

FIRST MERCHANTS CORP
Form 10-Q
August 09, 2013

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

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

For the quarterly period ended June 30, 2013
OR

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

For the Transition Period from _____ to _____

Commission File Number 0-17071

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

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

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

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

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

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

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

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

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

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

As of July 31, 2013, there were 28,807,341 outstanding common shares of the registrant.

1

Table of Contents

TABLE OF CONTENTS

FIRST MERCHANTS CORPORATION

<u>Part I. Financial Information</u>		Page No.
Item 1.	<u>Financial Statements:</u>	
	<u>Consolidated Condensed Balance Sheets</u>	<u>3</u>
	<u>Consolidated Condensed Statements of Income</u>	<u>4</u>
	<u>Consolidated Condensed Statements of Comprehensive Income</u>	<u>5</u>
	<u>Consolidated Condensed Statement of Stockholders' Equity</u>	<u>6</u>
	<u>Consolidated Condensed Statements of Cash Flows</u>	<u>7</u>
	<u>Notes to Consolidated Condensed Financial Statements</u>	<u>8</u>
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>38</u>
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>48</u>
Item 4.	<u>Controls and Procedures</u>	<u>49</u>
<u>Part II. Other Information</u>		
Item 1.	<u>Legal Proceedings</u>	<u>50</u>
Item 1A.	<u>Risk Factors</u>	<u>50</u>
Item 2.	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>50</u>
Item 3.	<u>Defaults Upon Senior Securities</u>	<u>50</u>
Item 4.	<u>Mine Safety Disclosures</u>	<u>50</u>
Item 5.	<u>Other Information</u>	<u>50</u>
Item 6.	<u>Exhibits</u>	<u>51</u>
	<u>Signatures</u>	<u>52</u>
	<u>Index to Exhibits</u>	<u>53</u>

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED BALANCE SHEETS

	June 30, 2013 (Unaudited)	December 31, 2012
ASSETS		
Cash and cash equivalents	\$69,404	\$101,460
Interest-bearing time deposits	59,898	38,443
Investment securities available for sale	584,593	513,343
Investment securities held to maturity (fair value of \$331,765 and \$378,174)	324,399	361,020
Mortgage loans held for sale	14,531	22,300
Loans, net of allowance for loan losses of \$68,202 and \$69,366	2,851,878	2,832,843
Premises and equipment	54,165	52,749
Federal Reserve and Federal Home Loan Bank stock	32,790	32,785
Interest receivable	15,186	16,367
Core deposit intangibles	7,384	8,154
Goodwill	141,375	141,375
Cash surrender value of life insurance	126,710	125,397
Other real estate owned	11,765	13,263
Tax asset, deferred and receivable	30,959	30,867
Other assets	13,227	14,455
TOTAL ASSETS	\$4,338,264	\$4,304,821
LIABILITIES		
Deposits:		
Noninterest-bearing	\$741,095	\$801,597
Interest-bearing	2,591,698	2,544,786
Total Deposits	3,332,793	3,346,383
Borrowings:		
Federal funds purchased	57,085	18,862
Securities sold under repurchase agreements	161,779	141,828
Federal Home Loan Bank advances	92,743	94,238
Subordinated debentures and term loans	111,778	112,161
Total Borrowings	423,385	367,089
Interest payable	1,150	1,841
Other liabilities	41,643	37,272
Total Liabilities	3,798,971	3,752,585
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY		
Preferred Stock, no-par value, \$1,000 liquidation value:		
Authorized - 500,000 shares		
Senior Non-Cumulative Perpetual Preferred Stock, Series B		
Issued and outstanding - 68,087 and 90,782.94 shares	68,087	90,783
Cumulative Preferred Stock, \$1,000 par value, \$1,000 liquidation value:		
Authorized - 600 shares		
Issued and outstanding - 125 shares	125	125

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Common Stock, \$.125 stated value:

Authorized - 50,000,000 shares

Issued and outstanding - 28,801,848 and 28,692,616 shares

Additional paid-in capital

Retained earnings

Accumulated other comprehensive loss

Total Stockholders' Equity

TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY

3,600

257,626

225,034

(15,179

539,293

\$4,338,264

3,587

256,843

206,397

) (5,499)

552,236

\$4,304,821

See notes to consolidated condensed financial statements.

3

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
INTEREST INCOME				
Loans receivable:				
Taxable	\$34,018	\$36,652	\$71,177	\$72,500
Tax exempt	113	123	230	240
Investment securities:				
Taxable	3,577	4,468	7,195	9,042
Tax exempt	2,515	2,551	4,969	5,113
Deposits with financial institutions	62	28	81	53
Federal Reserve and Federal Home Loan Bank stock	368	347	739	690
Total Interest Income	40,653	44,169	84,391	87,638
INTEREST EXPENSE				
Deposits	2,599	3,939	5,490	8,049
Federal funds purchased	1	12	12	24
Securities sold under repurchase agreements	208	197	402	492
Federal Home Loan Bank advances	462	637	921	1,631
Subordinated debentures and term loans	733	1,331	1,458	3,273
Total Interest Expense	4,003	6,116	8,283	13,469
NET INTEREST INCOME	36,650	38,053	76,108	74,169
Provision for loan losses	1,997	4,545	4,099	9,420
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	34,653	33,508	72,009	64,749
OTHER INCOME				
Service charges on deposit accounts	2,912	2,893	5,641	5,712
Fiduciary activities	2,264	1,938	4,371	3,921
Other customer fees	2,816	3,150	5,596	5,736
Commission income	1,748	1,485	3,920	3,152
Earnings on cash surrender value of life insurance	610	662	1,310	2,040
Net gains and fees on sales of loans	2,457	2,314	4,835	4,266
Net realized gains on sales of available for sale securities	239	502	487	1,291
Gain on FDIC modified whole bank transaction				9,124
Other income	1,013	221	1,776	581
Total Other Income	14,059	13,165	27,936	35,823
OTHER EXPENSES				
Salaries and employee benefits	20,536	19,641	41,327	38,995
Net occupancy	2,267	2,473	4,869	5,124
Equipment	1,742	1,656	3,516	3,461
Marketing	535	564	1,002	1,006
Outside data processing fees	1,391	1,506	2,871	2,882
Printing and office supplies	311	294	642	561
Core deposit amortization	383	480	770	949

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

FDIC assessments	674	862	1,418	1,979
Other real estate owned and credit-related expenses	1,479	2,122	3,345	4,308
Other expenses	4,424	4,582	8,682	8,943
Total Other Expenses	33,742	34,180	68,442	68,208
INCOME BEFORE INCOME TAX	14,970	12,493	31,503	32,364
Income tax expense	4,155	3,288	8,823	8,788
NET INCOME	10,815	9,205	22,680	23,576
Preferred stock dividends	(852	) (1,135	) (1,709	) (2,270
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$9,963	\$8,070	\$20,971	\$21,306
Per Share Data:				
Basic Net Income Available to Common Stockholders	\$0.35	\$0.28	\$0.73	\$0.74
Diluted Net Income Available to Common Stockholders	\$0.34	\$0.28	\$0.72	\$0.74
Cash Dividends Paid	\$0.05	\$0.03	\$0.08	\$0.04
Average Diluted Shares Outstanding (in thousands)	29,024	28,815	28,997	28,782

See notes to consolidated condensed financial statements.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Net income	\$10,815	\$9,205	\$22,680	\$23,576
Other comprehensive income net of tax:				
Unrealized holding gain (loss) on securities available for sale arising during the period, net of income tax of \$5,201, \$664, \$6,340, and \$653	(9,659	) 1,232	(11,773	) 1,212
Unrealized gain (loss) on securities available for sale for which a portion of an other than temporary impairment has been recognized in income, net of tax of \$113, \$24, \$151, and \$31	209	(44	) 281	(58
Unrealized gain (loss) on cash flow hedges arising during the period, net of income tax of \$525, \$568, \$629, and \$404	976	(1,053	) 1,169	(749
Amortization of items previously recorded in accumulated other comprehensive income, net of income tax of \$39, \$113, 73 \$384, and \$394		209	713	729
Reclassification adjustment for gains included in net income net of income tax expense of \$17, \$176, \$37, and \$452	(30	) (326	) (70	) (839
Comprehensive income	(8,431	) 18	(9,680	) 295
	\$2,384	\$9,223	\$13,000	\$23,871

See notes to consolidated condensed financial statements.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

	Preferred		Common Stock		Additional		Accumulated Other Comprehensive		Total
	Shares	Amount	Shares	Amount	Paid in Capital	Retained Earnings	Loss		
Balances, December 31, 2012	90,908	\$90,908	28,692,616	\$3,587	\$256,843	\$206,397	\$ (5,499)		\$552,236
Comprehensive Income									
Net Income						22,680			22,680
Other Comprehensive Income, net of tax							(9,680)		(9,680)
Cash Dividends on Common Stock (\$.08 per Share)							(2,334)		(2,334)
Cash Dividends on Preferred Stock under Small Business Lending Fund							(1,709)		(1,709)
Preferred Stock redeemed under Small Business Lending Fund		(22,696)							(22,696)
Share-based Compensation			105,857	13	797				810
Stock Issued Under Employee Benefit Plans			20,412	3	267				270
Stock Issued Under Dividend Reinvestment and Stock Purchase Plan			9,314	1	150				151
Stock options exercised			6,000	1	43				44
Stock Redeemed			(32,351)	(5)	(474)				(479)
Balances, June 30, 2013	68,212	\$68,212	28,801,848	\$3,600	\$257,626	\$225,034	\$ (15,179)		\$539,293

See notes to consolidated condensed financial statements.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	June 30, 2013	2012
Cash Flow From Operating Activities:		
Net income	\$22,680	\$23,576
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	4,099	9,420
Depreciation and amortization	2,162	2,348
Change in deferred taxes	8,083	7,452
Share-based compensation	810	686
Mortgage loans originated for sale	(184,270)	(177,645)
Proceeds from sales of mortgage loans	192,039	180,231
Gain on acquisition		(9,124)
Gains on sales of securities available for sale	(487)	(1,291)
Change in interest receivable	1,181	1,745
Change in interest payable	(691)	(1,124)
Other adjustments	(1,807)	1,297
Net cash provided by operating activities	\$43,799	\$37,571
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	\$(21,455)	\$11,091
Purchases of:		
Securities available for sale	(161,027)	(82,459)
Securities held to maturity	(7,772)	(566)
Proceeds from sales of securities available for sale	25,222	26,351
Proceeds from maturities of:		
Securities available for sale	56,417	47,379
Securities held to maturity	42,336	30,131
Change in Federal Reserve and Federal Home Loan Bank stock	(5)	(2)
Net change in loans	(27,059)	(4,579)
Net cash received from acquisition		29,113
Proceeds from the sale of other real estate owned	4,730	3,437
Other adjustments	(3,578)	(1,216)
Net cash provided (used) by investing activities	\$(92,191)	\$58,680
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	\$86,485	\$93,510
Certificates of deposit and other time deposits	(100,075)	(65,176)
Proceeds from borrowings	77,070	31,755
Repayment of borrowings	(20,391)	(157,811)
Cash dividends on common stock	(2,334)	(1,160)
Cash dividends on preferred stock	(1,709)	(2,270)
Stock issued under employee benefit plans	270	225
Stock issued under dividend reinvestment and stock purchase plans	151	87

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Stock options exercised	44	
Stock redeemed	(479	) (230)
Cumulative preferred stock redeemed (SBLF)	(22,696)
Net cash provided (used) by financing activities	\$16,336	\$(101,070)
Net Change in Cash and Cash Equivalents	(32,056	) (4,819)
Cash and Cash Equivalents, January 1	101,460	73,312
Cash and Cash Equivalents, June 30	\$69,404	\$68,493
Additional cash flow information:		
Interest paid	\$8,974	\$14,226
Income tax paid (refunded)	\$1,378	\$3,988
Loans transferred to other real estate owned	\$3,925	\$3,199
Non-cash investing activities using trade date accounting	\$9,854	\$757
Liabilities assumed, net of cash		\$166,112

See notes to consolidated condensed financial statements.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

NOTE 1

GENERAL

Financial Statement Preparation

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

The consolidated condensed balance sheet of the Corporation as of December 31, 2012, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation’s annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation’s Form 10-K annual report filed with the Securities and Exchange Commission. The results of operations for the six months ended June 30, 2013, are not necessarily indicative of the results to be expected for the year.

