HORIZON BANCORP /IN/
Form 10-K
March 24, 2006

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2005

Commission file number 0-10792

Horizon Bancorp

(Exact name of registrant as specified in its charter)

Indiana	35-1562417
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
515 Franklin Square, Michigan City	46360
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code: 219-879-0211

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

Title of each class	Name of each exchange on which registered
None	Not Applicable

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

Common Stock, no par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 of Section 15(d) of the Exchange Act Yes o No þ

Indicate by checkmark 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 þ No o

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

Indicate by checkmark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definitions of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one)

Large accelerated filer o Accelerated filer o Non-Accelerated Filer þ

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

The aggregate market value of the registrant s common stock held by nonaffiliates of the registrant, based on the average bid price of such stock as of June 30, 2005, the last day of the registrant s most recently completed second fiscal quarter, was approximately $60,671,760.

As of March 15, 2006, the registrant had 3,228,382 shares of Common Stock outstanding.

Documents Incorporated by Reference

Part of Form 10-K into which

Document	portion of document is incorporated
Portions of the Registrant s Proxy Statement to be filed for its May 4, 2006 annual meeting of shareholders	III

Horizon Bancorp
2005 Annual Report on Form 10-K
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PART I

ITEM 1. BUSINESS

General

Horizon Bancorp (Horizon) is a registered bank holding company incorporated in Indiana and headquartered in Michigan City, Indiana. Horizon provides a broad range of banking services in Northwestern Indiana and Southwestern Michigan through its bank subsidiary, Horizon Bank, N.A. (the Bank) and other affiliated entities. Horizon operates as a single segment which is commercial banking. Horizon s Common Stock is traded on the Nasdaq Capital Market under the symbol HBNC. The Bank was chartered as a national banking association in 1873 and has operated continuously since that time. The Bank is a full-service commercial bank offering commercial and retail banking services, corporate and individual trust and agency services and other services incident to banking.

On June 10, 2005, Horizon acquired Alliance Financial Corporation and its wholly owned bank subsidiary, Alliance Banking Company (collectively referred to as Alliance). Alliance had three offices in southwest Michigan, and one office in Michigan City, Indiana, $141 million of assets and $117 million of deposits at the date of the acquisition. See Note 2 of the Consolidated Financial Statements for further discussion regarding the acquisition.

On August 1, 2005, the Bank opened a full service branch in South Bend, Indiana. The Bank also has four offices in LaPorte County, Indiana, three offices in Porter County, Indiana, one office in Lake County, Indiana, and one office in Elkhart County, Indiana. At December 31, 2005, the Bank had total assets of $1,128 million and total deposits of $856 million. The Bank has three wholly-owned subsidiaries: Horizon Trust & Investment Management, N.A. (Horizon Trust), Horizon Investments, Inc. (Horizon Investments) and Horizon Insurance Services, Inc. (Horizon Insurance). Horizon Trust offers corporate and individual trust and agency services and investment management services. Horizon Investments manages the investment portfolio of the Bank. Horizon Insurance offered a full line of personal insurance products until March 2005, at which time the majority of its assets were sold to a third party. Horizon formed Horizon Statutory Trust I in 2002 (Trust I) and Horizon Bancorp Capital Trust II (Trust II) in 2004 for the purpose of participating in pooled trust preferred securities offerings. The Company assumed additional debentures as the result of the acquisition of Alliance in 2005 which formed Alliance Financial Statutory Trust I (Alliance Trust) . See Note 11 of the Consolidated Financial Statements for further discussion regarding these previously consolidated entities that are now reported separately. The business of Horizon is not seasonal to any material degree.

No material part of Horizon s business is dependent upon a single or small group of customers, the loss of any one or more of whom would have a materially adverse effect on the business of Horizon. In 2005, revenues from loans accounted for 67% of the total consolidated revenue. For the same year, revenues from investment securities accounted for 18% of total consolidated revenue.

Employees

The Bank, Horizon Trust and Horizon Insurance employed approximately 283 full and part-time persons as of December 31, 2005. Horizon does not have any employees.

Competition

A high degree of competition exists in all major areas where Horizon engages in business. The Bank s primary market consists of LaPorte and Porter Counties, Indiana, and Berrien County, Michigan. The Bank competes with commercial banks located in LaPorte County and contiguous counties in Indiana and Michigan, as well as with savings and loan associations, consumer finance companies, and credit unions. To a more moderate extent, the Bank competes with Chicago money center banks, mortgage banking companies, insurance companies, brokerage houses, other institutions engaged in money market financial services and certain government agencies.

Based on deposits as of June 30, 2005, the Bank was the largest of the 11 bank and thrift institutions with offices in LaPorte County with 39.14% of the deposits and the fifth largest of the 15 institutions

with offices in Porter County with 8.28% of deposits. Horizon opened its first office in Berrien County, Michigan in 2003 and as of June 30, 2005, was the fourth largest of the 10 bank and thrift institutions with deposits in that county with 7.29% of the deposits. (Source: FDIC Summary of Deposits Market Share Reports, available at www.fdic.gov).

Supervision and Regulation

Horizon is registered as a bank holding company and is subject to the supervision of, and regulation by, the Board of Governors of the Federal Reserve System (Federal Reserve) under the Bank Holding Company Act of 1956, as amended (BHC Act). The Federal Reserve has issued regulations under the BHC Act requiring a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. It is the policy of the Federal Reserve that, pursuant to this requirement, a bank holding company should stand ready to use its resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity.

The BHC Act requires the prior approval of the Federal Reserve to acquire more than a 5% voting interest of any bank or bank holding company. Additionally, the BHC Act restricts Horizon s nonbanking activities to those which are determined by the Federal Reserve to be closely related to banking and a proper incident thereto.

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 (the FDICIA), a bank holding company is required to guarantee the compliance of any insured depository institution subsidiary that may become undercapitalized (as defined in FDICIA) with the terms of any capital restoration plan filed by such subsidiary with its appropriate federal bank regulatory agency.

Bank holding companies are required to comply with the Federal Reserve s risk-based capital guidelines. The Federal Deposit Insurance Corporation (the FDIC) and the Office of the Comptroller of the Currency (the OCC) have adopted risk-based capital ratio guidelines to which depository institutions under their respective supervision are subject. The guidelines establish a systematic analytical framework that makes regulatory capital requirements more sensitive to differences in risk profiles among banking organizations. Risk-based capital ratios are determined by allocating assets and specified off-balance sheet commitments to four risk weighted categories, with higher levels of capital being required for the categories perceived as representing greater risk. As a condition of approval for the Alliance acquisition, the OCC required the Bank to maintain regulatory capital ratios at 100 basis points above the well capitalized minimums. The Bank exceeded the risk-based capital requirements of the FDIC and OCC as of December 31, 2005. For Horizon s regulatory capital ratios and regulatory requirements as of December 31, 2005, see the information in Management s Discussion and Analysis of Financial Condition and Results of Operation in Item 7 below, which is incorporated herein by reference.

The Bank is (i) subject to the provisions of the National Bank Act; (ii) supervised, regulated, and examined by the OCC; and (iii) subject to the rules and regulations of the OCC, Federal Reserve, and the FDIC. The Bank s deposits are insured up to $100,000 per insured account by the Bank Insurance Fund, which is administered by the FDIC.

Both federal and state law extensively regulates various aspects of the banking business, such as reserve requirements, truth-in-lending and truth-in-savings disclosures, equal credit opportunity, fair credit reporting, trading in securities and other aspects of banking operations. Branching by the Bank is subject to the jurisdiction and requires notice to or the prior approval of the OCC.

Horizon and the Bank are subject to the Federal Reserve Act, which restricts financial transactions between banks and affiliated companies. The statute limits credit transactions between banks, affiliated companies and its executive officers and its affiliates. The statute prescribes terms and conditions for bank affiliate transactions deemed to be consistent with safe and sound banking practices, and restricts the types of collateral security permitted in connection with a bank s extension of credit to an affiliate.

The FDICIA accomplished a number of sweeping changes in the regulation of depository institutions and their holding companies. The FDICIA requires, among other things, federal bank regulatory authorities to take prompt corrective action with respect to banks that do not meet minimum capital requirements. The FDICIA further directs that each federal banking agency prescribe standards for depository institutions and depository institution holding companies relating to internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, management compensation, a maximum ratio of classified assets to capital, minimum earnings sufficient to absorb losses, a minimum ratio of market value to book value of publicly traded shares and such other standards as the agency deems appropriate.

On November 12, 1999, the President signed into law comprehensive legislation that modernizes the financial services industry for the first time in decades. The Gramm-Leach-Bliley Act (GLBA) permits bank holding companies to conduct essentially unlimited securities and insurance activities, in addition to other activities determined by the Federal Reserve to be related to financial services. As a result of the GLBA, Horizon may underwrite and sell securities and insurance. It may acquire, or be acquired by, brokerage firms and insurance underwriters. Horizon does not anticipate significant changes in its products or services as a result of the GLBA.

The USA PATRIOT Act of 2001 (the PATRIOT Act) is intended to strengthen the ability of U.S. Law Enforcement to combat terrorism on a variety of fronts. The PATRIOT Act contains sweeping anti-money laundering and financial transparency laws and requires financial institutions to implement additional policies and procedures with respect to, or additional measures designed to address, any or all the following matters, among others: money laundering, suspicious activities and currency transaction reporting, and currency crimes. Many of the provisions in the PATRIOT Act were to have expired December 31, 2005, but the U.S. Congress authorized renewals that extended the provisions until March 10, 2006. In early March 2006, the U.S. Congress approved the USA PATRIOT Improvement and Reauthorization Act of 2005 (the Reauthorization Act) and the USA PATRIOT Act Additional Reauthorizing Amendments Act of 2006 (the PATRIOT Act Amendments), and they were signed into law by President Bush on March 9, 2006. The Reauthorization Act makes permanent all but two of the provisions that had been set to expire and provides that the remaining two provisions, which relate to surveillance and the production of business records under the Foreign Intelligence Surveillance Act, will expire in four years. The PATRIOT Act Amendments include provisions allowing recipients of certain subpoenas to obtain judicial review of nondisclosure orders and clarifying the use of certain subpoenas to obtain information from libraries. Horizon does not anticipate that these changes will materially affect its operations.

