LAKELAND FINANCIAL CORP
Form 10-K
March 05, 2015

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

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) of the
Securities Exchange Act of 1934

For the fiscal year ended December 31, 2014

Commission file number 0-11487

LAKELAND FINANCIAL CORPORATION

Indiana	35-1559596
(State of incorporation)	(I.R.S. Employer Identification No.)

202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581-1387
(Address of principal executive offices)

Telephone: (574) 267-6144

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, no par value	NASDAQ Global Select Market
(Title of class)	(Name of each exchange on which registered)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes __No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes __No X

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 twelve months (or for such other period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No __

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.[ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer and large accelerated filer” in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ]	Accelerated filer [X]	Non-accelerated filer [ ]	Smaller reporting company [ ]

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based on the last sales price quoted on the Nasdaq Global Select Market on June 30, 2014, the last business day of the registrant’s most recently completed second fiscal quarter, was approximately $595,912,322.

Number of shares of common stock outstanding at February 25, 2015: 16,604,568

DOCUMENTS INCORPORATED BY REFERENCE

Part III - Portions of the Proxy Statement for the Annual Meeting of Stockholders to be held on April 14, 2015 are incorporated by reference into Part III hereof.

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PART I

ITEM 1. BUSINESS

The Company

Lakeland Financial Corporation (“Lakeland Financial”), an Indiana corporation incorporated in 1983, is a bank holding company headquartered in Warsaw, Indiana that provides, through its wholly-owned subsidiary Lake City Bank (the “Bank” and together with Lakeland Financial, the “Company”), a broad array of products and services throughout its Northern and Central Indiana markets. The Company offers commercial and consumer banking services, as well as trust and wealth management, brokerage, and treasury management commercial services. The Company serves a wide variety of industries including, among others, manufacturing, agriculture, construction, retail, services, health care and transportation. The Company’s customer base is similarly diverse. The Company is not dependent upon any single industry or customer. At December 31, 2014, Lakeland Financial had consolidated total assets of $3.4 billion and was the fourth largest independent bank holding company headquartered in the State of Indiana.

Company’s Business. The Company is a bank holding company as defined in the Bank Holding Company Act of 1956, as amended. The Company owns all of the outstanding stock of the Bank, a full-service commercial bank organized under Indiana law. The Company conducts no business except that incident to its ownership of the outstanding stock of the Bank and the operation of the Bank. Although Lakeland Financial is a corporate entity, legally separate and distinct from its affiliates, bank holding companies such as Lakeland Financial are required to act as a source of financial strength for their subsidiary banks. The principal source of Lakeland Financial’s income is dividends from the Bank. There are certain regulatory restrictions on the extent to which subsidiary banks can pay dividends or otherwise supply funds to their holding companies. See the section captioned “Supervision and Regulation” below for further discussion of these matters. Lakeland Financial’s executive offices are located at 202 East Center Street, Warsaw, Indiana 46580, and its telephone number is (574) 267-6144.

Bank’s Business. The Bank was originally organized in 1872 and has continuously operated under the laws of the State of Indiana since its organization. As of December 31, 2014, the Bank had 46 offices in fourteen counties throughout Northern and Central Indiana. The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”). The Bank’s activities cover all phases of commercial banking, including deposit products, commercial and consumer lending, retail and merchant credit card services, corporate treasury management services, and wealth advisory, trust and brokerage services.

The Bank’s business strategy is focused on building long-term relationships with its customers based on top quality service, high ethical standards and safe and sound lending. The Bank operates as a community-based financial services organization augmented by experienced, centralized support in select critical areas. The Bank’s local market orientation is reflected in its regional management, which divides the Bank’s market area into five distinct geographic regions each headed by a retail and commercial regional manager. This arrangement allows decision making to be as close to the customer as possible and enhances responsiveness to local banking needs. Despite this local market, community-based focus, the Bank offers many of the products and services available at much larger regional and national competitors. While our strategy encompasses all phases of traditional community banking, including consumer lending and wealth advisory and trust services, we focus on building expansive commercial relationships and developing retail and commercial deposit gathering strategies through relationship-based client services. Substantially all of the Bank’s assets and income are located in and derived from the United States. At December 31, 2014, the Company had 496 full-time equivalent employees. The Company is not a party to any collective bargaining agreements, and employee relations are considered good.

Operating Segments. The Company's chief decision-makers monitor and evaluate financial performance on a Company-wide basis. All of the Company's financial service operations are similar and considered by management to be aggregated into one reportable operating segment. While the Company has assigned certain management responsibilities by region and business-line, the Company's chief decision-makers monitor and evaluate financial performance on a Company-wide basis. The majority of the Company's revenue is from the business of banking and the Company's assigned regions have similar economic characteristics, products, services and customers. Accordingly, all of the Company's operations are considered by management to be aggregated in one reportable operating segment.

Expansion Strategy. Since 1990, the Company has expanded from 17 offices in four Indiana counties to 46 branches in fourteen Indiana counties primarily through de novo branching. During this period, the Company has grown its assets from $286 million to $3.4 billion, an increase of 1,104%. Mergers and acquisitions have not played a role in this growth as the Company's expansion strategy has been driven by organic growth. The Company has opened four de novo branches in the past five years.

Over the past fifteen years, the Company has primarily targeted growth in the larger cities located in Northern Indiana and the Indianapolis market in Central Indiana. The Company believes these areas offer above average growth potential with attractive demographics and potential for commercial lending opportunities. The Company considers expanding into a market when the Company believes that market would be receptive to its strategic plan to deliver broad-based financial services with a commitment to local communities. When entering new markets, the Company believes it is critical to attract experienced local management and staff with a similar philosophy in order to provide a basis for success. The Company previously announced plans to build a fourth de novo office in Indianapolis, as well as to lease office space in downtown Fort Wayne upon completion of a major construction project currently underway. The Company does not currently have any definitive understandings or agreements for any acquisitions.

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Competition. The financial services industry is highly competitive. Competition is based on a number of factors including, among others, customer service, quality and range of products and services offered, price, reputation, interest rates on loans and deposits, lending limits and customer convenience. Our competitors include banks, thrifts, credit unions, farm credit services, finance companies, personal loan companies, brokerage firms, investment companies, insurance companies, mortgage banking companies, credit card issuers, mutual fund companies and e-commerce and other internet-based companies offering financial services. Many of these competitors enjoy fewer regulatory constraints and some may have lower cost structures.

Forward-looking Statements

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as "believe," "expect," "anticipate," "plan," "intend," "estimat "may," "will," "would," "could," "should" or other similar expressions. Additionally, all statements in this document, includin forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries, are detailed in the "Risk Factors" section included under Item 1A. of Part I of this Form 10-K. In addition to the risk factors described in that section, there are other factors that may impact any public company, including ours, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries. These additional factors include, but are not limited to, the following:

- the effects of future economic, business and market conditions and changes, both domestic and foreign, including seasonality;
- governmental monetary and fiscal policies;
- legislative and regulatory changes, including changes in banking, securities and tax laws and regulations and their application by our regulators;
- changes in the scope and cost of FDIC insurance, the state of Indiana's Public Deposit Insurance Fund and other coverages;
- changes in accounting policies, rules and practices;
- the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities and other interest sensitive assets and liabilities;
- the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates;
- changes in borrowers' credit risks and payment behaviors;
- changes in the availability and cost of credit and capital in the financial markets;

- changes in the prices, values and sales volumes of residential and commercial real estate;

- the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;

- the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions;

- changes in technology or products that may be more difficult, costly or less effective than anticipated;

- the effects of war or other conflicts, acts of terrorism or other catastrophic events, including storms, droughts, tornados and flooding, that may affect general economic conditions, including agricultural production and demand and prices for agricultural goods and land used for agricultural purposes, generally and in our markets;

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- the failure of assumptions and estimates used in our reviews of our loan portfolio and our analysis of our capital position;
- cyber-security risks and or cyber-security damage that could result from attacks on networks or data of the Company; and
- other factors and risks described under “Risk Factors” herein.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. For additional information regarding these and other risks, uncertainties and other factors, please review the disclosure in this annual report under “Risk Factors.”

Internet Website

The Company maintains an internet site at www.lakecitybank.com. The Company makes available free of charge in the Investor Relations section on this site its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and other reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as soon as reasonably practicable after it electronically files such material with, or furnishes it to, the Securities and Exchange Commission (the “SEC”). All such documents filed with the SEC are also available for free on the SEC’s website (www.sec.gov). The Company’s Articles of Incorporation, Bylaws, Code of Conduct and the charters of its various committees of the Board of Directors are also available on the website.

SUPERVISION AND REGULATION

General

Financial institutions, their holding companies and their affiliates are extensively regulated under federal and state law. As a result, the growth and earnings performance of the Company may be affected not only by management decisions and general economic conditions, but also by requirements of federal and state statutes and by the regulations and policies of various bank regulatory agencies, including the Indiana Department of Financial Institutions (the “DFI”), the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the FDIC and the Bureau of Consumer Financial Protection (the “CFPB”). Furthermore, taxation laws administered by the Internal Revenue Service and state taxing authorities, accounting rules developed by the Financial Accounting Standards Board, securities laws administered by the Securities and Exchange Commission (the “SEC”) and state securities authorities, and anti-money laundering laws enforced by the U.S. Department of the Treasury (the “Treasury”) have an impact on the business of the Company. The effect of these statutes, regulations, regulatory policies and accounting rules are significant to the operations and results of the Company and Bank, and the nature and extent of future legislative, regulatory or other changes affecting financial institutions are impossible to predict with any certainty.

Federal and state banking laws impose a comprehensive system of supervision, regulation and enforcement on the operations of financial institutions, their holding companies and affiliates that is intended primarily for the protection of the FDIC-insured deposits and depositors of banks, rather than shareholders. These federal and state laws, and the regulations of the bank regulatory agencies issued under them, affect, among other things, the scope of business, the kinds and amounts of investments banks may make, reserve requirements, capital levels relative to operations, the nature and amount of collateral for loans, the establishment of branches, the ability to merge, consolidate and acquire, dealings with insiders and affiliates and the payment of dividends.

This supervisory and regulatory framework subjects banks and bank holding companies to regular examination by their respective regulatory agencies, which results in examination reports and ratings that are not publicly available and that can impact the conduct and growth of their business. These examinations consider not only compliance with applicable laws and regulations, but also capital levels, asset quality and risk, management ability and performance, earnings, liquidity and various other factors. The regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of a regulated entity where the agencies determine, among other things, that such operations are unsafe or unsound, fail to comply with applicable laws or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

The following is a summary of the material elements of the supervisory and regulatory framework applicable to the Company and the Bank. It does not describe all of the statutes, regulations and regulatory policies that apply, nor does it restate all of the requirements of those that are described. The descriptions are qualified in their entirety by reference to the particular statutory and regulatory provision.

Financial Regulatory Reform

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) into law. The Dodd-Frank Act represented a sweeping reform of the U.S. supervisory and regulatory framework applicable to financial institutions and capital markets in the wake of the global financial crisis, certain aspects of which are described below in more detail. In particular, and among other things, the Dodd-Frank Act: created a Financial Stability Oversight Council as part of a regulatory structure for identifying emerging systemic risks and improving interagency cooperation; created the CFPB, which is authorized to regulate providers of consumer credit, savings, payment and other consumer financial products and services; narrowed the scope of federal preemption of state consumer laws enjoyed by national banks and federal savings associations and expanded the authority of state attorneys general to bring actions to enforce federal consumer protection legislation; imposed more stringent capital requirements on bank holding companies and subjected certain activities, including interstate mergers and acquisitions, to heightened capital conditions; with respect to mortgage lending, (i) significantly expanded requirements applicable to loans secured by 1-4 family residential real property, (ii) imposed strict rules on mortgage servicing, and (iii) required the originator of a securitized loan, or the sponsor of a securitization, to retain at least 5% of the credit risk of securitized exposures unless the underlying exposures are qualified residential mortgages or meet certain underwriting standards; repealed the prohibition on the payment of interest on business checking accounts; restricted the interchange fees payable on debit card transactions for issuers with $10 billion in assets or greater; in the so-called “Volcker Rule,” subject to numerous exceptions, prohibited depository institutions and affiliates from certain investments in, and sponsorship of, hedge funds and private equity funds and from engaging in proprietary trading; provided for enhanced regulation of advisers to private funds and of the derivatives markets; enhanced oversight of credit rating agencies; and prohibited banking agency requirements tied to credit ratings. These statutory changes shifted the regulatory framework for financial institutions, impacted the way in which they do business and have the potential to constrain revenues.

Numerous provisions of the Dodd-Frank Act were required to be implemented through rulemaking by the appropriate federal regulatory agencies. Many of the required regulations have been issued and others have been released for public comment, but are not yet final. Although the reforms primarily targeted systemically important financial service providers, their influence is expected to filter down in varying degrees to smaller institutions over time. Management of the Company and the Bank will continue to evaluate the effect of the Dodd-Frank Act; however, in many respects, the ultimate impact of the Dodd-Frank Act will not be fully known for years, and no current assurance may be given that the Dodd-Frank Act, or any other new legislative changes, will not have a negative impact on the results of operations and financial condition of the Company and the Bank.

The Increasing Regulatory Emphasis on Capital

Regulatory capital represents the net assets of a financial institution available to absorb losses. Because of the risks attendant to their business, depository institutions are generally required to hold more capital than other businesses, which directly affects earnings capabilities. While capital has historically been one of the key measures of the financial health of both bank holding companies and banks, its role has become fundamentally more important in the wake of the global financial crisis, as the banking regulators recognized that the amount and quality of capital held by banks prior to the crisis was insufficient to absorb losses during periods of severe stress. Certain provisions of the Dodd-Frank Act and Basel III, discussed below, establish strengthened capital standards for banks and bank holding companies, require more capital to be held in the form of common stock and disallow certain funds from being included in capital determinations. Once fully implemented, these standards will represent regulatory capital requirements that are meaningfully more stringent than those in place previously.

The Company and Bank Required Capital Levels. Bank holding companies have had to comply with less stringent capital standards than their bank subsidiaries and have been able to raise capital with hybrid instruments such as trust preferred securities. The Dodd-Frank Act mandated the Federal Reserve to establish minimum capital levels for bank holding companies on a consolidated basis as stringent as those required for insured depository institutions. As a consequence, the components of holding company permanent capital known as “Tier 1 Capital” were restricted to those capital instruments that are considered to be Tier 1 Capital for insured depository institutions. A result of this change is that the proceeds of hybrid instruments, such as trust preferred securities, are being excluded from Tier 1 Capital over a phase-out period. However, if such securities were issued prior to May 19, 2010 by bank holding companies with less than $15 billion of assets as of December 31, 2009, they may be retained as Tier I Capital subject to certain restrictions. Because the Company had assets of less than $15 billion, it was able to meet the requirements and maintain its trust preferred proceeds as Tier 1 Capital but will have to comply with the revised capital mandates in other respects and will not be able to raise Tier 1 Capital in the future through the issuance of trust preferred securities.

The minimum capital standards effective for the year ended December 31, 2014 were:

- A leverage requirement, consisting of a minimum ratio of Tier 1 Capital to total adjusted book assets of 3% for the most highly-rated banks with a minimum requirement of at least 4% for all others, and
- A risk-based capital requirement, consisting of a minimum ratio of Total Capital to total risk-weighted assets of 8% and a minimum ratio of Tier 1 Capital to total risk-weighted assets of 4%.