NOTE 2

PURCHASE AND ASSUMPTION

Effective February 10, 2012, First Merchants Bank, National Association (the “Bank”) assumed substantially all of the deposits and certain other liabilities and acquired certain assets of SCB Bank, a federal savings bank headquartered in Shelbyville, Indiana, from the Federal Deposit Insurance Corporation (“FDIC”), as receiver for SCB Bank (the “Acquisition”), pursuant to the terms of the Purchase and Assumption Agreement – Modified Whole Bank; All Deposits (the “Agreement”), entered into by the Bank, the FDIC as receiver of SCB Bank and the FDIC.

Under the terms of the Agreement, the Bank acquired \$147.7 million in assets, including approximately \$11.9 million of cash and cash equivalents, \$18.9 million of marketable securities, \$1.8 million in Federal Home Loan Bank stock, \$113.0 million in loans and \$2.1 million of premises and other assets. The Bank assumed approximately \$135.7 million of liabilities, including approximately \$125.9 million in customer deposits, \$9.6 million of other borrowed money and \$402,000 in other liabilities. These balances are book balances and do not reflect the fair value adjustments which are shown on the following table. The acquisition did not include any loss sharing agreement with the FDIC.

The bid accepted by the FDIC included no deposit premium. The assets were acquired at a discount of \$29.0 million from book value. The FDIC made a payment of \$17.2 million to the Bank upon the final closing date balance sheet for SCB Bank that reflected the difference between the purchase price of the assets acquired and the value of the liabilities assumed.

The Bank engaged in this transaction with the expectation that it would be immediately accretive and add a new market area with a demographic profile consistent with many of the current Indiana markets served by the Bank.

The transaction was accounted for under the acquisition method of accounting in accordance with the Business Combination topic of the FASB Accounting Standards Codification (“ASC 310-20 and 310-30”). The statement of net assets and liabilities acquired as of February 10, 2012, are presented below. The assets and liabilities of SCB were recorded at the respective acquisition date provisional fair values, and identifiable intangible assets were recorded at provisional fair value.

Assets		Liabilities	
Cash and due from banks (1)	\$29,113	Deposits:	
Investment securities, available for sale	18,896	Non-interest bearing	\$13,715
Federal Home Loan Bank stock	1,761	NOW accounts	14,746
Loans:		Savings and money market	25,843
Commercial	51,042	Certificate of deposit	71,605
Residential mortgage	11,181	Total Deposits	125,909
Installment	31,570		
Total Loans	93,793	Federal Home Loan Bank advances	10,286
		Other liabilities	804
Premises	1,516	Total Liabilities Assumed	\$136,999
Core deposit intangible	484		
Other assets	560	Net Gain on Acquisition	\$9,124
Total Assets Purchased	\$146,123		

(1) Includes \$17,200,000 cash received from the FDIC.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

In many cases, the fair values of assets acquired and liabilities assumed were determined by estimating cash flows expected to result from those assets and liabilities and discounting them at appropriate market rates. The most significant category of assets for which this procedure was used was acquired loans. The Bank acquired the \$113.0 million loan portfolio at a fair value discount of \$19.2 million. The performing portion of the portfolio, \$86.3 million, had an estimated fair value of \$76.5 million. The excess of expected cash flows above the fair value of the performing portion of loans will be accreted to interest income over the remaining lives of the loans in accordance with ASC 310-20. Discounts or premiums on term loans are accounted for under an effective yield method. Prepayments on term loans are accounted for in the effective yield calculation. Discounts or premiums on lines of credit are treated in a straight line method over the term of the lines of credit.

Certain loans for which specific credit-related deterioration has occurred since origination are recorded at fair value which is derived from calculating the present value of the amounts expected to be collected. Income recognition on these loans is based on reasonable expectation about the timing and amount of cash flows to be collected. Some of the acquired loans deemed impaired and considered collateral dependent, with the timing of a sale of loan collateral indeterminate, remain on non-accrual status and have little to no accretable yield.

In accordance with ASC 310-30 (formerly Statement of Position (“SOP”) 03-3 as of February 10, 2012, loans acquired during 2012 for which it was probable at acquisition that all contractually required payments would not be collected are as follows:

Preliminary estimate of contractually required principal and interest at acquisition	\$31,143
Preliminary estimate of contractual cash flows not expected to be collected (nonaccretable differences)	9,688
Preliminary estimate of expected cash flows at acquisition	21,455
Preliminary estimate of interest component of expected cash flows (accretable discount)	4,152
Preliminary estimate of fair value of acquired loans accounted for under ASC 310-30	\$17,303

Pro-forma statements were determined to be impracticable due to the nature of the transaction as certain assets were not purchased.

NOTE 3

INVESTMENT SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at June 30, 2013				
U.S. Government-sponsored agency securities	\$4,022	\$40		\$4,062
State and municipal	184,912	5,351	\$3,169	187,094
U.S. Government-sponsored mortgage-backed securities	390,114	5,357	4,488	390,983

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Corporate obligations	6,267		5,519	748
Equity securities	1,706			1,706
Total available for sale	587,021	10,748	13,176	584,593
Held to maturity at June 30, 2013				
State and municipal	115,943	552	11	116,484
U.S. Government-sponsored mortgage-backed securities	208,456	7,046	221	215,281
Total held to maturity	324,399	7,598	232	331,765
Total Investment Securities	\$911,420	\$18,346	\$13,408	\$916,358

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2012				
U.S. Government-sponsored agency securities	\$4,475	\$165		\$4,640
State and municipal	148,187	10,025	\$18	158,194
U.S. Government-sponsored mortgage-backed securities	337,631	10,994	46	348,579
Corporate obligations	6,105		5,881	224
Equity securities	1,706			1,706
Total available for sale	498,104	21,184	5,945	513,343
Held to maturity at December 31, 2012				
State and municipal	117,227	5,489	1	122,715
U.S. Government-sponsored mortgage-backed securities	243,793	11,681	15	255,459
Total held to maturity	361,020	17,170	16	378,174
Total Investment Securities	\$859,124	\$38,354	\$5,961	\$891,517

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The amortized cost and fair value of available for sale securities and held to maturity securities at June 30, 2013, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Maturity Distribution at June 30, 2013:				
Due in one year or less	\$6,554	\$6,735	\$1,755	\$1,757
Due after one through five years	13,272	13,763	9,429	9,692
Due after five through ten years	56,466	57,995	58,321	58,326
Due after ten years	118,909	113,411	46,438	46,709
	\$195,201	\$191,904	\$115,943	\$116,484
U.S. Government-sponsored mortgage-backed securities	390,114	390,983	208,456	215,281
Equity securities	1,706	1,706		
Total Investment Securities	\$587,021	\$584,593	\$324,399	\$331,765

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$317,638,000 at June 30, 2013, and \$335,775,000 at December 31, 2012.

The book value of securities sold under agreements to repurchase amounted to \$150,396,000 at June 30, 2013, and \$128,094,000 at December 31, 2012.

Gross gains and losses on the sales and redemptions of available for sale securities, and other-than-temporary impairment ("OTTI") losses recognized for the three and six months ended June 30, 2013 and 2012 are shown below.

	Three Months Ended		Six Months Ended	
	June 30, 2013	2012	June 30, 2013	2012
Sales and Redemptions of Available for Sale Securities:				
Gross gains	\$239	\$502	\$487	\$1,291
Gross losses	—	—	—	—
Other-than-temporary impairment losses	—	—	—	\$—

The following table shows the Corporation's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2013, and December 31, 2012:

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

Temporarily Impaired Investment
Securities at June 30, 2013

State and municipal	\$66,388	\$3,180			\$66,388	\$3,180
U.S. Government-sponsored mortgage-backed securities	183,941	4,709			183,941	4,709
Corporate obligations			\$717	\$5,519	717	5,519
Total Temporarily Impaired Investment Securities	\$250,329	\$7,889	\$717	\$5,519	\$251,046	\$13,408

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Investment Securities at December 31, 2012						
State and municipal	\$4,524	\$19			\$4,524	\$19
U.S. Government-sponsored mortgage-backed securities	12,320	61			12,320	61
Corporate obligations			\$194	\$5,881	194	5,881
Total Temporarily Impaired Investment Securities	\$16,844	\$80	\$194	\$5,881	\$17,038	\$5,961

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

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

	June 30, 2013	December 31, 2012	
Investments reported at less than historical cost:			
Historical cost	\$264,454	\$22,999	
Fair value	\$251,046	\$17,038	
Percent of the Corporation's available for sale and held to maturity portfolio	27.6	% 1.9	%

The Corporation's management has evaluated all securities with unrealized losses for other-than-temporary impairment ("OTTI") as of June 30, 2013. The evaluations are based on the nature of the securities, the extent and duration of the loss and the intent and ability of the Corporation to hold these securities either to maturity or through the expected recovery period.

The current unrealized losses are primarily concentrated within trust preferred securities held by the Corporation. Such investments have an amortized cost of \$6.3 million and a fair value of \$717,000, which is less than 1 percent of the Corporation's entire investment portfolio. On all but one small pool investment, the Corporation utilized Moody's to determine their fair value.

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

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

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

U.S. Government-Sponsored Mortgage-Backed Securities

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

Corporation does not consider the investment securities to be other-than-temporarily impaired at June 30, 2013.

State and Municipal

The unrealized losses on the Corporation's investments in securities of state and political subdivisions were caused by changes in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at June 30, 2013.

Corporate Obligations

The Corporation's unrealized losses on Corporate Obligations were due to the decline in value related to the pooled trust preferred securities, and is attributable to temporary illiquidity and the financial crisis affecting these markets, coupled with the potential credit loss resulting from the adverse change in expected cash flows. Due to the illiquidity in the market, it is unlikely that the Corporation would be able to recover its investment in these securities if the Corporation sold the securities at this time. Management has analyzed the cash flow characteristics of the securities and this analysis included utilizing the most recent trustee reports and any other relevant market information, including announcements of deferrals or defaults of trust preferred securities. The Corporation compared expected discounted cash flows, based on performance indicators of the underlying assets in the security, to the carrying value of the investment to determine if OTTI existed. The Corporation does not intend to sell the investment, and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the remainder of the investment securities, which are classified as Level 3 inputs in the fair value hierarchy, to be other-than-temporarily impaired at June 30, 2013.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Credit Losses Recognized on Investments

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

	Accumulated Credit Losses in 2013	Accumulated Credit Losses in 2012
Credit losses on debt securities held:		
Balance, January 1	\$ 11,355	\$ 11,355
Additions related to other-than-temporary losses not previously recognized		
Balance, June 30	\$ 11,355	\$ 11,355

NOTE 4

LOANS AND ALLOWANCE

The Corporation's primary lending focus is small business and middle market commercial, residential real estate, auto and small consumer lending, which results in portfolio diversification. The following tables show the composition in the loan portfolio, loan grades and the allowance for loan losses excluding loans held for sale. Residential real estate loans held for sale as of June 30, 2013, and December 31, 2012, were \$14,531,000 and \$22,300,000, respectively.

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

	June 30, 2013	December 31, 2012
Commercial and industrial loans	\$657,764	\$622,579
Agricultural production financing and other loans to farmers	105,175	112,527
Real estate loans:		
Construction	101,909	98,639
Commercial and farmland	1,272,761	1,266,682
Residential	460,108	473,537
Home Equity	203,788	203,406
Individuals' loans for household and other personal expenditures	79,258	75,748
Lease financing receivables, net of unearned income	1,828	2,590
Other loans	37,489	46,501
Loans	2,920,080	2,902,209
Allowance for loan losses	(68,202)	(69,366)
Net Loans	\$2,851,878	\$2,832,843

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. The allowance is increased by the provision for loan losses and decreased by charge offs less recoveries. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off. The Bank charges off a loan when a determination is made that all or a portion of the loan is uncollectible. The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings.

The amount provided for loan losses in a given period may be greater than or less than net loan losses experienced during the period, and is based on management's judgment as to the appropriate level of the allowance for loan losses. The determination of the provision amount in a given period is based on management's ongoing review and evaluation of the loan portfolio, including an internally administered loan "watch" list and independent loan reviews. The evaluation takes into consideration identified credit problems, the possibility of losses inherent in the loan portfolio that are not specifically identified and management's judgment as to the impact of current economic conditions on the portfolio.