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act). The Sarbanes-Oxley Act represents a comprehensive revision of laws affecting corporate governance, accounting obligations and corporate reporting. The Sarbanes-Oxley Act is applicable to all companies with equity or debt securities registered under the Securities Exchange Act of 1934 (the 1934 Act). In particular, the Sarbanes-Oxley Act establishes: (i) new requirements for audit committees, including independence, expertise and responsibilities; (ii) additional responsibilities regarding financial statements for the Chief Executive Officer and Chief Financial Officer of the reporting company; (iii) new standards for auditors and regulation of audits; (iv) increased disclosure and reporting obligations for the reporting company and their directors and executive officers; and (v) new and increased civil and criminal penalties for violation of the securities laws. Management expects that significant additional efforts and expense will continue to be required to comply with the provisions of the Sarbanes-Oxley Act.

The Fair and Accurate Credit Transactions Act of 2003 (the FACT Act) amended the Fair Credit Reporting Act and made permanent certain federal preemptions that form the basis for a national credit reporting system. The FACT Act was also intended to (i) address identity theft, (ii) increase access to credit information, (iii) enhance the accuracy of credit reporting, (iv) facilitate the opt-out by consumers from certain marketing solicitations, (v) protect medical information, and (vi) promote financial literacy. The statute applies to credit reporting agencies (commonly referred to as credit bureaus), financial institutions, other users of credit reports and those who furnish information to credit bureaus.

On February 8, 2006, President Bush signed into law deposit insurance reform legislation. The new legislation provides for the merger of the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) into a new Deposit Insurance Fund. The legislation directs the FDIC to develop a new system of assessing premiums and provides that institutions will receive credits for past premium payments that can be applied against future assessments. The legislation also makes other changes, including increasing the coverage level per account for retirement accounts to $250,000 and, beginning in 2011, will allow the FDIC to index the general $100,000 per account coverage every five years to keep pace with inflation.

In addition to the matters discussed above, Horizon Bank is subject to additional regulation of its activities, including a variety of consumer protection regulations affecting its lending, deposit, and collection activities and regulations affecting secondary mortgage market activities. The earnings of financial institutions are also affected by general economic conditions and prevailing interest rates, both domestic and foreign, and by the monetary and fiscal policies of the United States government and its various agencies, particularly the Federal Reserve.

Additional legislative and administrative actions affecting the banking industry may be considered by the United States Congress, state legislatures and various regulatory agencies, including those referred to above. It cannot be predicted with certainty whether such legislative or administrative action will be enacted or the extent to which the banking industry in general or Horizon and its affiliates will be affected.

BANK HOLDING COMPANY STATISTICAL DISCLOSURES

I. DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS EQUITY; INTEREST RATES AND INTEREST DIFFERENTIAL

Information required by this section of Securities Act Industry Guide 3 is presented in Management s Discussion and Analysis as set forth in Item 7 below, herein incorporated by reference.

II. INVESTMENT PORTFOLIO

A. The following is a schedule of the amortized cost and fair value of investment securities available for sale at December 31, 2005, 2004, and 2003:

	2005		**2004**		**2003**	
(In thousand)	**Cost**	**Fair Value**	**Cost**	**Fair Value**	**Cost**	**Fair Value**
Available for Sale						
U.S. Treasury and U.S. Government agencies and corporations	$ 72,153	$ 70,367	$ 86,348	$ 85,626	$ 66,945	$ 66,772
State and municipal	64,608	65,972	54,881	57,327	57,799	60,230
Mortgage-backed securities	119,392	116,020	124,666	124,308	72,806	73,546
Collateralized mortgage obligations	22,781	22,153	13,380	13,338	14,354	14,488
Corporate notes	632	665	632	683	600	659
Total investment securities	$279,566	$275,177	$279,907	$281,282	$212,504	$215,695

INVESTMENT PORTFOLIO (continued)

B. The following is a schedule of maturities of each category of debt securities and the related weighted-average yield of such securities as of December 31, 2005:

	One Year or Less		**After One Year Through Five Years**		**After Five Years Through Ten Years**		**After Ten Years**	
(In Thousands)	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**	**Amount**	**Yield**
Available for Sale								
U.S. Treasury and U.S. Government agency securities (1)	$ 5,909	3.38%	$ 57,594	3.41%	$ 6,864	3.72%		
Obligations of states and political subdivisions	975	5.58%	8,472	4.40%	24,492	4.32%	$ 32,033	4.46%
Mortgage-backed securities (2)			36,684	4.71%	18,783	5.27%	60,553	4.86%
Collateralized mortgage obligations (2)			1,767	4.75%	2,357	4.17%	18,029	4.09%
Other securities							665	7.58%
Total	$ 6,884	3.69%	$ 104,517	3.89%	$ 52,496	4.39%	$ 111,280	4.64%

(1) Fair value is based on contractual maturity or call date where a call option exists

(2) Maturity based upon final maturity date

The weighted-average interest rates are based on coupon rates for securities purchased at par value and on effective interest rates considering amortization or accretion if the securities were purchased at a premium or discount. Yields are not presented on a tax-equivalent basis.

Excluding those holdings of the investment portfolio in U.S. Treasury securities and other agencies and corporations of the U.S. Government, there were no investments in securities of any one issuer that exceeded 10% of the consolidated stockholders equity of Horizon at December 31, 2005.

III. LOAN PORTFOLIO

A.

Types of Loans Total loans on the balance sheet are comprised of the following classifications at December 31 for the years indicated.

(In thousands)	**2005**	**2004**	**2003**	**2002**	**2001**
Commercial, financial, agricultural and commercial tax-exempt loans	$273,310	$203,966	$152,362	$111,897	$100,912
Mortgage warehouse loans	97,729	127,992	126,056	268,452	205,511
Real estate mortgage loans	159,312	89,139	67,428	73,910	80,571
Installment loans	202,383	142,945	101,872	81,534	79,807
Total loans	$732,734	$564,042	$447,718	$535,793	$466,801

LOAN PORTFOLIO (continued)

B. Maturities and Sensitivities of Loans to Changes in Interest Rates The following is a schedule of maturities and sensitivities of loans to changes in interest rates, excluding real estate mortgage, mortgage warehousing and installment loans, as of December 31, 2005:

Maturing or repricing (In thousands)	One Year or Less	One Through Five Years	After Five Years	Total
Commercial, financial, agricultural and commercial tax-exempt loans	$150,047	$110,253	$13,010	$273,310

The following is a schedule of fixed-rate and variable-rate commercial, financial, agricultural and commercial tax-exempt loans due after one year. (Variable-rate loans are those loans with floating or adjustable interest rates.)

(In thousands)	Fixed Rate	Variable Rate
Total commercial, financial, agricultural and commercial tax-exempt loans due after one year	$69,936	$53,327

C. Risk Elements

1. Nonaccrual, Past Due and Restructured Loans The following schedule summarizes nonaccrual, past due and restructured loans.

December 31 (In thousands)	2005	2004	2003	2002	2001
a. Loans accounted for on a nonaccrual basis	$1,822	$1,358	$1,707	$1,217	$1,772
b. Accruing loans which are contractually past due 90 days or more as to interest and principal payments	251		176	76	128
c. Loans not included in (a) or (b) which are Troubled Debt Restructuring s as defined by SFAS No. 15					
Totals	$2,073	$1,358	$1,883	$1,293	$1,900

The increase in nonaccrual loans in 2005 is primarily due to nonaccrual loans acquired from Alliance of $389 thousand, an increase in consumer and commercial loans of $44 thousand and $189 thousand, respectively. These increases were offset by a decrease in mortgage loans of $158 thousand. The decrease in nonaccrual loans in 2004 is primarily due to decreases in consumer loans of $125 thousand and mortgage loans of $337 thousand partially offset by an increase in commercial loans of $112 thousand. The increase in nonaccrual loans in 2003 is primarily due to increases in consumer loans of $89 thousand, mortgage loans of $254 thousand and commercial loans of $146 thousand. The decrease in nonaccrual loans in 2002 is primarily due to a decrease in commercial loans of $868 thousand partially offset by an increase in mortgage loans of $340 thousand.

LOAN PORTFOLIO (continued)

(In thousands)	
Gross interest income that would have been recorded on nonaccrual loans outstanding as of December 31, 2005 in the period if the loans had been current, in accordance with their original terms and had been outstanding throughout the period or since origination if held for part of the period.	$ 123
Interest income actually recorded on nonaccrual loans outstanding as of December 31, 2005 and included in net income for the period.	63
Interest income not recognized during the period on nonaccrual loans outstanding as of December 31, 2005.	$ 60

Discussion of Nonaccrual Policy

1. From time to time, the Bank obtains information, which may lead management to believe that the collection of payments may be doubtful on a particular loan. In recognition of such, it is management s policy to convert the loan from an earning asset to a nonaccruing loan. Further, it is management s policy to place a commercial loan on a nonaccrual status when delinquent in excess of 90 days, unless the Loan Committee approves otherwise. The officer responsible for the loan, the senior lending officer and the senior collections officer must review all loans placed on nonaccrual status. The senior collections officer monitors the loan portfolio for any potential problem loans.

2. Potential Problem Loans

   Impaired loans for which the discounted cash flows or collateral value exceeded the carrying value of the loan totaled $583,000 and $428,000 at December 31, 2005 and 2004, respectively. The allowance for impaired loans, included in the Bank s allowance for loan losses totaled $492,000 and $65,000 at those respective dates. The average balance of impaired loans during 2005 and 2004 was $150,000 and $292,000, respectively.

3. Foreign outstandings

   None

4. Loan Concentrations

   As of December 31, 2005, there are no significant concentrations of loans exceeding 10% of total loans. See Item III A above for a listing of the types of loans by concentration.

D. Other Interest-Bearing Assets

   There are no other interest-bearing assets as of December 31, 2005, which would be required to be disclosed under Item III C.1 or 2 if such assets were loans.