For these purposes, “Tier 1 Capital” consisted primarily of common stock, noncumulative perpetual preferred stock and related surplus less intangible assets (other than certain loan servicing rights and purchased credit card relationships). “Total Capital” consisted primarily of Tier 1 Capital plus “Tier 2 Capital,” which included other non-permanent capital items, such as certain other debt and equity instruments that do not qualify as Tier 1 Capital, and a portion of the Bank’s allowance for loan and lease losses. Further, risk-weighted assets for the purpose of the risk-weighted ratio calculations were balance sheet assets and off-balance sheet exposures to which required risk weightings of 0% to 100% were applied.

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The capital standards described above are minimum requirements and were increased beginning January 1, 2015 under Basel III, as discussed below. Bank regulatory agencies uniformly encourage banks and bank holding companies to be "well-capitalized" and, to that end, federal law and regulations provide various incentives for banking organizations to maintain regulatory capital at levels in excess of minimum regulatory requirements. For example, a banking organization that is "well-capitalized" may: (i) qualify for exemptions from prior notice or application requirements otherwise applicable to certain types of activities; (ii) qualify for expedited processing of other required notices or applications; and (iii) accept roll-over or renew brokered deposits. Under the capital regulations of the FDIC and Federal Reserve, in order to be "well-capitalized," a banking organization, for the year ended December 31, 2014, must have maintained:

- A leverage ratio of Tier 1 Capital to total assets of 5% or greater,
- A ratio of Tier 1 Capital to total risk-weighted assets of 6% or greater, and
- A ratio of Total Capital to total risk-weighted assets of 10% or greater.

The FDIC and Federal Reserve guidelines also provide that banks and bank holding companies experiencing internal growth or making acquisitions would be expected to maintain capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Furthermore, the guidelines indicate that the agencies will continue to consider a "tangible Tier 1 leverage ratio" (deducting all intangibles) in evaluating proposals for expansion or to engage in new activities.

Higher capital levels could also be required if warranted by the particular circumstances or risk profile of individual banking organizations. For example, the Federal Reserve's capital guidelines contemplate that additional capital may be required to take adequate account of, among other things, interest rate risk, or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. Further, any banking organization experiencing or anticipating significant growth would be expected to maintain capital ratios, including tangible capital positions (i.e., Tier 1 Capital less all intangible assets), well above the minimum levels.

Prompt Corrective Action. A banking organization's capital plays an important role in connection with regulatory enforcement as well. Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators' powers depends on whether the institution in question is "adequately capitalized," "undercapitalized," "significantly undercapitalized" or "critically undercapitalized," in each case as defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators' corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution's asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to sell itself; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

As of December 31, 2014: (i) the Bank was not subject to a directive from its regulatory agencies to increase its capital and (ii) the Bank was "well-capitalized," as defined by Federal Reserve regulations. As of December 31, 2014, the Company had regulatory capital in excess of the Federal Reserve's requirements and met the Dodd-Frank Act requirements.

The Basel International Capital Accords. The risk-based capital guidelines described above are based upon the 1988 capital accord known as "Basel I" adopted by the international Basel Committee on Banking Supervision, a committee of central banks and bank supervisors, as implemented by the U.S. federal banking regulators on an interagency basis. In 2008, the banking agencies collaboratively began to phase-in capital standards based on a second capital accord, referred to as “Basel II,” for large or “core” international banks (generally defined for U.S. purposes as having total assets of $250 billion or more, or consolidated foreign exposures of $10 billion or more). Basel II emphasized internal assessment of credit, market and operational risk, as well as supervisory assessment and market discipline in determining minimum capital requirements.

On September 12, 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced agreement on a strengthened set of capital requirements for banking organizations around the world, known as Basel III, to address deficiencies recognized in connection with the global financial crisis. Basel III was intended to be effective globally on January 1, 2013, with phase-in of certain elements continuing until January 1, 2019, and it is currently effective in many countries.

U.S. Implementation of Basel III. In July of 2013, the U.S. federal banking agencies approved the implementation of the Basel III regulatory capital reforms in pertinent part, and, at the same time, promulgated rules effecting certain changes required by the Dodd-Frank Act (the “Basel III Rule”). In contrast to capital requirements previously, which were in the form of guidelines, Basel III was released in the form of regulations by each of the federal regulatory agencies. The Basel III Rule is applicable to all financial institutions that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as to bank and savings and loan holding companies other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than $1 billion).

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The Basel III Rule not only increased most of the required minimum capital ratios as of January 1, 2015, but it introduced the concept of "Common Equity Tier 1 Capital," which consists primarily of common stock, related surplus (net of Treasury stock), retained earnings, and Common Equity Tier 1 minority interests, subject to certain regulatory adjustments. The Basel III Rule also established more stringent criteria for instruments to be considered "Additional Tier 1 Capital" (Tier 1 Capital in addition to Common Equity) and Tier 2 Capital. A number of instruments that qualified as Tier 1 Capital will not qualify, or their qualifications will change. For example, cumulative preferred stock and certain hybrid capital instruments, including trust preferred securities, will no longer qualify as Tier 1 Capital of any kind, with the exception, subject to certain restrictions, of such instruments issued before May 10, 2010, by bank holding companies with total consolidated assets of less than $15 billion as of December 31, 2009. For those institutions, trust preferred securities and other nonqualifying capital instruments currently included in consolidated Tier 1 Capital were permanently grandfathered under the Basel III Rule, subject to certain restrictions. Noncumulative perpetual preferred stock, which formerly qualified as simple Tier 1 Capital, will not qualify as Common Equity Tier 1 Capital, but will instead qualify as Additional Tier 1 Capital. The Basel III Rule also constrained the inclusion of minority interests, mortgage-servicing assets and deferred tax assets in capital and requires deductions from Common Equity Tier 1 Capital in the event that such assets exceed a certain percentage of a banking institution's Common Equity Tier 1 Capital.

As of January 1, 2015, the Basel III Rule requires:

- A new minimum ratio of Common Equity Tier 1 Capital to risk-weighted assets of 4.5%;
- An increase in the minimum required amount of Tier 1 Capital to 6% of risk-weighted assets;
- A continuation of the current minimum required amount of Total Capital (Tier 1 plus Tier 2) at 8% of risk-weighted assets; and
- A minimum leverage ratio of Tier 1 Capital to total assets equal to 4% in all circumstances.

The Basel III Rule maintained the general structure of the prompt corrective action framework, while incorporating the increased requirements and adding the Common Equity Tier 1 Capital ratio. In order to be "well-capitalized" under the new regime, a depository institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; a Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more.

In addition, institutions that seek the freedom to make capital distributions (including for dividends and repurchases of stock) and pay discretionary bonuses to executive officers without restriction must also maintain 2.5% of risk-weighted assets in Common Equity Tier 1 attributable to a capital conservation buffer to be phased in over three years beginning in 2016. The purpose of the conservation buffer is to ensure that banking institutions maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. Factoring in the fully phased-in conservation buffer increases the minimum ratios depicted above to 7% for Common Equity Tier 1, 8.5% for Tier 1 Capital and 10.5% for Total Capital. The leverage ratio is not impacted by the conservation buffer, and a banking institution may be considered well-capitalized while remaining out of compliance with the capital conservation buffer.

As discussed above, most of the capital requirements are based on a ratio of specific types of capital to "risk-weighted assets." Not only did Basel III change the components and requirements of capital, but, for nearly every class of financial assets, the Basel III Rule requires a more complex, detailed and calibrated assessment of credit risk and calculation of risk weightings. While Basel III would have changed the risk weighting for residential mortgage loans based on loan-to-value ratios and certain product and underwriting characteristics, there was concern in the United States that the proposed methodology for risk weighting residential mortgage exposures and the higher risk weightings for certain types of mortgage products would increase costs to consumers and reduce their access to mortgage credit. As a result, the Basel III Rule did not effect this change, and banking institutions will continue to apply a risk weight of 50% or 100% to their exposure from residential mortgages.

Furthermore, there was significant concern noted by the financial industry in connection with the Basel III rulemaking as to the proposed treatment of accumulated other comprehensive income ("AOCI"). Basel III requires unrealized gains and losses on available-for-sale securities to flow through to regulatory capital as opposed to the previous treatment, which neutralized such effects. Recognizing the problem for community banks, the U.S. bank regulatory agencies adopted the Basel III Rule with a one-time election for smaller institutions like the Company and the Bank to opt-out of including most elements of AOCI in regulatory capital. This opt-out, which must be made in the first quarter of 2015, would exclude from regulatory capital both unrealized gains and losses on available-for-sale debt securities and accumulated net gains and losses on cash-flow hedges and amounts attributable to defined benefit post-retirement plans. The Company and the Bank expect to make this election to avoid variations in the level of their capital depending on fluctuations in the fair value of their securities portfolio.

Banking institutions (except for large, internationally active financial institutions) became subject to the Basel III Rule on January 1, 2015, and both the Company and the Bank are currently in compliance with the new required ratios. There are separate phase-in/phase-out periods for: (i) the capital conservation buffer; (ii) regulatory capital adjustments and deductions; (iii) nonqualifying capital instruments; and (iv) changes to the prompt corrective action rules. The phase-in periods commence on January 1, 2016 and extend until 2019.

The Company

General. The Company, as the sole shareholder of the Bank, is a bank holding company. As a bank holding company, the Company is registered with, and is subject to regulation by, the Federal Reserve under the Bank Holding Company Act of 1956, as amended (the "BHCA"). In accordance with Federal Reserve policy, and as now codified by the Dodd-Frank Act, the Company is legally obligated to act as a source of financial strength to the Bank and to commit resources to support the Bank in circumstances where the Company might not otherwise do so. Under the BHCA, the Company is subject to periodic examination by the Federal Reserve. The Company is required to file with the Federal Reserve periodic reports of the Company's operations and such additional information regarding the Company and its subsidiaries as the Federal Reserve may require. The Company is also subject to regulation by the DFI under Indiana law.

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Acquisitions, Activities and Change in Control. The primary purpose of a bank holding company is to control and manage banks. The BHCA generally requires the prior approval of the Federal Reserve for any merger involving a bank holding company or any acquisition by a bank holding company of another bank or bank holding company. Subject to certain conditions (including deposit concentration limits established by the BHCA and the Dodd-Frank Act), the Federal Reserve may allow a bank holding company to acquire banks located in any state of the United States. In approving interstate acquisitions, the Federal Reserve is required to give effect to applicable state law limitations on the aggregate amount of deposits that may be held by the acquiring bank holding company and its insured depository institution affiliates in the state in which the target bank is located (provided that those limits do not discriminate against out-of-state depository institutions or their holding companies) and state laws that require that the target bank have been in existence for a minimum period of time (not to exceed five years) before being acquired by an out-of-state bank holding company. Furthermore, in accordance with the Dodd-Frank Act, bank holding companies must be well-capitalized and well-managed in order to effect interstate mergers or acquisitions. For a discussion of the capital requirements, see “The Increasing Regulatory Emphasis on Capital” above.

The BHCA generally prohibits the Company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than that of banking, managing and controlling banks or furnishing services to banks and their subsidiaries. This general prohibition is subject to a number of exceptions. The principal exception allows bank holding companies to engage in, and to own shares of companies engaged in, certain businesses found by the Federal Reserve prior to November 11, 1999 to be “so closely related to banking ... as to be a proper incident thereto.” This authority would permit the Company to engage in a variety of banking-related businesses, including the ownership and operation of a savings association, or any entity engaged in consumer finance, equipment leasing, the operation of a computer service bureau (including software development) and mortgage banking and brokerage. The BHCA generally does not place territorial restrictions on the domestic activities of nonbank subsidiaries of bank holding companies.

Additionally, bank holding companies that meet certain eligibility requirements prescribed by the BHCA and elect to operate as financial holding companies may engage in, or own shares in companies engaged in, a wider range of nonbanking activities, including securities and insurance underwriting and sales, merchant banking and any other activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines by regulation or order is financial in nature or incidental to any such financial activity or that the Federal Reserve determines by order to be complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. The Company elected to, and continues to operate as, a financial holding company. Maintaining financial holding company status requires that the Bank remain “well-capitalized” and “well-managed” as defined by regulation and maintain at least a “satisfactory” rating under the Community Reinvestment Act. In addition, under the Dodd-Frank Act, the Company must also remain well-capitalized and well-managed to maintain its financial holding company status. If the Company or the Bank fails to continue to meet these requirements, the Company could be subject to restrictions on new activities and acquisitions and/or be required to cease and possibly divest of operations that conduct existing activities that are not permissible for a bank holding company that is not a financial holding company.

Federal law also prohibits any person or company from acquiring “control” of an FDIC-insured depository institution or its holding company without prior notice to the appropriate federal bank regulator. “Control” is conclusively presumed to exist upon the acquisition of 25% or more of the outstanding voting securities of a bank or bank holding company, but may arise under certain circumstances between 10% and 24.99% ownership.

Capital Requirements. Bank holding companies are required to maintain capital in accordance with Federal Reserve capital adequacy requirements, as affected by the Dodd-Frank Act and Basel III. For a discussion of capital requirements, see “—The Increasing Regulatory Emphasis on Capital” above.

Dividend Payments. The Company's ability to pay dividends to its shareholders may be affected by both general corporate law considerations and policies of the Federal Reserve applicable to bank holding companies. As an Indiana corporation, the Company is subject to the limitations of the Indiana General Business Corporation Law, which prohibit the Company from paying dividends if the Company is, or by payment of the dividend would become, insolvent, or if the payment of dividends would render the Company unable to pay its debts as they become due in the usual course of business. In addition, under the Basel III Rule, institutions that seek the freedom to pay dividends will have to maintain 2.5% in Common Equity Tier 1 attributable to the capital conservation buffer to be phased in over three years beginning in 2016. See "—The Increasing Regulatory Emphasis on Capital" above.

As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should eliminate, defer or significantly reduce dividends to shareholders if: (i) the company's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends; (ii) the prospective rate of earnings retention is inconsistent with the company's capital needs and overall current and prospective financial condition; or (iii) the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. The Federal Reserve also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies.

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Federal Securities Regulation. The Company's common stock is registered with the SEC under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Consequently, the Company is subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act.

Corporate Governance. The Dodd-Frank Act addresses many investor protection, corporate governance and executive compensation matters that will affect most U.S. publicly traded companies. The Dodd-Frank Act will increase stockholder influence over boards of directors by requiring companies to give stockholders a non-binding vote on executive compensation and so-called "golden parachute" payments, and authorizing the SEC to promulgate rules that would allow stockholders to nominate and solicit voters for their own candidates using a company's proxy materials. The legislation also directs the Federal Reserve to promulgate rules prohibiting excessive compensation paid to executives of bank holding companies, regardless of whether such companies are publicly traded.

The Bank

General. The Bank is an Indiana-chartered bank, the deposit accounts of which are insured by the Deposit Insurance Fund ("the DIF") to the maximum extent provided under federal law and FDIC regulations. The Bank is also a member of the Federal Reserve System (a "member bank"). As an Indiana-chartered, FDIC-insured member bank, the Bank is presently subject to the examination, supervision, reporting and enforcement requirements of the DFI, the chartering authority for Indiana banks, the Federal Reserve, as the primary federal regulator of member banks, and the FDIC, as administrator of the DIF.

Deposit Insurance. As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. The FDIC has adopted a risk-based assessment system whereby FDIC-insured depository institutions pay insurance premiums at rates based on their risk classification. An institution's risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to the regulators. For deposit insurance assessment purposes, an insured depository institution is placed in one of four risk categories each quarter. An institution's assessment is determined by multiplying its assessment rate by its assessment base. The total base assessment rates range from 2.5 basis points to 45 basis points. While in the past an insured depository institution's assessment base was determined by its deposit base, amendments to the Federal Deposit Insurance Act revised the assessment base so that it is calculated using average consolidated total assets minus average tangible equity. This change shifted the burden of deposit insurance premiums toward those large depository institutions that rely on funding sources other than U.S. deposits.