Management believes that the allowance for loan losses is adequate to cover probable losses inherent in the loan portfolio as of June 30, 2013. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments, to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examinations, and will increase or decrease as deemed necessary to ensure the allowance remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

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

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

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

Commercial

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

Commercial real estate

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

Residential and Consumer

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following tables summarize changes in the allowance for loan losses by loan segment for the three and six months ended June 30, 2013, and June 30, 2012:

	Three Months Ended June 30, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, April 1	\$25,371	\$24,978	\$2,689	\$15,479	\$20	\$68,537
Provision for losses	1,917	(673)	) 225	497	31	1,997
Recoveries on loans	683	1,389	107	347		2,526
Loans charged off	(1,408)	) (2,089)	) (136)	) (1,210)	) (15)	) (4,858)
Balances, June 30, 2013	\$26,563	\$23,605	\$2,885	\$15,113	\$36	\$68,202

	Six Months Ended June 30, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, January 1	\$25,913	\$26,703	\$2,593	\$14,157		\$69,366
Provision for losses	2,275	(1,428)	) 298	2,903	\$51	4,099
Recoveries on loans	2,556	2,765	316	635		6,272
Loans charged off	(4,181)	) (4,435)	) (322)	) (2,582)	) (15)	) (11,535)
Balances, June 30, 2013	\$26,563	\$23,605	\$2,885	\$15,113	\$36	\$68,202

	Three Months Ended June 30, 2012					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, April 1	\$15,574	\$37,907	\$2,805	\$14,083		\$70,369
Provision for losses	4,325	(750)	) (177)	) 1,147		4,545
Recoveries on loans	519	1,636	168	481		2,804
Loans charged off	(2,627)	) (3,660)	) (365)	) (923)	)	) (7,575)
Balances, June 30, 2012	\$17,791	\$35,133	\$2,431	\$14,788		\$70,143

	Six Months Ended June 30, 2012					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, January 1	\$17,731	\$37,919	\$2,902	\$12,343	\$3	\$70,898
Provision for losses	4,902	1,028	(161)	) 3,655	(4)	) 9,420
Recoveries on loans	667	1,864	376	794	1	3,702
Loans charged off	(5,509)	) (5,678)	) (686)	) (2,004)	)	) (13,877)
Balances, June 30, 2012	\$17,791	\$35,133	\$2,431	\$14,788		\$70,143

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

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

	June 30, 2013					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance Balances:						
Individually evaluated for impairment	\$1,353	\$2,754		\$5		\$4,112
Collectively evaluated for impairment	24,941	20,708	\$2,885	15,084	\$36	63,654
Loans Acquired with Deteriorated Credit Quality	269	143		24		436
Total Allowance for Loan Losses	\$26,563	\$23,605	\$2,885	\$15,113	\$36	\$68,202
Loan Balances:						
Individually evaluated for impairment	\$10,114	\$36,690		\$6,269		\$53,073
Collectively evaluated for impairment	789,354	1,328,427	\$79,258	656,900	\$1,828	2,855,767
Loans Acquired with Deteriorated Credit Quality	960	9,553		727		11,240
Loans	\$800,428	\$1,374,670	\$79,258	\$663,896	\$1,828	\$2,920,080

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

	December 31, 2012					
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance Balances:						
Individually evaluated for impairment	\$ 1,628	\$ 2,565		\$ 50		\$ 4,243
Collectively evaluated for impairment	24,285	24,138	\$ 2,593	14,107		65,123
Total Allowance for Loan Losses	\$ 25,913	\$ 26,703	\$ 2,593	\$ 14,157		\$ 69,366
Loan Balances:						
Individually evaluated for impairment	\$ 14,190	\$ 45,394		\$ 8,515		\$ 68,099
Collectively evaluated for impairment	765,707	1,309,912	\$ 75,748	667,401	\$ 2,590	2,821,358
Loans Acquired with Deteriorated Credit Quality	1,710	10,015		1,027		12,752
Loans	\$ 781,607	\$ 1,365,321	\$ 75,748	\$ 676,943	\$ 2,590	\$ 2,902,209

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

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

	June 30, 2013	December 31, 2012
Commercial and industrial loans	\$ 8,543	\$ 12,195
Agriculture Production financing and other loans to farmers	33	
Real Estate Loans:		
Construction	2,492	4,814
Commercial and farmland	15,352	22,612
Residential	11,148	11,476
Home Equity	1,234	1,997
Lease financing receivables, net of unearned income		301
Other Loans	169	4
Total	\$ 38,971	\$ 53,399

Commercial impaired loans include all non-accrual loans, loans accounted for under ASC 310-30 and renegotiated loans, as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected.

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

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

	June 30, 2013		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance:			
Commercial and industrial loans	\$17,836	\$5,556	
Agriculture production financing and other loans to farmers	34	33	
Real Estate Loans:			
Construction	4,540	3,053	
Commercial and farmland	44,620	32,658	
Residential	8,228	5,968	
Home equity	3,412	226	
Other loans	140	30	
Total	\$78,810	\$47,524	
Impaired loans with related allowance:			
Commercial and industrial loans	\$7,193	\$5,306	\$1,476
Real Estate Loans:			
Construction	961	599	74
Commercial and farmland	10,249	9,177	2,823
Residential	465	235	29
Other loans	321	148	146
Total	\$19,189	\$15,465	\$4,548
Total Impaired Loans	\$97,999	\$62,989	\$4,548
	December 31, 2012		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance:			
Commercial and industrial loans	\$28,532	\$11,730	
Real Estate Loans:			
Construction	9,787	5,164	
Commercial and farmland	58,173	43,204	
Residential	8,820	6,215	
Home equity	4,199	1,006	
Other loans	83	14	
Total	\$109,594	\$67,333	
Impaired loans with related allowance:			
Commercial and industrial loans	\$4,415	\$4,155	\$1,628
Real Estate Loans:			

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Construction	1,202	1,058	105
Commercial and farmland	5,579	5,182	2,460
Residential	1,722	1,451	50
Total	\$12,918	\$11,846	\$4,243
Total Impaired Loans	\$122,512	\$79,179	\$4,243

16

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

	Three Months Ended June 30, 2013		Six Months Ended June 30, 2013	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial	\$5,864	\$35	\$6,138	\$69
Agriculture production financing and other loans to farmers	33		33	
Real Estate Loans:				
Construction	3,060	19	3,070	38
Commercial and farmland	32,932	382	33,192	760
Residential	6,067	18	6,372	37
Home equity	226		245	
Other loans	31		32	
Total	\$48,213	\$454	\$49,082	\$904
Impaired loans with related allowance:				
Commercial and industrial	\$5,669	\$3	\$6,138	\$5
Real Estate Loans:				
Construction	599		599	
Commercial and farmland	9,227		9,323	
Residential	238		240	
Other loans	\$152		\$156	
Total	\$15,885	\$3	\$16,456	\$5
Total Impaired Loans	\$64,098	\$457	\$65,538	\$909
	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:				
Commercial and industrial loans	\$11,411	\$39	\$12,418	\$64
Real Estate Loans:				
Construction	8,040	16	8,581	29
Commercial and farmland	41,084	315	42,615	575
Residential	5,815	15	6,072	26
Home equity	570	3	585	6
Individuals' loans for household and other personal expenditures	139		139	
Other loans	18		19	
Total	\$67,077	\$388	\$70,429	\$700

Impaired loans with related allowance:

Commercial and industrial loans	\$6,111	\$11	\$6,136	\$21
Real Estate Loans:				
Construction	1,931		1,936	
Commercial and farmland	8,369	45	8,505	89
Residential	2,012	19	1,993	38
Total	\$18,423	\$75	\$18,570	\$148
Total Impaired Loans	\$85,500	\$463	\$88,999	\$848

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

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

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

Pass - Loans that are considered to be of acceptable credit quality.

Special Mention - Loans which possess some credit deficiency or potential weakness, which deserves close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Corporation's credit position at some future date. Special mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification. The key distinctions of this category's classification are that it is indicative of an unwarranted level of risk; and weaknesses are considered "potential", not "defined", impairments to the primary source of repayment. Examples include businesses that may be suffering from inadequate management, loss of key personnel or significant customer or litigation.

Substandard - A substandard loan is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness that jeopardizes the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Other characteristics may include:

- o the likelihood that a loan will be paid from the primary source of repayment is uncertain or financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss,
- o the primary source of repayment is gone, and the Corporation is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees,
- o loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
- o unusual courses of action are needed to maintain a high probability of repayment,
- o the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
- o the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
- o loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
- o the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
- o there is significant deterioration in market conditions to which the borrower is highly vulnerable.

Doubtful - Loans that have all of the weaknesses of those classified as Substandard. However, based on currently existing facts, conditions and values, these weaknesses make full collection of principal highly questionable and improbable. Other credit characteristics may include the primary source of repayment is gone or there is considerable doubt as to the quality of the secondary sources of repayment. The possibility of loss is high, but because of certain important pending factors that may strengthen the loan, loss classification is deferred until the exact status of repayment is known.

Loss – Loans that are considered uncollectible and of such little value that continuing to carry them as an asset is not warranted. Loans will be classified as Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following tables summarize the credit quality of the Corporation's loan portfolio, by loan class as of the periods indicated. Consumer non-performing loans include accruing consumer loans 90 plus days delinquent and consumer non-accrual loans. The entire balance of a loan is considered delinquent if the minimum payment contractually required to be made is not received by the specified date.

	June 30, 2013							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$606,312	\$ 24,198	\$ 25,352	\$ 1,902				\$657,764
Agriculture production financing and other loans to farmers	104,928	214	33					105,175
Real Estate Loans:								
Construction	87,384	7,880	6,253			\$ 392		101,909
Commercial and farmland	1,164,325	44,639	63,212	350			235	1,272,761
Residential	140,813	1,468	14,258	140		\$ 296,399	7,030	460,108
Home equity	10,034	663	866			191,023	1,202	203,788
Individuals' loans for household and other personal expenditures						79,258		79,258
Lease financing receivables, net of unearned income	1,695		133					1,828
Other loans	37,311	9	169					37,489
Loans	\$2,152,802	\$ 79,071	\$ 110,276	\$ 2,392		\$ 566,680	\$ 8,859	\$2,920,080
	December 31, 2012							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$559,852	\$ 23,678	\$ 34,460	\$ 4,589				\$622,579
Agriculture production financing and other loans to farmers	112,209	224	94					112,527
Real Estate Loans:								
Construction	85,728	1,384	11,356			\$ 171		98,639
Commercial and farmland	1,148,561	38,199	79,078	553			291	1,266,682
Residential	145,402	5,437	13,880	922		\$ 301,614	6,282	473,537
Home equity	9,092	893	1,657			189,721	2,043	203,406
						75,748		75,748

Individuals' loans for household and other personal expenditures							
Lease financing receivables, net of unearned income					2,289	301	2,590
Other loans	46,473		28				46,501
Loans	\$2,107,317	\$ 69,815	\$ 140,553	\$ 6,064	\$ 569,372	\$ 9,088	\$ 2,902,209

The following table shows a past due aging of the Corporation's loan portfolio, by loan class as of June 30, 2013, and December 31, 2012:

	June 30, 2013					Total Past Due & Non-Accrual	Total
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual		
Commercial and industrial loans	\$648,160	\$720	\$341		\$ 8,543	\$ 9,604	\$657,764
Agriculture production financing and other loans to farmers	105,142				33	33	105,175
Real Estate Loans:							
Construction	99,398	19			2,492	2,511	101,909
Commercial and farmland	1,252,554	4,424	431		15,352	20,207	1,272,761
Residential	442,918	3,828	1,335	\$ 879	11,148	17,190	460,108
Home equity	201,041	755	565	193	1,234	2,747	203,788
Individuals' loans for household and other personal expenditures	78,652	532	74			606	79,258
Lease financing receivables, net of unearned income	1,828						1,828
Other loans	37,320				169	169	37,489
Loans	\$2,867,013	\$10,278	\$2,746	\$1,072	\$ 38,971	\$ 53,067	\$2,920,080

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

	December 31, 2012						
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total
Commercial and industrial loans	\$607,442	\$2,628	\$144	\$170	\$ 12,195	\$ 15,137	\$622,579
Agriculture production financing and other loans to farmers	112,527						112,527
Real Estate Loans:							
Construction	93,426	399			4,814	5,213	98,639
Commercial and farmland	1,238,907	3,276	1,822	65	22,612	27,775	1,266,682
Residential	453,743	5,734	1,338	1,246	11,476	19,794	473,537
Home equity	199,063	1,467	323	556	1,997	4,343	203,406
Individuals' loans for household and other personal expenditures	74,919	799	30			829	75,748
Lease financing receivables, net of unearned income	2,289				301	301	2,590
Other loans	46,497				4	4	46,501
Loans	\$2,828,813	\$14,303	\$3,657	\$2,037	\$ 53,399	\$ 73,396	\$2,902,209

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

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

The following tables summarize troubled debt restructurings that occurred during the periods indicated:

	Three Months Ended June 30, 2013			Six Months Ended June 30, 2013		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and industrial loans	\$36	\$ 36	1	\$133	\$ 133	4
Real Estate Loans:						
Commercial and farmland	4,474	3,550	2	4,985	3,981	4
Residential	432	420	5	467	457	6