IV. SUMMARY OF LOAN LOSS EXPERIENCE

A. The following is an analysis of the activity in the allowance for loan losses account:

(In thousands)	2005	2004	2003	2002	2001
LOANS					
Loans outstanding at the end of the period (1)	$732,734	$564,042	$447,718	$535,793	$466,801
Average loans outstanding during the period (1)	640,758	514,916	512,441	478,311	426,821

(1) Net of unearned income and deferred loan fees

	2005	2004	2003	2002	2001
ALLOWANCE FOR LOAN LOSSES					
Balance at beginning of the period	$ 7,193	$ 6,909	$6,255	$ 5,410	$ 4,803
Loans charged-off:					
Commercial and agricultural loans	(305)	(161)		(244)	(149)
Real estate mortgage loans	(29)	(41)	(226)	(112)	(515)
Installment loans	(1,096)	(863)	(758)	(841)	(917)
Total loans charged-off	(1,430)	(1,065)	(984)	(1,197)	(1,581)
Recoveries of loans previously charged-off:					
Commercial and agricultural loans	161	79	20	90	115
Real estate mortgage loans	2	2	23	24	301
Installment loans	364	278	245	303	267
Total loan recoveries	527	359	288	417	683
Net loans charged-off	(903)	(706)	(696)	(780)	(898)
Provision charged to operating expense	1,521	990	1,350	1,625	1,505
Acquired through acquisition	557				
Balance at the end of the period	$ 8,368	$ 7,193	$6,909	$ 6,255	$ 5,410
Ratio of net charge-offs to average loans outstanding for the period	(.14)%	(.14)%	(.14)%	(.16)%	(.21)%

B. The following schedule is a breakdown of the allowance for loan losses allocated by type of loan and the percentage of loans in each category to total loans.

Allocation of the Allowance for Loan Losses at December 31 (thousands)

	2005		2004		2003		2002		2001	
	Allowance Amount	% of Loans to Total Loans	Allowance Amount	% of Loans to Total Loans	Allowance Amount	% of Loans to Total Loans	Allowance Amount	% of Loans to Total Loan	Allowance Amount	% of Loans to Total Loans
Commercial, financial and agricultural	$2,733	37%	$2,469	36%	$1,829		$1,732	21%	$1,678	22%
Real estate mortgage	585	22	808	16	834	12%	712	14	641	17
Mortgage warehousing	1,958	13	2,029	23	2,445	37	2,007	50	1,357	44
Installment	2,958	28	1,860	25	1,524	23	1,574	15	1,702	17
Unallocated	134		27		277		230		32	
Total	$8,368	100%	$7,193	100%	$6,909	100%	$6,255	100%	$5,410	100%

In 1999, Horizon began a mortgage warehousing program. This program is described in Management s Discussion and Analysis of Financial Condition and Results of Operation in Item 7 below and in the Notes to the Financial Statements in Item 8 below, which are incorporated herein by reference. The greatest risk related to these loans is transaction and fraud risk. During 2005, Horizon processed over $2.4 billion in mortgage warehouse loans.

V. DEPOSITS

Information required by this section is found in Management s Discussion and Analysis of Financial Condition and Results of Operation in Item 7 below and in the Consolidated Financial Statements and related notes in Item 8 below, which are incorporated herein by reference.

VI. RETURN ON EQUITY AND ASSETS

Information required by this section is found in Management s Discussion and Analysis of Financial Condition and Results of Operation in Item 7 below and in the Consolidated Financial Statements and related notes in Item 8 below, which are incorporated herein by reference.

VII. SHORT-TERM BORROWINGS

The following is a schedule of statistical information relative to securities sold under agreements to repurchase which are secured by U.S. Treasury and U.S. Government agency securities and mature within one year. There were no other categories of short-term borrowings for which the average balance outstanding during the period was 30 percent or more of stockholders equity at the end of the period.

December 31 (thousands)	**2005**	**2004**
Outstanding at year end	$35,824	$27,681
Approximate weighted-average interest rate at year-end	2.54%	1.40%
Highest amount outstanding as of any month-end during the year	$35,868	$29,371
Approximate average outstanding during the year	$26,430	$20,877
Approximate weighted-average interest during the year	1.97%	.95%

FORWARD-LOOKING STATEMENTS AND RISK FACTORS

A cautionary note about forward-looking statements: In its oral and written statements, Horizon from time to time includes forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements can include statements about estimated cost savings, plans and objectives for future operations and expectations about Horizon s financial and business performance as well as economic and market conditions. They often can be identified by the use of words like expect, may, could, intend, project, estimate, or anticipate.

Horizon may include forward-looking statements in filings with the Securities and Exchange Commission (SEC), such as this Form 10-K, in other written materials, and in oral statements made by senior management to analysts, investors, representatives of the media, and others. It is intended that these forward-looking statements speak only as of the date they are made, and Horizon undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the forward-looking statement is made or to reflect the occurrence of unanticipated events.

By their nature, forward-looking statements are based on assumptions and are subject to risks, uncertainties, and other factors. You are cautioned that actual results may differ materially from those contained in the forward-looking statement. The discussion in Management s Discussion and Analysis of Financial Condition and Results of Operation in Item 7 of this Form 10-K lists some of the factors that could cause Horizon s actual results to vary materially from those expressed in or implied by any forward-looking statements. Your attention is directed to this discussion.

Other risks and uncertainties that could affect Horizon s future performance are set forth immediately below in Item 1A Risk Factors

ITEM 1A. RISK FACTORS

As a financial institution, we are subject to a number of types of risks. Although we undertake a variety of efforts to manage and control those risks, many of the risks are outside of our control. Among the risks we face are the following:

- credit risk: the risk that loan customers or other parties will be unable to perform their contractual obligations;
- market risk: the risk that changes in market rates and prices will adversely affect our financial condition or results of operation;
- liquidity risk: the risk that Horizon or the Bank will have insufficient cash or access to cash to meet its operating needs; and
- operational risk: the risk of loss resulting from inadequate or failed internal processes, people and systems, or external events.

Investors should consider carefully these risks and the other risks and uncertainties described below. Any of the following risks could materially adversely affect our business, financial condition or operating results which could cause our stock price to decline. The risks and uncertainties described below are not, however, the only ones that we may face. Additional risks and uncertainties not currently known to us, or that we currently believe are not material, could also materially adversely affect our business, financial condition or operating results.

Our financial performance may be adversely impacted if we are unable to continue to grow our commercial and consumer loan portfolios, obtain low-cost funds and compete with other providers of financial services.

Our ability to maintain our history of record earnings year after year will depend, in large part, on our ability to continue to grow our commercial and consumer loan portfolios and obtain low-cost funds. During 2004 and 2005, we focused on increasing commercial and consumer loans, and we intend to continue to emphasize and grow these types of loans in the foreseeable future. This represented a shift in our emphasis from 2002 and 2003 when we focused on mortgage banking services, which generated a large portion of our income during those years.

We have also funded our growth with low-cost consumer deposits, and our ability to sustain our growth will depend in part on our continued success in attracting such deposits or finding other sources of low-cost funds.

Another factor in maintaining our history of record earnings will be our ability to expand our scope of available financial services to our customers in an increasingly competitive environment. In addition to other banks, our competitors include credit unions, securities dealers, brokers, mortgage bankers, investment advisors, and finance and insurance companies. Competition is intense in most of our markets. We compete on price and service with our competitors. Competition could intensify in the future as a result of industry consolidation, the increasing availability of products and services from non-banks, greater technological developments in the industry, and banking reform.

Our commercial and consumer loans expose us to increased credit risks.

We have a large percentage of commercial and consumer loans. Commercial loans generally have greater credit risk than residential mortgage loans because repayment of these loans often depends on the successful business operations of the borrowers. These loans also typically have much larger loan balances than residential mortgage loans. Consumer loans generally involve greater risk than residential mortgage loans because they are unsecured or secured by assets that depreciate in value. Although we undertake a variety of underwriting, monitoring and reserving protections with respect to these types of loans, there can be no guarantee that we will not suffer unexpected losses.

Changes in market interest rates could adversely affect our financial condition and results of operations.

Our financial condition and result of operations are significantly affected by changes in market interest rates. Our results of operations depend substantially on our net interest income, which is the difference between the interest income that we earn on our interest-earning assets and the interest expense that we pay on our interest-bearing liabilities. Our profitability depends on our ability to manage our assets and liabilities during periods of changing market interest rates. If rates increase rapidly as a result of an improving economy, we may have to increase the rates paid on our deposits and borrowed funds more quickly than loans and investments reprice, resulting in a negative impact on interest spreads and net interest income. The impact of rising rates could be compounded if deposit customers move funds from savings accounts to higher rate certificate of deposit accounts. Conversely, should market interest rates fall below current levels, our net interest margin could also be negatively affected, as competitive pressures could keep us from further reducing rates on our deposits, and prepayments and curtailments on assets may continue. Such movements may cause a decrease in our interest rate spread and net interest margin, and therefore, decrease our profitability.

We also are subject to reinvestment risk associated with changes in interest rates. Changes in interest rates may affect the average life of loans and mortgage-related securities. Increases in interest rates may decrease loan demand and/or may make it more difficult for borrowers to repay adjustable rate loans. Decreases in interest rates often result in increased prepayments of loans and mortgage-related securities, as borrowers refinance their loans to reduce borrowing costs. Under these circumstances, we are subject to reinvestment risk to the extent that we are unable to reinvest the cash received from such prepayments in loans or other investments that have interest rates that are comparable to the interest rates on existing loans and securities.

An economic slowdown in Northwestern Indiana and Southwestern Michigan could affect our business.

Our primary market area for deposits and loans consists of LaPorte and Porter Counties in Northwestern Indiana and Berrien County in Southwestern Michigan. An economic slowdown in these areas could hurt our business. Possible consequences of such a downturn could include the following:

- increases in loan delinquencies and foreclosures;
- declines in the value of real estate and other collateral for loans; and
- a decline in the demand for our products and services.

We are subject to increased regulatory capital requirements.

As a condition to the approval of our acquisition of Alliance Financial Corporation in 2005, the OCC, our primary regulator, required us to maintain regulatory capital ratios at 100 basis points above the well capitalized minimums. This could affect our ability to compete with other financial institutions not required to maintain these higher capital levels by limiting our ability to grow assets. The OCC has not told us when these increased capital requirements will be lifted, but as of December 31, 2005, we exceeded these heightened capital requirements.

If we are required to change the classification of our mortgage warehouse loans for capital purposes, this could restrict the capital we have available for further growth.

We purchase home mortgages from mortgage companies under warehouse agreements whereby the mortgage company has the right to repurchase the loan. We have historically classified these loans as home mortgage loans for call report and regulatory capital purposes as opposed to treating them as other loans. During the course of a routine, periodic examination by bank regulatory authorities commenced in February 2003, the examination personnel raised the issue of whether our mortgage warehouse loans should be treated as other loans for call report purposes. We submitted a position statement to the regulators in 2003 substantiating our classification of these loans and had various follow-up conversations with them thereafter. The regulatory authorities have never required us to change the classification of these loans, and we believe the matter is resolved; although the regulatory authorities have never told us this matter is settled. If we are required to change our treatment of these loans, it will change our calculations for risk-based capital and reduce our risk-based capital ratios which may restrict our ability to grow our assets.