The FDIC has authority to raise or lower assessment rates on insured deposits in order to achieve statutorily required reserve ratios in the DIF and to impose special additional assessments. In light of the significant increase in depository institution failures in 2008-2010 and the increase of deposit insurance limits, the DIF incurred substantial losses during recent years. To bolster reserves in the DIF, the Dodd-Frank Act increased the minimum reserve ratio of the DIF to 1.35% of insured deposits and deleted the statutory cap for the reserve ratio. In December 2010, the FDIC set the designated reserve ratio at 2%, 65 basis points above the statutory minimum. At least semi-annually, the FDIC will update its loss and income projections for the DIF and, if needed, will increase or decrease the assessment rates, following notice and comment on proposed rulemaking. As a result, the Bank's FDIC deposit insurance premiums could increase.

FICO Assessments. In addition to paying basic deposit insurance assessments, insured depository institutions must pay Financing Corporation ("FICO") assessments. FICO is a mixed-ownership governmental corporation chartered by the former Federal Home Loan Bank Board pursuant to the Competitive Equality Banking Act of 1987 to function as a financing vehicle for the recapitalization of the former Federal Savings and Loan Insurance Corporation. FICO issued 30-year noncallable bonds of approximately $8.1 billion that mature in 2017 through 2019. FICO's authority to issue bonds ended on December 12, 1991. Since 1996, federal legislation has required that all FDIC-insured depository institutions pay assessments to cover interest payments on FICO's outstanding obligations. The FICO assessment rate is adjusted quarterly and for the fourth quarter of 2014 was approximately 0.620 basis points (62 cents per $100 of assessable deposits).

Supervisory Assessments. All Indiana banks are required to pay supervisory assessments to the DFI to fund the operations of the DFI. The amount of the assessment is calculated on the basis of the bank's total assets. During the year ended December 31, 2014, the Bank paid supervisory assessments to the DFI totaling $224,000.

Capital Requirements. Banks are generally required to maintain capital levels in excess of other businesses. For a discussion of capital requirements, see "—The Increasing Regulatory Emphasis on Capital" above.

Liquidity Requirements. Liquidity is a measure of the ability and ease with which bank assets may be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations. To remain viable, financial institutions must have enough liquid assets to meet their near-term obligations, such as withdrawals by depositors. Because the global financial crisis was in part a liquidity crisis, Basel III also included a liquidity framework that requires financial institutions to measure their liquidity against specific liquidity tests. One test, referred to as the Liquidity Coverage Ratio ("LCR"), is designed to ensure that the banking entity has an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet liquidity needs for a 30-calendar day liquidity stress scenario. The other test, known as the Net Stable Funding Ratio ("NSFR"), is designed to promote more medium- and long-term funding of the assets and activities of financial institutions over a one-year horizon. These tests provide an incentive for banks and holding companies to increase their holdings in Treasury securities and other sovereign debt as a component of assets, increase the use of long-term debt as a funding source and rely on stable funding like core deposits (in lieu of brokered deposits).

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In addition to liquidity guidelines already in place, the U.S. bank regulatory agencies implemented the LCR in September 2014, which requires large financial firms to hold levels of liquid assets sufficient to protect against constraints on their funding during times of financial turmoil. While the LCR only applies to the largest banking organizations in the country, certain elements are expected to filter down to all insured depository institutions. The Company and the Bank are reviewing their liquidity risk management policies in light of the LCR and NSFR.

Dividend Payments. The primary source of funds for the Company is dividends from the Bank. Indiana law prohibits the Bank from paying dividends in an amount greater than its undivided profits. The Bank is required to obtain the approval of the DFI for the payment of any dividend if the total of all dividends declared by the Bank during the calendar year, including the proposed dividend, would exceed the sum of the Bank's net income for the year-to-date combined with its retained net income for the previous two years. Indiana law defines "retained net income" to mean the net income of a specified period, calculated under the consolidated report of income instructions, less the total amount of all dividends declared for the specified period. The Federal Reserve Act also imposes limitations on the amount of dividends that may be paid by state member banks, such as the Bank. Without Federal Reserve approval, a state member bank may not pay dividends in any calendar year that, in the aggregate, exceed the bank's calendar year-to-date net income plus the bank's retained net income for the two preceding calendar years.

The payment of dividends by any financial institution is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and a financial institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, the Bank exceeded its minimum capital requirements under applicable guidelines as of December 31, 2014. As of December 31, 2014, approximately $59.6 million was available to be paid as dividends by the Bank. Notwithstanding the availability of funds for dividends, however, the Federal Reserve may prohibit the payment of dividends by the Bank if it determines such payment would constitute an unsafe or unsound practice. In addition, under the Basel III Rule, institutions that seek the freedom to pay dividends will have to maintain 2.5% in Common Equity Tier 1 attributable to the capital conservation buffer to be phased in over three years beginning in 2016. See "—The Increasing Regulatory Emphasis on Capital" above.

Insider Transactions. The Bank is subject to certain restrictions imposed by federal law on "covered transactions" between the Bank and its "affiliates". The Company is an affiliate of the Bank for purposes of these restrictions, and covered transactions subject to the restrictions include extensions of credit to the Company, investments in the stock or other securities of the Company and the acceptance of the stock or other securities of the Company as collateral for loans made by the Bank. The Dodd-Frank Act enhances the requirements for certain transactions with affiliates as of July 21, 2011, including an expansion of the definition of "covered transactions" and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained.

Certain limitations and reporting requirements are also placed on extensions of credit by the Bank to its directors and officers, to directors and officers of the Company and its subsidiaries, to principal shareholders of the Company and to "related interests" of such directors, officers and principal shareholders. In addition, federal law and regulations may affect the terms upon which any person who is a director or officer of the Company or the Bank, or a principal shareholder of the Company, may obtain credit from banks with which the Bank maintains a correspondent relationship.

Safety and Soundness Standards/Risk Management. The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each financial institution is responsible for establishing its own procedures to achieve those goals. If a financial institution fails to comply with any of the standards set forth in the guidelines, the financial institution's primary federal regulator may require the financial institution to submit a plan for achieving and maintaining compliance. If a financial institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the financial institution to cure the deficiency. Until the deficiency cited in the regulator's order is cured, the regulator may restrict the financial institution's rate of growth, require the financial institution to increase its capital, restrict the rates the financial institution pays on deposits or require the financial institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal bank regulatory agencies, including cease and desist orders and civil money penalty assessments.

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During the past decade, the bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the financial institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk. In particular, recent regulatory pronouncements have focused on operational risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. New products and services, third-party risk management and cyber-security are critical sources of operational risk that financial institutions are expected to address in the current environment. The Bank is expected to have active board and senior management oversight; adequate policies, procedures and limits; adequate risk measurement, monitoring and management information systems; and comprehensive internal controls.

Branching Authority. Indiana banks, such as the Bank, have the authority under Indiana law to establish branches anywhere in the State of Indiana, subject to receipt of all required regulatory approvals.

Federal law permits state and national banks to merge with banks in other states subject to: (i) regulatory approval; (ii) federal and state deposit concentration limits; and (iii) state law limitations requiring the merging bank to have been in existence for a minimum period of time (not to exceed five years) prior to the merger. The establishment of new interstate branches has historically been permitted only in those states the laws of which expressly authorize such expansion. The Dodd-Frank Act permits well-capitalized and well-managed banks to establish new interstate branches or the acquisition of individual branches of a bank in another state (rather than the acquisition of an out-of-state bank in its entirety) without impediments.

State Bank Investments and Activities. The Bank is permitted to make investments and engage in activities directly or through subsidiaries as authorized by Indiana law. However, under federal law, FDIC-insured state banks are prohibited, subject to certain exceptions, from making or retaining equity investments of a type, or in an amount, that are not permissible for a national bank. Federal law also prohibits FDIC-insured state banks and their subsidiaries, subject to certain exceptions, from engaging as principal in any activity that is not permitted for a national bank unless the bank meets, and continues to meet, its minimum regulatory capital requirements and the FDIC determines that the activity would not pose a significant risk to the DIF. These restrictions have not had, and are not currently expected to have, a material impact on the operations of the Bank.

Transaction Account Reserves. Federal Reserve regulations require insured depository institutions to maintain reserves against their transaction accounts (primarily NOW and regular checking accounts). For 2015: the first $14.5 million of otherwise reservable balances are exempt from the reserve requirements; for transaction accounts aggregating more than $14.5 million to $103.6 million, the reserve requirement is 3% of total transaction accounts; and for net transaction accounts in excess of $103.6 million, the reserve requirement is $2,673,000 plus 10% of the aggregate amount of total transaction accounts in excess of $103.6 million. These reserve requirements are subject to annual adjustment by the Federal Reserve.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank of Indianapolis (the “FHLB”), which serves as a central credit facility for its members. The FHLB is funded primarily from proceeds from the sale of obligations of the FHLB system. It makes loans to member banks in the form of FHLB advances. All advances from the FHLB are required to be fully collateralized as determined by the FHLB.

Community Reinvestment Act Requirements. The Community Reinvestment Act requires the Bank to have a continuing and affirmative obligation in a safe and sound manner to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. Federal regulators regularly assess the Bank’s record of meeting the credit needs of its communities. Applications for additional acquisitions would be affected by the evaluation of the Bank’s effectiveness in meeting its Community Reinvestment Act requirements.

Anti-Money Laundering. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the “Patriot Act”) is designed to deny terrorists and criminals the ability to obtain access to the U.S. financial system and has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act mandates financial services companies to have policies and procedures with respect to measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between financial institutions and law enforcement authorities.

Concentrations in Commercial Real Estate. Concentration risk exists when financial institutions deploy too many assets to any one industry or segment. Concentration stemming from commercial real estate is one area of regulatory concern. The interagency Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices guidance (“CRE Guidance”) provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny: (i) commercial real estate loans exceeding 300% of capital and increasing 50% or more in the preceding three years; or (ii) construction and land development loans exceeding 100% of capital. The CRE Guidance does not limit banks’ levels of commercial real estate lending activities, but rather guides institutions in developing risk management practices and levels of capital that are commensurate with the level and nature of their commercial real estate concentrations. Based on the Bank’s loan portfolio, the Bank does not exceed these guidelines.

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Consumer Financial Services

The historical structure of federal consumer protection regulation applicable to all providers of consumer financial products and services changed significantly on July 21, 2011, when the CFPB commenced operations to supervise and enforce consumer protection laws. The CFPB has broad rulemaking authority for a wide range of consumer protection laws that apply to all providers of consumer products and services, including the Bank, as well as the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB has examination and enforcement authority over providers with more than $10 billion in assets. Banks and savings institutions with $10 billion or less in assets, like the Bank, will continue to be examined by their applicable bank regulators.

Because abuses in connection with residential mortgages were a significant factor contributing to the financial crisis, many new rules issued by the CFPB and required by the Dodd-Frank Act address mortgage and mortgage-related products, their underwriting, origination, servicing and sales. The Dodd-Frank Act significantly expanded underwriting requirements applicable to loans secured by 1-4 family residential real property and augmented federal law combating predatory lending practices. In addition to numerous disclosure requirements, the Dodd-Frank Act imposed new standards for mortgage loan originations on all lenders, including banks and savings associations, in an effort to strongly encourage lenders to verify a borrower's ability to repay, while also establishing a presumption of compliance for certain "qualified mortgages". In addition, the Dodd-Frank Act generally required lenders or securitizers to retain an economic interest in the credit risk relating to loans that the lender sells, and other asset-backed securities that the securitizer issues, if the loans do not comply with the ability-to-repay standards described below. The risk retention requirement generally is 5%, but could be increased or decreased by regulation. The Bank does not currently expect the CFPB's rules to have a significant impact on its operations, except for higher compliance costs.

Ability-to-Repay Requirement and Qualified Mortgage Rule. On January 10, 2013, the CFPB issued a final rule implementing the Dodd-Frank Act's ability-to-repay requirements. Under the final rule, lenders, in assessing a borrower's ability to repay a mortgage-related obligation, must consider eight underwriting factors: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) monthly payment on the subject transaction; (iv) monthly payment on any simultaneous loan; (v) monthly payment for all mortgage-related obligations; (vi) current debt obligations, alimony and child support; (vii) monthly debt-to-income ratio or residual income; and (viii) credit history. The final rule also includes guidance regarding the application of, and methodology for evaluating, these factors.

Further, the final rule clarified that qualified mortgages do not include "no-doc" loans and loans with negative amortization, interest-only payments, balloon payments, terms in excess of 30 years, or points and fees paid by the borrower that exceed 3% of the loan amount, subject to certain exceptions. In addition, for qualified mortgages, the rule mandated that the monthly payment be calculated on the highest payment that will occur in the first five years of the loan, and required that the borrower's total debt-to-income ratio generally may not be more than 43%. The final rule also provided that certain mortgages that satisfy the general product feature requirements for qualified mortgages and that also satisfy the underwriting requirements of Fannie Mae and Freddie Mac (while they operate under federal conservatorship or receivership), or the U.S. Department of Housing and Urban Development, Department of Veterans Affairs, or Department of Agriculture or Rural Housing Service, are also considered to be qualified mortgages. This second category of qualified mortgages will phase out as the aforementioned federal agencies issue their own rules regarding qualified mortgages, the conservatorship of Fannie Mae and Freddie Mac ends, and, in any event, after seven years.

As set forth in the Dodd-Frank Act, subprime (or higher-priced) mortgage loans are subject to the ability-to-repay requirement, and the final rule provided for a rebuttable presumption of lender compliance for those loans. The final rule also applied the ability-to-repay requirement to prime loans, while also providing a conclusive presumption of compliance (i.e., a safe harbor) for prime loans that are also qualified mortgages. Additionally, the final rule generally prohibited prepayment penalties (subject to certain exceptions) and set forth a 3-year record retention period with respect to documenting and demonstrating the ability-to-repay requirement and other provisions.

Mortgage Loan Originator Compensation. As a part of the overhaul of mortgage origination practices, mortgage loan originators' compensation was limited such that they may no longer receive compensation based on a mortgage transaction's terms or conditions other than the amount of credit extended under the mortgage loan. Further, the total points and fees that a bank and/or a broker may charge on conforming and jumbo loans was limited to 3.0% of the total loan amount. Mortgage loan originators may receive compensation from a consumer or from a lender, but not both. These rules contain requirements designed to prohibit mortgage loan originators from "steering" consumers to loans that provide mortgage loan originators with greater compensation. In addition, the rules contain other requirements concerning recordkeeping.

Servicing. The CFPB was also required to implement certain provisions of the Dodd-Frank Act relating to mortgage servicing through rulemaking. The servicing rules require servicers to meet certain benchmarks for loan servicing and customer service in general. Servicers must provide periodic billing statements and certain required notices and acknowledgments, promptly credit borrowers' accounts for payments received and promptly investigate complaints by borrowers and are required to take additional steps before purchasing insurance to protect the lender's interest in the property. The servicing rules also called for additional notice, review and timing requirements with respect to delinquent borrowers, including early intervention, ongoing access to servicer personnel and specific loss mitigation and foreclosure procedures. The rules provided for an exemption from most of these requirements for "small servicers". A small servicer is defined as a loan servicer that services 5,000 or fewer mortgage loans and services only mortgage loans that they or an affiliate originated or own.

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Additional Constraints on the Company and Bank

Monetary Policy. The monetary policy of the Federal Reserve has a significant effect on the operating results of financial or bank holding companies and their subsidiaries. Among the tools available to the Federal Reserve to affect the money supply are open market transactions in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid on deposits.