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Individuals' loans for household and other personal expenditures	44	45	2	44	45	2
Total	\$4,986	\$ 4,051	10	\$5,629	\$ 4,616	16

	Three Months Ended June 30, 2012			Six Months Ended June 30, 2012		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and industrial loans	\$166	\$ 166	2	\$405	\$ 405	4
Real Estate Loans:						
Construction	491	350	1	491	350	1
Commercial and farmland	730	735	4	2,508	2,369	6
Residential	1,733	1,598	11	1,957	1,822	15
Total	\$3,120	\$ 2,849	18	\$5,361	\$ 4,946	26

Residential real estate loans account for 50 percent and 38 percent of the troubled debt restructured loans made in the three and six months ended June 30, 2013, respectively. Nine and eleven troubled debt restructured loans made during the three and six months ended June 30, 2013, respectively, are in accrual status.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

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

	Three Months Ended June 30, 2013			
	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans	\$36			\$36
Real Estate Loans:				
Commercial and farmland			\$3,549	3,549
Residential		\$100	319	419
Individuals' loans for household and other personal expenditures			45	45
Total	\$36	\$100	\$3,913	\$4,049
	Six Months Ended June 30, 2013			
	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans	\$60		\$66	\$126
Real Estate Loans:				
Commercial and farmland			3,935	3,935
Residential		\$100	355	455
Individuals' loans for household and other personal expenditures			45	45
Total	\$60	\$100	\$4,401	\$4,561
	Three Months Ended June 30, 2012			
	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans			\$31	\$31
Real Estate Loans:				
Construction			346	346
Commercial and farmland	\$82		599	681
Residential	531	\$258	720	1,509
Total	\$613	\$258	\$1,696	\$2,567
	Six Months Ended June 30, 2012			
	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans	\$238		\$31	\$269
Real Estate Loans:				
Construction			346	346
Commercial and farmland	1,717		599	2,316
Residential	531	\$258	944	1,733
Total	\$2,486	\$258	\$1,920	\$4,664

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

The following tables summarize troubled debt restructures that occurred during the twelve months ended June 30, 2013, and June 30, 2012, that subsequently defaulted during the period indicated:

	Three Months Ended June 30, 2013		Six Months Ended June 30, 2013	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Commercial and Industrial loans	1	\$3	1	\$3
Real Estate Loans:				
Commercial and farmland			1	223
Total	1	\$3	2	\$226

	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
	Number of Loans	Recorded Balance	Number of Loans	Recorded Balance
Commercial and Industrial loans			1	\$46
Real Estate Loans:				
Commercial and farmland	2	\$445	3	1,203
Residential	5	2,283	5	2,283
Total	7	\$2,728	9	\$3,532

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

NOTE 5

ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE

The Bank acquired loans in a purchase during the year ended December 31, 2012. The following table includes the carrying amount of these loans, which are included in the balance sheet amounts of loans receivable at June 30, 2013 and December 31, 2012.

	June 30, 2013	December 31, 2012
--	---------------	-------------------

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Commercial and industrial loans	\$5,408	\$8,542
Agricultural production financing and other loans to farmers	872	1,127
Real estate loans:		
Construction		58
Commercial and farmland	21,129	24,259
Residential	10,415	12,118
Home Equity	17,509	18,805
Individuals' loans for household and other personal expenditures	464	691
Other Loans	169	
Total	\$55,966	\$65,600

Accretable yield, or income expected to be collected, is as follows:

	Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Beginning balance	\$4,371	\$5,142
Accretion	(412	) (1,183
Ending balance, June 30, 2013	\$3,959	\$3,959

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

	Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
Beginning balance, February 10, 2012	\$9,774	\$9,774
Accretion	(726	) (726
Ending balance, June 30, 2012	\$9,048	\$9,048

At acquisition, certain purchased loans evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected.

Loans purchased with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be credit impaired. Evidence of credit quality deterioration as of the purchase date may include information such as past-due and nonaccrual status, borrower credit scores and recent loan to value percentages. Purchased credit-impaired loans are accounted for under the accounting guidance for loans and debt securities acquired with deteriorated credit quality (ASC 310-30) and initially measured at fair value, which includes estimated future credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for credit losses related to these loans is not carried over and recorded at the acquisition date. Management estimated the cash flows expected to be collected at acquisition, which incorporated the estimate of current key assumptions, such as default rates, severity and prepayment speeds.

NOTE 6

DERIVATIVE FINANCIAL INSTRUMENTS

Risk Management Objective of Using Derivatives

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

Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish these objectives, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. As of June 30, 2013 and 2012, the Corporation had two interest rate swaps with a notional amount of \$26.0 million and one interest rate cap with a notional amount of \$13.0 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2013, such derivatives were used to hedge the variable cash outflows (LIBOR-based) associated with existing trust preferred securities when the outflows converted from a fixed rate to variable rate in September of 2012. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the six months ended June 30, 2013, and 2012, the Corporation did not recognize any ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation expects to reclassify \$772,000 from accumulated other comprehensive income to interest expense.

Non-designated Hedges

The Corporation does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Corporation provides to certain customers. The Corporation executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Corporation executes with a third party, such that the Corporation minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of June 30, 2013, the notional amount of customer-facing swaps was approximately \$158,410,000. This amount is offset with third party counterparties, as described above.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Corporation's derivative financial instruments, as well as their classification on the Balance Sheet, as of June 30, 2013, and December 31, 2012.

	Asset Derivatives		December 31, 2012		Liability Derivatives		December 31, 2012	
	June 30, 2013		Balance	Fair	June 30, 2013		Balance	Fair
	Balance	Fair	Sheet	Value	Balance	Fair	Sheet	Value
	Sheet	Value	Sheet	Value	Sheet	Value	Sheet	Value
	Location	Value	Location	Value	Location	Value	Location	Value
Derivatives designated as hedging instruments:								
Interest rate contracts	Other Assets	\$440	Other Assets	\$197	Other Liabilities	\$1,409	Other Liabilities	\$3,332
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	\$3,186	Other Assets	\$6,103	Other Liabilities	\$3,252	Other Liabilities	\$6,434

Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Corporation's derivative financial instruments on the Income Statement for three and six months ended June 30, 2013, and 2012.

Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative	
		Three Months Ended June 30, 2013	Six Months Ended June 30, 2013
Interest rate contracts	Other income	\$200	\$266
Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative	
		Three Months Ended June 30, 2012	Six Months Ended June 30, 2012
Interest rate contracts	Other income	\$(58)	\$(55)

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

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Other Comprehensive Income on Derivative (Effective Portion)			
	Three Months ended		Six Months ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Interest Rate Products	\$1,501	\$(1,621)	\$1,798	\$(1,153)

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

Location of Gain (Loss) Reclassified from Accumulated Other Comprehensive Income (Effective Portion)	Amount of Gain (Loss) Reclassified from Other Comprehensive Income into Income (Effective Portion)			
	Three Months ended		Six Months ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
Interest Expense	\$(192)	)	\$(380))

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Credit-risk-related Contingent Features

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

The Corporation has agreements with certain of its derivative counterparties that contain a provision where if the Corporation defaults on any of its indebtedness, including default where repayment of the indebtedness has not been accelerated by the lender, the Corporation could also be declared in default on its derivative obligations.

As of June 30, 2013, the termination value of derivatives in a net liability position related to these agreements was \$4,554,000. As of June 30, 2013, the Corporation had minimum collateral posting thresholds with certain of its derivative counterparties and had posted collateral of \$4,051,000. If the Corporation had breached any of these provisions at June 30, 2013, it could have been required to settle its obligations under the agreements at their termination value.

NOTE 7

DISCLOSURES ABOUT FAIR VALUE OF ASSETS AND LIABILITIES

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

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

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability. Inputs can be observable or unobservable. Observable inputs are those assumptions which market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of the Corporation. Unobservable inputs are assumptions based on the Corporation's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date. All inputs, whether observable or unobservable, are ranked in accordance with a prescribed fair value hierarchy which gives the highest ranking to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest ranking to

unobservable inputs for which there is little or no market activity (Level 3). Fair values for assets or liabilities classified as Level 2 are based on one or a combination of the following factors: (i) quoted prices for similar assets; (ii) observable inputs for the asset or liability, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation considers an input to be significant if it drives 10 percent or more of the total fair value of a particular asset or liability.

Recurring Measurements

The following table presents the fair value measurements of assets and liabilities recognized in the Consolidated Condensed Balance Sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at June 30, 2013, and December 31, 2012.

June 30, 2013	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$4,062		\$4,062	
State and municipal	187,094		169,931	\$17,163
U.S. Government-sponsored mortgage-backed securities	390,983		390,983	
Corporate obligations	748			748
Equity securities	1,706		1,702	4
Interest rate swap asset	3,186		3,186	
Interest rate cap	440		440	
Interest rate swap liability	4,661		4,661	

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

December 31, 2012	Fair Value	Fair Value Measurements Using:		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$4,640		\$4,640	
State and municipal	158,194		140,094	\$18,100
U.S. Government-sponsored mortgage-backed securities	348,579		348,579	
Corporate obligations	224			224
Equity securities	1,706		1,702	4
Interest rate swap asset	6,103		6,103	
Interest rate cap	197		197	
Interest rate swap liability	9,766		9,766	

Following is a description of the valuation methodologies and inputs used for instruments measured at fair value on a recurring basis and recognized in the accompanying Consolidated Condensed Balance Sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques as of June 30, 2013.

Available for Sale Investment Securities

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

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

Pooled Trust Preferred Securities

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

Interest Rate Derivative Agreements

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

The fair value of the interest rate swap and cap instruments were transferred from Level 3 to Level 2 as of March 31, 2012 due to the availability of additional valuation information. These instruments were valued using widely accepted valuation techniques including discounted cash flow analysis using observable inputs such as contractual terms and LIBOR-based rate curves.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Level 3 Reconciliation

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the Consolidated Condensed Balance Sheets using significant unobservable (Level 3) inputs for three and six months ended June 30, 2013, and 2012.

	Three Months Ended June 30, 2013				Six Months Ended June 30, 2013			
	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability
Balance at beginning of the period	17,678				18,328			
Total realized and unrealized gains and losses:								
Included in net income (loss)								
Included in other comprehensive income	140				(35)			
Purchases, issuances and settlements								
Transfers in/(out) of Level 3								
Principal payments/additions	97				(378)			
Ending balance at June 30, 2013	17,915				17,915			
	Three Months Ended June 30, 2012				Six Months Ended June 30, 2012			
	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability
Balance at beginning of the period	\$19,878				\$20,838	\$5,241	\$424	\$(7,797)
Total realized and unrealized gains and losses:								
Included in net income (loss)						(860)		863
Included in other comprehensive	(238)				(761)	481	(15)	

income								
Purchases, issuances and settlements								
Transfers in/(out) of Level 3					(4,862	)	(409	) 6,934
Principal payments	100				(337)		
Ending balance at June 30, 2012	\$ 19,740	—	—	—	\$ 19,740	\$—	\$—	\$—

There were no gains or losses for the period included in earnings that were attributable to the changes in unrealized gains or losses related to assets or liabilities held at June 30, 2013 or December 31, 2012.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Transfers Between Levels

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

	Six Months Ended June 30, 2012			Reason for Transfer
	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Transfers to/(from) Level:				
Interest rate swap asset		\$4,862	\$(4,862	) The interest rate swap and cap
Interest rate cap		409	(409	) instruments were transferred from
				Level 3 to Level 2 as of March 31,
				2012 due to the availability of
				additional valuation
Interest rate swap		6,934	(6,934	) information. These instruments are
liability				valued using widely accepted
				valuation techniques including
				discounted cash flow analysis using
				observable inputs such as contractual
				terms and LIBOR-based rate curves.
		\$12,205	\$(12,205)

Nonrecurring Measurements

The following table presents the fair value measurement of assets and liabilities measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at June 30, 2013, and December 31, 2012.

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2013				
Impaired loans (collateral dependent)	\$ 14,230			\$ 14,230
Other real estate owned	\$ 7,949			\$ 7,949
December 31, 2012				

		Identical Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)
Impaired loans (collateral dependent)	\$ 17,703			\$ 17,703
Other real estate owned	\$ 7,684			\$ 7,684

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

Impaired Loans (collateral dependent)

Loans for which it is probable that the Corporation will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. During 2013, certain impaired loans were partially charged off or re-evaluated. Impaired loans that are collateral dependent are classified within Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

Other Real Estate Owned

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Unobservable (Level 3) Inputs

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

	Fair Value	Valuation Technique	Unobservable Inputs	Range
State and municipal securities	\$17,163	Discounted cash flow	Maturity/Call date Blend of US Muni BQ curve Discount rate	1 month to 11 yrs A- to BBB- 1% - 4%
Corporate obligations/Equity securities	\$752	Discounted cash flow	Risk free rate plus Premium for illiquidity	3 month LIBOR plus 200bps
Impaired loans (collateral dependent)	\$14,230	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 50%
Other real estate owned	\$7,949	Appraisals	Discount to reflect current market conditions	0% - 20%

Sensitivity of Significant Unobservable Inputs

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

State and Municipal Securities

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

Corporate Obligations/Equity Securities

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Fair Value of Financial Instruments

The following table presents estimated fair values of the Corporation's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at June 30, 2013, and December 31, 2012.

