$ (275)	Interest expense - subordinated debentures and term loans
Related income tax benefit	30	58	Income tax expense
	<u>\$ (113)</u>	<u>\$ (217)</u>	
Total reclassifications for the period, net of tax	<u>\$ 2,244</u>	<u>\$ 1,940</u>	

<sup>(1)</sup> 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 of these Notes to Consolidated Condensed Financial Statements.

<sup>(2)</sup> For additional detail related to unrealized gains (losses) on cash flow hedges and related amounts reclassified from accumulated other comprehensive income see NOTE 8. DERIVATIVE FINANCIAL INSTRUMENTS of these Notes to Consolidated Condensed Financial Statements.



**PART I. FINANCIAL INFORMATION**

**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**

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

*(Unaudited)*

**NOTE 12**
**SHARE-BASED COMPENSATION**

Stock options and RSAs have been issued to directors, officers and other management employees under the Corporation's 2009 Long-term Equity Incentive Plan, the 2019 Long-term Equity Incentive Plan, and the Equity Compensation Plan for Non-Employee Directors. The stock options, which have a ten year life, become 100 percent vested based on time ranging from one year 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. The RSAs issued to employees and non-employee directors provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after 3 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. For non-employee directors, the RSAs vest only if the non-employee director remains as an active board member on the vesting date and, therefore, any unvested shares are forfeited. The RSAs for employees and non-employee directors are either immediately vested at retirement, disability or death, or, continue to vest after retirement, disability or death, depending on the plan under which the shares were granted.

The Corporation's 2009 ESPP and 2019 ESPP provide 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. The 2009 ESPP expired on June 30, 2019.

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 six months ended June 30, 2019 was \$844,000 and \$1,825,000, respectively, compared to \$776,000 and \$1,653,000, respectively, for the three and six months ended June 30, 2018. Share-based compensation has been recognized as a component of salaries and benefits expense in the accompanying Consolidated Condensed Statements of Income.

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 1.7 percent for the six months ended June 30, 2019, based on historical experience.

The following table summarizes the components of the Corporation's share-based compensation awards recorded as an expense and the income tax benefit of such awards.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<b>Stock and ESPP Options</b>				
Pre-tax compensation expense	\$ 25	\$ 24	\$ 36	\$ 49
Income tax benefit	(41)	(80)	(57)	(138)
Stock and ESPP option expense, net of income taxes	<u>\$ (16)</u>	<u>\$ (56)</u>	<u>\$ (21)</u>	<u>\$ (89)</u>
<b>Restricted Stock Awards</b>				
Pre-tax compensation expense	\$ 819	\$ 752	\$ 1,789	\$ 1,604
Income tax benefit	(186)	(181)	(726)	(747)
Restricted stock awards expense, net of income taxes	<u>\$ 633</u>	<u>\$ 571</u>	<u>\$ 1,063</u>	<u>\$ 857</u>
<b>Total Share-Based Compensation</b>				
Pre-tax compensation expense	\$ 844	\$ 776	\$ 1,825	\$ 1,653
Income tax benefit	(227)	(261)	(783)	(885)
Total share-based compensation expense, net of income taxes	<u>\$ 617</u>	<u>\$ 515</u>	<u>\$ 1,042</u>	<u>\$ 768</u>

As of June 30, 2019, unrecognized compensation expense related to RSAs was \$5,431,000 and is expected to be recognized over a weighted-average period of 1.54 years. The Corporation did not have any unrecognized compensation expense related to stock options as of June 30, 2019.

**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

Stock option activity under the Corporation's stock option plans as of June 30, 2019 and changes during the six months ended June 30, 2019, were as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2019	76,300	\$ 12.40		
Exercised	(11,200)	\$ 9.34		
Cancelled	—	\$ —		
Outstanding June 30, 2019	65,100	\$ 12.92	2.77	\$ 1,625,958
Vested and Expected to Vest at June 30, 2019	65,100	\$ 12.92	2.77	\$ 1,625,958
Exercisable at June 30, 2019	65,100	\$ 12.92	2.77	\$ 1,625,958

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 six months of 2019 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 June 30, 2019. 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 six months ended June 30, 2019 and 2018 was \$308,000 and \$1,038,000, respectively. Cash receipts of stock options exercised during this same period were \$105,000 and \$953,000, respectively.

The following table summarizes information on unvested RSAs outstanding as of June 30, 2019:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2019	344,362	\$ 36.80
Granted	7,034	\$ 37.78
Vested	(108,638)	\$ 23.48
Forfeited	(1,900)	\$ 40.54
Unvested RSAs at June 30, 2019	240,858	\$ 42.81

The grant date fair value of ESPP options was estimated to be \$25,000 at the beginning of the April 1, 2019 quarterly offering period. The ESPP options vested during the three months ending June 30, 2019, leaving no unrecognized compensation expense related to unvested ESPP options at June 30, 2019.

## NOTE 13

### INCOME TAX

The following table summarizes the major components creating differences between income taxes at the federal statutory and the effective tax rate recorded in the consolidated statements of income for the three and six months ended June 30, 2019 and 2018:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
Reconciliation of Federal Statutory to Actual Tax Expense:				
Federal statutory income tax at 21%	\$ 10,249	\$ 9,995	\$ 19,858	\$ 19,086
Tax-exempt interest income	(2,403)	(2,045)	(4,670)	(4,060)
Share-based compensation	(41)	(91)	(391)	(532)
Tax-exempt earnings and gains on life insurance	(199)	(211)	(406)	(458)
Tax credits	(63)	(62)	(141)	(23)
Other	206	375	440	559
Actual Tax Expense	\$ 7,749	\$ 7,961	\$ 14,690	\$ 14,572
Effective Tax Rate	15.9%	16.7%	15.5%	16.0%



**PART I. FINANCIAL INFORMATION**  
**ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS**  
*(table dollar amounts in thousands, except share data)*  
*(Unaudited)*

**NOTE 14**
**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 the weighted-average shares outstanding during the reporting period and all potentially dilutive common shares. Potentially dilutive common shares include stock options and RSAs issued under the Corporation's share-based compensation plans. Potentially dilutive common shares are excluded from the computation of diluted earnings per share in the periods where the effect would be antidilutive.

The following table reconciles basic and diluted net income per share for the three and six months ended June 30, 2019 and 2018.

Three Months Ended June 30,						
	2019			2018		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Net income available to common stockholders	\$ 41,056	49,432,167	\$ 0.83	\$ 39,634	49,252,580	\$ 0.80
Effect of potentially dilutive stock options and restricted stock awards		117,720			198,826	
Diluted net income per share	\$ 41,056	49,549,887	\$ 0.83	\$ 39,634	49,451,406	\$ 0.80

  

Six Months Ended June 30,						
	2019			2018		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Net income available to common stockholders	\$ 79,873	49,400,770	\$ 1.62	\$ 76,313	49,222,779	\$ 1.55
Effect of potentially dilutive stock options and restricted stock awards		144,382			217,266	
Diluted net income per share	\$ 79,873	49,545,152	\$ 1.61	\$ 76,313	49,440,045	\$ 1.54

For the three and six months ended June 30, 2019 and 2018, there were no stock options with an option price greater than the average market price of the common shares.

**NOTE 15**
**GENERAL LITIGATION AND REGULATORY EXAMINATIONS**

The Corporation is subject to claims and lawsuits that arise primarily in the ordinary course of business. Additionally, the Corporation is subject to periodic examinations by various regulatory agencies. It is the general opinion of management that the disposition or ultimate resolution of such claims, lawsuits, and examinations will not have a material adverse effect on the consolidated financial position, results of operations and cash flow of the Corporation.

A discussion of the Bank's Settlement Agreement and Agreed Order with the United States Department of Justice is contained in the "REGULATORY DEVELOPMENTS" section of Part I, Item 2. Management's Discussion & Analysis of this Quarterly Report on Form 10-Q.

## ***PART I: FINANCIAL INFORMATION***

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

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

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

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

- fluctuations in market rates of interest and loan and deposit pricing, which could negatively affect our net interest margin, asset valuations and expense expectations;
- adverse changes in the economy, which might affect our business prospects and could cause credit-related losses and expenses;
- adverse developments in our loan and investment portfolios;
- competitive factors in the banking industry, such as the trend towards consolidation in our market;
- changes in the banking legislation or the regulatory requirements of federal and state agencies applicable to bank holding companies and banks like our affiliate bank;
- acquisitions of other businesses by us and integration of such acquired businesses;
- our ability to implement and comply with the Settlement Agreement and Agreed Order entered into with the United States Department of Justice (DOJ) related to our fair lending practices;
- 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, 2018. 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 six months ended June 30, 2019, 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, 2018.