Because our stock is thinly traded, it may be more difficult for you to sell your shares or buy additional shares when you desire to do so and the price may be volatile.

Although our common stock has been listed on The Nasdaq Capital Market since December 2001, our common stock is thinly traded. Average daily trading volume during 2005 was only 2,914 shares. The prices of thinly traded stocks, such as ours, are typically more volatile than stocks traded in a large, active public market and can be more easily impacted by sales or purchases of large blocks of stock. Thinly traded stocks are also less liquid, and because of the low volume of trades, you may be unable to sell your shares when you desire to do so.

The preparation of our financial statements requires the use of estimates that may vary from actual results.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make significant estimates that affect the financial statements. One of our most critical estimates is the level of the allowance for loan losses. Due to the inherent nature of these estimates, we cannot provide absolute assurance that we will not have to increase the allowance for loan losses and/or sustain loan losses that are significantly higher than the provided allowance.

Our mortgage warehouse and indirect lending operations are subject to a higher fraud risk than our other lending operations.

We buy loans originated by mortgage bankers and automobile dealers. Because we must rely on the mortgage bankers and automobile dealers in making and documenting these loans, there is an increased risk of fraud to us on the part of the third-party originators and the underlying borrowers. In order to guard against this increased risk, we perform investigations on the loan originators we do business with, and we review the loan files and loan documents we purchase to attempt to detect any irregularities or legal noncompliance. However, there is no guarantee that our procedures will detect all cases of fraud or legal noncompliance.

We are subject to extensive regulation and changes in laws, regulations and policies could adversely affect our business.

Our operations are subject to extensive regulation by federal agencies. See Supervision and Regulation in the description of our Business in Item 1 above for detailed information on the laws and regulations to which we are subject. Changes in applicable laws, regulations or regulator policies could materially affect our business. The likelihood of any major changes in the future and their effects are impossible to determine.

Our inability to continue to accurately process large volumes of transactions could adversely impact our business and financial results.

In the normal course of business, we process large volumes of transactions. If systems of internal control should fail to work as expected, if systems are used in an unauthorized manner, or if employees subvert the system of internal controls, significant losses could result.

We process large volumes of transactions on a daily basis and are exposed to numerous types of operational risk. Operational risk resulting from inadequate or failed internal processes, people, and systems includes the risk of fraud by persons inside or outside the company, the execution of unauthorized transactions by employees, errors relating to transaction processing and systems, and breaches of the internal control system and compliance requirements. This risk of loss also includes the potential legal actions that could arise as a result of the operational deficiency or as a result of noncompliance with applicable regulatory standards.

We establish and maintain systems of internal operational controls that provide us with timely and accurate information about our level of operational risk. While not foolproof, these systems have been designed to manage operational risk at appropriate, cost-effective levels. Procedures exist that are designed to ensure that policies relating to conduct, ethics, and business practices are followed. From time to time, losses from operational risk may occur, including the effects of operational errors.

While we continually monitor and improve the system of internal controls, data processing systems, and corporate-wide processes and procedures, there can be no assurance that future losses will not occur.

The preparation of our financial statements requires the use of estimates that may vary from actual results.

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make significant estimates that affect the financial statements. One of our most critical estimates is the level of the allowance for loan losses. Due to the inherent nature of these estimates, we cannot provide absolute assurance that we will not have to increase the allowance for loan losses and/or sustain loan losses that are significantly higher than the provided allowance.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

ITEM 2. PROPERTIES

The main office of Horizon and the Bank is located at 515 Franklin Square, Michigan City, Indiana. The building located across the street from the main office of Horizon and the Bank, at 502 Franklin Square, houses the credit administration, operations, facilities and purchasing and information technology departments of the Bank. In addition to these principal facilities, the Bank has 14 sales

offices located at:
3631 South Franklin Street, Michigan City, Indiana
113 W. First St., Wanatah, Indiana
1500 W. Lincolnway, LaPorte, Indiana
423 South Roosevelt Street, Chesterton, Indiana
4208 N. Calumet, Valparaiso, Indiana
2650 Willowcreek Road, Portage, Indiana
233 East 84th Drive, Merrillville, Indiana
811 Ship Street, St Joseph, Michigan
2608 Niles Road, St Joseph, Michigan
233 South Main Street, South Bend, Indiana
1808 East Bristol Street, Suite K, Elkhart, Indiana
500 West Buffalo Street, New Buffalo, Michigan
13696 Redarrow Highway, Harbert, Michigan
6801 West U.S. 12 Three Oaks, Michigan
Horizon owns all of the facilities, except for the South Bend, Elkhart, Portage and Merrillville, Indiana offices, which are leased from third parties.

ITEM 3. LEGAL PROCEEDINGS

No material pending legal proceedings, other than ordinary routine litigation incidental to the business to which Horizon or any of its subsidiaries is a party or of which any of their property is subject.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of Horizon s stockholders during the fourth quarter of the 2005 fiscal year.

SPECIAL ITEM: EXECUTIVE OFFICERS OF REGISTRANT

Robert C. Dabagia	67	Chairman of Horizon since 1998; Chief Executive Officer of Horizon and the Bank until July 1, 2001.
Craig M. Dwight	48	Chairman and Chief Executive Officer of the Bank since January 2003; President and Chief Executive Officer of Horizon and the Bank since July 1, 2001; President and Chief Administrative Officer of Horizon and President of the Bank since 1998.
Thomas H. Edwards	53	President and Chief Operating Officer of the Bank since January 2003; Executive Vice President and Senior Lender of Horizon and the Bank since 1999.
Lawrence J. Mazur	57	President and Chief Executive Officer of Horizon Trust & Investment Management, N.A. since January 2003; President of Horizon Trust & Investment Management, N.A. since December 1998; Secretary of Horizon Bancorp since 2001.
James H. Foglesong	60	Chief Financial Officer of Horizon and the Bank since January 2001; Executive Vice President and Chief Financial Officer, Security Financial Bancorp since 1995.
James D. Neff	46	Executive Vice President-Mortgage Banking of Horizon Bank since January 2004; Senior Vice President, Horizon Bank since October 1999.
Richard M. Leagre, Esq.	68	Vice President and General Counsel of Horizon since April 1, 2005; Partner, Barnes & Thornburg LLP (law firm) from September 1, 2003 until March 31, 2005; Senior Counsel of Leagre Chandler & Millard LLP (law firm) and Principal of Concord Partners (strategic advisory firm) from July 1, 1997 to August 31, 2003.

PART II

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

There were no purchases by the Company of its common stock during the fourth quarter.

The other information regarding Horizon s common stock is included under the caption Horizon s Common Stock and Related Stockholders Matters in Item 8 below, which is incorporated by reference.

ITEM 6. SELECTED FINANCIAL DATA

The information required under this item is incorporated by reference to the information appearing under the caption Summary of Selected Financial Data in Item 8 of this Form 10-K.

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

Horizon Bancorp and Subsidiaries
Management s Discussion and Analysis of
Financial Condition and Results of Operations
(Table Dollar Amounts in Thousands)

Overview

In June of 2005, Horizon completed the purchase of Alliance. Included in the purchase were total assets of $141 million, including $29 million of investments and $86 million of loans. Total liabilities assumed in the purchase were $128 million, including deposits of $117 million and $9 million of borrowings.

In 2004, Horizon shifted the emphasis in lending from residential mortgage lending to more traditional commercial banking functions. This shift continued in 2005, and Horizon was able to continue to diversify its revenue streams. Commercial loans grew 34% to over $270 million and consumer loans increased by 42% to over $200 million. Residential portfolio loans increased 79% to over $159 million and mortgage warehouse loans decreased 24% to under $98 million. An improving local economy, strong sales effort and the addition of experienced lenders fueled the commercial growth. The southwest Michigan market continued to have its strong growth pattern. Consumer loans grew as a result of additional home equity lending in all markets and expansion of indirect lending into southwest Michigan.

An increase of 40% in deposits funded the increase in earning assets and provided liquidity to decrease borrowed funds by 17%.

Critical Accounting Policies

Horizon has established various accounting policies, which govern the application of accounting principles generally accepted in the United States in the preparation the Company s financial statements. The significant accounting policies of the Company are described in the notes to the consolidated financial statements included in Part II, Item 8 on Form 10-K. Certain of these policies are important to the portrayal of the Company s financial condition, since they require management to

make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Management has identified the following as critical accounting policies:

Allowance for Loan Losses

The allowance for loan losses, which is established through the provision for loan losses, is based on management s evaluation of the level of allowance required in relation to the estimated loss exposure in the loan portfolio. Management believes the allowance for loan losses is a significant estimate and therefore evaluates it for adequacy each quarter. Management considers factors such as previous loss experience, the size and composition of the loan portfolio, current economic and real estate market conditions, the performance of individual loans in relation to contract terms, and estimated fair value of collateral that secures the loans. The use of different estimates or assumptions could produce a different allowance for loan losses. Additional discussion regarding the allowance for loan losses is included the following Analysis of Financial Condition.

Goodwill and Intangible Assets

Management believes that the accounting for goodwill and other intangible assets also involves a higher degree of judgment than most other significant accounting policies. Statement of Financial Accounting Standard (SFAS) No. 142, Accounting for Goodwill and Other Intangible Assets, establishes standards for the amortization of acquired intangible assets and impairment assessment of goodwill. At December 31, 2005, Horizon had core deposit intangibles of $2.780 million subject to amortization and $5.787 million of goodwill, which was not subject to amortization. Goodwill arising from business combinations represents the value attributable to unidentifiable intangible assets in the business acquired. Horizon s goodwill relates to the value inherent in the banking industry and that value is dependent upon the ability of Horizon to provide quality, cost effective banking services in a competitive marketplace. The goodwill value is supported by revenue that is in part driven by the volume of business transacted. A decrease in earnings resulting from a decline in the customer base or the inability to deliver cost effective services over sustained periods can lead to impairment of goodwill that could adversely impact earnings in future periods. SFAS No. 142 requires an annual evaluation of goodwill for impairment. The evaluation of goodwill for impairment requires the use of estimates and assumptions. Horizon has concluded that the recorded value of goodwill was not impaired.