		June 30, 2013 (unaudited)		
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and due from banks	\$69,404	\$69,404		
Interest-bearing time deposits	59,898	59,898		
Investment securities available for sale	584,593		\$566,678	\$17,915
Investment securities held to maturity	324,399		320,861	10,904
Mortgage loans held for sale	14,531		14,531	
Loans	2,851,878			2,826,038
Federal Reserve Bank and Federal Home Loan Bank stock	32,790		32,790	
Interest rate swap and cap asset	3,626		3,626	
Interest receivable	15,186		15,186	
Liabilities:				
Deposits	\$3,332,793	\$2,565,193	\$760,068	
Borrowings:				
Federal funds purchased	57,085		57,085	
Securities sold under repurchase agreements	161,779		162,120	
Federal Home Loan Bank advances	92,743		95,080	
Subordinated debentures and term loans	111,778		63,563	
Interest rate swap liability	4,661		4,661	
Interest payable	1,150		1,150	
		December 31, 2012		
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and due from banks	\$101,460	\$101,460		
Interest-bearing time deposits	38,443	38,443		
Investment securities available for sale	513,343		\$495,015	\$18,328
Investment securities held to maturity	361,020		366,590	11,584

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Mortgage loans held for sale	22,300		22,300	
Loans	2,832,843			2,852,614
Federal Reserve Bank and Federal Home Loan				
Bank stock	32,785		32,785	
Interest rate swap and cap asset	6,300		6,300	
Interest receivable	16,367		16,367	
Liabilities:				
Deposits	\$3,346,383	\$2,478,706	\$865,793	
Borrowings:				
Federal funds purchased	18,862		18,862	
Securities sold under repurchase agreements	141,828		142,318	
Federal Home Loan Bank advances	94,238		97,357	
Subordinated debentures and term loans	112,161		62,133	
Interest rate swap liability	9,766		9,766	
Interest payable	1,841		1,841	

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

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

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

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

Investment securities: Fair value is based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

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

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

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

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

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

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

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

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

NOTE 8

ACCUMULATED OTHER COMPREHENSIVE INCOME

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

The following table summarizes the changes in the balances of each component of accumulated other comprehensive income (loss), net of tax, as of June 30, 2013 and 2012:

	Accumulated Other Comprehensive Income					Total
	Unrealized Gains (Losses) on Securities Available for Sale	Unrealized Gains (Losses) on Securities Available for Sale for which a Portion of Other-Than-Temporary Impairment has been Recognized in Income	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans		
Balance at December 31, 2012	\$17,904	\$ (3,272)	\$ (2,652)	\$ (17,479)		\$ (5,499)
Other comprehensive income before reclassifications	(11,773)	281	1,169			(10,323)
Amounts reclassified from accumulated other comprehensive income	(317)		247	713		643
Period change	(12,090)	281	1,416	713		(9,680)
Balance at June 30, 2013	\$5,814	\$ (2,991)	\$ (1,236)	\$ (16,766)		\$ (15,179)
Balance at December 31, 2011	\$18,244	\$ (3,168)	\$ (1,841)	\$ (16,837)		\$ (3,602)
Other comprehensive income before reclassifications	1,212	(58)	(749)			405
Amounts reclassified from accumulated other comprehensive income	(839)			729		(110)
Period change	373	(58)	(749)	729		295
Balance at June 30, 2012	\$18,617	\$ (3,226)	\$ (2,590)	\$ (16,108)		\$ (3,307)

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Realized securities gains reclassified into income	\$487	\$1,291	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(170)	(452)	Income tax expense
	\$317	\$839	
Unrealized gains (losses) on cash flow hedges (2)			
Interest rate contracts	\$(380)		Interest expense - subordinated debentures and term loans
Related income tax benefit	133		Income tax expense
	\$(247)		
Unrealized gains (losses) on defined benefit plans			
Amortization of net loss and prior service costs	\$(1,097)	\$(1,123)	Other expenses - salaries and employee benefits
Related income tax benefit	384	394	Income tax expense
	\$(713)	\$(729)	
Total reclassifications for the period, net of tax	\$(643)	110	

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

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

NOTE 9

SHARE-BASED COMPENSATION

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a 10-year life, become 100 percent vested ranging from six months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. RSAs for employees retired from the Corporation continue to vest after retirement. Deferred stock units ("DSUs") can be credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of June 30, 2013, there were no outstanding DSUs.

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

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three and six months ended June 30, 2013 was \$436,000 and \$810,000, respectively compared to \$360,000 and \$686,000 for the three and six months ended June 30, 2012. Share-based compensation has been recognized as a component of salaries and benefits expense in the accompanying CONSOLIDATED CONDENSED STATEMENTS OF INCOME.

The estimated fair value of the stock options granted during 2013 and in prior year was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2013 Black Scholes model:

Risk-free interest rate	1.25	%
Expected price volatility	45.68	%
Dividend yield	2.96	%
Forfeiture rate	4.73	%
Weighted-average expected life, until exercise	7.3 years	

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

Share-based compensation expense recognized in the CONSOLIDATED CONDENSED STATEMENTS OF INCOME is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately five percent for the six months ended June 30, 2013, based on historical experience.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

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

	Three Months Ended		Six Months Ended		
	June 30,		June 30,		
	2013	2012	2013	2012	
Stock and ESPP Options					
Pre-tax compensation expense	\$50	\$80	\$88	\$126	
Income tax expense (benefit)	20	(2) 18	(2)
Stock and ESPP option expense, net of income taxes	\$70	\$78	\$106	\$124	
Restricted Stock Awards					
Pre-tax compensation expense	\$386	\$280	\$722	\$560	
Income tax benefit	(135) (112) (252) (218)
Restricted stock awards expense, net of income taxes	\$251	\$168	\$470	\$342	
Total Share-Based Compensation					
Pre-tax compensation expense	\$436	\$360	\$810	\$686	
Income tax benefit	(115) (114) (234) (220)
Total share-based compensation expense, net of income taxes	\$321	\$246	\$576	\$466	

As of June 30, 2013, unrecognized compensation expense related to stock options and RSAs totaling \$75,000 and \$2,847,000, respectively, is expected to be recognized over weighted-average periods of 0.89 and 1.65 years, respectively.

Stock option activity under the Corporation's stock option plans as of June 30, 2013 and changes during the six months ended June 30, 2013, were as follows:

	Number of	Weighted-Average	Weighted Average	Aggregate
	Shares	Exercise Price	Remaining	Intrinsic
			Contractual Term	Value
			(in Years)	
Outstanding at January 1, 2013	906,636	\$ 21.58		
Granted	9,000	\$ 15.32		
Exercised	(6,000	) \$ 7.37		
Canceled	(8,471	) \$ 24.69		
Outstanding June 30, 2013	901,165	\$ 21.66	4.03	1,471,401
Vested and Expected to Vest at June 30, 2013	901,165	\$ 21.66	3.6	1,471,401
Exercisable at June 30, 2013	863,865	\$ 22.06	3.79	1,291,640

The weighted-average grant date fair value was \$5.32 and \$3.86 for stock options granted during the six months ended June 30, 2013 and 2012, respectively.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of the first six months of 2013 and the exercise price,

multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their stock options on June 30, 2013. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock. The aggregate intrinsic value of stock options exercised during the six months ended June 30, 2013 was \$52,000. Cash receipts of stock options exercised during this same period were \$44,000. There were no stock options exercised during the six months ended June 30, 2012.

The following table summarizes information on unvested RSAs outstanding as of June 30, 2013:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2013	401,375	\$9.29
Granted	114,561	\$15.39
Vested	(105,866	) \$6.07
Forfeited	(450	) \$12.41
Unvested RSAs at June 30, 2013	409,620	\$11.82

The grant date fair value of ESPP options was estimated at the beginning of the April 1, 2013 quarterly offering period of approximately \$30,000. The ESPP options vested during the three months ending June 30, 2013, leaving no unrecognized compensation expense related to unvested ESPP options at June 30, 2013.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

NOTE 10

Income Tax

	Three Months Ended		Six Months Ended	
	June 30,	2012	June 30,	2012
	2013		2013	
Income Tax Expense :				
Currently Payable:				
Federal	\$ 1,646	\$ 518	\$ 740	\$ 1,336
State				
Deferred:				
Federal	2,509	2,770	8,083	7,452
State				
Total Income Tax Expense	\$ 4,155	\$ 3,288	\$ 8,823	\$ 8,788
Reconciliation of Federal Statutory to Actual Tax Expense:				
Federal statutory income tax at 35%	\$ 5,239	\$ 4,372	\$ 11,026	\$ 11,327
Tax-exempt interest income	(921	) (930	) (1,818	) (1,861
Stock compensation	15	26	26	42
Earnings on life insurance	(214	) (231	) (459	) (714
Tax credits	(18	) (18	) (36	) (36
Other	54	69	84	30
Actual Tax Expense	\$ 4,155	\$ 3,288	\$ 8,823	\$ 8,788

NOTE 11

Net Income Per Share

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

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

The following table reconciles basic and diluted net income per share for the three months ended June 30, 2013 and 2012.

Three Months Ended June 30,

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

	2013			2012		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	\$10,815			\$9,205		
Less: Preferred Stock dividends and discount accretion	(852)			(1,135)		
Net income available to common stockholders	9,963	28,783,407	\$0.35	8,070	28,624,609	\$0.28
Effect of dilutive stock options and warrants		240,106			190,410	
Diluted net income per share:						
Net income available to common stockholders	\$9,963	29,023,513	\$0.34	\$8,070	28,815,019	\$0.28

The following table reconciles basic and diluted net income per share for the six months ended June 30, 2013 and 2012 .

	Six Months Ended June 30, 2013			2012		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	\$22,680			\$23,576		
Less: Preferred Stock dividends and discount accretion	(1,709)			(2,270)		
Net income available to common stockholders	20,971	28,750,197	\$0.73	21,306	28,603,612	\$0.74
Effect of dilutive stock options and warrants		246,577			178,430	
Diluted net income per share:						
Net income available to common stockholders	\$20,971	28,996,774	\$0.72	\$21,306	28,782,042	\$0.74

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Stock options to purchase 695,868 and 890,642 shares for the three months ended June 30, 2013, and 2012, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

Stock options to purchase 693,930 and 881,661 shares for the six months ended June 30, 2013, and 2012, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

NOTE 12

IMPACT OF ACCOUNTING CHANGES

ASU 2011-11 - Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. The ASU amends Topic 210 by requiring additional improved information to be disclosed regarding financial instruments and derivative instruments that are offset in accordance with the conditions under ASC 210-20-45 or ASC 810-10-45 or subject to an enforceable master netting arrangement or similar agreement. The amendments are effective for annual and interim reporting periods beginning on or after January 1, 2013. The disclosures required by the amendments were applied retrospectively for all comparative periods presented. The amendments did not have a material impact on the Corporation's Condensed Consolidated Financial Statements.

ASU 2013-01- Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. The ASU amends Update 2011-11 to clarify that the scope applies to derivatives, repurchase and reverse repurchase agreements, and securities borrowing and lending transactions that are either offset in accordance with Section 210-20-45 or Section 815-10-45 or subject to master netting or similar arrangements. Other types of financial assets and liabilities subject to master netting or similar arrangements are not subject to the disclosure requirements in Update 2011-11. The amendments are effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The amendments did not have a material impact on the Corporation's Condensed Consolidated Financial Statements.

ASU 2013-02- Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The ASU requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. The amendments are effective prospectively for reporting periods beginning after December 15, 2012. The disclosures required by the amendment were applied retrospectively for all comparative periods presented. See NOTE 8.