## **PART I: FINANCIAL INFORMATION**

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

### **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 (the "Bank"), which opened for business in Muncie, Indiana, in March 1893. The Bank also operates First Merchants Private Wealth Advisors (a division of First Merchants Bank). The Bank includes 110 banking locations in thirty Indiana, two Illinois and two Ohio counties. In addition to its traditional branch network, the Corporation offers comprehensive electronic and mobile delivery channels to its customers. 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, savings and demand deposits; making consumer, commercial, agri-business and real estate mortgage loans; providing personal and corporate trust services; offering full-service brokerage and private wealth management; and providing letters of credit, repurchase agreements and other corporate services.

### **REQUIREMENTS FOR BANK HOLDING COMPANIES WITH \$10 BILLION OR MORE IN ASSETS**

Various federal banking laws and regulations, including rules adopted by the Federal Reserve pursuant to the requirements of the Dodd-Frank Act, impose heightened requirements on certain large banks and bank holding companies. Most of these rules apply primarily to bank holding companies with at least \$50 billion in total consolidated assets, but certain rules also apply to banks and bank holding companies with at least \$10 billion in total consolidated assets. As of March 31, 2019, the Corporation, for the first time, exceeded the \$10 billion threshold.

Following the fourth consecutive quarter (and any applicable phase-in period) where the Corporation's or the Bank's total consolidated assets, as applicable, equal or exceed \$10 billion, the Corporation or the Bank, as applicable, will, among other requirements:

- calculate the FDIC deposit assessment base using a performance score and a loss-severity scoring system; and
- be examined for compliance with federal consumer protection laws primarily by the Consumer Financial Protection Bureau.

Additionally, on July 21, 2010, President Obama signed the Dodd-Frank Act into law. The Dodd-Frank Act has had a broad impact on the financial services industry, including significant regulatory and compliance changes. Although most of the required regulations of the Dodd-Frank Act have been promulgated and implemented (or are being implemented over time), there are additional regulations yet to be finalized by the authorized federal agencies. The changes resulting from the Dodd-Frank Act have impacted the profitability of the Corporation's business activities, required changes to certain business practices, and imposed more stringent capital, liquidity and leverage requirements, and, when fully implemented, may further adversely affect the Corporation's business. Among other things, the Dodd-Frank Act has resulted in:

- increases to the cost of the Corporation's operations due to greater regulatory oversight, supervision and examination of banks and bank holding companies, including higher deposit insurance premiums;
- limitations on the Corporation's ability to raise additional capital through the use of trust preferred securities, as new issuances of these securities may no longer be included as Tier 1 capital;
- reduced flexibility for the Corporation to generate or originate certain revenue-producing assets based on increased regulatory capital standards; and
- limitations on the Corporation's ability to expand consumer product and service offerings due to stricter consumer protection laws and regulations.
- as the Corporation's assets have now exceeded \$10 billion, compliance with the Durbin Amendment will result in a material reduction of interchange fee income paid by merchants when debit cards are used as payment.

The Corporation's management continues to take the steps necessary to minimize the adverse impact of the Dodd-Frank Act on its business, financial condition and results of operation.

### **RESULTS OF OPERATIONS**

#### *Executive Summary*

The Corporation reported second quarter 2019 net income of \$41.1 million, compared to \$39.6 million during the second quarter of 2018. Diluted earnings per share for the period totaled \$0.83 per share, compared to \$0.80 per diluted share during the same period in 2018, an increase of 3.8 percent. Year-to-date income totaled \$79.9 million, compared to \$76.3 million during the same period in 2018. Diluted earnings per share for the six months ended June 30, 2019 totaled \$1.61, an increase of 4.5 percent, over the same period in 2018.

As of June 30, 2019, total assets equaled \$10.7 billion, an increase of \$853.1 million, or 8.6 percent from December 31, 2018. Interest-bearing time deposits and total investment securities increased \$92.7 million and \$460.3 million, respectively, from December 31, 2018 as excess liquidity generated from deposit growth was used to invest in the bond portfolio and loans. The Corporation's total loan portfolio increased \$288.0 million, or 8.0 percent annualized, from December 31, 2018. The largest loan segments that experienced increases were commercial and industrial, construction, and public finance and other commercial loans. The largest loan segments that experienced decreases were commercial and farmland real estate loans and agricultural production financing and other loans to farmers. Additional details of the changes in the Corporation's loans and other earning assets are discussed within NOTE 4. LOANS AND ALLOWANCE, of the Notes to Consolidated Condensed Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q, and the "EARNING ASSETS" section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.

**PART I: FINANCIAL INFORMATION**

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

The Corporation's allowance for loan losses totaled \$81.3 million as of June 30, 2019 and equaled 1.08 percent of total loans. The Corporation's provision expense and net charge offs for the three months ended June 30, 2019 were \$500,000 and \$128,000, respectively, compared to provision expense and net charge offs of \$1.7 million and \$540,000, respectively, during the same period of 2018. For the six months ended June 30, 2019, the Corporation's provision expense and net charge offs were \$1.7 million and \$978,000, respectively, compared to provision expense and net charge offs of \$4.2 million and \$1.7 million, respectively, during the same period in 2018. Credit metrics continue to improve and are discussed within the "LOAN QUALITY/PROVISION FOR LOAN LOSSES" section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.

The Corporation's tax asset, deferred and receivable, equaled \$12.3 million as of June 30, 2019 and decreased \$11.3 million from December 31, 2018. At December 31, 2018, the Corporation's available for sale investment portfolio had an unrealized loss of \$7.5 million, compared to an unrealized gain at June 30, 2019 of \$39.0 million. The change in unrealized gains/losses from December 31, 2018 to June 30, 2019 is primarily due to the changes in interest rates. The longer term points on the yield curve have declined since year-end which increases the fair value of securities held in the portfolio. This change resulted in a deferred tax asset of \$1.6 million at December 31, 2018 changing to a deferred tax liability at June 30, 2019 of \$8.2 million.

The Corporation's other assets increased \$35.5 million from December 31, 2018 primarily due to implementation of new lease accounting guidance in ASU 2016-02, *Leases (Topic 842)*, associated with the Corporation's leased banking center locations. As of June 30, 2019, the Corporation's right of use asset (recorded in other assets) was \$22.0 million and the lease liability (recorded in other liabilities) was \$22.6 million. The new lease accounting guidance and lease disclosures are discussed within NOTE 1. GENERAL and NOTE 7. LEASES, of the Notes to Consolidated Condensed Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q.

Additionally, the Corporation's derivative hedge asset (recorded in other assets) and derivative hedge liability (recorded in other liabilities), related to the Corporation's interest rate swaps with commercial banking customers, which are simultaneously hedged by offsetting interest rate swaps with a third party, increased \$13.1 million and \$14.0 million, respectively from December 31, 2018. The increases were primarily due to a \$71.2 million increase in outstanding notional balance and yield curve rates used for valuation purposes were lower at each term point as of June 30, 2019 compared to December 31, 2018.

As of June 30, 2019, total deposits equaled \$8.3 billion, an increase of \$564.7 million from December 31, 2018, or 14.6 percent annualized. As interest rates have risen, the Corporation experienced a decrease in non-interest bearing deposits, which were offset by increases in interest-bearing deposits. Deposit increases from December 31, 2018 were in interest-bearing checking and money market accounts of \$324.3 million, certificates of deposit of \$209.7 million and savings deposits of \$76.0 million. Those increases were offset by a \$45.2 million decrease in brokered deposits from December 31, 2018.

Total borrowings increased \$122.3 million as of June 30, 2019, compared to December 31, 2018. Federal Home Loan Bank advances increased \$145.1 million compared to December 31, 2018. Offsetting the increase in Federal Home Loan Bank advances, was a reduction in Federal funds purchased of \$29.0 million compared to December 31, 2018.

The Corporation's other liabilities as of June 30, 2019 increased \$71.6 million compared to December 31, 2018. At June 30, 2019, the Corporation accrued \$40.6 million for trade date accounting related to investment securities purchases. Also as a result of the implementation of the new lease accounting guidance noted above, the Corporation's lease liability totaled \$22.6 million at June 30, 2019. Additionally, as noted above, the Corporation's derivative hedge liability increased by \$14.0 million from December 31, 2018.

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 this Management's Discussion and Analysis of Financial Condition and Results of Operations.

## **PART I: FINANCIAL INFORMATION**

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

#### **NET INTEREST INCOME**

Net interest income is the most significant component of our earnings, comprising 81 percent of revenues for the six months ended June 30, 2019. Net interest income and margin are influenced by many factors, primarily the volume and mix of earnings assets, funding sources, and interest rate fluctuations. Other factors include the level of accretion income on purchased loans, prepayment risk on mortgage and investment-related assets, and the composition and maturity of earning assets and interest-bearing liabilities. Loans typically generate more interest income than investment securities with similar maturities. Funding from customer deposits generally costs less than wholesale funding sources. Factors such as general economic activity, Federal Reserve Board monetary policy, and price volatility of competing alternative investments, can also exert significant influence on our ability to optimize the mix of assets and funding and the net interest income and margin.