Mortgage Servicing Rights

Servicing assets are recognized as separate assets when rights are acquired through purchase or through the sale of financial assets on a servicing-retained basis. Capitalized servicing rights are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated regularly for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying servicing rights by predominant characteristics, such as interest rates, original loan terms and whether the loans are fixed or adjustable rate mortgages. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. When the book value of an individual stratum exceeds its fair value, an impairment reserve is recognized so that each individual stratum is carried at the lower of its amortized book value or fair value. In periods of falling market interest rates, accelerated loan prepayment speeds can adversely impact the fair value of these mortgage-servicing rights relative to their book value. In the event that the fair value of these assets was to increase in the future, Horizon can recognize the increased fair value to the extent of the impairment allowance but cannot recognize an asset in excess of its amortized book value. Future changes in management s assessment of the impairment of these servicing assets, as a result of changes in observable market data relating to market interest rates, loan prepayment speeds, and other factors, could impact Horizon s financial condition and results of operations either positively or adversely.

Analysis of Financial Condition

Investment Securities

Horizon maintains a high quality investment portfolio with low credit risk. Investment securities totaled $275.177 million at December 31, 2005, and consisted of U. S. Treasury and Government Agency securities of $70.367 million (25.6)%; Municipal securities of $65.972 million (24.0)%; Mortgage-Backed securities of $116.020 million (42.2)%; collateralized mortgage obligations of $22.153 million (8.0)%; and corporate securities of $665 thousand (.2)%.

As indicated above, 50.2% of the investment portfolio consists of mortgage-backed securities and collateralized mortgage obligations. These instruments are secured by residential mortgages of varying maturities. Principal and interest payments are received monthly as the underlying mortgages are repaid. These payments also include prepayments of mortgage balances as borrowers either sell their homes or refinance their mortgages. Therefore, mortgage-backed securities and collateralized mortgage obligations have maturities that are stated in terms of average life. The average life is the average amount of time that each dollar of principal is expected to be outstanding. As of December 31, 2005, the mortgage-backed securities and collateralized mortgage obligations in the investment portfolio had an average life of 3.96 years. Securities that have interest rates above current market rates are purchased at a premium. These securities may experience a significant increase in prepayments when lower market interest rates create an incentive for the borrower to refinance the underlying mortgage. This may result in a decrease of current income, however, this risk is mitigated by a shorter average life. Management currently believes that prepayment risk on these securities is nominal.

At December 31, 2005 and 2004, all investment securities were classified as available for sale. Securities classified as available for sale are carried at their fair value, with both unrealized gains and losses added or subtracted, net of tax, directly to stockholders equity. This accounting method adds potential volatility to stockholders equity, but net income is not affected unless securities are sold. Net depreciation on these securities totaled $4.389 million, which resulted in a $2.853 million reduction, net of tax, to stockholders equity at December 31, 2005. This compared to an $894 thousand, net of tax, addition in stockholders equity at December 31, 2004.

As a member of the Federal Reserve and Federal Home Loan Bank system, Horizon is required to maintain an investment in the common stock of each entity. The investment in common stock is based on a predetermined formula. At December 31, 2005, Horizon has investments in the common stock of the Federal Reserve and Federal Home Loan Bank totaling $12.983 million compared to $11.279 million at December 31, 2004.

At December 31, 2005, Horizon does not maintain a trading account and is not using any derivative products for hedging or other purposes.

Loans

Total loans, the principal earning asset of the Bank, were $732.734 million at December 31, 2005. The current level of loans is an increase of 29.9% from the December 31, 2004, level of $564.042 million. As the table below indicates, the increase is related to growth in all lending areas except for mortgage warehouse loans which declined during 2005.

December 31	**2005**	**2004**	**Dollar Change**	**Percent Change**
Real estate loans				
1 4 family	$152,818	$ 85,694	$ 67,124	78.33%
Other	6,494	3,445	3,049	88.51
Total	159,312	89,139	70,173	78.72
Commercial loans				
Working capital and equipment	130,410	99,783	30,627	30.69
Real estate, including agriculture	128,240	89,818	38,422	42.78
Tax exempt	2,529	5,804	(3,275)	(56.43)
Other	12,131	8,561	3,570	41.70
Total	273,310	203,966	69,344	34.00
Consumer loans				
Auto	95,514	55,363	40,151	72.52
Recreation	7,708	4,969	2,739	55.12
Real estate/home improvement	36,767	32,079	4,688	14.61
Home equity	52,129	39,492	12,637	32.00
Unsecured	1,918	1,653	265	16.03
Other	8,347	9,389	(1,042)	(11.10)
Total	202,383	142,945	59,438	41.58
Mortgage warehouse loans				
Prime	48,571	66,402	(17,831)	(26.85)
Sub-Prime	49,158	61,590	(12,432)	(20.19)
Total	97,729	127,992	(30,263)	(23.64)
Grand total	$732,734	$564,042	$168,692	29.91

The acceptance and management of credit risk is an integral part of the Bank s business as a financial intermediary. The Bank has established rigorous underwriting standards including a policy that monitors the lending function through strict administrative and reporting requirements as well as an internal loan review of consumer and small business loans. The Bank also uses an independent third-party loan review function that regularly reviews asset quality.

Real Estate Loans

Real estate loans totaled $159.312 million or 21.7% of total loans as of December 31, 2005, compared to $89.139 million or 15.8% of total loans as of December 31, 2004. This category consists of home mortgages that generally require a loan to value of no more than 80%. Some special guaranteed or insured real estate loan programs do permit a higher loan to collateral value ratio.

In addition to the customary real estate loans described above, the Bank also has outstanding on December 31, 2005, $52.129 million in home equity lines of credit compared to $39.492 million at December 31, 2004. Credit lines normally limit the loan to collateral value to no more than 89%. These loans are classified as consumer loans in the table above and in Note 4 of the consolidated financial statements.
Residential real estate lending is a highly competitive business. As of December 31, 2005, the real estate loan portfolio reflected a wide range of interest rates and repayment patterns, but could generally be categorized as follows:

	2005			2004		
	Amount	**Percent of Portfolio**	**Yield**	**Amount**	**Percent of Portfolio**	**Yield**
Fixed rate						
Monthly payment	$ 43,752	27.46%	6.13%	$26,500	29.73%	5.85%
Biweekly payment	3,275	2.06	6.43	3,803	4.27	6.56
Adjustable rate						
Monthly payment	112,240	70.45	5.29	58,781	65.94	5.20
Biweekly payment	45	.03	6.12	55	.06	4.20
Total	$159,312	100.00%	5.54%	$89,139	100.00%	5.44%

During 2005 and 2004, approximately $98 million and $106 million, respectively, of residential mortgages were sold into the secondary market. Horizon anticipates that the volume of mortgage loan activity will remain fairly constant in 2006. Overall mortgage activity is anticipated to decline, however, as Horizon enters new markets, originations in these markets should offset the overall decline.
In addition to the real estate loan portfolio, the Bank sells real estate loans and retains the servicing rights. Loans serviced for others are not included in the consolidated balance sheets. The unpaid principal balances and number of loans serviced for others totaled approximately $164,885,000 and 1,971 and $171,367,000 and 2,048 at December 31, 2005 and 2004, respectively.
The Bank began capitalizing mortgage servicing rights during 2000 and the aggregate fair value of capitalized mortgage servicing rights at December 31, 2005, totaled approximately $1,793,000. Comparable market values and a valuation model that calculates the present value of future cash flows were used to estimate fair value. For purposes of measuring impairment, risk characteristics including product type, investor type and interest rates, were used to stratify the originated mortgage servicing rights.

	2005	**2004**	**2003**
Mortgage Servicing Rights			
Balances, January 1	$1,473	$1,429	$ 939
Servicing rights capitalized	239	482	860
Amortization of servicing rights	(434)	(438)	(370)
	1,278	1,473	1,429
Impairment allowance	(44)	(141)	(296)
Balances, December 31	$1,234	$1,332	$1,133

Commercial Loans

Commercial loans totaled $273.310 million or 37.3% of total loans as of December 31, 2005, compared to $203.966 million or 36.2% as of December 31, 2004. An improving local economy, a strong sales effort, the addition of experienced lenders and the Alliance acquisition all contributed to the commercial growth.

Commercial loans consisted of the following types of loans at December 31:

	2005			2004		
	Number	**Amount**	**Percent of Portfolio**	**Number**	**Amount**	**Percent of Portfolio**
SBA guaranteed loans	26	$ 4,782	1.75%	25	$ 6,110	3.00%
Municipal government	44	2,529	.93	20	5,804	2.85
Lines of credit	406	46,999	17.20	304	31,480	15.43
Real estate and equipment term loans	998	219,000	80.12	634	160,572	78.72
Total	1,474	$273,310	100.00%	983	$203,966	100.00%

Consumer Loans

Consumer loans totaled $202.383 million or 27.6% of total loans as of December 31, 2005, compared to $142.945 million or 25.3% as of December 31, 2004. The total consumer loan portfolio increased 41.6% in 2005. The growth in consumer loans resulted from an increase in the number of automobile dealers from whom Horizon buys loans. Growth also came in home equity lines of credit through increased marketing and a more competitive product.

Mortgage Warehouse Loans

In November 1999, Horizon began a mortgage-warehousing program. Horizon enters into agreements with mortgage companies and purchases, at its discretion, mortgage loans from mortgage companies at par, net of certain fees, and later sells them back to the mortgage companies at the same amount and without recourse provisions. Interest income is recorded based upon a rate of interest tied to the prime rate during the funding period, not the rates on the individual note. Such loans are made to individuals and reviewed, prior to purchase, for evidence that the loans are of secondary market quality and meet Horizon s internal underwriting guidelines. An assignment of the mortgage to Horizon is required. In addition, Horizon takes possession of the original note and forwards such note to the end investor. In the event that the end investor would not honor this commitment and the mortgage companies would not be able to honor their repurchase obligations, Horizon would then need to sell these loans in the secondary market at the fair value of these loans. Loans are typically resold within 30 days and are seldom held more than 90 days.

Allowance and Provision for Loan Losses/Critical Accounting Policy

An allowance for loan losses is maintained to absorb loan losses inherent in the loan portfolio. The determination of the allowance for loan losses is a critical accounting policy that involves management s ongoing quarterly assessments of the probable estimated losses inherent in the loan portfolio. The identification of loans that may have potential losses is subjective, therefore, a general reserve is maintained to cover all potential losses within the entire loan portfolio. Horizon utilizes a loan grading system that helps identify, monitor, and address asset quality problems, in an adequate and timely manner. Each quarter, various factors affecting the quality of the loan portfolio are reviewed. Large credits are reviewed on an individual basis for loss potential. Other loans are reviewed as a group based upon previous trends of loss experience. Horizon also reviews the current and anticipated economic conditions of its lending market as well as transaction risk to determine the effect they may have on the loss experience of the loan portfolio.