The Volcker Rule. In addition to other implications of the Dodd-Frank Act discussed above, the Act amended the BHCA to require the federal regulatory agencies to adopt rules that prohibit banking entities and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds). This statutory provision is commonly called the “Volcker Rule.” On December 10, 2013, the federal regulatory agencies issued final rules to implement the prohibitions required by the Volcker Rule. Thereafter, in reaction to industry concern over the adverse impact to community banks of the treatment of certain collateralized debt instruments in the final rule, the federal regulatory agencies approved an interim final rule to permit financial institutions to retain interests in collateralized debt obligations backed primarily by trust preferred securities (“TruPS CDOs”) from the investment prohibitions contained in the final rule. Under the interim final rule, the regulatory agencies permitted the retention of an interest in or sponsorship of covered funds by banking entities if the following qualifications were met: (i) the TruPS CDO was established, and the interest was issued, before May 19, 2010; (ii) the banking entity reasonably believes that the offering proceeds received by the TruPS CDO were invested primarily in qualifying TruPS collateral; and (iii) the banking entity's interest in the TruPS CDO was acquired on or before December 10, 2013.

Although the Volcker Rule has significant implications for many large financial institutions, the Company does not currently anticipate that it will have a material effect on the operations of the Company or the Bank, particularly as the Company does not own any TruPS CDOs. The Company may incur costs if it is required to adopt additional policies and systems to ensure compliance with certain provisions of the Volcker Rule, but any such costs are not expected to be material.

ITEM 1A. RISK FACTORS

In addition to the other information in this Annual Report on Form 10-K, stockholders or prospective investors should carefully consider the following risk factors:

A downturn in the general economic or business conditions, where our business is concentrated, could have an adverse effect on our business, results of operations and financial condition.

We operate branch offices in five geographical markets concentrated in Northern Indiana and three full service offices in Central Indiana in the Indianapolis market. We have divided our Northern Indiana markets into four distinct regions, the North Region, the South Region, the East Region and the West Region. Our most mature market, the South Region, includes Kosciusko County and portions of contiguous counties. The Bank was founded in this market in 1872. Warsaw is this region’s primary city. The Bank entered the North Region in 1990, which includes portions of Elkhart and St. Joseph counties. This region includes the cities of Elkhart and South Bend. The Central Region includes portions of Elkhart County and contiguous counties and is anchored by the city of Goshen. The North and Central regions represent relatively older markets for us with nearly 25 years of business activity. We entered the East Region in 1999, which includes Allen and DeKalb counties. Fort Wayne represents the primary city in this market. We have experienced rapid commercial loan growth in this market over the past 14 years. We entered the Indianapolis market in 2006 with the opening of a loan production office in Hamilton County and opened a full service retail and commercial branch in late 2011. We opened a second office in the Indianapolis market in January 2014 and a third in December 2014.

Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers’ business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. A severe economic downturn began in late 2007 that had broad based impact throughout the United States on the national economy. During the downturn, certain areas of our geographical markets experienced notably worse economic conditions than those suffered by the country at-large. Weak economic conditions were characterized by, among other indicators, deflation, unemployment, fluctuations in debt and equity capital markets, increased delinquencies on mortgage, commercial and consumer loans, residential and commercial real estate price declines and lower home sales and commercial activity. All of those factors are generally detrimental to our business. While conditions have improved and there have been indications of economic growth both nationally and within our geographic area, the lingering impact of this downturn continues to represent a risk to our business.

As reported for December 2014, the 14 counties in which we operate had unemployment rates between 4.1% and 6.4%, which represent a considerable improvement from prior years. If the overall economic climate in the United States, generally, and our market areas, specifically, fails to continue to improve, our financial condition and the results of operations could be affected, including the volume of loan originations, increase the level of nonperforming assets, increase the rate of foreclosure losses on loans and reduce the value of our loans and loan servicing portfolio. Additionally, we could experience a lack of demand for our products and services, an increase in loan delinquencies and defaults and high or increased levels of problem assets and foreclosures. Moreover, because of our geographic concentration, we are less able than other regional or national financial institutions to diversify our credit risks across multiple markets.

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If we do not effectively manage our credit risk, we may experience increased levels of nonperforming loans, charge - offs and delinquencies, which could require further increase in our provision for loan losses.

There are risks inherent in making any loan, including risks inherent in dealing with individual borrowers, risks of nonpayment, risks resulting from uncertainties as to the future value of collateral and risks resulting from changes in economic and industry conditions. We attempt to minimize our credit risk through prudent loan application approval procedures, careful monitoring of the concentration of our loans within specific industries, a centralized credit administration department and periodic independent reviews of outstanding loans by our loan review department. However, we cannot make assurances that such approval and monitoring procedures will reduce these credit risks. If the overall economic climate in the United States, generally, and our market areas, specifically, does not continue to improve, or even if it does, our borrowers may experience difficulties in repaying their loans, and the level of nonperforming loans, charge-offs and delinquencies could rise and require increases in the provision for loan losses, which would cause our net income and return on equity to decrease.

Commercial and industrial and agri-business loans make up a significant portion of our loan portfolio.

Commercial and industrial and agri-business loans were $1.309 billion, or approximately 47.4% of our total loan portfolio, as of December 31, 2014. Commercial loans are often larger and involve greater risks than other types of lending. Because payments on such loans are often dependent on the successful operation of the borrower involved, repayment of such loans is often more sensitive than other types of loans to adverse conditions in the general economy. Our commercial loans are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. Most often, this collateral is accounts receivable, inventory, machinery or real estate. Whenever possible, we require a personal guarantee on commercial loans. Credit support provided by the borrower for most of these loans and the probability of repayment is based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any exists. As a result, 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. The collateral securing other loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. Due to the larger average size of each commercial loan as compared with other loans such as residential loans, as well as collateral that is generally less readily-marketable, losses incurred on a small number of commercial loans could adversely affect our business, results of operations and growth prospects.

Our loan portfolio includes commercial real estate loans, which involve risks specific to real estate value.

Commercial real estate loans were $1.026 billion, or approximately 37.1% of our total loan portfolio, as of December 31, 20143. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Although a significant portion of such loans are secured by real estate as a secondary form of collateral, continued adverse developments affecting real estate values in one or more of our markets could increase the credit risk associated with our loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties.

If the loans that are collateralized by real estate become troubled and the value of the real estate has been significantly impaired, then we may not be able to recover the full contractual amount of principal and interest that we anticipated at the time of originating the loan, which could cause us to increase our provision for loan losses and adversely affect our operating results and financial condition.

Our consumer loans generally have a higher degree of risk of default than our other loans.

At December 31, 2014, consumer loans totaled $49.5 million, or 1.8% of our total loan and lease portfolio. Consumer loans typically have shorter terms and lower balances with higher yields as compared to commercial loans, but generally carry higher risks of default. Consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on these loans.

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Our continued pace of growth may require us to raise additional capital in the future, but that capital may not be available when it is needed.

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. We may at some point need to raise additional capital to support our continued growth. Our ability to raise additional capital depends on conditions in the capital markets, economic conditions and a number of other factors, including investor perceptions regarding the banking industry, market conditions and governmental activities, and on our financial condition and performance. Accordingly, we cannot make assurances of our ability to raise additional capital, if needed, on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth or acquisitions could be materially impaired.

Interest rate shifts may reduce net interest income and otherwise negatively impact our financial condition and results of operations.

Shifts in short-term interest rates may reduce net interest income, which is the principal component of our earnings. Net interest income is the difference between the amounts received by us on our interest-earning assets and the interest paid by us on our interest-bearing liabilities. When interest rates rise, the rate of interest we pay on our liabilities rises more quickly than the rate of interest that we receive on our interest-bearing assets, which may cause our profits to decrease. The impact on earnings is more adverse when the slope of the yield curve flattens, i.e. when short-term interest rates increase more than long-term interest rates or when long-term interest rates decrease more than short-term interest rates.

Interest rate increases often result in larger payment requirements for our borrowers, which increases the potential for default. At the same time, the marketability of the underlying property may be adversely affected by any reduced demand resulting from higher interest rates. In a declining interest rate environment, there may be an increase in prepayments on the loans underlying our participation interests as borrowers refinance their mortgages at lower rates.

Changes in interest rates also can affect the value of loans, securities and other assets. An increase in interest rates that adversely affects the ability of borrowers to pay the principal or interest on loans may lead to an increase in nonperforming assets and a reduction of income recognized, which could have a material adverse effect on our results of operations and cash flows. Thus, an increase in the amount of nonperforming assets would have an adverse impact on net interest income.

If short-term interest rates remain at their historically low levels for a prolonged period, and assuming long-term interest rates fall further, we could experience net interest margin compression as our interest-earning assets would continue to reprice downward while our interest bearing liability rates could fail to decline in tandem. This would have a material adverse effect on our net interest income and our results of operations.

We must effectively manage credit risk and if we are unable to do so our allowance for loan losses may prove to be insufficient to absorb potential losses in our loan portfolio.

We establish our allowance for loan losses and maintain it at a level considered adequate by management to absorb probable incurred loan losses that are inherent in the portfolio. The allowance contains provisions for probable incurred losses that have been identified relating to specific borrowing relationships, as well as probable losses inherent in the loan portfolio and credit undertakings that are not specifically identified. Additions to the allowance for loan losses, which are charged to earnings through the provision for loan losses, are determined based on a variety of factors, including an analysis of the loan portfolio, historical loss experience and an evaluation of current economic conditions in our market areas. The actual amount of loan losses is affected by changes in economic, operating and other conditions within our markets, which may be beyond our control, and such losses may exceed current estimates.

At December 31, 2014, our allowance for loan losses as a percentage of total loans was 1.67% and as a percentage of total nonperforming loans was 338%. Because of the nature of our loan portfolio and our concentration in commercial and industrial loans, which tend to be larger loans, the movement of a small number of loans to nonperforming status can have a significant impact on these ratios. Although management believes that the allowance for loan losses is adequate to absorb probable losses on any existing loans, we cannot predict loan losses with certainty and we cannot assure you that our allowance for loan losses will prove sufficient to cover actual loan losses in the future. Loan losses in excess of our reserves may adversely affect our business, results of operations and financial condition.

Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition and could result in further losses in the future.

Our nonperforming assets adversely affect our net income in various ways. We do not record interest income on nonaccrual loans or other real estate owned, which adversely affects our net income and returns on assets and equity, increases our loan administration costs and adversely affects our efficiency ratio. When we take collateral in foreclosure and similar proceedings, we are required to mark the collateral to its then fair market value, which may result in a loss. These nonperforming loans and other real estate owned also increase our risk profile and our regulatory capital requirements may increase in light of such risks. The resolution of nonperforming assets requires significant time commitments from management and can be detrimental to the performance of their other responsibilities. If we experience increases in nonperforming loans and nonperforming assets, our net interest income may be negatively impacted and our loan administration costs could increase, each of which could have an adverse effect on our net income and related ratios, such as return on assets and equity.

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Liquidity risks could affect operations and jeopardize our business, results of operations and financial condition.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial, negative effect on our liquidity. Our primary sources of funds consist of cash from operations, investment maturities and sales and deposits. Additional liquidity is provided by brokered deposits, Certificate of Deposit Account Registry Service (“CDARS”) deposits, repurchase agreements as well as our ability to borrow from the Federal Reserve and the FHLB. Our access to funding sources in amounts adequate to finance or capitalize our activities or on terms that are acceptable to us could be impaired by factors that affect us directly or the financial services industry or economy in general, such as disruptions in the financial markets or negative views and expectations about the prospects for the financial services industry.

During the recent recession, the financial services industry and the credit markets generally were materially and adversely affected by significant declines in asset values and historically depressed levels of liquidity. The liquidity issues were also particularly acute for regional and community banks, as many of the larger financial institutions curtailed their lending to regional and community banks to reduce their exposure to the risks of other banks. In addition, many of the larger correspondent lenders reduced or even eliminated federal funds lines for their correspondent customers. Furthermore, regional and community banks generally have less access to the capital markets than national and super-regional banks because of their smaller size and limited analyst coverage. Although availability has improved since the beginning of the recession, any decline in available funding, similar to the decline experienced during the recession, could adversely impact our ability to originate loans, invest in securities, meet our expenses, pay dividends to our stockholders, or fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could have a material adverse impact on our liquidity, business, results of operations and financial condition.

Any action or steps to change coverages or eliminate Indiana’s Public Deposit Insurance Fund could require us to find alternative, higher-cost funding sources to replace public fund deposits or to provide for collateralization of these deposits.

Approximately 26% of our deposits are concentrated in public funds from a small number of municipalities and government agencies. A shift in funding away from public fund deposits would likely increase our cost of funds, as the alternate funding sources, such as brokered certificates of deposit, are higher-cost, less favorable deposits. The inability to maintain these public funds on deposit could result in a material adverse effect on the Bank’s liquidity and could materially impact our ability to grow and remain profitable.

Declines in asset values may result in impairment charges and adversely affect the value of our investments, financial performance and capital.

We maintain an investment portfolio that includes, but is not limited to, mortgage-backed securities. The market value of investments may be affected by factors other than the underlying performance of the servicer of the securities or the mortgages underlying the securities, such as ratings downgrades, adverse changes in the business climate and a lack of liquidity in the secondary market for certain investment securities. On a monthly basis, we evaluate investments and other assets for impairment indicators. We may be required to record additional impairment charges if our investments suffer a decline in value that is considered other-than-temporary. If we determine that a significant impairment has occurred, we would be required to charge against earnings the credit-related portion of the other-than-temporary impairment, which could have a material adverse effect on our results of operations in the periods in which the write-offs occur.

We may experience difficulties in managing our growth, and our growth strategy involves risks that may negatively impact our net income.

In addition to our ongoing expansion in Indianapolis, we may expand into additional communities or attempt to strengthen our position in our current markets through opportunistic acquisitions of all or part of other financial institutions, including FDIC-assisted transactions, or by opening new branches. To the extent that we undertake acquisitions or new branch openings, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Other effects of engaging in such growth strategies may include potential diversion of our management's time and attention and general disruption to our business.

To the extent that we grow through acquisitions and branch openings, we cannot assure you that we will be able to adequately and profitably manage this growth. Acquiring other banks and businesses will involve similar risks to those commonly associated with branching but may also involve additional risks, including:

- potential exposure to unknown or contingent liabilities of banks and businesses we acquire;

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- exposure to potential asset quality issues of the acquired bank or related business;
- difficulty and expense of integrating the operations and personnel of banks and businesses we acquire; and
- the possible loss of key employees and customers of the banks and businesses we acquire.

Attractive acquisition opportunities may not be available to us in the future.

We expect that other banking and financial service companies, many of which have significantly greater resources than us, will compete with us in acquiring other financial institutions if we pursue such acquisitions. This competition could increase prices for potential acquisitions that we believe are attractive. Also, acquisitions are subject to various regulatory approvals. If we fail to receive the appropriate regulatory approvals, we will not be able to consummate an acquisition that we believe is in our best interests. Among other things, our regulators consider our capital, liquidity, profitability, regulatory compliance and levels of goodwill and intangibles when considering acquisition and expansion proposals. Any acquisition could be dilutive to our earnings and stockholders' equity per share of our common stock.

Our accounting policies and methods are the basis for how we report our financial condition and results of operations, and they may require management to make estimates about matters that are inherently uncertain.

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. Our management must exercise judgment in selecting and applying many of these accounting policies and methods in order to ensure they comply with GAAP and reflect management's judgment as to the most appropriate manner in which to record and report our financial condition and results of operations. In some cases, management must select the accounting policy or method to apply from two or more alternatives, any of which might be reasonable under the circumstances. The application of that chosen accounting policy or method might result in the Company reporting different amounts than would have been reported under a different alternative. If management's estimates or assumptions are incorrect, the Company may experience material losses.