Net interest income is the excess of interest received from earning assets over interest paid on interest-bearing liabilities. For analytical purposes, net interest income is also presented on an FTE basis in the tables that follow to reflect what tax-exempt assets would need to yield in order to achieve the same after-tax yield as a taxable asset. The federal statutory rate of 21 percent was used for 2019 and 2018, adjusted for the TEFRA interest disallowance applicable to certain tax-exempt obligations. The FTE analysis portrays the income tax benefits associated with tax-exempt assets and helps to facilitate a comparison between taxable and tax-exempt assets. Management believes that it is a standard practice in the banking industry to present net interest margin and net interest income on a fully taxable equivalent basis. Therefore, management believes these measures provide useful information for both management and investors by allowing them to make peer comparisons.

For the three and six months ended June 30, 2019, the increase in net interest income and earning assets, was primarily driven by core organic loan growth.

In the second quarter of 2019, asset yields increased 12 basis points FTE and interest costs increased 46 basis points, resulting in a 34 basis point FTE decrease in net interest spread as compared to the same period in 2018. Primarily as a result of organic loan growth and an increase in the investment securities portfolio, average earning assets increased \$777,719,000 in the second quarter of 2019 compared to the second quarter of 2018. The Corporation recognized fair value accretion income on purchased loans, which is included in interest income, of \$2,217,000 and \$3,812,000, respectively, for the three months ended June 30, 2019 and 2018. The decrease in fair value accretion in the second quarter of 2019 compared to the same period in 2018, resulted in a net interest margin decline of 9 basis points. Additionally, strong growth in institutional deposits and deployment into the bond portfolio produced earnings per share of \$0.01 for the second quarter of 2019, but negatively impacted net interest margin by 10 basis points. Net interest margin, on a tax equivalent basis, decreased to 3.71 percent for the second quarter of 2019 compared to 3.99 percent during the same period in 2018.

In the six months ended June 30, 2019, asset yields increased 22 basis points FTE and interest costs increased 47 basis points, resulting in a 25 basis point FTE decrease in net interest spread as compared to the same period in 2018. Primarily as a result of organic loan growth and an increase in the investment securities portfolio, average earning assets increased \$747,503,000 in the six months ended June 30, 2019 compared to the same period in 2018. The Corporation recognized fair value accretion income on purchased loans, which is included in interest income, of \$4,470,000 and \$6,970,000, respectively, for the six months ended June 30, 2019 and 2018. The decrease in fair value accretion for the six months ended June 30, 2019 compared to the same period in 2018, resulted in a net interest margin decline of 7 basis points. Additionally, strong growth in institutional deposits and deployment into the bond portfolio produced earnings per share of \$0.01 for the six months ended 2019, but negatively impacted net interest margin by 7 basis points. Net interest margin, on a tax equivalent basis, decreased to 3.78 percent for the six months ended June 30, 2019 compared to 3.96 percent during the same period in 2018.

Asset yields increased primarily as a result of the Federal Reserve's discount rate increases of 25 basis points at each of the Board's March, June and September 2018 meetings. Interest costs also increased as both core deposits and wholesale funding rates increased year-over-year.

# PART I: FINANCIAL INFORMATION

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

The following tables presents the Corporation's average balance sheet, interest income/interest expense, and the average rate as a percent of average earning assets/liabilities for the three months ended June 30, 2019, and 2018.

	Three Months Ended					
	June 30, 2019			June 30, 2018		
	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate
<b>Assets:</b>						
Interest-bearing time deposits	\$ 144,626	\$ 784	2.17%	\$ 142,385	\$ 633	1.78%
Federal Home Loan Bank stock	24,588	335	5.45	24,588	263	4.28
Investment Securities: <sup>(1)</sup>						
Taxable	1,054,068	6,998	2.66	852,865	5,434	2.55
Tax-Exempt <sup>(2)</sup>	910,295	9,435	4.15	745,598	7,906	4.24
Total Investment Securities	1,964,363	16,433	3.35	1,598,463	13,340	3.34
Loans held for sale	11,430	127	4.44	6,408	83	5.18
Loans: <sup>(3)</sup>						
Commercial	5,419,169	74,638	5.51	5,142,093	67,510	5.25
Real Estate Mortgage	766,528	8,686	4.53	729,681	8,792	4.82
Installment	677,133	9,373	5.54	631,897	8,278	5.24
Tax-Exempt <sup>(2)</sup>	511,055	5,372	4.20	465,658	4,597	3.95
Total Loans	7,385,315	98,196	5.32	6,975,737	89,260	5.12
Total Earning Assets	9,518,892	115,748	4.86%	8,741,173	103,496	4.74%
Net unrealized gain (loss) on securities available for sale	12,841			(13,068)		
Allowance for loan losses	(81,691)			(77,197)		
Cash and cash equivalents	130,987			132,481		
Premises and equipment	91,563			94,757		
Other assets	827,356			818,874		
<b>Total Assets</b>	<b>\$ 10,499,948</b>			<b>\$ 9,697,020</b>		
<b>Liabilities:</b>						
Interest-bearing deposits:						
Interest-bearing NOW deposits	\$ 2,935,925	\$ 8,541	1.16%	\$ 2,325,705	\$ 4,276	0.74%
Money market deposits	1,220,020	3,509	1.15	1,081,830	1,583	0.59
Savings deposits	1,164,901	2,525	0.87	1,096,003	1,332	0.49
Certificates and other time deposits	1,652,203	8,512	2.06	1,491,207	4,974	1.33
Total Interest-bearing Deposits	6,973,049	23,087	1.32	5,994,745	12,165	0.81
Borrowings	613,446	4,274	2.79	674,040	4,135	2.45
Total Interest-bearing Liabilities	7,586,495	27,361	1.44	6,668,785	16,300	0.98
Noninterest-bearing deposits	1,348,410			1,642,076		
Other liabilities	85,789			58,818		
Total Liabilities	9,020,694			8,369,679		
Stockholders' Equity	1,479,254			1,327,341		
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 10,499,948</b>	<b>27,361</b>		<b>\$ 9,697,020</b>	<b>16,300</b>	
<b>Net Interest Income (FTE)</b>		<b>\$ 88,387</b>			<b>\$ 87,196</b>	
<b>Net Interest Spread (FTE) <sup>(4)</sup></b>			3.42%			3.76%
<b>Net Interest Margin (FTE):</b>						
Interest Income (FTE) / Average Earning Assets			4.86%			4.74%
Interest Expense / Average Earning Assets			1.15%			0.75%
<b>Net Interest Margin (FTE) <sup>(5)</sup></b>			<b>3.71%</b>			<b>3.99%</b>

<sup>(1)</sup> Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments. Annualized amounts are computed utilizing a 30/360 day basis.

<sup>(2)</sup> Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 21 percent for 2019 and 2018. These totals equal \$3,109 and \$2,625 for the three months ended June 30, 2019 and 2018, respectively.

<sup>(3)</sup> Non-accruing loans have been included in the average balances.

<sup>(4)</sup> Net Interest Spread (FTE) is interest income expressed as a percentage of average earning assets minus interest expense expressed as a percentage of average interest-bearing liabilities.

<sup>(5)</sup> Net Interest Margin (FTE) is interest income expressed as a percentage of average earning assets minus interest expense expressed as a percentage of average earning assets.