ACCUMULATED OTHER COMPREHENSIVE INCOME, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

Accounting Standards Update No. 2013-04 - Liabilities (Topic 405). On February 28, 2013, FASB issued ASU 2013-04. The amendments in this Update provide guidance for the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements for which the total amount of the obligation within the scope of this Update is fixed at the reporting date, except for obligations addressed within existing guidance in U.S. GAAP. The guidance requires an entity to measure those obligations as the sum of the amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors and any additional amount the reporting entity expects to pay on behalf of its co-obligors. The guidance in this Update also requires an entity to disclose the

nature and amount of the obligation as well as other information about those obligations. This Accounting Standards Update is the final version of Proposed Accounting Standards Update EITF12D - Liabilities (Topic 405) which has been deleted. The amendments in this Update are effective for fiscal years beginning after December 31, 2013. Early adoption is permitted. The Corporation will adopt the methodologies prescribed by this ASU by the date required, and does not anticipate that the ASU will have a material effect on its financial position or results of operations.

Accounting Standards Update No. 2013-07 - Presentation of Financial Statements (Topic 205). On April 22, 2013, FASB issued ASU 2013-07. The objective of this Update is to clarify when an entity should apply the liquidation basis of accounting and to provide principles for the measurement of assets and liabilities under the liquidation basis of accounting, as well as any required disclosures. This Accounting Standards Update is the final version of Proposed Accounting Standards Update 2012-210 - Presentation of Financial Statements (Topic 205), which has been deleted. The amendments are effective for entities that determine liquidation is imminent during annual reporting periods beginning after December 15, 2013, and interim reporting periods therein. Entities should apply the requirements prospectively from the day that liquidation becomes imminent. Early adoption is permitted. The Corporation will adopt the methodologies prescribed by this ASU by the date required, and does not anticipate that the ASU will have a material effect on its financial position or results of operations.

NOTE 13

BUSINESS COMBINATIONS

On May 13, 2013, First Merchants Corporation ("First Merchants") and CFS Bancorp, Inc. ("Citizens") entered into an Agreement of Reorganization and Merger (the "Merger Agreement"), pursuant to which, Citizens will, subject to the terms and conditions of the Merger Agreement, merge with and into First Merchants (the "Merger"), whereupon the separate corporate existence of Citizens will cease and First Merchants will survive. Immediately following the Merger, Citizens Financial Bank, a federal savings bank and wholly-owned subsidiary of Citizens, will be merged with and into First Merchants Bank, National Association, a national bank and wholly-owned subsidiary of First Merchants, with First Merchants Bank, National Association as the surviving bank.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

Based on the closing price of First Merchants' common stock on May 10, 2013 of \$16.14 per share, the transaction value is estimated at approximately \$115 million. The transaction is expected to be a tax-free stock exchange for those Citizens shareholders receiving First Merchants' common stock pursuant to the Merger. Subject to Citizens' and First Merchants' common shareholders' approval of the Merger, regulatory approvals and other customary closing conditions, the parties anticipate completing the Merger in the fourth quarter of 2013.

The Boards of Directors of both First Merchants and Citizens have approved the Merger Agreement. The members of the Board of Directors of Citizens have entered into a Voting Agreement pursuant to which they have agreed to vote their shares of Citizens common stock in favor of the Merger.

Subject to the terms and conditions of the Merger Agreement, upon the completion of the Merger, each share of outstanding Citizens common stock, \$0.01 par value per share, will be converted into 0.65 shares (the "Exchange Ratio") of First Merchants common stock, \$0.125 stated value per share. The Exchange Ratio is subject to adjustments for stock splits, stock dividends, recapitalization, or similar transactions, or as otherwise described in the Merger Agreement. Immediately prior to the Merger, each outstanding share of Citizens restricted stock will automatically vest and, upon the Merger, will also be converted into First Merchants common stock pursuant to the Exchange Ratio. First Merchants will pay cash in lieu of any fractional shares of First Merchants common stock resulting from exchange of shares of Citizens common stock or restricted stock, all at a price and as adjusted pursuant to the Merger Agreement. Immediately prior to the Merger, Citizens stock options will fully vest, and, upon the Merger, all Citizens stock options will automatically convert into stock options to purchase First Merchants common stock on the same terms and conditions as were applicable under the terms of the Citizens option plan under which such Citizens options were granted and the applicable award agreements thereunder. In such a case, the number of shares of First Merchants common stock subject to such converted option will equal the product of (i) the number of shares of Citizens' common stock purchasable upon exercise of the original Citizens option and (ii) the Exchange Ratio, and rounded down to the next whole share. The price per share to exercise such converted option will equal (i) the exercise price per share of Citizens common stock under the original Citizens option divided by (ii) the Exchange Ratio, and rounded up to the nearest cent.

NOTE 14

CONTINGENT LIABILITIES

On April 16, 2013, First Merchants was named in a class action lawsuit in Delaware County Circuit Court challenging First Merchant's checking account practices associated with the assessment of overdraft fees. The plaintiff seeks damages and other relief, including restitution and injunctive relief. First Merchants believes it has meritorious defenses to the claims brought by the plaintiff. First Merchants removed the case from state court to federal district court. First Merchants also recently filed a motion to stay the federal action pending arbitration. No discovery has been conducted and no class has been certified. Accordingly, at this phase of the litigation, it is not possible for management of First Merchants to determine the probability of a material adverse outcome or reasonably estimate the amount of any loss.

On July 30, 2013, a purported shareholder of CFS Bancorp, Inc. filed a putative class action lawsuit captioned Jay Orlando v. CFS Bancorp, Inc., et al., No. 2:13-CV-00261 in U.S. District Court in the Northern District of Indiana against CFS Bancorp, Inc., its board of directors and First Merchants. The complaint generally alleges various claims of federal securities law violations and that the directors of CFS Bancorp, Inc. breached their fiduciary duties by

providing materially inadequate disclosures and material disclosure omissions with respect to the proposed merger of CFS Bancorp, Inc. into First Merchants. The plaintiff seeks (1) class certification, (2) to enjoin the merger or, in the event the merger is completed before entry of a final judgment, to rescind the merger or be awarded an unspecified amount of rescissory damages, (3) compensatory damages in an unspecified amount, and (4) costs and expenses, including attorneys' fees. At this early stage of the litigation, it is not possible to assess the probability of a material adverse outcome or reasonably estimate any potential financial impact of the lawsuit on First Merchants. The defendants believe the claims against them are without merit and intend to contest the matter vigorously.

NOTE 15

SUBSEQUENT EVENTS

On 7/2/2013, the Corporation redeemed 34,044 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock") held by the U.S. Department of the Treasury (the "Treasury") at an aggregate redemption price of \$34,044,000, plus accrued but unpaid dividends. The Series B Preferred Stock was issued to the Treasury in September of 2011 as part of the Corporation's participation in the Small Business Lending Fund Program. Following this redemption, the Treasury holds 34,043 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$34 million.

37

Table of Contents

PART I: FINANCIAL INFORMATION

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

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

FORWARD-LOOKING STATEMENTS

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

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

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

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

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

CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles are complex and require us to apply significant judgments to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply those principles where actual measurement is not possible or practical. For a complete discussion of our significant accounting policies, see "Notes to the Consolidated Financial Statements" in our Annual Report on Form 10-K for the year ended December 31,

2012. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

We believe there have been no significant changes during the six months ended June 30, 2013, to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2012.

BUSINESS SUMMARY

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

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

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported net income available to common stockholders of \$10.0 million, or \$0.34 per fully diluted common share for the quarter ended June 30, 2013, an increase of \$1.9 million, compared to net income available to common stockholders of \$8.1 million, or \$0.28 per common share for quarter ended June 30, 2012.

Net income available to common stockholders for the six months ended June 30, 2013 was \$21.0 million, or \$0.72 per fully diluted common share, compared to net income available to common stockholders of \$21.3 million, or \$0.74 per fully diluted common share for the six months ended June 30, 2012. On February 10, 2012, the Bank assumed substantially all the deposits and certain other liabilities and acquired certain assets of SCB Bank, from the FDIC as the receiver of SCB Bank. This transaction generated a pre-tax gain of \$9.1 million, or \$0.21 per common share after tax. Details of this transaction are included in NOTE 2. PURCHASE AND ASSUMPTION, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q.

As of June 30, 2013, total assets equaled \$4.3 billion, an increase of \$33.4 million from December 31, 2012. Total loans of \$2.9 billion increased \$10.1 million and investment securities increased \$34.6 million from December 31, 2012. Additional details of the changes in the Corporation's loans and other earning assets are discussed within NOTE 4. LOANS AND ALLOWANCE, included within the Notes to Consolidated Condensed Financial Statements, and the "EARNING ASSETS" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

The Corporation's allowance for loan losses totaled \$68.2 million as of June 30, 2013. The allowance provides 175.0 percent coverage of all non-accrual loans and 2.32 percent of total loans. Provision expense totaled \$2.0 million for second quarter of 2013, compared to \$4.5 million in the second quarter of 2012. Net charge-offs totaled \$2.3 million for the second quarter of 2013, down from \$4.8 million for the second quarter of 2012. Provision expense totaled \$4.1 million for six months ended June 30, 2013, compared to \$9.4 million in six months ended June 30, 2012. Net charge-offs totaled \$5.3 million for six months ended June 30, 2013, compared to \$10.2 million for six months ended June 30, 2012. Additional details are discussed within the "LOAN QUALITY/PROVISION FOR LOAN LOSSES" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

Total Deposits of \$3.3 billion decreased slightly from December 31, 2012 by \$13.6 million, or less than 1.0 percent. Non-maturity deposits and maturity deposits both remained steady at \$2.6 billion and \$768,000, respectively.

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

Net interest income totaled \$36.7 million for the quarter, as net interest margin during the quarter totaled 3.88 percent as yields on earning assets totaled 4.29 percent and the cost of supporting liabilities totaled 0.41 percent. Net interest income totaled \$76.1 million for six months ended June 30, 2013, as net interest margin during the six months ended June 30, 2013 totaled 4.06 percent as yields on earning assets totaled 4.49 percent and the cost of supporting liabilities totaled 0.43 percent. Additional details of the Corporation's net interest income are discussed within the "NET INTEREST INCOME" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

NET INTEREST INCOME

Net interest income is the primary source of the Corporation's earnings. Net interest margin is a function of net interest income and the level of average earning assets. Net interest income and net interest margin are presented in the following table on a fully taxable equivalent basis ("FTE"), which adjusts tax-exempt or nontaxable interest income to an amount that would be comparable to interest subject to income taxes using the federal statutory tax rate of 35 percent in effect for all periods. Net interest margin decreased 23 basis points from 4.11 percent in the second quarter of 2012 to 3.88 percent in the second quarter of 2013, while earning assets increased by \$84.6 million. During the six months ended June 30, 2013, asset yields decreased 26 basis points FTE and interest costs decreased 28 basis points, resulting in a 2 basis points FTE increase in net interest income as compared to the same period in 2012.

The increased net interest income during the six months ended June 30, 2013 compared with the same period in 2012 was driven by three primary factors. The first factor is a result of the February 10, 2012 assumption of substantially all the deposits, certain other liabilities and acquisition of certain assets of SCB Bank. Due to this transaction, the Bank had a higher level of earning assets and interest income resulting from the assumption of SCB loans and related fair value accretion recognized in interest income. Additional details can be found in NOTE 2. PURCHASE AND ASSUMPTION and NOTE 5. ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q. The second factor contributing to the improvement in the net interest margin, expressed as a percentage of earning assets, was a \$2.5 million interest income recovery on a previously charged-off loan. Lastly, the improvement in net interest income was also a result of the Corporation's ability to lower its cost of funds and in particular its cost of deposits, due to the growth of the Corporation's non-interest bearing demand deposits and interest-bearing non-maturity deposits.

Table of Contents

PART I: FINANCIAL INFORMATION

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

The following table presents the Corporation's interest income, interest expense, and net interest income as a percent of average earning assets for the three and six months ended June 30, 2013, and 2012.

(Dollars in Thousands)	Three Months Ended June 30,		Six Months Ended June 30,		
	2013	2012	2013	2012	
Annualized net interest income	\$146,602	\$152,210	\$152,216	\$148,337	
Annualized FTE adjustment	\$5,660	\$5,758	\$5,599	\$5,765	
Annualized net interest income on a fully taxable equivalent basis	\$152,262	\$157,968	\$157,815	\$154,102	
Average earning assets	\$3,922,303	\$3,837,738	\$3,883,239	\$3,813,587	
Interest income (FTE) as a percent of average earning assets	4.29	% 4.75	% 4.49	% 4.75	%
Interest expense as a percent of average earning assets	0.41	% 0.64	% 0.43	% 0.71	%
Net interest income (FTE) as a percent of average earning assets	3.88	% 4.11	% 4.06	% 4.04	%

Average earning assets include the average balance of securities classified as available for sale, computed based on the average of the historical amortized cost balances without the effects of the fair value adjustment. Annualized amounts are computed utilizing a 30/360 day basis.