Management has identified two accounting policies as being "critical" to the presentation of the Company's financial condition and results of operations because they require management to make particularly subject and complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These critical accounting policies relate to: (1) determining the fair value and possible other than temporary impairment of investment securities available for sale and (2) the allowance for loan losses. Because of the inherent uncertainty of these estimates, no assurance can be given that the application of alternative policies or methods might not result in the reporting of different amounts of the fair value of securities available for sale, or the allowance for loan losses and, accordingly, net income.

From time to time, the FASB and the SEC change the financial accounting and reporting standards or the interpretation of those standards that govern the preparation of our external financial statements. These changes are beyond our control, can be difficult to predict and could materially impact how we report our financial condition and results of operations. Changes in these standards are continuously occurring, and given the current economic environment, more drastic changes may occur. The implementation of such changes could have a material adverse effect on our financial condition and results of operations.

We face intense competition in all phases of our business from other banks and financial institutions.

The banking and financial services business in our market is highly competitive. Our competitors include large national and regional banks, local community banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market mutual funds, credit unions, farm credit services and other nonbank financial service providers. Many of these competitors are not subject to the same regulatory restrictions as we are and are able to provide customers with a feasible alternative to traditional banking services.

Increased competition in our market may also result in a decrease in the amounts of our loans and deposits, reduced spreads between loan rates and deposit rates or loan terms that are more favorable to the borrower. Any of these results could have a material adverse effect on our ability to grow and remain profitable. If increased competition causes us to significantly discount the interest rates we offer on loans or increase the amount we pay on deposits, our net interest income could be adversely impacted. If increased competition causes us to relax our underwriting standards, we could be exposed to higher losses from lending activities. Moreover, we rely on deposits to be a low cost source of funding, and a loss in our deposit base could cause us to incur higher funding costs. Additionally, many of our competitors are much larger in total assets and capitalization, have greater access to capital markets, possess larger lending limits and offer a broader range of financial services than we can offer.

The repeal of federal prohibitions on payment of interest on business demand deposits could increase our interest expense and have a material adverse effect on us.

All federal prohibitions on the ability of financial institutions to pay interest on business demand deposit accounts were repealed as part of the Dodd-Frank Act. As a result, some financial institutions have commenced offering interest on these demand deposits to compete for customers. If competitive pressures require us to pay interest on these demand deposits to attract and retain business customers, our interest expense would increase and our net interest margin would decrease. This could have a material adverse effect on us. Further, the effect of the repeal of the prohibition could be more significant in a higher interest rate environment as business customers would have a greater incentive to seek interest on demand deposits.

We are required to maintain capital to meet regulatory requirements, and, if we fail to maintain sufficient capital, whether due to losses, an inability to raise additional capital or otherwise, our financial condition, liquidity and results of operations, as well as our ability to maintain regulatory compliance, would be adversely affected.

The Company, on a consolidated basis, and the Bank, on a stand-alone basis, must meet certain regulatory capital requirements and maintain sufficient liquidity. We face significant capital and other regulatory requirements as a financial institution, which were heightened with the implementation of the Basel III rule on January 1, 2015. Our ability to raise additional capital depends on conditions in the capital markets, economic conditions and a number of other factors, including investor perceptions regarding the banking industry, market conditions and governmental activities and on our financial condition and performance. Accordingly, we cannot assure you that we will be able to raise additional capital if needed or on terms acceptable to us. If we fail to maintain capital to meet regulatory requirements, our financial condition, liquidity and results of operations would be materially and adversely affected.

Monetary policies and regulations of the Federal Reserve could adversely affect our business, financial condition and results of operations.

In addition to being affected by general economic conditions, our earnings and growth are affected by the policies of the Federal Reserve. An important function of the Federal Reserve is to regulate the money supply and credit conditions. Among the instruments used by the Federal Reserve to implement these objectives are open market operations in U.S. government securities, adjustments of the discount rate and changes in reserve requirements against bank deposits. These instruments are used in varying combinations to influence overall economic growth and the distribution of credit, bank loans, investments and deposits. Their use also affects interest rates charged on loans or paid on deposits.

The monetary policies and regulations of the Federal Reserve have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. The effects of such policies upon our business, financial condition and results of operations cannot be predicted.

We may be materially and adversely affected by the highly regulated environment in which we operate.

We are subject to extensive federal and state regulation, supervision and examination. A more detailed description of the primary federal and state banking laws and regulations that affect us is contained in the section of this Form 10-K captioned “Supervision and Regulation.” Banking regulations are primarily intended to protect depositors’ funds, FDIC funds, customers and the banking system as a whole, rather than our shareholders. These regulations affect our lending practices, capital structure, investment practices, dividend policy and growth, among other things.

As a bank holding company, we are subject to extensive regulation and supervision and undergo periodic examinations by our regulators, who have extensive discretion and authority to prevent or remedy unsafe or unsound practices or violations of law by banks and bank holding companies. Failure to comply with applicable laws, regulations or policies could result in sanctions by regulatory agencies, civil monetary penalties and/or damage to our reputation, which could have a material adverse effect on us. Although we have policies and procedures designed to mitigate the risk of any such violations, there can be no assurance that such violations will not occur.

The laws, regulations, rules, standards, policies and interpretations governing us are constantly evolving and may change significantly over time. For example, on July 21, 2010, the Dodd-Frank Act was signed into law, which significantly changed the regulation of financial institutions and the financial services industry. The Dodd-Frank Act, together with the regulations to be developed thereunder, includes provisions affecting large and small financial institutions alike, including several provisions that affect how community banks, thrifts and small bank and thrift holding companies will be regulated. In addition, the Federal Reserve, in recent years, has adopted numerous new regulations addressing banks' overdraft and mortgage lending practices. Further, the CFPB was recently established, with broad powers to supervise and enforce consumer protection laws, and additional consumer protection legislation and regulatory activity is anticipated in the near future.

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In addition, in July 2013, the U.S. federal banking authorities approved the implementation of the Basel III Rules. The Basel III Rules are applicable to all U.S. banks that are subject to minimum capital requirements as well as to bank and saving and loan holding companies, other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than $1 billion).

The Basel III Rules became effective on January 1, 2015, with a phase in period through 2019 for many of the changes. The Basel III Rules not only increase most of the required minimum regulatory capital ratios, they introduce a new Common Equity Tier 1 Capital ratio and the concept of a capital conservation buffer. The Basel III Rules also expand the current definition of capital by establishing additional criteria that capital instruments must meet to be considered Additional Tier 1 Capital (i.e., Tier 1 Capital in addition to Common Equity) and Tier 2 Capital. A number of instruments that formerly qualified as Tier 1 Capital will not qualify or their qualifications will change when the Basel III Rules are fully implemented. However, the Basel III Rules permit banking organizations with less than $15 billion in assets to retain, through a one-time election, the existing treatment for accumulated other comprehensive income, which currently does not affect regulatory capital. The Basel III Rules have maintained the general structure of the current prompt corrective action thresholds while incorporating the increased requirements, including the Common Equity Tier 1 Capital ratio. In order to be a “well-capitalized” depository institution under the new regime, an institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; a Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more. Institutions must also maintain a capital conservation buffer consisting of Common Equity Tier 1 Capital.

These provisions, as well as any other aspects of current or proposed regulatory or legislative changes to laws applicable to the financial industry, may impact the profitability of our business activities and may change certain of our business practices, including our ability to offer new products, obtain financing, attract deposits, make loans and achieve satisfactory interest spreads and could expose us to additional costs, including increased compliance costs. Although we are currently compliant with the Basel III Rules, these changes also may require us to invest significant management attention and resources to make any necessary changes to operations in order to comply and could therefore also materially and adversely affect our business, financial condition and results of operations.

Our ability to attract and retain management and key personnel and any damage to our reputation may affect future growth and earnings.

Much of our success and growth has been influenced strongly by our ability to attract and retain management experienced in banking and financial services and familiar with the communities in our market areas. Our ability to retain the executive officers, management teams, branch managers and loan officers at the Bank will continue to be important to the successful implementation of our strategy. It is also critical, as we grow, to be able to attract and retain qualified additional management and loan officers with the appropriate level of experience and knowledge about our market areas to implement our community-based operating strategy. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our business, results of operations and financial condition.

In addition, our business depends on earning and maintaining the trust of our customers and communities. Harm to our reputation could arise from numerous sources, including employee misconduct, compliance failures, litigation or our failure to deliver appropriate levels of service. If any events or circumstances occur which could undermine our reputation, there can be no assurance that the additional costs and expenses we may incur as a result would not have an adverse impact on our business.

We have a continuing need for technological change and we may not have the resources to effectively implement new technology.

The financial services industry is constantly undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market areas. Many of our larger competitors have substantially greater resources to invest in technological improvements. As a result, they may be able to offer additional or superior products to those that we will be able to offer, which would put us at a competitive disadvantage. Accordingly, we cannot provide assurances that we will be able to effectively implement new technology-driven products and services or be successful in marketing such products and services to our customers.

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The Company's information systems may experience an interruption or breach in security and cyber-attacks, all if which could have a material adverse effect on the Company's business.

The Company relies heavily on internal and outsourced technologies, communications, and information systems to conduct its business. Additionally, in the normal course of business, the Company collects, processes and retains sensitive and confidential information regarding our customers. As the Company's reliance on technology has increased, so have the potential risks of a technology-related operation interruption (such as disruptions in the Company's customer relationship management, general ledger, deposit, loan, or other systems) or the occurrence of a cyber-attacks (such as unauthorized access to the Company's systems). These risks have increased for all financial institutions as new technologies, the use of the Internet and telecommunications technologies (including mobile devices) to conduct financial and other business transactions and the increased sophistication and activities of organized crime, perpetrators of fraud, hackers, terrorists and others. In addition to cyber-attacks or other security breaches involving the theft of sensitive and confidential information, hackers recently have engaged in attacks against large financial institutions, particularly denial of service attacks, that are designed to disrupt key business services, such as customer-facing web sites. The Company is not able to anticipate or implement effective preventive measures against all security breaches of these types, especially because the techniques used change frequently and because attacks can originate from a wide variety of sources. However, applying guidance from FFIEC, the Company has analyzed and will continue to analyze security related to device specific considerations, user access topics, transaction-processing and network integrity.

The Company also faces risks related to cyber-attacks and other security breaches in connection with credit card and debit card transactions that typically involve the transmission of sensitive information regarding the Company's customers through various third parties, including merchant acquiring banks, payment processors, payment card networks and its processors. Some of these parties have in the past been the target of security breaches and cyber-attacks, and because the transactions involve third parties and environments such as the point of sale that the Company does not control or secure, future security breaches or cyber-attacks affecting any of these third parties could impact the Company through no fault of its own, and in some cases it may have exposure and suffer losses for breaches or attacks relating to them. Further cyber-attacks or other breaches in the future, whether affecting the Company or others, could intensify consumer concern and regulatory focus and result in reduced use of payment cards and increased costs, all of which could have a material adverse effect on the Company's business. To the extent we are involved in any future cyber-attacks or other breaches, the Company's reputation could be affected, would could also have a material adverse effect on the Company's business, financial condition or results of operations.

We are subject to certain operational risks, including, but not limited to, customer or employee fraud and data processing system failures and errors.

Employee errors and misconduct could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Misconduct by our employees could include hiding their own unauthorized activities from us, improper or unauthorized activities on behalf of our customers or improper use of confidential information. It is not always possible to prevent employee errors and misconduct, and the precautions we take to prevent and detect this activity may not be effective in all cases. Employee errors could also subject us to financial claims for negligence, among others.

We maintain a system of internal controls and insurance coverage to mitigate operational risks, including data processing system failures and errors and customer or employee fraud. Should our internal controls fail to prevent or detect an occurrence, or if any resulting loss is not insured or exceeds applicable insurance limits, it could have a material adverse effect on our business, results of operations and financial condition.

The preparation of our consolidated financial statements requires us to make estimates and judgments, which are subject to an inherent degree of uncertainty and which may differ from actual results.

Our consolidated financial statements are prepared in accordance with GAAP and general reporting practices within the financial services industry, which require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Some accounting policies, such as those pertaining to our allowance for loan losses and deferred tax asset and the necessity of any related valuation allowance, require the application of significant judgment by management in selecting the appropriate assumptions for calculating financial estimates. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty and actual results may differ from these estimates and judgments under different assumptions or conditions, which may have a material adverse effect on our financial condition or results of operations in subsequent periods.

We may be subject to a higher consolidated effective tax rate if there is a change in tax laws relating to LCB Investments II, Inc. or if LCB Funding, Inc. fails to qualify as a real estate investment trust.

The Bank holds certain investment securities in its wholly-owned subsidiary LCB Investments II, Inc., which is incorporated in Nevada. Pursuant to the State of Indiana’s current tax laws and regulations, we are not subject to Indiana income tax for income earned through that subsidiary. If there are changes in Indiana’s tax laws or interpretations thereof requiring us to pay state taxes for income generated by LCB Investments II, Inc., the resulting tax consequences could increase our effective tax rate or cause us to have a tax liability for prior years.

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The Bank also holds certain commercial real estate loans, residential real estate loans and other loans in a real estate investment trust through LCB Investments II, Inc. Qualification as a real estate investment trust involves application of specific provisions of the Internal Revenue Code relating to various asset tests. If LCB Funding, Inc. fails to meet any of the required provisions for real estate investment trusts, it could no longer qualify as a real estate investment trust and the resulting tax consequences would increase our effective tax rate or cause us to have a tax liability for prior years.

ITEM 1B. UNRESOLVED STAFF COMMENTS

We have no unresolved SEC staff comments.

ITEM 2. PROPERTIES

The Company is headquartered in the main office building of the Bank at 202 E. Center Street, Warsaw, Indiana. The Company operates in 53 locations, 48 of which are owned by the Bank and five of which are leased from third parties. In addition, the Company leases the real estate for its four freestanding ATMs.

None of the Company's assets are the subject of any material encumbrances.

ITEM 3. LEGAL PROCEEDINGS

There are no material pending legal proceedings other than ordinary routine litigation incidental to the business to which the Company and the Bank are a party or of which any of their property is subject.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The quarterly high and low closing prices for the Company's common stock and the cash dividends declared and paid on that common stock are set forth in the table below.

	2014			2013			
	High*	Low*	Cash Dividend	High*	Low*	Cash Dividend	
Fourth quarter	$ 44.15	$ 36.98	$ 0.21	$ 39.32	$ 31.72	$ 0.19	
Third quarter	$ 39.93	$ 35.50	$ 0.21	$ 34.69	$ 27.74	$ 0.19	
Second quarter	$ 41.26	$ 34.96	$ 0.21	$ 28.50	$ 25.26	$ 0.19	
First quarter	$ 41.46	$ 35.31	$ 0.19	$ 27.02	$ 23.92	$ 0.00	(1)

(1) The Company declared and paid the fourth quarter 2012 dividend in the fourth quarter of 2012 instead of the first quarter of 2013 because of possible tax increases on dividends to individuals.

* The trading ranges are the high and low prices as obtained from The Nasdaq Stock Market.

The common stock of the Company was first quoted on The Nasdaq Stock Market under the symbol LKFN in August 1997. Currently, the Company's common stock is listed for trading on the Nasdaq Global Select Market under the symbol "LKFN". On December 31, 2014, the Company had approximately 351 stockholders of record and estimates that it has approximately 2,100 stockholders in total.