# PART I: FINANCIAL INFORMATION

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

(Dollars in Thousands)

	Six Months Ended					
	June 30, 2019			June 30, 2018		
	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate
<b>Assets:</b>						
Federal Funds Sold						
Interest-bearing time deposits	\$ 145,277	\$ 1,659	2.28%	\$ 87,883	\$ 764	1.74%
Federal Reserve and Federal Home Loan Bank stock	24,588	673	5.47	24,487	667	5.45
Investment Securities: <sup>(1)</sup>						
Taxable	978,654	13,093	2.68	831,743	10,530	2.53
Tax-Exempt <sup>(2)</sup>	869,914	18,133	4.17	741,096	15,661	4.23
Total Investment Securities	1,848,568	31,226	3.38	1,572,839	26,191	3.33
Loans held for sale	10,697	239	4.47	8,515	221	5.19
Loans: <sup>(3)</sup>						
Commercial	5,364,884	147,394	5.49	5,061,717	129,663	5.12
Real Estate Mortgage	755,070	17,008	4.51	729,202	16,791	4.61
Installment	671,125	18,664	5.56	627,686	16,255	5.18
Tax-Exempt <sup>(2)</sup>	506,370	10,629	4.20	466,747	9,149	3.92
Total Loans	7,308,146	193,934	5.31	6,893,867	172,079	4.99
Total Earning Assets	9,326,579	227,492	4.88%	8,579,076	199,701	4.66%
Net unrealized gain on securities available for sale	3,963			(9,772)		
Allowance for loan losses	(81,301)			(76,528)		
Cash and cash equivalents	124,143			129,499		
Premises and equipment	92,395			95,139		
Other assets	825,426			818,360		
<b>Total Assets</b>	<b>\$ 10,291,205</b>			<b>\$ 9,535,774</b>		
<b>Liabilities:</b>						
Interest-bearing deposits:						
Interest-bearing NOW deposits	\$ 2,813,541	\$ 15,560	1.11%	\$ 2,153,878	\$ 6,965	0.65%
Money market deposits	1,179,765	6,291	1.07	1,085,740	2,858	0.53
Savings deposits	1,157,852	4,792	0.83	1,021,386	1,714	0.34
Certificates and other time deposits	1,609,130	16,038	1.99	1,488,664	9,630	1.29
Total Interest-bearing Deposits	6,760,288	42,681	1.26	5,749,668	21,167	0.74
Borrowings	624,192	8,627	2.76	760,643	8,837	2.32
Total Interest-bearing Liabilities	7,384,480	51,308	1.39	6,510,311	30,004	0.92
Noninterest-bearing deposits	1,369,832			1,646,660		
Other liabilities	82,260			60,679		
<b>Total Liabilities</b>	<b>8,836,572</b>			<b>8,217,650</b>		
Stockholders' Equity	1,454,633			1,318,124		
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 10,291,205</b>	<b>51,308</b>		<b>\$ 9,535,774</b>	<b>30,004</b>	
<b>Net Interest Income (FTE)</b>		<b>\$ 176,184</b>			<b>\$ 169,697</b>	
<b>Net Interest Spread (FTE) <sup>(4)</sup></b>			<b>3.49%</b>			<b>3.74%</b>
<b>Net Interest Margin (FTE):</b>						
Interest Income (FTE) / Average Earning Assets			4.88%			4.66%
Interest Expense / Average Earning Assets			1.10%			0.70%
<b>Net Interest Margin (FTE) <sup>(5)</sup></b>			<b>3.78%</b>			<b>3.96%</b>

<sup>(1)</sup> Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments. Annualized amounts are computed utilizing a 30/360 day basis.

<sup>(2)</sup> Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 21 percent for 2019 and 2018. These totals equal \$6,040 and \$5,210 for the six months ended June 30, 2019 and 2018, respectively.

<sup>(3)</sup> Non-accruing loans have been included in the average balances.

<sup>(4)</sup> Net Interest Spread (FTE) is interest income expressed as a percentage of average earning assets minus interest expense expressed as a percentage of average interest-bearing liabilities.

<sup>(5)</sup> Net Interest Margin (FTE) is interest income expressed as a percentage of average earning assets minus interest expense expressed as a percentage of average earning assets.

## ***PART I: FINANCIAL INFORMATION***

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

#### **NON-INTEREST INCOME**

Non-interest income increased \$3.4 million, or 18.8 percent, in the second quarter of 2019, compared to the second quarter of 2018. The Corporation experienced increases in customer related line items of \$2.4 million primarily driven by \$1.3 million of derivative hedge fee growth. Additional increases totaling \$1.1 million were noted in net realized gains on sales of available for sale securities and other income when compared to the second quarter of 2018.

During the first six months of 2019, non-interest income increased \$2.6 million, or 6.8 percent, over the same period in 2018. Customer related line items increased \$2.4 million primarily driven by \$1.2 million derivative hedge fee growth in the first six months of 2019 when compared to the same period in 2018. Additional increases totaling \$461,000 were noted in net realized gains on sales of available securities and other income when compared to the first six months of 2018.

#### **NON-INTEREST EXPENSE**

Non-interest expense increased \$4.1 million, or 7.6 percent, in the second quarter of 2019, compared to the second quarter of 2018. Increases totaling \$1.7 million were noted in professional and other outside services, equipment and other real estate owned and foreclosure expenses when compared to the same period of 2018. Marketing expense increased \$1.3 million in the second quarter of 2019, compared to the second quarter of 2018, due to fair lending settlement expenses. Additional details of the fair lending settlement expenses are discussed in the "REGULATORY DEVELOPMENTS" section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.

Additionally, customer related line items primarily driven by outside data processing fees increased \$588,000 due to growth in our customer base when compared to the second quarter of 2018.

During the first six months of 2019, non-interest expense increased \$7.0 million, or 6.5 percent, over the same period in 2018. Increases totaling \$2.8 million were noted in other real estate owned and foreclosure expense, professional and other outside services and equipment software contracts over the same period in 2018. Additionally, customer related line items, driven by outside data processing fees and net occupancy increased \$1.2 million and \$478,000 due to growth in our customer base over the same period in 2018. Marketing expense increased \$1.5 million in the first six months of 2019, compared to the same period in 2018, due to fair lending settlement expenses. Salaries and employee benefits increased \$1.3 million in the first six months of 2019 primarily due to annual employee merit increases when compared to the first six months of 2018.

#### **INCOME TAXES**

Income tax expense for the second quarter of 2019 was \$7,749,000 on pre-tax net income of \$48,805,000. For the same period in 2018, income tax expense was \$7,961,000 on pre-tax net income of \$47,595,000. The effective income tax rates for the second quarter of 2019 and 2018 were 15.9 percent and 16.7 percent, respectively.

Income tax expense for the six months ended June 30, 2019 was \$14,690,000 on pre-tax net income of \$94,563,000. For the same period in 2018, income tax expense was \$14,572,000 on pre-tax net income of \$90,885,000. The effective income tax rates for the six months ended June 30, 2019 and 2018 were 15.5 percent and 16.0 percent, respectively.

The lower effective income tax rates during the three and six months ended June 30, 2019 when compared to the same periods in 2018 were primarily the result of an increase in tax-exempt interest income.

The detailed reconciliation of federal statutory to actual tax expense is shown in NOTE 13. INCOME TAX of the Notes to Consolidated Condensed Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q.

#### **CAPITAL**

Capital adequacy is an important indicator of financial stability and performance. The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by four ratios that are calculated according to the regulations: total risk-based capital, tier 1 risk-based capital, CET1, and tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios.

There are five capital categories defined in the regulations, ranging from well capitalized to critically undercapitalized. Classification of a bank in any of the undercapitalized categories can result in actions by regulators that could have a material effect on a bank's operations. Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of total and tier 1 capital to risk-weighted assets, and of tier 1 capital to average assets, or leverage ratio, all of which are calculated as defined in the regulations. Banks with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual levels. The appropriate federal regulatory agency may also downgrade a bank to the next lower capital category upon a determination that the bank is in an unsafe or unsound practice. Banks are required to monitor closely their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category.

Basel III was effective for the Corporation on January 1, 2015. Basel III requires the Corporation and the Bank to maintain a minimum ratio of CET1 capital to risk weighted assets, as defined in the regulation. Under the new Basel III rules, in order to avoid limitations on capital distributions, including dividends, the Corporation must hold a capital conservation buffer above the adequately capitalized CET1 capital to risk-weighted assets ratio. The capital conservation buffer was phased in from zero percent in 2015 to the fully-implemented 2.50 percent in 2019.



# PART I: FINANCIAL INFORMATION

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

Under Basel III, the Corporation and Bank elected to opt-out of including accumulated other comprehensive income in regulatory capital.