NON-INTEREST INCOME

Non-interest income increased \$894,000 or 6.8 percent in the second quarter of 2013, compared to the second quarter of 2012. The largest increases realized during the second quarter of 2013 when compared to the same quarter of 2012 were gains on sale of other real estate owned, fiduciary activities, loan level hedge activity, and insurance commissions totaling \$427,000, \$326,000, \$317,000 and \$263,000 respectively. The largest decreases realized during the second quarter of 2013 when compared to the same quarter of 2012 were electronic card fees and security transactions gains of \$345,000 and \$263,000 respectively.

During the first six months of 2013, non-interest income decreased \$7.9 million or 22.0 percent over the same period in 2012. The largest item contributing to the decrease was a gross purchase gain of \$9.1 million recognized from the purchase of certain assets and assumption of certain liabilities of SCB Bank in Shelby County Indiana. See NOTE 2. PURCHASE AND ASSUMPTION in the Notes to Consolidated Condensed Financial Statements included of this Form 10-Q for additional discussion of this transaction.

Additionally, earnings on cash surrender value of life insurance decreased by \$730,000 compared to the first six months of 2012. This decrease was primarily driven by a death benefit of \$576,000 received from Bank Owned Life Insurance during 2012. Finally, \$804,000 less gains on the sale of investment securities was realized in the first six months of 2013 than in the first six months of 2012.

Offsetting these declines were increased insurance commissions, gains on the sale of mortgage loans, and fiduciary activities of \$768,000, \$569,000 and \$450,000, respectively, from the same period of 2012.

NON-INTEREST EXPENSE

Non-interest expenses decreased \$438,000 or 1.3 percent in the second quarter of 2013, compared to the second quarter of 2012. Salaries and employee benefits increased \$895,000 or 4.6 percent over the same quarter last year. Base salaries were up \$674,000 while commissions and incentives increased \$443,000 over the same quarter last year. These increases were partially offset by temporary employee and employee insurance expenses decreasing by \$239,000 and \$202,000, respectively, when compared to the second quarter of 2012.

Additionally, declines in other real estate owned and credit related expenses, net occupancy expenses, and FDIC assessment expense of \$643,000, \$206,000 and \$188,000, respectively, were realized from the second quarter of 2012 to the second quarter of 2013.

During the first six months of 2013, non-interest expense increased \$234,000 or 0.3 percent when compared to the first six months of 2012. Salaries and employee benefits increased by \$2.3 million over the same period in 2012. Base salaries were up \$911,000 while commissions and incentives increased \$1.0 million and retirement plan expenses increased \$236,000 over the same period in 2012. The increase in salaries and employee benefits was offset by declines in other real estate owned and credit related expenses of \$963,000, FDIC assessment expense of \$561,000 and net occupancy expenses of \$255,000, from the first six months of 2012 to the first six months of 2013.

INCOME TAX EXPENSE

The income tax expense for the six months ended June 30, 2013, was \$8,823,000 on pre-tax net income of \$31,503,000. For the same period in 2012, the income tax expense was \$8,788,000 on pre-tax net income of \$32,364,000. Additional details are discussed within the "RESULTS OF OPERATIONS" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Form 10-Q.

Table of Contents

PART I: FINANCIAL INFORMATION

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

CAPITAL

Capital adequacy is an important indicator of financial stability and performance. The Corporation maintained a strong capital position as tangible common equity to tangible assets was 7.74% percent at June 30, 2013, and 7.55% percent at December 31, 2012.

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk-based capital, Tier 1 capital, and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios. At June 30, 2013, the management of the Corporation believes that it meets all capital adequacy requirements to which it is subject. The most recent notifications from the regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

There are five capital categories defined in the regulations, ranging from well capitalized to critically undercapitalized. Classification of a bank in any of the undercapitalized categories can result in actions by regulators that could have a material effect on a bank's operations.

To be considered well capitalized, a bank must have a total risk-based capital ratio of at least 10 percent, a Tier I capital ratio of at least 6 percent, a Tier 1 leverage ratio of at least 5 percent, and must not be subject to any order or directive requiring the bank to improve its capital level. An adequately capitalized bank has a total risk-based capital ratio of at least 8 percent, a Tier I capital ratio of at least 4 percent and a Tier 1 leverage ratio of at least 4 percent. Banks with lower capital levels are deemed to be undercapitalized, significantly undercapitalized or critically undercapitalized, depending on their actual levels. The appropriate federal regulatory agency may also downgrade a bank to the next lower capital category upon a determination that the bank is in an unsafe or unsound practice. Banks are required to monitor closely their capital levels and to notify their appropriate regulatory agency of any basis for a change in capital category.

As of June 30, 2013, the Corporation, on a consolidated basis, as well as the Bank, exceeded the minimum capital levels of the well capitalized category.

(Dollars in Thousands)	June 30, 2013		December 31, 2012		
	Amount	Ratio	Amount	Ratio	
Consolidated					
Total risk-based capital (to risk-weighted assets)	\$522,573	15.69	% \$526,792	16.34	%
Tier 1 capital (to risk-weighted assets)	460,603	13.83	% 456,132	14.15	%
Tier 1 capital (to average assets)	460,603	11.02	% 456,132	11.03	%
First Merchants Bank					
Total risk-based capital (to risk-weighted assets)	\$535,214	16.16	% \$515,337	16.01	%
Tier 1 capital (to risk-weighted assets)	493,501	14.90	% 474,782	14.75	%
Tier 1 capital (to average assets)	493,501	11.87	% 474,782	11.50	%

Tier I regulatory capital consists primarily of total stockholders' equity and subordinated debentures issued to business trusts categorized as qualifying borrowings, less non-qualifying intangible assets and unrealized net securities gains or losses.

On January 3, 2013, the Corporation redeemed 22,695.94 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Stock") held by the U.S. Department of the Treasury (the "Treasury") at an aggregate redemption price of \$22,695,940, plus accrued but unpaid dividends. The Series B Preferred Stock was issued to the Treasury in September of 2011 as part of the Corporation's participation in the Small Business Lending Fund Program. Following this redemption, the Treasury held 68,087 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$68 million.

On July 2, 2013, the Corporation redeemed an additional 34,044 shares of the Series B Preferred Stock at an aggregate redemption price of \$34,044,000, plus accrued but unpaid dividends. Following this redemption, the Treasury holds 34,043 shares of the Series B Preferred Stock representing a remaining liquidation amount of approximately \$34 million.

Table of Contents

PART I: FINANCIAL INFORMATION

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

Management believes that all of the above capital ratios are meaningful measurements for evaluating the safety and soundness of the Corporation. Additionally, management believes the following table is also meaningful when considering performance measures of the Corporation. The table details and reconciles tangible earnings per share, return on tangible capital and tangible assets to traditional GAAP measures for the three and six months ended June 30, 2013 and 2012.

(Dollars in Thousands, Except Per Share Amounts)	Three Months Ended June 30,		Six Months Ended June 30,		
	2013	2012	2013	2012	
Average goodwill	\$ 141,374	\$ 141,357	\$ 141,374	\$ 141,357	
Average core deposit intangible (CDI)	7,580	8,883	7,772	8,877	
Average deferred tax on CDI	(2,263)	(2,223)	(2,253)	(2,212)	
Intangible adjustment	\$ 146,691	\$ 148,017	\$ 146,893	\$ 148,022	
Average stockholders' equity (GAAP capital)	\$ 542,921	\$ 531,612	\$ 538,384	\$ 524,693	
Average cumulative preferred stock	(125)	(125)	(125)	(125)	
Average non-cumulative preferred stock issued under the Small Business Lending Fund Program	(68,087)	(90,783)	(68,338)	(90,783)	
Intangible adjustment	(146,691)	(148,017)	(146,893)	(148,022)	
Average tangible capital	\$ 328,018	\$ 292,687	\$ 323,028	\$ 285,763	
Average assets	\$ 4,329,579	\$ 4,249,909	\$ 4,289,490	\$ 4,226,432	
Intangible adjustment	(146,691)	(148,017)	(146,893)	(148,022)	
Average tangible assets	\$ 4,182,888	\$ 4,101,892	\$ 4,142,597	\$ 4,078,410	
Net income available to common stockholders	\$ 9,963	\$ 8,070	\$ 20,971	\$ 21,306	
CDI amortization, net of tax	205	271	413	537	
Tangible net income available to common stockholders	\$ 10,168	\$ 8,341	\$ 21,384	\$ 21,843	
Per Share Data:					
Diluted net income available to common stockholders	\$ 0.34	\$ 0.28	\$ 0.72	\$ 0.74	
Diluted tangible net income available to common stockholders	\$ 0.35	\$ 0.29	\$ 0.74	\$ 0.76	
Ratios:					
Return on average GAAP capital (ROE)	7.34	% 6.07	% 7.79	% 8.12	%
Return on average tangible capital	12.40	% 11.40	% 13.24	% 15.29	%
Return on average assets (ROA)	0.92	% 0.76	% 0.98	% 1.01	%
Return on average tangible assets	0.97	% 0.81	% 1.03	% 1.07	%

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

LOAN QUALITY/PROVISION FOR LOAN LOSSES

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

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The amount provided for loan losses and the determination of the adequacy of the allowance are based on a continuous review of the loan portfolio, including an internally administered loan "watch" list and an ongoing loan review. The evaluation takes into consideration identified credit problems, as well as the possibility of losses inherent in the loan portfolio that are not specifically identified.

Non-performing loan balances will change as a result of routine problem loan recognition and resolution through collections, sales or charge offs. The performance of any loan can be affected by external factors such as economic conditions, or factors particular to a borrower, such as actions of a borrower's management.

Non-accrual loans decreased by \$14,428,000 during the six months ended June 30, 2013, from \$53,399,000 at December 31, 2012 to the June 30, 2013, balance of \$38,971,000. In addition, other real estate owned declined \$1,498,000 during the same period. For other real estate owned, current appraisals are obtained to determine value as management continues to aggressively market these real estate assets. Accruing loans delinquent 90 or more days at June 30, 2013 decreased \$965,000, or 47.4 percent from December 31, 2012, and was comprised of loans secured by residential real estate.

Commercial impaired loans include all non-accrual loans, loans accounted for under SOP-03-3 and renegotiated loans as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more.

A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected substantially within the contractual terms of the note. At June 30, 2013, commercial impaired loans totaled \$62,989,000, a decrease of \$5,088,000 from the March 31, 2013, balance of \$68,077,000, and were down 20.4 percent from December 31, 2012. At June 30, 2013, an allowance for losses was not deemed necessary for commercial impaired loans totaling \$47,524,000 as there was no identified loss on these credits. An allowance of \$4,548,000 was recorded for the remaining balance of these impaired loans totaling \$15,465,000 and is included in the corporation's allowance for loan losses.

The following table details the Corporation's non-performing assets plus loans 90-days or more delinquent, and notes total commercial impaired loans for the periods indicated.

(Dollars in Thousands)	June 30, 2013	December 31, 2012
Non-Performing Assets:		
Non-accrual loans	\$38,971	\$53,399

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Renegotiated loans	4,407	12,681
Non-performing loans (NPL)	43,378	66,080
Other real estate owned	11,765	13,263
Non-performing assets (NPA)	55,143	79,343
90+ days delinquent and still accruing	1,072	2,037
Non-performing assets plus 90+ days delinquent	56,215	81,380
Impaired Loans	\$62,989	\$79,179

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

(Dollars in Thousands)	June 30, 2013	December 31, 2012
Non-Performing Assets and 90+ Days Delinquent:		
Commercial and industrial loans	\$8,614	\$13,690
Agricultural production financing and other loans to farmers	33	
Real estate loans:		
Construction	8,188	12,378
Commercial and farmland	23,610	34,999
Residential	14,019	16,620
Home Equity	1,537	3,198
Individuals' loans for household and other personal expenditures	45	190
Lease financing receivables, net of unearned income		301
Other loans	169	4
Non-performing assets plus 90+ days delinquent	\$56,215	\$81,380

Table of Contents

PART I: FINANCIAL INFORMATION

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

At June 30, 2013, the allowance for loan losses was \$68,202,000, a decrease of \$1,164,000 from December 31, 2012. As a percent of loans, the allowance was 2.32 percent at June 30, 2013, 2.36 percent at March 31, 2013, 2.37 percent at December 31, 2012 and 2.43 percent at September 30, 2012. The provision for loan losses for the six months ended June 30, 2013 was \$4,099,000, a decrease of \$5,321,000 from \$9,420,000 for the same period in 2012. The continued improvement in credit quality, primarily the declines in loans graded substandard, doubtful and loss, contributed to the decrease in provision expense. Specific reserves, on impaired loans increased \$305,000 from \$4,243,000 at December 31, 2012, to \$4,548,000 at June 30, 2013.