The Company paid dividends on its common stock as set forth in the table above. The Company's ability to pay dividends to stockholders is largely dependent upon the dividends it receives from the Bank, and the Bank is subject to regulatory limitations on the amount of cash dividends it may pay.

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Equity Compensation Plan Information

The table below sets forth the following information as of December 31, 2014 for (i) all compensation plans previously approved by the Company's stockholders and (ii) all compensation plans not previously approved by the Company's stockholders:

(a) the number of securities to be issued upon the exercise of outstanding options, warrants and rights;

(b) the weighted-average exercise price of such outstanding options, warrants and rights; and

(c) other than securities to be issued upon the exercise of such outstanding options, warrants and rights, the number of securities remaining available for future issuance under the plans.

EQUITY COMPENSATION PLAN INFORMATION

Plan category	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by security holders(1)(2)(3)	57,918	$ 22.95	215,275
Equity compensation plans not approved by security holders	0	0.00	0
Total	57,918	$ 22.95	215,275

(1) Lakeland Financial Corporation 1997 Share Incentive Plan adopted on April 14, 1998 by the Board of Directors.
(2) Lakeland Financial Corporation 2008 Equity Incentive Plan adopted on May 14, 2008 by the Board of Directors.
(3) Lakeland Financial Corporation 2013 Equity Incentive Plan adopted on April 9, 2013 by the Board of Directors.

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STOCK PRICE PERFORMANCE GRAPH

The graph below compares the cumulative total return of the Company, the Nasdaq Market Index, and the NASDAQ Bank Index.

INDEX	2009	2010	2011	2012	2013	2014
Lakeland Financial Corporation	$100.00	$128.54	$159.24	$164.30	$252.70	$287.91
NASDAQ Composite	100.00	118.15	117.22	138.02	193.47	222.16
NASDAQ Bank Index	100.00	114.16	102.17	121.26	171.86	180.31

The above returns assume $100 invested on December 31, 2009 and dividends were reinvested.

The following table provides information about purchases by the Company and its affiliates during the quarter ended December 31, 2014 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act:

ISSUER PURCHASES OF EQUITY SECURITIES

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 (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
10/01/14-10/31/14	0	$0.00	0	$0.00
11/01/14-11/30/14	425	41.45	0	0.00
12/01/14-12/31/14	0	0.00	0	0.00
Total	425	$41.45	0	$0.00

The shares purchased during the quarter were credited to the deferred share accounts of eight nonemployee directors under the Company’s directors’ deferred compensation plan.

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ITEM 6. SELECTED FINANCIAL DATA

(in thousands except share and per share data)	2014	2013	2012	2011	2010
Ending period balances					
Assets	$3,443,284	$3,175,764	$3,064,144	$2,889,688	$2,681,926
Deposits	2,873,120	2,546,068	2,581,756	2,412,696	2,201,025
Loans	2,762,320	2,535,098	2,257,520	2,233,709	2,089,959
Allowance for loan losses	46,262	48,797	51,445	53,400	45,007
Total equity	361,385	321,964	297,828	273,289	247,086
Average balances					
Total assets	$3,318,271	$3,009,738	$2,976,239	$2,792,770	$2,652,624
Earning assets	3,137,082	2,833,505	2,720,783	2,642,158	2,522,360
Investments	475,068	474,711	477,010	447,620	430,615
Loans	2,650,678	2,343,422	2,216,131	2,148,046	2,049,209
Total deposits	2,797,929	2,505,341	2,505,195	2,325,964	2,132,608
Interest bearing deposits	2,299,578	2,087,870	2,151,094	2,015,440	1,866,184
Interest bearing liabilities	2,461,352	2,265,303	2,316,375	2,206,714	2,107,351
Total equity	343,135	310,627	287,866	260,335	262,861
Income statement data					
Net interest income	$102,303	$90,439	$87,671	$92,080	$92,653
Net interest income-fully tax equivalent	104,232	92,235	89,277	93,664	94,028
Provision for loan loss	0	0	2,549	13,800	23,947
Non-interest income	30,053	30,737	25,196	22,205	21,509
Non-interest expense	66,166	62,778	57,742	55,105	53,435
Net income	43,805	38,839	35,394	30,662	24,543
Net income available to shareholders	43,805	38,839	35,394	30,662	21,356
Per share data					
Basic net income per common share	$2.65	$2.36	$2.17	$1.89	$1.32
Diluted net income per common share	2.61	2.33	2.15	1.88	1.32
Cash dividends declared per common share	0.82	0.57	0.84	0.62	0.62
Dividend payout	31.42 %	24.46 %	38.84 %	32.98 %	46.97 %
Book value per common share	21.83	19.54	18.18	16.85	15.28
Basic weighted average common shares outstanding	16,535,530	16,436,131	16,323,870	16,204,952	16,120,606
Diluted weighted average common shares outstanding	16,781,455	16,634,338	16,482,937	16,324,644	16,213,747
Key ratios					
Return on average assets	1.32 %	1.29 %	1.19 %	1.10 %	0.93 %
Return on average total equity	12.77 %	12.50 %	12.30 %	11.78 %	9.34 %
Equity to average assets	10.34 %	10.32 %	9.67 %	9.32 %	9.91 %
Net interest margin	3.32 %	3.26 %	3.28 %	3.54 %	3.73 %
Efficiency	49.99 %	51.81 %	51.16 %	48.22 %	46.81 %
Asset Quality					
Net charge offs to average loans	0.10 %	0.11 %	0.20 %	0.25 %	0.54 %

Loan loss reserve to total loans	1.67	%	1.92	%	2.28	%	2.39	%	2.15	%
Loan loss reserve to nonperforming loans	337.51	%	203.79	%	166.60	%	135.27	%	121.90	%
Nonperforming assets to total loans	0.51	%	0.96	%	1.40	%	1.86	%	1.95	%
Other Data										
Full-time equivalent employees	496		497		493		482		467	
Offices	46		45		45		44		43	

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

Net income in 2014 was $43.8 million, up 13% from $38.8 million in 2013 and up from $35.4 million in 2012. Diluted net income per common share was $2.61 in 2014, $2.33 in 2013 and $2.15 in 2012. Return on average total assets was 1.32% in 2014 compared to 1.29% in 2013 and 1.19% in 2012. Return on average common shareholders' equity was 12.77% in 2014 versus 12.50% in 2013, and 12.30% in 2012. The dividend payout ratio with respect to diluted earnings per share was 31.42% in 2014, 24.46% in 2013 and 38.84% in 2012. The equity to average assets ratio was 10.34% in 2014 compared to 10.32% in 2013 and 9.67% in 2012.

Net income in 2014 was positively impacted by an $11.9 million increase in net interest income. Offsetting this positive impact was a $3.4 million increase in noninterest expense and a $684,000 decrease in noninterest income. Net income in 2013, as compared to 2012, was positively impacted by a $5.5 million increase in noninterest income, a $2.8 million increase in net interest income and a $2.5 million decrease in in the provision for loan losses. Offsetting these positive impacts in 2013 was a $5.0 million increase in noninterest expense.

Total assets were $3.443 billion as of December 31, 2014 versus $3.176 billion as of December 31, 2013, an increase of $267.5 million or 8.4%. This increase was primarily due to a $227.2 million increase in total loans.

CRITICAL ACCOUNTING POLICIES

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Some of the facts and circumstances which could affect these judgments include changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses and the valuation and other-than-temporary impairment of investment securities.

Allowance for Loan Losses

The Company maintains an allowance for loan losses to provide for probable incurred credit losses. Loan losses are charged against the allowance when management believes that the principal is uncollectable. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance are made for specific loans and for pools of similar types of loans, although the entire allowance is available for any loan that, in management's judgment, should be charged against the allowance. A provision for loan losses is taken based on management's ongoing evaluation of the appropriate allowance balance. A formal evaluation of the adequacy of the loan loss allowance is conducted monthly. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The level of loan loss provision is influenced by growth in the overall loan portfolio, emerging market risk, emerging concentration risk, commercial loan focus and large credit concentration, new industry lending activity, general economic conditions and historical loss analysis. In addition, management gives consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Furthermore, management's overall view on credit quality is a factor in the determination of the provision.

The determination of the appropriate allowance is inherently subjective, as it requires significant estimates by management. The Company has an established process to determine the adequacy of the allowance for loan losses that generally includes consideration of the following factors: changes in the nature and volume of the loan portfolio, overall portfolio quality and current economic conditions that may affect the borrowers' ability to repay. Consideration is not limited to these factors although they represent the most commonly cited factors. With respect to specific allocation levels for individual credits, management considers the amounts and timing of expected future cash flows and the current valuation of collateral as the primary measures. Management also considers trends in adversely classified loans based upon an ongoing review of those credits. With respect to pools of similar loans, allocations are assigned based upon historical experience unless the rate of loss is expected to be greater than historical losses as noted below. A detailed analysis is performed on loans that are classified but determined not to be impaired which incorporates probability of default with a loss given default scenario to develop non-specific allocations for the loan pool. These allocations may be adjusted based on the other factors cited above. An appropriate level of general allowance for pooled loans is determined after considering the following: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentration, new industry lending activity and general economic conditions. It is also possible that the following could affect the overall process: social, political, economic and terrorist events or activities. All of these factors are susceptible to change, which may be significant. As a result of this detailed process, the allowance results in two forms of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover probable losses inherent in the loan portfolio.

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Commercial loans are subject to a dual standardized grading process administered by the credit administration function. These grade assignments are performed independent of each other and a loan may or may not be graded the same. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that indicate the loan is impaired. Considerations with respect to specific allocations for these individual credits include, but are not limited to, the following: (a) does the customer's cash flow or net worth appear insufficient to repay the loan; (b) is there adequate collateral to repay the loan; (c) has the loan been criticized in a regulatory examination; (d) is the loan impaired; (e) are there other reasons where the ultimate collectability of the loan is in question; or (f) are there unique loan characteristics that require special monitoring.

Allocations are also applied to categories of loans considered not to be individually impaired, but for which the rate of loss is expected to be consistent with or greater than historical averages. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values. In addition, general allocations are made for other pools of loans, including non-classified loans. These general pooled loan allocations are performed for portfolio segments of commercial and industrial, commercial real estate and multi-family, agri-business and agricultural, other commercial, consumer 1-4 family mortgage and other consumer loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a three-year historical average for loan losses for these portfolios, subjectively adjusted for economic factors and portfolio trends.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes an unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's judgmental determination of inherent losses that may not be fully reflected in other allocations, including factors such as the level of classified credits, economic uncertainties, industry trends impacting specific portfolio segments, broad portfolio quality trends and trends in the composition of the Company's large commercial loan portfolio and related large dollar exposures to individual borrowers.

Valuation and Other-Than-Temporary Impairment of Investment Securities

The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges or pricing models, which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Different judgments and assumptions used in pricing could result in different estimates of value. The fair value of certain securities is determined using unobservable inputs, primarily observable inputs of similar securities.

At the end of each reporting period, securities held in the investment portfolio are evaluated on an individual security level for other-than-temporary impairment in accordance with current accounting guidance. Impairment is other-than-temporary if the decline in the fair value of the security is below its amortized cost and it is probable that all amounts due according to the contractual terms of a debt security will not be received.

Significant judgments are required in determining impairment, which includes making assumptions regarding the estimated prepayments, loss assumptions and the change in interest rates.

We consider the following factors when determining other-than-temporary impairment for a security or investment:

- the length of time and the extent to which the market value has been less than amortized cost;
- the financial condition and near-term prospects of the issuer;
- the underlying fundamentals of the relevant market and the outlook for such market for the near future; and
-

our intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in market value.

If, in management’s judgment, other-than-temporary impairment exists, the cost basis of the security will be written down to the computed net present value, and the unrealized loss will be transferred from accumulated other comprehensive loss as an immediate reduction of current earnings (as if the loss had been realized in the period of other-than-temporary impairment). In addition, discount accretion will be discontinued on any bond that meets one or both of the following: (1) the rating by S&P, Moody’s or Fitch decreases to below “A” and/or (2) the cash flow analysis on a security indicates under any scenario modeled by the third party there is a potential to not receive the full amount invested in the security.

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RESULTS OF OPERATIONS

Overview

Selected income statement information for the years ended December 31, 2014, 2013 and 2012 is presented in the following table.

(dollars in thousands)	2014		2013		2012	
Income Statement Summary:						
Net interest income	$102,303		$90,439		$85,122	
Provision for loan losses	0		0		2,549	
Noninterest income	30,053		30,737		25,196	
Noninterest expense	66,166		62,778		57,742	
Other Data:						
Efficiency ratio	49.99	%	51.81	%	51.16	%
Dilutive EPS	$2.61		$2.33		$2.15	
Tangible capital ratio	10.41	%	10.05	%	9.63	%
Net charge-offs to average loans	0.10	%	0.11	%	0.20	%
Net interest margin	3.32	%	3.26	%	3.28	%
Noninterest income to total revenue	22.71	%	25.37	%	22.32	%

Net Income

Net income was $43.8 million in 2014, an increase of $5.0 million, or 12.8%, versus net income of $38.8 million in 2013. Net interest income increased $11.9 million, or 13.1%, to $102.3 million versus $90.4 million in 2013. Net interest income increased primarily due to a 10.7% increase in average earning assets, driven by an increase of 14.8% in the commercial loan portfolio, which reflects our continuing strategic focus on commercial lending. The net interest margin increased to 3.32% in 2014 versus 3.26% in 2013. The higher margin resulted from a general decline in funding costs as well as higher levels of earning assets.

Net income was $38.8 million in 2013, an increase of $3.4 million, or 9.7%, versus net income of $35.4 million in 2012. Net interest income increased $2.8 million, or 3.2%, to $90.4 million versus $87.7 million in 2012. Net interest income increased primarily due to a 4.1% increase in average earning assets. Significantly affecting average earning assets during 2013 was an increase of 7.4% in the commercial loan portfolio, combined with a decrease in noninterest earning cash and due from banks. In addition, noninterest bearing demand deposits increased while interest bearing liabilities decreased. The net interest margin was 3.26% in 2013 versus 3.28% in 2012. The stable margin reflected a decline in funding costs offset by lower yields on earning assets.

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Net Interest Income

The following table presents a three-year average balance sheet and, for each major asset and liability category, its related interest income and yield or its expense and rate for the years ended December 31.