At December 31, 2005, the allowance for loan losses was $8.368 million or 1.14% of total loans outstanding, compared to $7.193 million or 1.28% at December 31, 2004. During 2005, the provision for loan losses totaled $1.521 million compared to $990 thousand in 2004. Additionally, Horizon added $557 thousand to the allowance for homogeneous loan pools acquired through the Alliance acquisition. The allowance as a percent of total loans decreased due to strong credit quality and loan loss ratios which are better than those of Horizon s peers. However, no assurance can be given that Horizon will not, in any particular period, sustain loan losses that are significant in relation to the amount reserved, or that subsequent evaluations of the loan portfolio, in light of factors then prevailing, including economic conditions and management s ongoing quarterly assessments of the portfolio, will not require increases in the allowance for loan losses. Horizon considers the allowance for loan losses to be adequate to cover losses inherent in the loan portfolio as of December 31, 2005.

Nonperforming Loans

Nonperforming loans are defined as loans that are greater than 90 days delinquent or have had the accrual of interest discontinued by management. Management continues to work diligently toward returning nonperforming loans to an earning asset basis. Nonperforming loans for the previous three years ending December 31 are as follows:

	2005	**2004**	**2003**
Nonperforming loans	$1,822	$1,358	$1,882

Nonperforming loans total 22% of the allowance for loan losses at December 31, 2005, compared to 19% and 27% of the allowance for loan losses on December 31, 2004 and 2003, respectively.

A loan becomes impaired when, based on current information, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is classified as impaired, the degree of impairment must be recognized by estimating future cash flows from the debtor. The present value of these cash flows is computed at a discount rate based on the interest rate contained in the loan agreement. However, if a particular loan has a determinable market value, the creditor may use that value. Also, if the loan is secured and considered collateral dependent, the creditor may use the fair value of the collateral.

Smaller-balance, homogeneous loans are evaluated for impairment in total. Such loans include residential first mortgage loans secured by 1 4 family residences, residential construction loans, automobile, home equity, second mortgage loans and mortgage warehouse loans. Commercial loans and mortgage loans secured by other properties are evaluated individually for impairment. When analysis of borrower operating results and financial condition indicate that underlying cash flows of a borrower s business are not adequate to meet its debt service requirements, the loan is evaluated for impairment. Often this is associated with a delay or shortfall in payments of 30 days or more. Loans are generally moved to nonaccrual status when 90 days or more past due. These loans are often considered impaired. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Other real estate owned (OREO) net of any related allowance for OREO losses for the previous three years ending December 31 are as follows:

	2005	**2004**	**2003**
Other real estate owned	$23	$276	$15

Deposits

The primary source of funds for the Bank comes from the acceptance of demand and time deposits. However, at times the Bank will use its ability to borrow funds from the Federal Home Loan Bank and other sources when it can do so at interest rates and terms that are superior to those required for deposited funds. Total deposits were $855.566 million at December 31, 2005, compared to $612.217 million at December 31, 2004, or an increase of 39.7%. Average deposits and rates by category for the pervious three years ended December 31 are as follows:

	Average Balance Outstanding for the Year Ended December 31			Average Rate Paid for the Year Ended December 31		
	2005	2004	2003	2005	2004	2003
Noninterest-bearing demand deposits	$ 73,501	$ 62,634	$ 56,763			
Interest-bearing demand deposits	165,767	104,909	90,614	1.44%	.46%	.38%
Savings deposits	38,231	36,265	34,955	.36	.20	.27
Money market	143,652	123,013	90,494	2.37	1.27	1.33
Time deposits	320,014	266,201	237,676	3.42	3.22	3.55
Total deposits	$741,165	$593,022	$510,502			

Horizon continually revises and enhances its interest-bearing consumer and commercial demand deposit products based on local market conditions and its need for funding to support various types of assets. These product changes caused the changes in the average balances and rates paid as displayed in the table above.

Certificates of deposit of $100,000 or more, which are considered to be rate sensitive and are not considered a part of core deposits, mature as follows as of December 31, 2005:

Due in three months or less	$51,319
Due after three months through six months	9,639
Due after six months through one year	15,126
Due after one year	35,759

Interest expense on time certificates of $100,000 or more was approximately $2.059 million, $1.762 million and $1.757 million for 2005, 2004 and 2003, respectively.

Off-Balance Sheet Arrangements

As of December 31, 2005, Horizon does not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on the Company s financial condition, change in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors. The term off-balance sheet arrangement generally means any transaction, agreement, or other contractual arrangement to which an entity unconsolidated with the Company is a party under which the Company has (i) any obligation arising under a guarantee contract, derivative instrument or variable interest; or (ii) a retained or contingent interest in assets transferred to such entity or similar arrangement that serves as credit, liquidity or market risk support for such assets.

Contractual Obligations

	Within One Year	One to Three Years	Three to Five Years	After Five Years
Deposits	$ 711,501	$ 140,351	$ 3,118	$ 596
Long-term debt obligations (1)	$ 15,658	38,596	142	79,213
Subordinated debentures (2)				27,837

(1) Includes debt obligations to the Federal Home Loan Bank and term repurchase agreements with maturities beyond one year borrowed by Horizon s banking subsidiary. See Note 9 in Horizon s Consolidated Financial Statements.

(2) Includes Trust Preferred Capital Securities issued by Horizon Statutory Trusts I and II and those assumed in the acquisition of Alliance. See Note 11 in Horizon s Consolidated Financial Statements.

Expiration by Period
Greater

	Within One Year	Than One Year
Letters of credit	$ 720	$ 1,275
Unfunded loan commitments	100,898	46,536

Shareholder Value Plan

During 2001, Horizon initiated a Shareholder Value Plan. The Plan is a comprehensive strategic plan to broaden and improve the market for Horizon s common stock with local community investors who have a long-term, personal interest in helping Horizon remain an independent community bank. It includes improved communications with stockholders and customers as well as efforts to improve the marketability of its common stock. During the fourth quarter of 2001, two important components of the Shareholder Value Plan were completed. These included a 3-for-1 stock split and the listing of Horizon s stock on the NASDAQ Capital Market (formerly named the NASDAQ SmallCap Market). Before this, Horizon s stock was traded on the Bulletin Board. A dividend reinvestment plan was implemented in early 2002 and the quarterly per share dividend was increased to $.102/3 in the fourth quarter of 2002. In October of 2003 Horizon s Board of Director s declared a 3-for-2 stock split and in December of 2003 increased the dividend to $.12. In December 2004, the Board of Director s increased the quarterly dividend to $.13 per share and in December 2005, the Board of Director s increased the quarterly dividend to $.14 per share. This is the fourth consecutive year for an increase in cash dividends.

Capital Resources

The capital resources of Horizon and the Bank exceed regulatory capital ratios for well capitalized banks at December 31, 2005. Stockholders equity totaled $53.530 million as of December 31, 2005, compared to $50.432 million as of December 31, 2004. At year-end 2005, the ratio of stockholders equity to assets was 4.75% compared to 5.52% for 2004. Horizon s capital increased during the year 2005 as a result of increased earnings, net of dividends declared, exercise of stock options and net of tax, decrease in unrealized gain (loss) on securities available for sale and the amortization of unearned compensation. Due to the acquisition of Alliance for cash, the percentage growth in assets was greater than the percentage growth in equity, causing the equity to asset ratio from 2004 to 2005 to decrease.

Horizon declared dividends in the amount of $.53 per share in 2005, and $.49 per share in 2004 and $.44 per share in 2003. These amounts have been adjusted for the 3-for-2 stock split declared in 2003. The dividend payout ratio (dividends as a percent of net income) was 23% during 2005, 21% during 2004 and 19% in 2003. For additional information regarding dividend conditions, see Note 1 of the Notes to the Consolidated Financial Statements.

In March 2002, Horizon formed Horizon Statutory Trust I (Trust I), a statutory business trust. Trust I issued $12 million of Trust Preferred Capital Securities as a participant in a pooled trust preferred securities offering. Horizon issued subordinated debentures aggregating $12 million to Trust I. The junior subordinated debentures are the sole assets of Trust I. The junior subordinated debentures and the trust preferred securities pay interest and dividends, respectively, on a quarterly basis. The junior subordinated debentures and the securities bear interest at a rate of 90 day LIBOR plus 3.60% and mature on March 26, 2032, and are noncallable for five years. After that period, the securities may be called at any quarterly interest payment date at par. Costs associated with the issuance of the securities totaling $362 thousand were capitalized and are being amortized to the first call date of the securities.

In October of 2004, Horizon formed Horizon Bancorp Capital Trust II (Trust II), a statutory business trust. Trust II issued $10 million of Trust Preferred Capital Securities as a participant in a pooled trust preferred securities offering. Horizon issued junior subordinated debentures aggregating $10 million to Trust II. The junior subordinated debentures are the sole assets of Trust II. The junior subordinated debentures and the trust preferred securities pay interest and dividends, respectively, on a quarterly basis. The junior subordinated debentures and the securities bear interest at a rate of 90 day LIBOR plus 1.95% and mature on October 21, 2034, and are noncallable for five years. After that period, the securities may be called at any quarterly interest payment date at par. Costs associated with the issuance of the securities totaling $17,500 were capitalized and are being amortized to the first call date of the securities.

The Company assumed additional debentures as the result of the acquisition of Alliance in 2005. In June 2004, Alliance formed Alliance Financial Statutory Trust I (Alliance Trust) to issue the $5 million in trust preferred securities. Alliance had issued junior subordinated debentures aggregating $5 million to Alliance Trust. The junior subordinated debentures are the sole assets of Alliance Trust. The junior subordinated debentures and the trust preferred securities pay interest and dividends, respectively, on a quarterly basis. The junior subordinated debentures and the securities bear interest at a rate of 90 day LIBOR plus 2.65%, mature in June 2034, and are noncallable for five years. After that period, the securities may be called at any quarterly interest payment date at par.

The Trust Preferred Capital Securities, subject to certain limitations, are included in Tier 1 Capital for regulatory purposes. At December 31, 2005, $11.061 million of the $27 million in securities were not included in Tier 1 Capital for regulatory purposes. Dividends on the Trust Preferred Capital Securities are recorded as interest expense.