Net charge offs for the six months ended June 30, 2013, were \$5,263,000, a decrease of \$4,912,000 from the same period in 2012. Of this amount, four charge offs, totaling 73.0 percent of net charge offs, were greater than \$500,000. The distribution of the net charge offs for the three and six months ended June 30, 2013 and June 30, 2012 is reflected in the following table:

(Dollars in Thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net Charge Offs (Recoveries):				
Commercial and industrial loans	\$755	\$2,137	\$1,685	\$4,343
Agricultural production financing and other loans to farmers	(4	) (6	) (22	) (20
Real estate loans:				
Construction	115	(471	) (143	) (328
Commercial and farmland	585	2,495	1,813	4,142
Residential		266	746	691
Home Equity	863	176	1,201	519
Individuals' loans for household and other personal expenditures	29	197	6	310
Lease financing receivables, net of unearned income	15		15	(1
Other Loans	(26	) (23	) (38	) 519
Total Net Charge Offs	\$2,332	\$4,771	\$5,263	\$10,175

Management continually evaluates commercial borrowers by including consideration of specific borrower cash flow analysis and estimated collateral values, types and amounts on non-performing loans, past and anticipated loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans outstanding. The determination of the provision for loan losses in any period is based on management's continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio.

LIQUIDITY

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

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

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. In addition, Federal Home Loan Bank ("FHLB") advances are utilized as funding sources. At June 30, 2013, total borrowings from the FHLB were \$92,743,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at June 30, 2013, was \$205,692,000.

On March 30, 2012, the Bank completed repayment of \$79,000,000 of Senior Notes (the "Notes") that had matured. The Notes, which were originally issued by the Bank on March 31, 2009, were guaranteed by the FDIC under its Temporary Liquidity Guarantee Program ("TLGP").

On August 22, 2012, the Corporation exercised its option to redeem the \$4,124,000 subordinated debenture associated with the CNBC Statutory Trust I. The redemption price premium was 104.59. The debenture had carried a fixed interest rate of 10.2 percent.

The principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$584,593,000 at June 30, 2013, an increase of \$71,250,000, or 13.9 percent, from December 31, 2012. Securities classified as held to maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held to maturity that are maturing in one year or less, totaled \$1,755,000 at June 30, 2013. In addition, other types of assets such as cash and due from banks, federal funds sold, and securities purchased under agreements to resell, loans and interest-bearing deposits with other banks maturing within one year are sources of liquidity.

Table of Contents

PART I: FINANCIAL INFORMATION

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

The Corporation currently has a \$55.0 million credit facility with Bank of America, N.A., comprised of (a) a term loan in the principal amount of \$5.0 million (the "Term Loan") and (b) a subordinated debenture in the principal amount of \$50.0 million (the "Subordinated Debt"). Pursuant to the terms of the underlying Loan Agreement (the "Loan Agreement"), the Term Loan and the Subordinated Debt each mature on February 15, 2015. The Term Loan is secured by a pledge of all of the issued and outstanding shares of the Bank. The Loan Agreement contains certain customary representations and warranties and financial and negative covenants. A breach of any of these covenants could result in a default under the Loan Agreement. As of June 30, 2013, the Corporation was in compliance with these financial covenants.

In the normal course of business, the Bank is a party to a number of other off-balance sheet activities that contain credit, market and operational risk that are not reflected in whole or in part in our consolidated financial statements. Such activities include traditional off-balance sheet credit-related financial instruments, commitments under operating leases and long-term debt.

The Bank provides customers with off-balance sheet credit support through loan commitments and standby and commercial letters of credit. Summarized credit-related financial instruments at June 30, 2013, are as follows:

(Dollars in Thousands)	June 30, 2013
Amounts of commitments:	
Loan commitments to extend credit	\$885,133
Standby and commercial letters of credit	14,854
	\$899,987

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

In addition to owned banking facilities, the Corporation has entered into a number of long-term leasing arrangements to support ongoing activities. The required payments under such commitments and borrowings at June 30, 2013, are as follows:

(Dollars in Thousands)	Remaining 2013	2014	2015	2016	2017	2018	2019 and after	Total
Operating leases	\$1,149	\$2,260	\$2,088	\$1,668	\$1,025	\$326	\$1,049	\$9,565
Federal funds purchased	57,085							57,085
Securities sold under repurchase agreements	151,779	10,000						161,779
Federal Home Loan Bank advances	211	26,437	30,972	28,933	2,726	3,360	104	92,743
Subordinated debentures and term loans	76		55,000				56,702	111,778
Total	\$210,300	\$38,697	\$88,060	\$30,601	\$3,751	\$3,686	\$57,855	\$432,950

INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK

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

It is the objective of the Corporation to monitor and manage risk exposure to net interest income caused by changes in interest rates. It is the goal of the Corporation's Asset/Liability function to provide optimum and stable net interest income. To accomplish this, management uses two asset liability tools. GAP/Interest Rate Sensitivity Reports and Net Interest Income Simulation Modeling are constructed, presented and monitored quarterly.

Net interest income simulation modeling, or earnings-at-risk, measures the sensitivity of net interest income to various interest rate movements. The Corporation's asset liability process monitors simulated net interest income under three separate interest rate scenarios; base, rising and falling. Estimated net interest income for each scenario is calculated over a 12-month horizon. The immediate and parallel changes to the base case scenario used in the model are presented below. The interest rate scenarios are used for analytical purposes and do not necessarily represent management's view of future market movements. Rather, these are intended to provide a measure of the degree of volatility interest rate movements may introduce into the earnings of the Corporation.

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of June 30, 2013, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In the current rate environment, many driver rates are at or near historical lows, thus total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management have the following results:

Driver Rates	June 30, 2013	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	—
Federal funds	200	—
One-year CMT	200	(7)
Three-year CMT	200	(33)
Five-year CMT	200	(79)
CD's	200	(21)
FHLB advances	200	(52)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at June 30, 2013. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	June 30, 2013		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$ 148,528	\$ 154,101	\$ 144,845
Variance from base		\$ 5,573	\$(3,683)
Percent of change from base		3.75	% (2.48)%

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2012, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management in the base simulation are as follows:

Driver Rates	December 31, 2012	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	—
Federal funds	200	—
One-year CMT	200	(8)
Three-year CMT	200	(3)
Five-year CMT	200	(10)
CD's	200	(25)
FHLB advances	200	(5)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	December 31, 2012		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$ 145,846	\$ 153,621	\$ 144,122
Variance from base		\$ 7,775	\$(1,724)
Percent of change from base		5.33	% (1.18)%

Table of Contents

PART I: FINANCIAL INFORMATION

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

EARNING ASSETS

The following table presents the earning asset mix as of June 30, 2013, and December 31, 2012. Earning assets increased by \$66,191,000 in the six months ended June 30, 2013. Interest-bearing time deposits increased \$21,455,000, while investments increased by approximately \$34,629,000. Loans and loans held for sale increased by \$10,102,000. The three loan classes that experienced the largest increases from December 31, 2012 were commercial and industrial loans, commercial and farmland, and individuals' loans for household and other personal expenditures.

(Dollars in Thousands)	June 30, 2013	December 31, 2012
Interest-bearing time deposits	\$59,898	\$38,443
Investment securities available for sale	584,593	513,343
Investment securities held to maturity	324,399	361,020
Mortgage loans held for sale	14,531	22,300
Loans	2,920,080	2,902,209
Federal Reserve and Federal Home Loan Bank stock	32,790	32,785
Total	\$3,936,291	\$3,870,100

OTHER

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

Table of Contents

PART I: FINANCIAL INFORMATION

ITEM 3. QUANTITATIVE AND QUALITATIVE
DISCLOSURES ABOUT MARKET RISK

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

48

Table of Contents

PART I: FINANCIAL INFORMATION

ITEM 4. CONTROLS AND PROCEDURES

ITEM 4. CONTROLS AND PROCEDURES

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

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

Table of Contents

PART II: OTHER INFORMATION

ITEM 1., ITEM 1A., ITEM 2., ITEM 3., ITEM 4. AND ITEM 5.

(table dollar amounts in thousands, except share data)

ITEM 1. LEGAL PROCEEDINGS

On April 16, 2013, First Merchants was named in a class action lawsuit in Delaware County Circuit Court challenging First Merchant's checking account practices associated with the assessment of overdraft fees. The plaintiff seeks damages and other relief, including restitution and injunctive relief. First Merchants believes it has meritorious defenses to the claims brought by the plaintiff. First Merchants removed the case from state court to federal district court. First Merchants also recently filed a motion to stay the federal action pending arbitration. No discovery has been conducted and no class has been certified. Accordingly, at this phase of the litigation, it is not possible for management of First Merchants to determine the probability of a material adverse outcome or reasonably estimate the amount of any loss.

On July 30, 2013, a purported shareholder of CFS Bancorp, Inc. filed a putative class action lawsuit captioned Jay Orlando v. CFS Bancorp, Inc., et al., No. 2:13-CV-00261 in U.S. District Court in the Northern District of Indiana against CFS Bancorp, Inc., its board of directors and First Merchants. The complaint generally alleges various claims of federal securities law violations and that the directors of CFS Bancorp, Inc. breached their fiduciary duties by providing materially inadequate disclosures and material disclosure omissions with respect to the proposed merger of CFS Bancorp, Inc. into First Merchants. The plaintiff seeks (1) class certification, (2) to enjoin the merger or, in the event the merger is completed before entry of a final judgment, to rescind the merger or be awarded an unspecified amount of rescissory damages, (3) compensatory damages in an unspecified amount, and (4) costs and expenses, including attorneys' fees. At this early stage of the litigation, it is not possible to assess the probability of a material adverse outcome or reasonably estimate any potential financial impact of the lawsuit on First Merchants. The defendants believe the claims against them are without merit and intend to contest the matter vigorously.

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors previously disclosed in the Corporation's December 31, 2012, Annual Report on Form 10-K.

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

a. None

b. None

c. Issuer Purchases of Equity Securities

The following table presents information relating to our purchases of equity securities during three months ended June 30, 2013, as follows:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as part of Publicly announced Plans or Programs	Maximum Number of Shares that may yet be Purchased Under the Plans or Programs
--------	----------------------------------	------------------------------	--	--

April, 2013	364	\$14.53
May, 2013		
June, 2013		

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

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

ITEM 5. OTHER INFORMATION

a. None

b. None

50

Table of Contents

PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

ITEM 6. EXHIBITS

Exhibit No: Description of Exhibits:

2.1	Agreement of Reorganization and Merger between First Merchants Corporation and CFS Bancorp, Inc. dated May 13, 2013 (Incorporated by reference to Registrant's Form 8-K filed May 13, 2013). Upon request, the Registrant agrees to furnish supplementally to the Commission a copy of the Disclosure Letters referenced in the Agreement of Reorganization and Merger.
3.1	First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2011)
3.2	Bylaws of First Merchants Corporation dated October 28, 2009 (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2009)
4.1	First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.2	Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.3	Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.4	Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.5	First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009)
10.1	Voting Agreement dated May 13, 2013 by and among First Merchants Corporation and certain shareholders of CFS Bancorp, Inc. (Incorporated by reference to Registrant's Form 8-K filed May 13, 2013).
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)
101.INS	XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkebase Document (2)

(1) Filed herewith.

(2) Furnished herewith.

Table of Contents

PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

SIGNATURES

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

First Merchants Corporation
(Registrant)

Date: August 9, 2013

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

Date: August 9, 2013

by /s/ Mark K. Hardwick
Mark K. Hardwick
Executive Vice President and
Chief Financial Officer
(Principal Financial and Accounting Officer)

Table of Contents

PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

INDEX TO EXHIBITS

Exhibit No: Description of Exhibits:

2.1	Agreement of Reorganization and Merger between First Merchants Corporation and CFS Bancorp, Inc. dated May 13, 2013 (Incorporated by reference to Registrant's Form 8-K filed May 13, 2013). Upon request, the Registrant agrees to furnish supplementally to the Commission a copy of the Disclosure Letters referenced in the Agreement of Reorganization and Merger.
3.1	First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2011)
3.2	Bylaws of First Merchants Corporation dated October 28, 2009 (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2009)
4.1	First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.2	Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.3	Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.4	Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
4.5	First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009)
10.1	Voting Agreement dated May 13, 2013 by and among First Merchants Corporation and certain shareholders of CFS Bancorp, Inc. (Incorporated by reference to Registrant's Form 8-K filed May 13, 2013).
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)
101.INS	XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkebase Document (2)

(1) Filed herewith.

(2) Furnished herewith.