THREE YEAR AVERAGE BALANCE SHEET AND NET INTEREST ANALYSIS

(fully tax equivalent	2014			2013			2012		
basis, dollars in thousands)	Average Balance	Interest Income	Yield (1)/ Rate	Average Balance	Interest Income	Yield (1)/ Rate	Average Balance	Interest Income	Yield (1)/ Rate
Earning Assets									
Loans:									
Taxable (2)(3)	$2,638,507	$105,317	3.99%	$2,334,857	$98,757	4.23%	$2,206,600	$102,749	4.66%
Tax exempt (1)	12,171	705	5.79	8,565	609	7.11	9,531	660	6.93
Investments: (1)									
Available for sale	475,068	13,151	2.77	474,711	10,111	2.13	477,010	12,498	2.62
Short-term investments	5,253	11	0.21	6,515	5	0.08	25,299	24	0.09
Interest bearing deposits	6,083	33	0.54	8,857	50	0.56	2,343	44	1.88
Total earning assets	$3,137,082	$119,217	3.80%	$2,833,505	$109,532	3.87%	$2,720,783	$115,975	4.26%
Less: Allowance for loan losses	(46,831)			(50,651)			(52,795)		
Nonearning Assets									
Cash and due from banks	75,158			79,014			178,322		
Premises and equipment	40,241			36,544			34,945		
Other nonearning assets	112,621			111,326			94,984		
Total assets	$3,318,271			$3,009,738			$2,976,239		
Interest Bearing Liabilities									
Savings deposits	$233,657	$507	0.22%	$229,440	$634	0.28%	$195,666	$697	0.36%
Interest bearing checking accounts	1,169,338	4,660	0.40	1,028,224	5,287	0.51	1,002,418	9,012	0.90
Time deposits:									

In denominations under $100,000	280,819	3,205	1.14	327,736	4,574	1.40	389,894	6,885	1.77
In denominations over $100,000	615,764	5,196	0.84	502,470	5,250	1.04	563,116	8,073	1.43
Miscellaneous short-term borrowings	130,811	388	0.30	145,030	490	0.34	119,314	441	0.37
Long-term borrowings and									
subordinated debentures (4)	30,963	1,029	3.32	32,403	1,062	3.28	45,967	1,590	3.46
Total interest bearing liabilities	$2,461,352	$14,985	0.61%	$2,265,303	$17,297	0.76%	$2,316,375	$26,698	1.15%
Noninterest Bearing Liabilities									
Demand deposits	498,351			417,471			354,101		
Other liabilities	15,433			16,337			17,897		
Stockholders' Equity	343,135			310,627			287,866		
Total liabilities and stockholders' equity	$3,318,271			$3,009,738			$2,976,239		
Interest Margin Recap									
Interest income/average earning assets		119,217	3.80		109,532	3.87		115,975	4.26
Interest expense/average earning assets		14,985	0.48		17,297	0.61		26,698	0.98
Net interest income and margin		$104,232	3.32%		$92,235	3.26%		$89,277	3.28%

(1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2014, 2013 and 2012. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") adjustment applicable to nondeductible interest expenses.

(2) Loan fees, which are immaterial in relation to total taxable loan interest income for the years ended December 31, 2014, 2013 and 2012, are included as taxable loan interest income.

(3) Nonaccrual loans are included in the average balance of taxable loans.

(4) Long-term borrowings and subordinated debentures interest expense was reduced by interest capitalized on construction in process for 2014 and 2013.

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The following table shows fluctuations in net interest income attributable to changes in the average balances of assets and liabilities and the yields earned or rates paid for the years ended December 31.

NET INTEREST INCOME – RATE/VOLUME ANALYSIS (fully tax equivalent basis, dollars in thousands)

	2014 Over (Under) 2013 (1)			2013 Over (Under) 2012 (1)		
	Attributable to		Total	Attributable to		Total
	Volume	Rate	Change	Volume	Rate	Change
Interest Income (2)						
Loans:						
Taxable	$12,339	$(5,779)	$6,560	$5,760	$(9,752)	$(3,992)
Tax exempt	223	(127)	96	(68)	17	(51)
Investments:						
Available for sale	8	3,032	3,040	(60)	(2,327)	(2,387)
Short-term investments	(1)	7	6	(15)	(4)	(19)
Interest bearing deposits	(15)	(2)	(17)	54	(48)	6
Total interest income	12,554	(2,869)	9,685	5,671	(12,114)	(6,443)
Interest Expense						
Savings deposits	11	(138)	(127)	109	(172)	(63)
Interest bearing checking accounts	664	(1,291)	(627)	226	(3,951)	(3,725)
Time deposits:						
In denominations under $100,000	(602)	(767)	(1,369)	(998)	(1,313)	(2,311)
In denominations over $100,000	1,061	(1,115)	(54)	(802)	(2,021)	(2,823)
Miscellaneous short-term borrowings	(45)	(57)	(102)	89	(40)	49
Long-term borrowings and subordinated debentures	(48)	15	(33)	(448)	(80)	(528)
Total interest expense	1,041	(3,353)	(2,312)	(1,824)	(7,577)	(9,401)
Net Interest Income	$11,513	$484	$11,997	$7,495	$(4,537)	$2,958

(1) The earning assets and interest bearing liabilities used to calculate interest differentials are based on average daily balances for 2014, 2013 and 2012. The changes in volume represent "changes in volume times the old rate". The changes in rate represent "changes in rate times the old volume". The changes in rate/volume were also calculated by "change in rate times change in volume" and allocated consistently based upon the relative absolute values of the changes in volume and changes in rate.

(2) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2014, 2013 and 2012. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the TEFRA adjustment applicable to nondeductible interest expense.

Growth in the commercial loan portfolio accounted for most of the growth in loans, as well as total earning assets during both 2014 and 2013 thereby positively impacting total interest income. Management believes that the growth in the loan portfolio will likely continue in a measured, but prudent, fashion as a result of our strategic focus on commercial lending, including commercial real estate lending, and in conjunction with the general expansion and penetration of the geographical markets the Company serves, including as our ongoing expansion in the Indianapolis market. Growth in loans was funded through an increase in interest bearing deposits. Interest bearing checking accounts represented primarily by public funds increased $141.1 million. In addition demand deposits increased $80.9 million in 2014.

The decreases in the Company’s yields on average earning assets resulted from decreases in market rates overall, including declines in loan portfolio yields during 2014 and 2013, and investment yields during 2013. One factor that contributed to the decline in investment portfolio yields throughout 2013 was an ongoing strategic realignment of the portfolio with respect to private label mortgage-backed securities. Another factor that contributed to the decline in the investment portfolio yields into 2013 was the impact of increased prepayments of agency mortgage-backed securities. In an ongoing effort to reduce the risk of incurring additional other-than-temporary impairment on certain non-agency residential mortgage-backed securities and to improve the overall quality of the securities in the investment portfolio, the Company sold the remaining non-agency residential mortgage-backed securities in September 2013 as part of the ongoing strategic realignment of its securities portfolio. These actions impacted investment portfolio performance as the proceeds from the sale of the higher yielding non-agency residential mortgage-backed securities were invested in lower yielding securities during 2013.

As a result of competitive pressures and the overall low interest rate environment in the market the Company serves, yields on commercial loans declined in 2014. These declines were impacted by more aggressive pricing on new loan opportunities, management’s continued focus on growing the commercial portfolio in a prudent and responsible manner, and by the scheduled amortization of existing fixed rate commercial loans. Cost of funds declined during 2014 driven by continued declines in market rates, in particular, a decrease in the interest rate paid on the Rewards checking product.

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Provision for Loan Losses

Despite increases in the size of the overall loan portfolio, no provision for loan loss expense was recorded in 2014 or 2013, resulting in an allowance for loan losses at December 31, 2014 of $46.3 million, which represented 1.67% of the loan portfolio, versus an allowance for loan losses of $48.8 million at the end of 2013, which represented 1.92% of the loan portfolio. The lack of a provision in 2014 and 2013 was attributable to a number of factors but was primarily a result of stabilization or improvement in key loan quality metrics, including a decrease in net charge-offs, strong reserve coverage of nonperforming loans, a decrease in historical loss percentages, continuing signs of stabilization in economic conditions in the Company's markets and general signs of improvement in borrower performance and future prospects. In addition, management gave consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses. The Company's management continues to monitor the adequacy of the provision based on loan levels, asset quality, economic conditions and other factors that may influence the assessment of the collectability of loans.

The provision for loan loss expense was $2.5 million in 2012, which resulted in an allowance for loan losses at December 31, 2012 of $51.4 million, and which represented 2.28% of the loan portfolio. Key drivers of the 2012 provision included stabilization or improvement in key loan quality metrics, including a decrease in net charge-offs, strong reserve coverage of nonperforming loans, a decrease in historical loss percentages, continued signs of stabilization in economic conditions in the Company's markets and general signs of improvement in borrower performance and future prospects. In addition, management gave consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses.

Noninterest Income

The following table presents changes in the components of noninterest income for the years ended December 31.

				% Change From Prior Year	
(dollars in thousands)	2014	2013	2012	2014	2013
Wealth advisory fees	$4,072	$3,847	$3,823	5.8 %	0.6 %
Investment brokerage fees	3,370	4,736	3,061	-28.8 %	54.7 %
Service charges on deposit accounts	9,495	8,806	8,015	7.8 %	9.9 %
Loan, insurance and service fees	6,799	6,404	5,876	6.2 %	9.0 %
Merchant card fee income	1,549	1,265	1,130	22.5 %	11.9 %
Bank owned life insurance	1,393	1,653	973	-15.7 %	69.9 %
Other income	2,978	2,488	1,174	19.7 %	111.9 %
Mortgage banking income	621	1,431	2,546	-56.6 %	-43.8 %
Net securities gains (losses)	(224)	107	(376)	-309.3 %	-128.5 %
Net impairment loss recognized in earnings	0	0	(1,026)	0.0 %	-100.0 %
Total noninterest income	$30,053	$30,737	$25,196	-2.2 %	22.0 %
Noninterest income to total revenue	22.7 %	25.4 %	22.3 %		

Noninterest income was $30.1 million in 2014 versus $30.7 million in 2013, a decrease of $684,000, or 2.2%. The decrease was primarily driven by a $1.4 million decrease in investment brokerage fees due to lower production volumes. Mortgage banking income decreased by $810,000 due to lower refinance volumes as rates remained at historically low levels and now refinancing opportunities are not available. Noninterest income was positively impacted by a $689,000 increase in service charges on deposit accounts driven by higher deposit fees. In addition, other income increased $490,000, driven by income related to bank owned life insurance proceeds.

Noninterest income was $30.7 million in 2013 versus $25.2 million in 2012, an increase of $5.5 million, or 22.0%. The increase was primarily driven by a $1.7 million increase in investment brokerage fees due to a shift towards fixed income investments by clients, which generally have a more favorable revenue impact to the Company. Other income increased $1.3 million due to fees from interest rate swaps as well as rental income from operating leases. The Company implemented an interest rate derivative program for commercial loan clients in 2013. In addition, no other-than-temporary impairment was recorded during 2013, versus $1.0 million recorded during 2012. Noninterest income was negatively impacted by a $1.1 million decrease in mortgage banking income in 2013 due to lower volumes as a result of higher mortgage interest rates.

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Noninterest Expense

The following table presents changes in the components of noninterest expense for the years ended December 31.

				% Change From Prior Year	
(dollars in thousands)	2014	2013	2012	2014	2013
Salaries and employee benefits	$38,648	$37,176	$34,539	4.0 %	7.6 %
Net occupancy expense	3,776	3,376	3,296	11.8 %	2.4 %
Equipment costs	3,231	2,831	2,572	14.1 %	10.1 %
Data processing fees and supplies	6,171	5,635	4,378	9.5 %	28.7 %
Corporate and business development	3,073	2,734	2,305	12.4 %	18.6 %
FDIC insurance and other regulatory fees	1,936	1,855	2,097	4.4 %	-11.5 %
Professional fees	2,990	3,171	2,453	-5.7 %	29.3 %
Other expense	6,341	6,000	6,102	5.7 %	-1.7 %
Total noninterest expense	$66,166	$62,778	$57,742	5.4 %	8.7 %

Noninterest expense was $66.2 million in 2014 versus $62.8 million in 2013, an increase of $3.4 million, or 5.4%. Salaries and employee benefits increased by $1.5 million, continuing to be driven by staff additions, normal annual salary increases, higher health insurance costs and higher performance based compensation costs. Data processing fees increased by $536,000, continuing to be driven by technology related expenditures with the Company’s core processor and other technology based providers to enhance the delivery of electronic banking alternatives and improve commercial product solutions.

Noninterest expense was $62.8 million in 2013 versus $57.7 million in 2012, an increase of $5.0 million, or 8.7%. Salaries and employee benefits increased by $2.6 million, driven by staff additions, normal salary increases, higher health insurance costs and higher performance based compensation costs. Data processing fees increased by $1.3 million driven by a larger customer base as well as greater utilizations of services from the Company’s core processor and related technology vendors.

Income Taxes

The Company recognized income tax expense in 2014 of $22.4 million, compared to $19.6 million in 2013, and $17.2 million in 2012. The effective tax rate in 2014 was 33.8% compared to 33.5% in 2013, and 32.7% in 2012. The effective tax rate was higher in 2014 and 2013 compared to 2012 due to an additional provision for income taxes related to a revaluation of the Company’s state deferred tax items. For a detailed analysis of the Company’s income taxes see Note 13 of the Notes to Consolidated Financial Statements.

FINANCIAL CONDITION

Overview

Total assets of the Company were $3.443 billion as of December 31, 2014, an increase of $267.5 million, or 8.4%, when compared to $3.176 billion as of December 31, 2013. Total loans increased by $227.2 million, or 9.0%, to $2.762 billion at December 31, 2014 from $2.535 billion at December 31, 2013. Funding for the loan growth came from a $327.1 million increase in total deposits in 2014 offset by a $101.5 million decrease in short-term borrowings.

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Uses of Funds

Investment Portfolio

The amortized cost and the fair value of securities as of December 31, 2014, 2013 and 2012 were as follows:

	2014		2013		2012	
(fully tax equivalent basis, dollars in thousands)	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Treasury securities	$986	$1,004	$1,001	$1,017	$1,002	$1,037
U.S. Government sponsored agencies	0	0	0	0	5,026	5,304
Agency residential mortgage-backed securities	366,596	372,095	374,611	371,977	359,326	365,644
Non-agency residential mortgage-backed securities	0	0	0	0	6,211	6,453
State and municipal securities	99,399	102,812	95,388	95,973	83,263	88,583
Total debt securities available for sale	$466,981	$475,911	$471,000	$468,967	$454,828	$467,021

At year-end 2014, 2013 and 2012, there were no holdings of securities of any one issuer, other than the U.S. government, government agencies and government sponsored agencies, in an amount greater than 10% of stockholders' equity. See Note 2 for more information on these investments.

Purchases of securities available for sale totaled $73.4 million in 2014, $167.5 million in 2013 and $161.6 million in 2012. Securities sales totaled $13.8 million in 2014, $30.0 million in 2013 and $27.9 million in 2012. Paydowns from prepayments and scheduled payments of $55.9 million, $104.6 million and $120.1 million were received in 2014, 2013 and 2012, and the amortization of premiums, net of the accretion of discounts, was $5.4 million, $8.9 million and $8.2 million. Maturities and calls of securities totaled $2.1 million, $8.0 million and $5.0 million in 2014, 2013 and 2012. Other-than-temporary impairment of $1.0 million was recognized on non-agency residential mortgage-backed securities in 2012. No other-than-temporary impairment was recognized in 2014 or 2013. Purchases of securities were lower in 2014 due to the decrease in prepayments and other scheduled payments resulting in less cash flow for reinvestment. Sales of securities were higher in 2013 and 2012 than 2014 due to the strategic realignment of the investment portfolio with respect to non-agency residential mortgage-backed securities as discussed below. The investment portfolio is managed to provide for an appropriate balance between liquidity, credit risk and investment return and to limit the Company's exposure to risk to an acceptable level.

During the third quarter of 2012, the Company sold nine non-agency residential mortgage-backed securities as part of a strategic realignment of the investment portfolio. The securities sold had a book value of $20.7 million and a fair value of $19.5 million. The sales included all five of the non-agency residential mortgage-backed securities on which the Company had previously recognized other-than-temporary impairment. During the third quarter of 2013, the Company sold the four remaining non-agency mortgage-backed securities. The securities sold had a book value of $3.8 million and a fair value of $3.9 million.