The Bank purchases home mortgages from mortgage companies under warehouse agreements whereby the mortgage company has the right to repurchase the loan. Because these transactions are sales of the loans to the Bank and the Bank is the owner of the purchased loans, the Bank has historically treated these loans as home mortgage loans for call report and regulatory capital purposes. During the course of the routine, periodic examination by bank regulatory authorities commenced in February 2003, the examination personnel raised the issue of whether the Bank s mortgage warehouse loans should be treated as other loans rather than as home mortgage loans for call report purposes. If these mortgage loans were treated as other loans, it would change the calculations for risk-based capital and reduce the Bank s risk-based capital ratios. The following table shows, for year-ends in 2005, 2004 and 2003 the amount of the Bank s risk-based and Tier 1 capital ratios as reported and as they would be under this alternative treatment:

Horizon Bank and Horizon Bancorp as of:	Reported	Alternative Treatment	Minimum Required To Be Well Capitalized
December 31, 2005			
Total capital (to risk-weighted assets)			
Consolidated	11.54%	10.81%	N/A
Bank	11.82%	11.06%	10.00%
Tier 1Capital (to risk-weighted assets)			
Consolidated	8.84%	8.28%	N/A
Bank	10.66%	9.97%	6.00%
Tier 1Capital (to average assets)			
Consolidated	5.83%	5.83%	N/A
Bank	7.02%	7.03%	5.00%
December 31, 2004			
Total capital (to risk-weighted assets)			
Consolidated	13.95%	12.52%	N/A
Bank	13.62%	12.11%	10.00%
Tier 1 Capital (to risk-weighted assets)			
Consolidated	11.71%	10.51%	N/A
Bank	12.37%	10.97%	6.00%
Tier 1 Capital (to average assets)			
Consolidated	7.37%	7.37%	N/A
Bank	7.78%	7.78%	5.00%
December 31, 2003			
Total capital (to risk-weighted assets)			
Consolidated	14.43%	12.06%	N/A
Bank	15.22%	13.15%	10.00%
Tier 1 Capital (to risk-weighted assets)			
Consolidated	13.19%	11.48%	N/A
Bank	13.97%	11.90%	6.00%
Tier 1 Capital (to average assets)			
Consolidated	7.48%	7.48%	N/A
Bank	7.90%	7.90%	5.00%

If the Bank is required to reclassify such loans, the Bank still meets the regulatory well capitalized standards for all of 2005, 2004 and 2003. Bank regulators have not issued a final opinion on this matter but management continues to believe that these loans are properly characterized for risk-based capital purposes. However, there is no assurance that the regulators will concur with that determination. If required to treat mortgage warehouse loans as commercial loans, the Bank will consider increasing the amount of its capital through the issuance of subordinated debt, trust preferred securities or equity securities; or consider other alternatives.

As a condition of approval for the Alliance acquisition, the OCC required Horizon Bank to maintain regulatory capital ratios at 100 basis points above the well capitalized minimums shown above.

As of December 31, 2005, management is not aware of any other recommendations by banking regulatory authorities, which, if they were to be implemented, would have or are reasonably likely to have a material effect on Horizon s liquidity, capital resources or operations.

Results of Operations

Net Income

Consolidated net income was $7.091 million or $2.24 per diluted share in 2005, $6.935 million or $2.22 per share in 2004 and $6.534 million or $2.10 per share in 2003. All per share information has been adjusted for the 3-for-2 stock split declared October 21, 2003.

Net Interest Income

The primary source of earnings for Horizon is net interest income. Net interest income is the difference between what Horizon has earned on assets it has invested and the interest paid on deposits and other funding sources. The net interest margin is net interest income expressed as a percentage of average earning assets. Horizon s earning assets consist of loans, investment securities and interest-bearing balances in banks.

	2005			**2004**			**2003**		
	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate	Average Balance	Interest	Yield/ Rate
Assets									
Interest-bearing assets									
Loans total (1) (3)	$ 640,758	$44,749	6.98%	$514,916	$33,386	6.48%	$512,441	$34,527	6.74%
Taxable investment securities, including FRB and FHLB stock	244,495	9,610	3.93	192,419	7,211	3.75	121,521	4,743	3.87
Nontaxable investment securities (2)	54,806	2,372	4.32	52,722	2,264	4.29	47,299	2,038	4.31
Interest-bearing balances and money market investments (4)	1,177	38	3.23	4,924	69	1.40	4,576	57	1.25
Federal funds sold	755	24	3.18	4,560	58	1.28	18,590	196	1.05
Total interest-earning assets	941,991	56,793	6.03	769,541	42,988	5.59	704,427	41,561	5.90
Noninterest-earning assets									
Cash and due from banks	19,610			16,822			18,911		
Allowance for loan losses	(7,615)			(6,985)			(6,581)		
Other assets	46,127			39,547			24,933		
Total assets	$1,000,113			$818,925			$741,690		
Liabilities and Stockholders									

Equity									
Interest-bearing liabilities									
Savings deposits	$ 38,231	139	.36	$ 36,265	74	.20	$ 34,955	95	.27
Money market	143,652	3,414	2.37	123,013	1,558	1.27	90,494	1,204	1.38
Interest-bearing demand deposits	165,767	2,385	1.44	104,909	482	.46	90,614	347	.38
Time deposits	320,014	10,934	3.42	266,200	8,579	3.22	237,676	8,444	3.55
Short-term borrowings	45,517	1,573	3.46	37,205	600	1.61	34,110	388	1.14
Long-term debt	155,393	7,475	4.81	135,362	6,273	4.63	147,417	6,932	4.70
Total interest-bearing liabilities	868,574	25,920	2.98	702,954	17,566	2.50	635,266	17,410	2.74
Noninterest-bearing liabilities									
Demand deposits	73,501			62,634			56,763		
Other liabilities	6,153			5,013			5,049		
Stockholders equity	51,885			48,324			44,612		
Total liabilities and stockholders equity	$1,000,113			$818,925			$741,690		
Net interest income		$30,873			$25,422			$24,151	
Net interest income as a percent of interest earning assets			3.28%			3.31%			3.43%

(1) Nonaccruing loans for the purpose of the computations above are included in the daily average loan amounts outstanding. Loan totals are shown net of unearned income and deferred loans fees.

(2)

Yields are not presented on a tax-equivalent basis.

(3) Loan fees and late fees included in interest on loans aggregated $3,246,000, $3,129,000 and $3,771,000 in 2005, 2004 and 2003 respectively.

(4) Horizon has no foreign office and, accordingly, no assets or liabilities to foreign operations. Horizon s subsidiary bank had no funds invested in Eurodollar Certificates of Deposit at December 31, 2005.

	2005 2004 Increase/(Decrease)			2004 2003 Increase/(Decrease)		
	Total Change	**Change Due to Volume**	**Change Due to Rate**	**Total Change**	**Change Due to Volume**	**Change Due to Rate**
Interest Income						
Loans total	$11,363	$ 8,638	$ 2,725	$(1,141)	$ 166	$ (1,307)
Taxable investment securities	2,447	2,051	396	2,486	2,627	(141)
Nontaxable investment securities	108	90	18	226	233	(7)
Interest-bearing balances and money market investments	(31)	(78)	47	12	5	7
Federal funds sold	(34)	(75)	41	(138)	(173)	35
Total interest income	13,853	10,626	3,227	1,445	2,858	(1,413)
Interest Expense						
Savings deposits	65	4	61	(21)	3	(24)
Money market	1,856	298	1,558	354	414	(60)
Interest-bearing demand deposits	1,903	407	1,496	135	60	75
Time deposits	2,355	1,815	540	135	960	(825)
Short-term borrowings	973	159	814	212	38	174
Long-term debt	1,250	979	271	(641)	(564)	(77)
Total interest expense	8,402	3,662	4,740	174	911	(737)
Net Interest Earnings	$ 5,451	$ 6,964	$ (1,513)	$ 1,271	$ 1,947	$ (676)

Horizon s average earning assets were $941.991 million in 2005 compared to $769.100 million in 2004 and $704.055 million in 2003. The net interest margin for 2005 was 3.28% compared to 3.31% and 3.43% in 2004 and 2003, respectively. Short-term interest rates began to increase in the third quarter of 2004 and continued through 2005 after being relatively stable in 2003.

Horizon began to experience slightly higher loan yields due to the increase in short-term rates throughout 2005. This is due in part to new loans and loan renewals coming in at higher rates than those maturing or paying off and rates on loans with variable rates rising with short term rates. Average loans outstanding during 2005 showed significant growth from 2004 due to the acquisition and concerted effort in new business. The mix of the loan portfolio also

showed significant change as shown in the following table.

	2005	**2004**	**2003**
Commercial loans	$234,971	$174,391	$126,315
Mortgage warehouse loans	108,298	134,063	225,880
Real estate loans	123,815	85,314	70,386
Installment loans	173,674	121,148	89,860
Total average loans outstanding	$640,758	$514,916	$512,441

Average commercial loans grew nearly 35%, consumer loans increased by over 43% and residential real estate loans increased by over 45%. An improving local economy, strong sales effort and the addition of experienced lenders fueled the commercial growth. The southwest Michigan market, in which Horizon increased market share through the acquisition of Alliance, continued to have a strong growth pattern. Average consumer loans grew as a result of additional home equity lending in all markets and expansion of indirect lending into southwest Michigan and north central Indiana. The continued decrease in mortgage refinancing caused mortgage warehouse loans to decrease by over 19%.

To keep the Bank s regulatory capital leveraged, the average investment portfolio was increased by 22%. Increasing this category of earning assets causes a decline in the net interest margin as investment securities carry lower yields than loans; however, the increase in average loans outstanding was greater than the increase in average investments. While reducing the net interest margin, increasing investment balances did have a positive impact on net income and earnings per share.

Average interest-bearing deposits increased by over 23% during 2005. Short-term deposit rates increased throughout the year. The overall cost of time deposits increased as maturing certificates of deposit renewed at higher rates.

The increase in net interest income during 2005 and 2004 is primarily the result of increased earning assets, particularly investment securities in 2004 and the loan portfolio in 2005. The increase in net interest income resulting from increased earning assets was offset by declines in the net interest margin.

Noninterest Income

The major components of noninterest income consist of service charges on deposit accounts, gain on sale of loans and fiduciary fees. Service charges on deposit accounts are based upon: a) recovery of direct operating expenses associated with providing the service, b) allowing for a profit margin that provides an adequate return on assets and stockholders equity and c) competitive factors within the Bank s markets. Service charges on deposits were $2.966 million, $3.088 million and $3.161 million, for 2005, 2004 and 2003, respectively.