As of June 30, 2019, the Bank met all capital adequacy requirements to be considered well capitalized. There is no threshold for well capitalized status for bank holding companies. The Corporation's and Bank's actual and required capital ratios as of June 30, 2019 and December 31, 2018 were as follows:

				Prompt Corrective Action Thresholds			
June 30, 2019	Actual		Adequately Capitalized		Well Capitalized		
	Amount	Ratio	Amount	Ratio	Amount	Ratio	
Total risk-based capital to risk-weighted assets							
First Merchants Corporation	\$ 1,235,963	14.56%	\$ 679,295	8.00%	N/A	N/A	
First Merchants Bank	1,114,589	13.04	683,654	8.00	\$ 854,567	10.00%	
Tier 1 capital to risk-weighted assets							
First Merchants Corporation	\$ 1,089,689	12.83%	\$ 509,471	6.00%	N/A	N/A	
First Merchants Bank	1,033,315	12.09	512,740	6.00	\$ 683,654	8.00%	
CET1 capital to risk-weighted assets							
First Merchants Corporation	\$ 1,023,437	12.05%	\$ 382,103	4.50%	N/A	N/A	
First Merchants Bank	1,033,315	12.09	384,555	4.50	\$ 555,468	6.50%	
Tier 1 capital to average assets							
First Merchants Corporation	\$ 1,089,689	10.86%	\$ 401,459	4.00%	N/A	N/A	
First Merchants Bank	1,033,315	10.31	400,750	4.00	\$ 500,938	5.00%	

			Prompt Corrective Action Thresholds			
December 31, 2018	Actual		Adequately Capitalized		Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital to risk-weighted assets						
First Merchants Corporation	\$ 1,177,725	14.61%	\$ 644,871	8.00%	N/A	N/A
First Merchants Bank	1,092,602	13.46	649,531	8.00	\$ 811,914	10.00%
Tier 1 capital to risk weighted assets						
First Merchants Corporation	\$ 1,032,173	12.80%	\$ 483,653	6.00%	N/A	N/A
First Merchants Bank	1,012,050	12.47	487,148	6.00	\$ 649,531	8.00%
CET1 capital to risk-weighted assets						
First Merchants Corporation	\$ 966,032	11.98%	\$ 362,740	4.50%	N/A	N/A
First Merchants Bank	1,012,050	12.47	365,361	4.50	\$ 527,744	6.50%
Tier 1 capital to average assets						
First Merchants Corporation	\$ 1,032,173	10.91%	\$ 378,379	4.00%	N/A	N/A
First Merchants Bank	1,012,050	10.70	379,397	4.00	\$ 472,996	5.00%

Management believes that all of the above capital ratios are meaningful measurements for evaluating the safety and soundness of the Corporation. Traditionally, the banking regulators have assessed bank and bank holding company capital adequacy based on both the amount and the composition of capital, the calculation of which is prescribed in federal banking regulations. The Federal Reserve focuses its assessment of capital adequacy on a component of Tier 1 capital known as CET1. Because the Federal Reserve has long indicated that voting common shareholders' equity (essentially Tier 1 risk-based capital less preferred stock and non-controlling interest in subsidiaries) generally should be the dominant element in Tier 1 risk-based capital, this focus on CET1 is consistent with existing capital adequacy categories. Tier I regulatory capital consists primarily of total stockholders' equity and subordinated debentures issued to business trusts categorized as qualifying borrowings, less non-qualifying intangible assets and unrealized net securities gains or losses.

# PART I: FINANCIAL INFORMATION

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

	June 30, 2019		December 31, 2018	
(Dollars in thousands, except per share amounts)	First Merchants Corporation	First Merchants Bank	First Merchants Corporation	First Merchants Bank
<b>Total Risk-Based Capital</b>				
Total Stockholders' Equity (GAAP)	\$ 1,501,636	\$ 1,513,662	\$ 1,408,260	\$ 1,456,220
Adjust for Accumulated Other Comprehensive (Income) Loss <sup>(1)</sup>	(14,602)	(17,357)	21,422	19,031
Less: Preferred Stock	(125)	(125)	(125)	(125)
Add: Qualifying Capital Securities	66,252	—	66,141	—
Less: Disallowed Goodwill and Intangible Assets	(460,885)	(460,436)	(463,525)	(463,076)
Less: Disallowed Deferred Tax Assets	(2,587)	(2,429)	—	—
<b>Total Tier 1 Capital (Regulatory)</b>	<b>1,089,689</b>	<b>1,033,315</b>	<b>1,032,173</b>	<b>1,012,050</b>
Qualifying Subordinated Debentures	65,000	—	65,000	—
Allowance for Loan Losses Includible in Tier 2 Capital	81,274	81,274	80,552	80,552
<b>Total Risk-Based Capital (Regulatory)</b>	<b>\$ 1,235,963</b>	<b>\$ 1,114,589</b>	<b>\$ 1,177,725</b>	<b>\$ 1,092,602</b>
<b>Net Risk-Weighted Assets (Regulatory)</b>	<b>\$ 8,491,188</b>	<b>\$ 8,545,669</b>	<b>\$ 8,060,882</b>	<b>\$ 8,119,141</b>
<b>Average Assets</b>	<b>\$ 10,036,476</b>	<b>\$ 10,018,752</b>	<b>\$ 9,459,477</b>	<b>\$ 9,459,925</b>
<b>Total Risk-Based Capital Ratio (Regulatory)</b>	<b>14.56%</b>	<b>13.04%</b>	<b>14.61%</b>	<b>13.46%</b>
<b>Tier 1 Capital to Risk-Weighted Assets</b>	<b>12.83%</b>	<b>12.09%</b>	<b>12.80%</b>	<b>12.47%</b>
<b>Tier 1 Capital to Average Assets</b>	<b>10.86%</b>	<b>10.31%</b>	<b>10.91%</b>	<b>10.70%</b>
<b>CET1 Capital Ratio</b>				
Total Tier 1 Capital (Regulatory)	\$ 1,089,689	\$ 1,033,315	\$ 1,032,173	\$ 1,012,050
Less: Qualified Capital Securities	(66,252)	—	(66,141)	—
<b>CET1 Capital (Regulatory)</b>	<b>\$ 1,023,437</b>	<b>\$ 1,033,315</b>	<b>\$ 966,032</b>	<b>\$ 1,012,050</b>
<b>Net Risk-Weighted Assets (Regulatory)</b>	<b>\$ 8,491,188</b>	<b>\$ 8,545,669</b>	<b>\$ 8,060,882</b>	<b>\$ 8,119,141</b>
<b>CET1 Capital Ratio (Regulatory)</b>	<b>12.05%</b>	<b>12.09%</b>	<b>11.98%</b>	<b>12.47%</b>

<sup>(1)</sup> Includes net unrealized gains or losses on available for sale securities, net gains or losses on cash flow hedges, and amounts resulting from the application of the applicable accounting guidance for defined benefit and other postretirement plans.

Additionally, management believes the following tables are also meaningful when considering performance measures of the Corporation. Non-GAAP financial measures such as tangible common equity to tangible assets, return on average tangible capital and return on average tangible assets are important measures of the strength of the Corporation's capital and ability to generate earnings on tangible common equity invested by our shareholders. These non-GAAP measures provide useful supplemental information and may assist investors in analyzing the Corporation's financial position without regard to the effects of intangible assets and preferred stock. Disclosure of these measures also allows analysts and banking regulators to assess our capital adequacy on these same bases.

Because these measures are not defined in GAAP or federal banking regulations, they are considered non-GAAP financial measures. Non-GAAP financial measures have inherent limitations, are not required to be uniformly applied, and are not audited. Although these non-GAAP financial measures are frequently used by investors to evaluate a company, they have limitations as analytical tools, and should not be considered in isolation, or as a substitute for analyses of results as reported under GAAP.

# PART I: FINANCIAL INFORMATION

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

The Corporation had a strong capital position as evidenced by the tangible common equity to tangible assets ratio of 10.07 percent at June 30, 2019, and 9.97 percent at December 31, 2018.

	Tangible Common Equity to Tangible Assets (non-GAAP)	
	June 30, 2019	December 31, 2018
(Dollars in thousands, except per share amounts)		
Total Stockholders' Equity (GAAP)	\$ 1,501,636	\$ 1,408,260
Less: Cumulative preferred stock (GAAP)	(125)	(125)
Less: Intangible assets (GAAP)	(466,736)	(469,784)
Tangible common equity (non-GAAP)	\$ 1,034,775	\$ 938,351
Total assets (GAAP)	\$ 10,737,857	\$ 9,884,716
Less: Intangible assets (GAAP)	(466,736)	(469,784)
Tangible assets (non-GAAP)	\$ 10,271,121	\$ 9,414,932
Stockholders' Equity to Assets (GAAP)	13.98%	14.25%
Tangible common equity to tangible assets (non-GAAP)	10.07%	9.97%
Tangible common equity (non-GAAP)	\$ 1,034,775	\$ 938,351
Plus: Tax Benefit of intangibles (non-GAAP)	4,391	5,017
Tangible common equity, net of tax (non-GAAP)	\$ 1,039,166	\$ 943,368
Common Stock outstanding	49,457	49,350
Book Value (GAAP)	\$ 30.36	\$ 28.53
Tangible book value - common (non-GAAP)	\$ 21.01	\$ 19.12