The weighted average yields and maturity distribution for the securities portfolio at December 31, 2014, were as follows:

	Within One Year		After One Within five Years		After five Years Within Ten years		Over Ten Years	
	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield
(fully tax equivalent, basis, dollars in thousands)								
U.S. Treasury securities	$0	0.00 %	$0	0.00 %	$1,004	2.25 %	$0	0.00 %
Agency residential mortgage-backed securities	0	0.00 %	26,610	2.24 %	95,921	2.06 %	249,564	2.62 %
State and municipal securities	5,454	3.96 %	18,210	3.70 %	47,428	3.24 %	31,720	3.33 %
Total Securities	$5,454	3.96 %	$44,820	2.83 %	$144,353	2.44 %	$281,284	2.70 %

The company does not trade or invest in or sponsor certain unregistered investment companies defined as hedge funds and private equity funds in the Volcker Rule.

Real Estate Mortgage Loans HFS

Real estate mortgages held for sale decreased by $193,000 to $1.6 million at December 31, 2014 from $1.8 million at December 31, 2013. This asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. The Company generally sells almost all of the mortgage loans it originates on the secondary market. Proceeds from sales totaled $56.1 million in 2014, $91.0 million in 2013 and $115.2 million in 2012. After several years of historically low mortgage rates, many or most mortgagees who would benefit from refinancing have already done so, resulting in decreases in mortgage sales proceeds in 2013 and again in 2014.

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Loan Portfolio

The loan portfolio by class as of December 31, 2014, 2013, 2012, 2011 and 2010 were as follows:

(dollars in thousands)	2014	2013	2012	2011	2010
Commercial and industrial loans:					
Working capital lines of credit loans	$544,043	$457,690	$439,638	$373,768	$281,546
Non-working capital loans	491,330	443,877	407,184	377,388	384,138
Total commercial and industrial loans	1,035,373	901,567	846,822	751,156	665,684
Commercial real estate and multi-family residential loans:					
Construction and land development loans	156,636	157,630	82,494	82,284	106,980
Owner occupied loans	403,154	370,386	358,617	346,669	329,760
Nonowner occupied loans	394,458	394,748	314,889	385,090	355,393
Multifamily loans	71,811	63,443	45,011	38,477	24,158
Total commercial real estate and multi-family residential loans	1,026,059	986,207	801,011	852,520	816,291
Agri-business and agricultural loans:					
Loans secured by farmland	137,407	133,458	109,147	118,224	111,961
Loans for agricultural production	136,380	120,571	115,572	119,705	117,518
Total agri-business and agricultural loans	273,787	254,029	224,719	237,929	229,479
Other commercial loans	75,715	70,770	56,807	58,278	38,778
Total commercial loans	2,410,934	2,212,573	1,929,359	1,899,883	1,750,232
Consumer 1-4 family mortgage loans:					
Closed end first mortgage loans	145,167	125,444	109,823	106,999	103,118
Open end and junior lien loans	150,220	146,946	161,366	175,694	182,325
Residential construction and land development loans	6,742	4,640	11,541	5,462	4,140
Total consumer 1-4 family mortgage loans	302,129	277,030	282,730	288,155	289,583
Other consumer loans	49,541	46,125	45,755	45,999	51,123
Total consumer loans	351,670	323,155	328,485	334,154	340,706
Subtotal	2,762,604	2,535,728	2,257,844	2,234,037	2,090,938
Less: Allowance for loan losses	(46,262)	(48,797)	(51,445)	(53,400)	(45,007)
Net deferred loan fees	(284)	(630)	(324)	(328)	(979)
Loans, net	$2,716,058	$2,486,301	$2,206,075	$2,180,309	$2,044,952

The ratio of loans to total loans by portfolio segment as of December 31, 2014, 2013, 2012, 2011 and 2010 were as follows:

	2014	2013	2012	2011	2010
Commercial and industrial loans	37.48%	35.55%	37.50%	33.62%	31.84%
Commercial real estate and multi-family residential loans	37.14%	38.89%	35.48%	38.16%	39.04%
Agri-business and agricultural loans	9.91%	10.02%	9.95%	10.65%	10.98%
Other commercial loans	2.74%	2.79%	2.52%	2.61%	1.85%
Consumer 1-4 family mortgage loans	10.94%	10.93%	12.52%	12.90%	13.85%
Other consumer loans	1.79%	1.82%	2.03%	2.06%	2.44%

Total Loans	100.00%	100.00%	100.00%	100.00%	100.00%

In 2014 loan balances increased by $227.2 million, which is net of approximately $55.1 million in loans originated and sold and $1.1 million transferred to other real estate in 2014. In 2013 loan balances increased by $280.7 million, which is net of approximately $81.7 million in loans originated and sold and $491,000 transferred to other real estate in 2013. In 2012, loan balances increased by $28.7 million, which is net of approximately $119.6 million in loans originated and sold and $413,000 transferred to other real estate in 2012.

The mix of loan types within the Company's portfolio continued a trend toward a higher percentage of the total loan portfolio being in commercial loans. This general increase in commercial loans was a result of the Company's long standing strategic plan that is focused on expanding and growing the commercial lending business.

The residential construction and land development loans class included construction loans totaling $5.3 million, $3.8 million, $10.7 million, $4.3 million, $2.6 million and $5.8 million as of December 31, 2014, 2013, 2012, 2011 and 2010. The Bank generally sells conforming mortgage loans which it originates on the secondary market. These loans generally represent mortgage loans that are made to clients with long-term or substantial relationships with the Bank on terms consistent with secondary market requirements. The loan classifications are based on the nature of the loans as of the loan origination date. There were no foreign loans included in the loan portfolio for the periods presented.

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Repricing opportunities of the loan portfolio occur either according to predetermined adjustable rate schedules included in the related loan agreements or upon maturity of each principal payment. The following table indicates the scheduled maturities of the loan portfolio as of December 31, 2014.

(dollars in thousands)	Commercial	Residential Real Estate Mortgage	Installment	Line of Credit	Total	Percent
Within one year	$ 1,217,825	$ 15,937	$ 11,083	$ 28,884	$ 1,273,729	46.11 %
After one year, within five years	1,054,298	46,737	21,222	75,966	1,198,223	43.37
Over five years	190,403	38,975	2,299	45,398	277,075	10.03
Nonaccrual loans	11,950	1,023	401	203	13,577	0.49
Total loans	$ 2,474,476	$ 102,672	$ 35,005	$ 150,451	$ 2,762,604	100.00 %

At maturity, credits are reviewed and, if renewed, are renewed at rates and conditions that prevail at the time of maturity.

Loans due after one year which have a predetermined interest rate and loans due after one year which have floating or adjustable interest rates as of December 31, 2014 amounted to $599,000 and $877,000, respectively.

Bank Owned Life Insurance

Bank owned life insurance increased by $3.7 million to $66.6 million at December 31, 2014 and by $1.8 million to $62.9 million at December 31, 2013 from $61.1 million at December 31, 2012. This increase during 2014 was primarily due to purchases to help offset employee benefit plan expenses, which have continued to increase since 2002, by providing investment income from the securities the life insurance is invested in.

Sources of Funds

The average daily deposits and borrowings and the average rates paid on those deposits and borrowings for the years ended December 31, 2014, 2013 and 2012 are summarized in the following table:

	2014		2013		2012		% Balance Change From Prior Year	
(dollars in thousands)	Balance	Rate	Balance	Rate	Balance	Rate	2014	2013
Demand deposits	$ 498,351	0.00 %	$ 417,471	0.00 %	$ 354,101	0.00 %	19 %	18 %
Savings and transaction accounts:								
Regular savings	233,657	0.22	229,440	0.28	195,666	0.36	2	17
Interest bearing checking	1,169,338	0.40	1,028,224	0.51	1,002,418	0.90	14	3
Time deposits:								
Deposits of $100,000 or more	615,764	0.84	502,470	1.04	563,116	1.43	23	(11)

Other time deposits	280,819	1.14		327,736	1.40		389,894	1.77		(14)	(16)
Total deposits	$2,797,929	0.48	%	$2,505,341	0.63	%	$2,505,195	0.98	%	12	0
FHLB advances and other borrowings	161,774	0.88		177,433	0.89		165,281	1.23		(9)	7
Total funding sources	$2,959,703	0.61	%	$2,682,774	0.76	%	$2,670,476	1.15	%	10	0

Time deposits as of December 31, 2014 will mature as follows:

(dollars in thousands)	$100,000 or more	% of Total		Other	% of Total	
Within three months	$95,302	16.29	%	$30,275	10.60	%
Over three months, within six months	119,342	20.39		34,377	12.05	
Over six months, within twelve months	163,362	27.91		100,323	35.16	
Over twelve months	207,205	35.41		120,404	42.19	
Total time certificates of deposit	$585,211	100.00	%	$285,379	100.00	%

Deposits

Average deposits increased $292.6 million comparing December 31, 2014 to December 31, 2013. The growth in deposits consisted of $176.8 million in core deposit growth and an increase of $115.8 million in brokered deposits. Average interest bearing public funds transaction accounts increased by $134.9 million, average brokered time deposits increased by $83.3 million, average commercial demand deposits increased by $62.2 million, average public funds time deposits increased by $49.0 million and average brokered transaction accounts increased by $32.5 million. The Company believes that the prolonged low rate environment has caused depositors to shift their deposits to short-term liquid products in anticipation of higher future market deposit rates.

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Average deposit growth was flat comparing December 31, 2013 to December 31, 2012. The deposit mix changed, however, with a decrease in average time deposits and an increase in average noninterest bearing demand accounts and other transaction accounts. Average commercial demand deposit accounts increased $62.8 million, average savings accounts increased $33.8 million and average public fund deposits increased $17.6 million. The Company believed that the decline in average time deposits was reflective of the ongoing low interest rate environment and the consumers' desire to seek the highest rate in the market, which the Company sometimes did not match.

As previously noted, the Company has substantial funding from public fund entities. A shift in funding away from public fund deposits could require the Company to execute alternate funding plans under the Contingency Funding Plan discussed in further detail under "Liquidity Risk" below.

Borrowings

During 2014, average total short-term borrowings decreased $14.2 million primarily due to a $29.1 million decrease in securities sold under agreements to repurchase and average long-term borrowings decreased $1.4 million due to a decrease in advances with the Federal Home Loan Bank of Indianapolis. Ending balances of total short-term borrowings decreased $101.5 million during 2014 due to decreases in securities sold under agreements to repurchase as well as decreases in Federal Home Loan Bank of Indianapolis advances. During 2014, the Company changed the mix of wholesale funding by reducing Federal Home Loan Bank advances and increasing brokered deposits.

During 2013, average total short-term borrowings increased $25.7 million primarily due to a $21.5 million increase in federal funds purchased and average long-term borrowings decreased $13.6 million due to a decrease in advances with the Federal Home Loan Bank of Indianapolis. Ending balances of total short-term borrowings increased $140.0 million during 2013 due to an increase in Federal Home Loan Bank of Indianapolis advances late in December 2013.

Capital

The Company believes that a strong, appropriately managed capital position is critical to long-term earnings and continuing growth in loans. The Company had a total risk-based capital ratio of 14.4% and a Tier I risk-based capital ratio of 13.1% as of December 31, 2014. These ratios met or exceeded the Federal Reserve's "well-capitalized" minimums of 10.0% and 6.0%, respectively. The Company also had a Tier 1 leverage ratio of 11.2% and a tangible equity ratio of 10.4%. See Note 16 – Capital Requirements for more information.

The ability to maintain these ratios is a function of the balance between net income and a prudent dividend policy. Total stockholders' equity increased by 12.3% to $361.3 million as of December 31, 2014 from $321.9 million as of December 31, 2013. The Company earned $43.8 million in 2014 and $38.8 million in 2013. The Company declared cash dividends of $0.82 per share in 2014, which decreased equity by $13.6 million. The Company declared cash dividends of $0.57 per share in 2013, which decreased equity by $9.4 million. The change in accumulated other comprehensive income, largely due to changes in the fair values of available-for-sale securities, increased equity by $6.3 million in 2014, and decreased equity by $8.2 million in 2013. The impact to equity due to other comprehensive income is not included in regulatory capital. Stock based compensation expense increased equity by $2.8 million in 2014 and $2.0 million in 2013.

RISK MANAGEMENT

Overview

The Company, with the oversight of the Corporate Risk Committee of the Board of Directors, has developed a company-wide risk management program to manage and mitigate the various business risks the Company is exposed to. Following is a discussion addressing the risks identified as most significant to the Company – Credit, Liquidity and

Interest Rate or Market Risk. Item 7A includes additional market risk discussion.

Credit Risk

Credit risk represents the risk of loss arising from an obligor’s inability or failure to meet contractual payment or performance terms. Our primary credit risks result from investment and lending activities.

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Investment Portfolio

The Company's investment portfolio consists of Treasury securities, mortgage-backed securities and municipal bonds. During 2014, purchases in the securities portfolio consisted of primarily mortgage-backed securities and municipal bonds. As of December 31, 2014, the Company's investment in mortgage-backed securities represented approximately 78% of total securities consisting of Collateralized Mortgage Obligations ("CMOs"), Commercial Mortgage-Backed Securities ("CMBSs") and mortgage pools issued by Ginnie Mae, Fannie Mae and Freddie Mac. Ginnie Mae, Fannie Mae and Freddie Mac securities are each guaranteed by their respective agencies as to principal and interest. All mortgage securities purchased by the Company are within risk tolerances for price, prepayment, extension and original life risk characteristics contained in the Company's investment policy. The Company uses Bloomberg analytics and BondEdge Fixed Income Analytics software to evaluate and monitor all purchases. Based upon the BondEdge analytics, as of December 31, 2014, the securities in the available for sale portfolio had approximately a 3.75 year effective duration with approximately a negative 12.8% change in market value in the event of a 300 basis points upward rate shock over a one-year period and an approximate positive 3.30% change in market value in the event of a 100 basis point downward rate shock over the same period. As of December 31, 2014, all mortgage-backed securities were performing in a manner consistent with management's original ALCO modeled expectations.

Loan Portfolio

The Company has a relatively high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses from a wide variety of industries. Traditionally, this type of lending may have more credit risk than other types of lending because of the size and diversity of the credits. The Company manages this risk by adjusting its pricing to the perceived risk of each individual credit and by diversifying the portfolio by customer, product, industry and market area.

There were no loan concentrations within industries, which exceeded ten percent of total loans, except commercial real estate and manufacturing. Commercial real estate was $917.3 million, or 33.8% of total loans, and manufacturing was $345.9 million, or 12.7% of total loans, at December 31, 2014. Nearly all of the Bank's commercial, industrial, agricultural real estate mortgage, real estate construction mortgage and consumer loans are made within its basic market areas.

The following is a summary of nonperforming loans as of December 31, 2014, 2013, 2012, 2011 and 2010.

(dollars in thousands)	2014	2013	2012	2011	2010
Commercial and industrial loans					
Past due accruing loans (90 days or more)	$101	$0	$50	$0	$0
Nonaccrual loans(1)	4,230	5,616	6,713	10,174	10,560
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	4,331	5,616	6,763	10,174	10,560
Commercial real estate and multi-family residential loans					
Past due accruing loans (90 days or more)	0	0	0	0	0
Nonaccrual loans(1)	7,204	15,459	22,346	26,745	23,418
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	7,204	15,459	22,346	26,745	23,418
Agri-business and agricultural loans					
Past due accruing loans (90 days or more)	0	0	0	0	0
Nonaccrual loans(1)	486	1,114	798	853	1,283
Troubled debt restructured loans	0	0	0	0	0

Subtotal nonperforming loans	486	1,114	798	853	1,283
Other commercial loans					
Past due accruing loans (90 days or more)	0	0	0	0	0
Nonaccrual loans(1)	30	0	0	0	0
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	30	0	0	0	0
Consumer 1-4 family mortgage loans					
Past due accruing loans (90 days or more)	29	46	0	52	319
Nonaccrual loans(1)	1,576	1,605	895	1,646	1,112
Troubled debt restructured loans	0				