Gain on sale of loans was $1.756 million for 2005 compared to $2.126 million in 2004 and $3.843 million for 2003. In 2003, Horizon sold approximately 85% of its residential mortgage loan production to the secondary market. However, in 2005 and 2004 this percentage dropped to around 50% and 60% respectively as more customers took adjustable rate mortgages which are held in the Bank s permanent portfolio of real estate loans. During 2005 Horizon sold $98 million of current production of residential mortgage loans into the secondary market compared to $106 million in 2004 and $185 million in 2003. The 2004 gain includes approximately $394 thousand from the sale of portfolio loans. Portfolio mortgage loans were sold to reduce the interest rate risk related to long-term fixed rate assets and to provide funding for the growth in other loan areas. Horizon anticipates that the volume of mortgage loan activity will remain fairly constant in 2006. Overall mortgage activity is anticipated to decline, however, as Horizon enters new markets, originations in these markets should offset the overall decline.

Fiduciary fees were $2.748 million in 2005 compared to $2.694 million in 2004 and $2.411 million in 2003. The fluctuations are primarily due to changes in the market value of assets under administration and an increase in one time estate fees.

Noninterest Expense

Noninterest expense totaled $29.177 million in 2005 compared to $25.672 million in 2004 and $24.771 million in 2003.

Salaries and benefits increased 11.9% during 2005 compared to an increase of 5.9% during 2004. The increase for 2005 related to the cost of expansion into new markets, including the acquisition of Alliance, partially offset by declines in incentive compensation and commissions paid to mortgage

originators. The increase for 2004 also related to the cost of expansion into new markets partially offset by declines in incentive compensation and commissions paid to mortgage originators.

Total other expenses, excluding salaries and benefits, increased 15.6% in 2005 and .76% in 2004. During 2005 other expenses were impacted by costs related to the acquisition of Alliance as well as ongoing expenses relative to the operation of the additional branches, including the amortization of the core deposit intangible acquired in the acquisition.

During 2004 Horizon reviewed all areas of noninterest expense and developed annual reductions of over $350 thousand. The more significant reductions included revisions to services provided by third parties, a change in check clearing vendors and real estate and personal property tax revisions.

Income Taxes

Income tax expense totaled $2.945 million in 2005, $2.494 million in 2004 and $2.636 million in 2003. The effective tax rate was 29.3%, 26.45% and 28.75% for 2005, 2004 and 2003, respectively. The increase in the effective rate in 2005 was due to a decline in the percentage of tax exempt income to pre-tax income. The decline in the effective tax rate in 2004 was caused by increased tax exempt income from bank owned life insurance and tax exempt investment income.

Liquidity and Rate Sensitivity Management

Management and the Board of Directors meet regularly to review both the liquidity and rate sensitivity position of Horizon. Effective asset and liability management ensures Horizon s ability to monitor the cash flow requirements of depositors along with the demands of borrowers and to measure and manage interest rate risk. Horizon utilizes an interest rate risk assessment model designed to highlight sources of existing interest rate risk and consider the effect of these risks on strategic planning. Management maintains (within certain parameters) an essentially balanced ratio of interest sensitive assets to liabilities in order to protect against the effects of wide interest rate fluctuations.

Liquidity

The Bank maintains a stable base of core deposits provided by long standing relationships with consumers and local businesses. These deposits are the principal source of liquidity for Horizon. Other sources of liquidity for Horizon include earnings, loan repayments, investment security sales and maturities, sale of real estate loans and borrowing relationships with correspondent banks, including the Federal Home Loan Bank (FHLB). At December 31, 2005, Horizon has available approximately $182.484 million in available credit from various money center banks, including the FHLB. During 2005, cash flows were generated primarily from proceeds from borrowings of $107 million, increase in deposits of $126.2 million and sales, maturities, and prepayments of investment securities of $61.2 million. Cash flows were used to purchase investments totaling $38.4 million, pay borrowings of $149.2 million, and increase loans $81.7 million. The net cash and cash equivalent position increased by $21.0 million during 2005.

Interest Sensitivity

The degree by which net interest income may fluctuate due to changes in interest rates is monitored by Horizon using computer simulation models, incorporating not only the current GAP position but the effect of expected repricing of specific financial assets and liabilities. When repricing opportunities are not properly aligned, net interest income may be affected when interest rates change. Forecasting results of the possible outcomes determines the exposure to interest rate risk inherent in Horizon s balance sheet. The goal is to manage imbalanced positions that arise when the total amount of assets that reprice or maturing in a given time period differs significantly from liabilities that reprice or mature in the same time period. The theory behind managing the difference between repricing assets and liabilities is to have more assets repricing in a rising rate environment and more liabilities repricing in a declining rate environment. At December 31, 2005 and 2004, the amount of assets that reprice within one year were approximately 109% of the amount of liabilities that reprice within the same time period.

		Rate Sensitivity			
	3 Months or Less	> 3 Months and < 6 Months	> 6 Months and < 1 Year	Greater Than 1 Year	Total
Loans	$ 301,518	$ 70,018	$ 137,220	$ 226,418	$ 735,174
Federal funds sold					
Interest-bearing balances with Banks	15,735				15,735
Investment securities and FRB and FHLB stock	25,075	7,956	21,047	234,082	288,160
Other assets	12,925			75,881	88,806
Total assets	$ 355,253	$ 77,974	$ 158,267	$ 536,381	$ 1,127,875

		Rate Sensitivity			
	3 Months or Less	> 3 Months and < 6 Months	> 6 Months and < 1 Year	Greater Than 1 Year	Total
Noninterest-bearing deposits	$ 12,257	$ 12,257	$ 24,515	$ 99,098	$ 148,127
Interest-bearing deposits	190,572	129,833	71,551	315,483	707,439
Borrowed funds	65,593	21,030	15,218	109,629	211,470
Other liabilities				7,309	7,309
Stockholders equity				53,530	53,530
Total liabilities and stockholders equity	$ 268,422	$ 163,120	$ 111,284	$ 585,049	$ 1,127,875
GAP	$ 86,831	$ (85,146)	$ 46,983	$ (48,668)	
Cumulative GAP	$ 86,831	$ 1,685	$ 48,668		

Included in the GAP analysis are certain interest-bearing demand accounts and savings accounts. These interest-bearing accounts are subject to immediate withdrawal. However, Horizon considers approximately 50% of these deposits to be insensitive to gradual changes in interest rates and generally to behave like deposits with longer maturities based upon historical experience.

Quantitative and Qualitative Disclosures About Market Risk

Horizon s primary market risk exposure is interest rate risk. Interest rate risk (IRR) is the risk that Horizon s earnings and capital will be adversely affected by changes in interest rates. The primary approach to IRR management is one that focuses on adjustments to the asset/liability mix in order to limit the magnitude of IRR.

Horizon s exposure to interest rate risk is due to repricing or mismatch risk, embedded options risk, and yield curve risk. Repricing risk is the risk of adverse consequence from a change in interest rates that arise because of differences in the timing of when those interest rate changes affect Horizon s assets and liabilities. Basis risk is the risk that the spread, or rate difference, between instruments of similar maturities will change. Options risk arises whenever products give the customer the right, but not the obligation, to alter the quantity or timing of cash flows. Yield curve risk is the risk that changes in prevailing interest rates will affect instruments of different maturities by different amounts. Horizon s

objective is to remain reasonably neutral with respect to IRR. Horizon utilizes a variety of strategies to maintain this position including the sale of mortgage loans on the secondary market and varying maturities of FHLB advances, certificates of deposit funding and investment securities.

The table, which follows, provides information about Horizon s financial instruments that are sensitive to changes in interest rates as of December 31, 2005. The table incorporates Horizon s internal system generated data related to the maturity and repayment/withdrawal of interest-earning assets and interest-bearing liabilities. For loans, securities, and liabilities with contractual maturities, the table presents principal cash flows and related weighted-average interest rates by contractual maturities as well as the historical experience of Horizon related to the impact of interest rate fluctuations on the prepayment of residential loans and mortgage-backed securities. From a risk management perspective, Horizon believes that repricing dates are more relevant than contractual maturity dates when analyzing the value of financial instruments. For deposits with no contractual maturity dates, the table presents principal cash flows and weighted average rate, as applicable, based upon Horizon s experience and management s judgment concerning the most likely withdrawal behaviors.

Horizon had no derivative financial instruments or trading portfolio as of December 31, 2005.

Quantitative Disclosure of Market Risk

	2005	2006	2007	2008	2009	2010 and Beyond	Total	Fair Value 12/31/05
Rate-sensitive assets								
Fixed interest rate loans	$ 94,276	$ 68,741	$ 50,136	$32,045	$17,141	$ 35,690	$ 298,029	$ 298,328
Average interest rate	6.43%	6.37%	6.36%	6.50%	6.70%	7.13%	6.51%	
Variable interest rate loans	414,437	3,409	1,842	5,358	3,607	8,492	437,145	435,210
Average interest rate	6.68%	6.44%	6.67%	6.38%	6.95%	6.23%	6.67%	
Total loans	508,713	72,150	51,978	37,403	20,748	44,182	735,174	728,538
Average interest rate	6.63%	6.37%	6.37%	6.48%	6.74%	6.96%	6.60%	
Securities, including FRB and FHLB stock	54,078	51,546	50,065	23,127	14,865	94,479	288,160	288,160
Average interest rate	4.14%	3.68%	3.86%	4.40%	4.44%	4.54%	4.18%	
Other interest-bearing assets	28,660						28,660	28,660
Average interest rate	4.30%						4.30%	
Total earnings assets	591,451	123,696	102,043	60,530	35,613	138,661	1,051,994	1,045,358
Average interest rate	6.29%	5.25%	5.14%	5.69%	5.78%	5.31%	5.88%	
Rate-sensitive liabilities								
Noninterest-bearing deposits	$ 49,029	$ 30,087	$ 20,952	$14,591	$10,161	$ 23,307	$ 148,127	$ 148,127
NOW accounts	48,393	28,948	23,130	18,557	14,843	62,146	196,017	177,064
Average interest rate	1.38%	1.58%	1.60%	1.61%	1.62%	1.66%	1.56%	
Savings and money market accounts	179,288	7,422	5,269	3,754	2,680	7,009	205,422	197,052

Average interest rate	2.74