The following table details and reconciles tangible earnings per share, return on tangible capital and tangible assets to traditional GAAP measures for the three and six months ended June 30, 2019 and 2018.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
(Dollars in thousands, except per share amounts)				
Average goodwill (GAAP)	\$ 445,354	\$ 445,354	\$ 445,354	\$ 445,354
Average core deposit intangible (GAAP)	22,226	28,664	23,018	29,480
Average deferred tax on CDI (GAAP)	(4,565)	(5,887)	(4,727)	(6,055)
Intangible adjustment (non-GAAP)	\$ 463,015	\$ 468,131	\$ 463,645	\$ 468,779
Average stockholders' equity (GAAP)	\$ 1,479,254	\$ 1,327,341	\$ 1,454,633	\$ 1,318,124
Average cumulative preferred stock (GAAP)	(125)	(125)	(125)	(125)
Intangible adjustment (non-GAAP)	(463,015)	(468,131)	(463,645)	(468,779)
Average tangible capital (non-GAAP)	\$ 1,016,114	\$ 859,085	\$ 990,863	\$ 849,220
Average assets (GAAP)	\$ 10,499,948	\$ 9,697,020	\$ 10,291,205	\$ 9,535,774
Intangible adjustment (non-GAAP)	(463,015)	(468,131)	(463,645)	(468,779)
Average tangible assets (non-GAAP)	\$ 10,036,933	\$ 9,228,889	\$ 9,827,560	\$ 9,066,995
Net income available to common stockholders (GAAP)	\$ 41,056	\$ 39,634	\$ 79,873	\$ 76,313
CDI amortization, net of tax (GAAP)	1,202	1,357	2,409	2,721
Tangible net income available to common stockholders (non-GAAP)	\$ 42,258	\$ 40,991	\$ 82,282	\$ 79,034
Per Share Data:				
Diluted net income available to common stockholders (GAAP)	\$ 0.83	\$ 0.80	\$ 1.61	\$ 1.54
Diluted tangible net income available to common stockholders (non-GAAP)	\$ 0.85	\$ 0.83	\$ 1.66	\$ 1.60

Ratios:				
Return on average GAAP capital (ROE)	11.10%	11.94%	10.98%	11.58%
Return on average tangible capital	16.64%	19.09%	16.61%	18.61%
Return on average assets (ROA)	1.56%	1.63%	1.55%	1.60%
Return on average tangible assets	1.68%	1.78%	1.67%	1.74%

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

## PART I: FINANCIAL INFORMATION

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

### LOAN QUALITY/PROVISION FOR LOAN LOSSES

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

#### Loan Quality

The quality of the loan portfolio and the amount of non-performing loans may increase or decrease as a result of acquisitions, organic portfolio growth, problem loan recognition and resolution through collections, sales or charge-offs. The performance of any loan can be affected by external factors such as economic conditions, or internal factors specific to a particular borrower, such as the actions of a customer's internal management.

At June 30, 2019, non-performing loans totaled \$26,275,000, a decrease of \$976,000 from December 31, 2018 and \$2,383,000 from March 31, 2019. Loans not accruing interest income totaled \$25,635,000 at June 30, 2019, a decrease of \$513,000 from December 31, 2018 and \$2,314,000 from March 31, 2019. The Corporation's coverage ratio of allowance for loan losses to non-accrual loans increased from 308.1 percent at December 31, 2018 to 317.0 percent at June 30, 2019. This non-accrual coverage ratio at March 31, 2019 was 289.5 percent. Troubled debt restructures totaled \$640,000 at June 30, 2019, a decrease of \$463,000 from December 31, 2018 and \$69,000 from March 31, 2019. See additional information regarding the allowance for loan losses in the "Provision for Loan Losses" section of this Management's Discussion and Analysis of Financial Condition and Results of Operations.

Other real estate owned, totaling \$1,131,000 at June 30, 2019, decreased \$746,000 from March 31, 2019 and \$1,048,000 from December 31, 2018. For other real estate owned, current appraisals are obtained to determine fair value as management continues to aggressively market these real estate assets.

Impaired loans include loans deemed impaired according to the guidance set forth in ASC 310-10. Commercial loans under \$500,000 and consumer loans, with the exception of troubled debt restructures, are not individually evaluated for impairment. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected substantially within the contractual terms of the note. At June 30, 2019, impaired loans totaled \$21,973,000, a decrease of \$52,000 from the December 31, 2018 balance of \$22,025,000. Also at June 30, 2019, a specific allowance for losses was not deemed necessary for impaired loans totaling \$16,471,000 as there were no identified losses on these credits. An allowance of \$2,296,000 was recorded for the remaining balance of these impaired loans totaling \$5,502,000, and was included in the Corporation's allowance for loan losses.

The Corporation's non-performing assets plus accruing loans 90-days or more delinquent and impaired loans are presented in the table below.

(Dollars in Thousands)	June 30, 2019	December 31, 2018
<b>Non-Performing Assets:</b>		
Non-accrual loans	\$ 25,635	\$ 26,148
Renegotiated loans	640	1,103
Non-performing loans (NPL)	26,275	27,251
Other real estate owned	1,131	2,179
Non-performing assets (NPA)	27,406	29,430
Loans 90-days or more delinquent and still accruing	209	1,855
NPAs and loans 90-days or more delinquent	\$ 27,615	\$ 31,285
Impaired Loans	\$ 21,973	\$ 22,025

The non-accrual balances in the table above include troubled debt loan restructures totaling \$673,000 and \$705,000 as of June 30, 2019 and December 31, 2018, respectively.

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

(Dollars in Thousands)	June 30, 2019	December 31, 2018
<b>Non-performing assets and loans 90-days or more delinquent:</b>		
Commercial and industrial loans	\$ 2,770	\$ 2,052
Agricultural production financing and other loans to farmers	2,785	679
Real estate loans:		
Construction	7,778	11,606
Commercial and farmland	6,436	8,682
Residential	5,540	5,987
Home equity	1,880	1,815
Individuals' loans for household and other personal expenditures	73	110
Public finance and other commercial loans	353	354
Non-performing assets and loans 90-days or more delinquent:	\$ 27,615	\$ 31,285

## PART I: FINANCIAL INFORMATION

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

Although the Corporation believes its underwriting and loan review procedures are appropriate for the various kinds of loans it makes, its results of operations and financial condition could be adversely affected in the event the quality of its loan portfolio declines. Deterioration in the economic environment including residential and commercial real estate values may result in increased levels of loan delinquencies and credit losses.

#### Provision and Allowance for Loan Losses

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. Based on management's judgment as to the appropriate level of the allowance for loan losses, the amount provided in any period may be greater or less than net loan losses for the same period. The determination of the provision amount and the adequacy of the allowance in any period is based on management's continuing review and evaluation of the loan portfolio, including an internally administered loan "watch" list and independent loan reviews. The evaluation also takes into consideration identified credit problems, portfolio growth, management's judgment as to the impact of current economic conditions on the portfolio and the possibility of losses inherent in the loan portfolio that are not specifically identified.

In conformance with ASC 805 and ASC 820, purchased loans are recorded at the acquisition date fair value. Such loans are included in the allowance to the extent a specific impairment is identified that exceeds the fair value adjustment on an impaired loan. An allowance may also be necessary if the historical loss and environmental factor analysis indicates losses inherent in a purchased portfolio exceed the fair value adjustment on the portion of the purchased portfolio not deemed impaired. At June 30, 2019, one purchased loan was determined to require a specific impairment of \$329,000.

At June 30, 2019, the allowance for loan losses was \$81,274,000, an increase of \$372,000 from March 31, 2019 and \$722,000 from December 31, 2018. As a percent of loans, the allowance was 1.08 percent at June 30, 2019 compared to 1.11 percent at both March 31, 2019 and December 31, 2018. The provision for loan losses for the three months and six months ended June 30, 2019 was \$500,000 and \$1,700,000, respectively, and was primarily a result of organic loan growth during the six month period. Comparatively, the provision for loan losses for the three and six months ended June 30, 2018 was \$1,663,000 and \$4,163,000, respectively. The year-over-year decrease in the provision for loan losses was primarily the result of lower organic loan growth in the six months ended June 30, 2019 compared to the same period in the prior year. Specific reserves on impaired loans increased \$424,000 from \$1,872,000 at December 31, 2018, to \$2,296,000 at June 30, 2019.

Net charge-offs totaling \$978,000 were recognized for the six months ended June 30, 2019. Comparatively, the same period in 2018 had net charge-offs of \$1,652,000. For the six months ended June 30, 2019, there were two individual charge-offs greater than \$500,000 that totaled \$1,954,000. For the three and six months ended June 30, 2019 there was one individual recovery of \$738,000. For the three and six months ended June 30, 2018 there were two charge-offs greater than \$500,000 that totaled \$1,300,000. During the three and six month period ending June 30, 2018, recoveries on a single relationship totaled \$802,000 and \$809,000, respectively. The distribution of the net charge-offs (recoveries) for the three and six months ended June 30, 2019 and 2018 are reflected in the following table:

(Dollars in Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2019	2018	2019	2018
<b>Net charge-offs (Recoveries):</b>				
Commercial and industrial loans	\$ (30)	\$ (223)	\$ (153)	\$ 220
Agricultural production financing and other loans to farmers	(3)	(3)	16	44
Real estate loans:				
Construction	(738)	736	219	738
Commercial and farmland	961	192	948	(88)
Residential	(26)	(299)	54	151
Home equity	(28)	102	(69)	442
Individuals' loans for household and other personal expenditures	(8)	35	35	145
Public finance and other commercial loans	—	—	(72)	—
<b>Total net charge-offs</b>	<b>\$ 128</b>	<b>\$ 540</b>	<b>\$ 978</b>	<b>\$ 1,652</b>

Management continually evaluates the commercial loan portfolio by including consideration of specific borrower cash flow analysis and estimated collateral values, types and amounts on non-performing loans, past and anticipated loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans outstanding. The determination of the provision 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.

#### LIQUIDITY

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

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

# PART I: FINANCIAL INFORMATION

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

The principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$1,399,959,000 at June 30, 2019, an increase of \$257,764,000, or 22.6 percent, from December 31, 2018. Securities classified as held to maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held to maturity and that are maturing in one year or less totaled \$3,784,000 at June 30, 2019. In addition, other types of assets such as cash and interest-bearing deposits with other banks, federal funds sold and loans maturing within one year are sources of liquidity.

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. Federal funds purchased and securities sold under agreements to repurchase are also considered a source of liquidity. In addition, FHLB advances are utilized as funding sources. At June 30, 2019, total borrowings from the FHLB were \$460,042,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at June 30, 2019 was \$451,541,000.

The required payments related to borrowings at June 30, 2019 are as follows:

(Dollars in Thousands)	Remaining 2019	2020	2021	2022	2023	2024	2025 and after	ASC 805 fair value adjustments at acquisition	Total
Federal funds purchased	\$ 75,000	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 75,000
Securities sold under repurchase agreements	119,674	—	—	—	—	—	—	—	119,674
Federal Home Loan Bank advances	128,769	41,273	55,000	95,000	115,000	—	25,000	—	460,042
Subordinated debentures and term loans	—	—	—	—	—	—	142,322	(3,748)	138,574
Total	<u>\$ 323,443</u>	<u>\$ 41,273</u>	<u>\$ 55,000</u>	<u>\$ 95,000</u>	<u>\$ 115,000</u>	<u>\$ —</u>	<u>\$ 167,322</u>	<u>\$ (3,748)</u>	<u>\$ 793,290</u>

Additionally, the Corporation has entered into a number of long-term leasing arrangements to support ongoing activities. Details related to the Corporation's lease obligations are discussed within NOTE 7. LEASES of the Notes to Consolidated Condensed Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q.

Also, in the normal course of business, the Bank is a party to a number of other off-balance sheet activities that contain credit, market and operational risk that are not reflected in whole or in part in our consolidated financial statements. These activities primarily consist of traditional off-balance sheet credit-related financial instruments such as loan commitments and standby letters of credit.

Summarized credit-related financial instruments at June 30, 2019 are as follows:

(Dollars in Thousands)	June 30, 2019
Amounts of commitments:	
Loan commitments to extend credit	\$ 3,038,011
Standby and commercial letters of credit	33,664
	<u>\$ 3,071,675</u>

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

### INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK

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

It is the objective of the Corporation to monitor and manage risk exposure to net interest income caused by changes in interest rates. It is the goal of the Corporation's Asset/Liability management function to provide optimum and stable net interest income. To accomplish this, management uses two asset liability tools. GAP/Interest Rate Sensitivity Reports and Net Interest Income Simulation Modeling are constructed, presented and monitored quarterly. Management believes that the Corporation's liquidity and interest sensitivity position at June 30, 2019, remained adequate to meet the Corporation's primary goal of achieving optimum interest margins while avoiding undue interest rate risk.

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

## PART I: FINANCIAL INFORMATION

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

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

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of June 30, 2019, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. Total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management have the following results:

Driver Rates	June 30, 2019	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	(100)
Federal funds	200	(100)
One-year CMT	200	(100)
Three-year CMT	200	(100)
Five-year CMT	200	(100)
CD's	200	(25)
FHLB advances	200	(96)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at June 30, 2019. The net interest income shown represents cumulative net interest income over a twelve-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	June 30, 2019		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$ 327,920	\$ 347,852	\$ 316,639
Variance from base		\$ 19,932	\$ (11,281)
Percent of change from base		6.08%	(3.44)%

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2018, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. Total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management in the base simulation are as follows:

Driver Rates	December 31, 2018	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	(100)
Federal funds	200	(100)
One-year CMT	200	(100)
Three-year CMT	200	(100)
Five-year CMT	200	(100)
CD's	200	(25)
FHLB advances	200	(100)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at December 31, 2018. The net interest income shown represents cumulative net interest income over a twelve-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	December 31, 2018		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$ 344,064	\$ 371,221	\$ 330,990
Variance from base		\$ 27,157	\$ (13,074)
Percent of change from base		7.89%	(3.80)%

# PART I: FINANCIAL INFORMATION

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

### EARNING ASSETS

The following table presents the earning asset mix as of June 30, 2019 and December 31, 2018. Earning assets increased by \$840,972,000 during the six months ended June 30, 2019.

Interest-bearing time deposits and investment securities increased \$92,651,000 and \$460,342,000, respectively, since December 31, 2018, primarily as a result of excess liquidity generated from deposit growth during the same period.

Loans and loans held for sale increased \$287,979,000 from December 31, 2018. The largest loan segments that experienced increases were commercial and industrial, construction and public finance and other commercial loans. The largest loan segments that experienced decreases were commercial and farmland real estate loans and agricultural production financing and other loans to farmers. Additional details of the changes in the Corporation's loan portfolio are discussed within NOTE 4. LOANS AND ALLOWANCE of the Notes to Consolidated Condensed Financial Statements included in Item 1 of this Quarterly Report on Form 10-Q.

(Dollars in Thousands)	June 30, 2019	December 31, 2018
Interest-bearing time deposits	\$ 129,614	\$ 36,963
Investment securities available for sale	1,399,959	1,142,195
Investment securities held to maturity	692,965	490,387
Loans held for sale	5,854	4,778
Loans	7,511,370	7,224,467
Federal Home Loan Bank stock	24,588	24,588
Total	<u>\$ 9,764,350</u>	<u>\$ 8,923,378</u>

### REGULATORY DEVELOPMENTS

On June 13, 2019, the Bank entered into a Settlement Agreement and Agreed Order with the United States Department of Justice ("DOJ") to address issues raised relative to the Equal Credit Opportunity Act ("ECOA") and the Fair Housing Act ("FHA"). The Order is currently pending approval before the United States District Court for the Southern District of Indiana.

The Bank first physically entered the Indianapolis-Marion County market in February 2016 through its newly-constructed branch in the Broad Ripple neighborhood. In mid-2017, the Bank completed a system-wide fair lending assessment for the calendar year 2016, the first assessment that included Indianapolis-Marion County. Based on the analysis, the Bank concluded that it needed to enhance its mortgage lending strategy in majority-minority neighborhoods and began implementing steps to make those improvements.

In the meantime, in June 2017, the DOJ notified the Bank that an investigation of its fair lending practices has been opened. The investigation ultimately focused on the Indianapolis-Marion County market during the period between January 1, 2011 and December 31, 2016. The Settlement Agreement and Agreed Order arose from that investigation.

There was no actual finding or adjudication with respect to any matter alleged by the DOJ, and the Bank has not admitted any of the allegations or to any liability. Rather, the settlement provides an opportunity for the Bank to instead devote additional resources to continue serving the communities in which it operates, including helping meet the credit needs of all borrowers in those communities. The Bank prohibits any act or practice that discriminates in aspect of a residential real estate-related transaction in violation of the FHA or in any aspect of a credit transaction in violation of the ECOA. Nothing in the Settlement Agreement prohibits the Corporation from making future acquisitions or opening branches.

Pursuant to the Settlement Agreement, the Bank will invest \$1.12 million over four years in a special loan subsidy fund that will offer residents in Indianapolis-Marion County majority-black census tracts access to home mortgage loans and home improvement loans. Subsidies may be used for down payment assistance, closing cost assistance, mortgage insurance premiums, and any other appropriate assistance measures approved by the DOJ. The maximum loan subsidy is \$7,500 per loan. Up to 25 percent of the aggregate amount can be used for refinancings of existing loans.

The Bank will also open a full-service banking center in an Indianapolis-Marion county majority-black census tract and a new Loan Production Office (with an ATM) in Indianapolis-Marion County. The locations will be staffed with at least one full-time residential loan officer who is fully trained in all aspects of home mortgage and home equity lending, and whose marketing and community outreach work is consistent with standards laid out in the agreement. Additionally, the Bank will dedicate at least \$125,000 per year for four years to marketing, community outreach, education and credit repair initiatives in Indianapolis-Marion County majority-black census tracts.

Additionally, the Bank partnered with the Fair Housing Center of Central Indiana ("FHCCI") on several initiatives designed to increase mortgage lending to residents in Marion County's majority-black neighborhoods and census tracts. As part of this partnership the Bank contributed \$550,000 to the FHCCI and agreed to contribute \$500,000 in grants to be shared by three community development corporations over the next three years.

The Bank recognized \$1.2 million of expenses related to the DOJ and FHCCI agreements, which is reflected in marketing expense in the accompanying Consolidated Condensed Statements of Income.

For additional information regarding the terms of the Settlement Agreement and Agreed Order, see the Corporation's Current Report on Form 8-K filed on June 13, 2019.



***PART I: FINANCIAL INFORMATION***

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

**OTHER**

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

***PART I: FINANCIAL INFORMATION***  
***ITEM 3. QUANTITATIVE AND QUALITATIVE***  
***DISCLOSURES ABOUT MARKET RISK***

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

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

***PART I: FINANCIAL INFORMATION***  
***ITEM 4. CONTROLS AND PROCEDURES***

**ITEM 4. CONTROLS AND PROCEDURES**

At the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective. Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the Securities Exchange Act of 1934 are recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

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

**PART II: OTHER INFORMATION**  
**ITEM 1., ITEM 1A., ITEM 2., ITEM 3., ITEM 4. AND ITEM 5.**  
*(table dollar amounts in thousands, except share data)*

**ITEM 1. LEGAL PROCEEDINGS**

There are no pending legal proceedings, other than litigation incidental to the ordinary business of the Corporation or its subsidiaries, of a material nature to which the Corporation or its subsidiaries is a party or of which any of their properties are subject. Further, there are no material legal proceedings in which any director, officer, principal shareholder, or affiliate of the Corporation, or any associate of any such director, officer or principal shareholder, is a party, or has a material interest, adverse to the Corporation or any of its subsidiaries.

None of the routine legal proceedings, individually or in the aggregate, in which the Corporation or its affiliates are involved are expected to have a material adverse impact on the financial position or the results of operations of the Corporation.

**ITEM 1A. RISK FACTORS**

***The Bank is operating under a Settlement Agreement and Agreed Order with the DOJ, and its failure to comply with the Agreement could materially and adversely affect our business.***

The Bank is operating under a Settlement Agreement and Agreed Order with the DOJ, and its failure to comply with the Agreement could materially and adversely affect our business. Our Board of Directors and executive management team have been working diligently to comply with the Settlement Agreement and believe that they have allocated sufficient resources to address the corrective actions required by the DOJ. Compliance with and resolution of the Settlement Agreement will ultimately be determined by the DOJ. The Bank's failure to comply with the Settlement Agreement and to successfully implement its requirements or the general perception of the Settlement Agreement by other regulators with jurisdiction over the Corporation or the Bank could have a material and adverse effect on our business, results of operation, financial condition, plans for and timing of future acquisitions and expansion, cash flows and stock price.

Otherwise, there have been no material changes to the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2018.

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

- a. None
- b. None
- c. Issuer Purchases of Equity Securities

The following table presents information relating to our purchases of equity securities during the three months ended June 30, 2019.

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as part of Publicly announced Plans or Programs	Maximum Number of Shares that may yet be Purchased Under the Plans or Programs
April, 2019	86	\$38.29		
May, 2019				
June, 2019	352	\$36.46		

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

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None

**ITEM 4. MINE SAFETY DISCLOSURES**

Not Applicable

**ITEM 5. OTHER INFORMATION**

- a. None
- b. None

## PART II: OTHER INFORMATION

### ITEM 6. EXHIBITS

#### ITEM 6. EXHIBITS

Exhibit No:	Description of Exhibits:
2.1	<a href="#">Agreement and Plan of Reorganization and Merger between First Merchants Corporation and MBT Financial Corp., dated October 9, 2018 (Incorporated by reference to registrant's Form 8-K filed on October 10, 2018) (SEC No. 000-17071)</a>
3.1	<a href="#">First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 8-K filed on May 2, 2017) (SEC No. 000-17071)</a>
3.2	<a href="#">Bylaws of First Merchants Corporation dated August 11, 2016 (Incorporated by reference to registrant's Form 10-K filed on March 1, 2017) (SEC No. 000-17071)</a>
4.1	<a href="#">First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)</a>
4.2	<a href="#">Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)</a>
4.3	<a href="#">Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)</a>
4.4	<a href="#">Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)</a>
4.5	<a href="#">First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Form S-3 filed on February 6, 2019) (SEC No. 333-229527)</a>
4.6	<a href="#">Upon request, the registrant agrees to furnish supplementally to the Commission a copy of the instruments defining the rights of holders of its (a) 5.00% Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million and (b) 6.75% Fixed-to-Floating Rate Subordinated Notes due 2028 in aggregate principal amount of \$65 million.</a>
4.7	<a href="#">Description of Assumed Junior Subordinated Debt Securities of Independent Alliance Banks, Inc. and Agreement to Furnish Copies of Related Instruments and Documents (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2017) (SEC No. 000-17071)</a>
10.1*	<a href="#">First Merchants Corporation 2019 Long-Term Equity Incentive Plan (incorporated by reference to registrant's Form 8-K filed on May 15, 2019) (SEC No. 000-17071)</a>
10.2*	<a href="#">First Merchants Corporation 2019 Employee Stock Purchase Plan (incorporated by reference to registrant's Form 8-K filed on May 15, 2019) (SEC No. 000-17071)</a>
10.3*	<a href="#">First Merchants Corporation Equity Compensation Plan for Non-Employee Directors (incorporated by reference to registrants Form S-8 filed on June 26, 2019) (SEC No. 333-232362)</a>
31.1	<a href="#">Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)</a>
31.2	<a href="#">Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)</a>
32	<a href="#">Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)</a>
101.INS	XBRL Instance Document - the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (2)

\* Management contract or compensatory plan or arrangement

(1) Filed herewith.

(2) Furnished herewith.

## ***SIGNATURES***

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

First Merchants Corporation  
(Registrant)

August 7, 2019

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

August 7, 2019

By: /s/ Mark K. Hardwick  
Mark K. Hardwick  
Executive Vice President,  
Chief Financial Officer and Chief Operating Officer  
(Principal Financial and Accounting Officer)

**PART II: OTHER INFORMATION**  
**ITEM 6. EXHIBITS**

**EXHIBIT-31.1**

**CERTIFICATIONS PURSUANT TO  
SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002**

**CERTIFICATION**

---

I, Michael C. Rechin, President and Chief Executive Officer of First Merchants Corporation, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Merchants Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

August 7, 2019

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

**PART II: OTHER INFORMATION**  
**ITEM 6. EXHIBITS**

**EXHIBIT-31.2**

**CERTIFICATIONS PURSUANT TO  
SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002**

**CERTIFICATION**

---

I, Mark K. Hardwick, Executive Vice President, Chief Financial Officer and Chief Operating Officer of First Merchants Corporation, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Merchants Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

8/7/2019

By: /s/ Mark K. Hardwick  
Mark K. Hardwick  
Executive Vice President,  
Chief Financial Officer and Chief Operating Officer  
(Principal Financial and Accounting Officer)



**PART II: OTHER INFORMATION**  
**ITEM 6. EXHIBITS**

**EXHIBIT-32**

**CERTIFICATIONS PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of First Merchants Corporation (the "Corporation") on Form 10-Q for the period ending June 30, 2019, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael C. Rechin, President and Chief Executive Officer of the Corporation, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o (d)); and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

August 7, 2019

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

A signed copy of this written statement required by Section 906 has been provided to First Merchants Corporation and will be retained by First Merchants Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

---

In connection with the Quarterly Report of First Merchants Corporation (the "Corporation") on Form 10-Q for the period ending June 30, 2019, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Mark K. Hardwick, Executive Vice President, Chief Financial Officer and Chief Operating Officer of the Corporation, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o (d)); and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

August 7, 2019

By: /s/ Mark K. Hardwick  
Mark K. Hardwick  
Executive Vice President,  
Chief Financial Officer and Chief Operating Officer  
(Principal Financial and Accounting Officer)

A signed copy of this written statement required by Section 906 has been provided to First Merchants Corporation and will be retained by First Merchants Corporation and furnished to the Securities and Exchange Commission or its staff upon request.