

FIRST MERCHANTS CORP
Form 10-Q
August 09, 2011

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

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

For the quarterly period ended June 30, 2011

OR

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

For the Transition Period from _____ to _____

Commission File Number 0-17071

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

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

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to

submit and post such files).

Yes No

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

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

As of July 29, 2011, there were 25,690,649 outstanding common shares of the registrant.

FIRST MERCHANTS CORPORATION
FORM 10Q

INDEX

		Page No.
PART I. Financial Information:		
ITEM 1.	Financial Statements:	
	<u>Consolidated Condensed Balance Sheets</u>	3
	<u>Consolidated Condensed Statements of Income</u>	4
	<u>Consolidated Condensed Statements of Comprehensive</u>	
	<u>Income</u>	5
	<u>Consolidated Condensed Statement of Stockholders' Equity</u>	6
	<u>Consolidated Condensed Statements of Cash Flows</u>	7
	<u>Notes to Consolidated Condensed Financial Statements</u>	8
ITEM 2.	<u>Management's Discussion and Analysis of Financial</u>	
	<u>Condition and Results of Operations</u>	34
	<u>Quantitative and Qualitative Disclosures About Market</u>	
ITEM 3.	<u>Risk</u>	46
ITEM 4.	<u>Controls and Procedures</u>	46
PART II. Other Information:		
ITEM 1.	<u>Legal Proceedings</u>	47
ITEM 1.A.	<u>Risk Factors</u>	47
	<u>Unregistered Sales of Equity Securities and Use of</u>	
ITEM 2.	<u>Proceeds</u>	47
ITEM 3.	<u>Defaults Upon Senior Securities</u>	47
ITEM 4.	<u>[RESERVED]</u>	47
ITEM 5.	<u>Other Information</u>	47
ITEM 6.	<u>Exhibits</u>	48
	<u>Signatures</u>	49
	<u>Index to Exhibits</u>	50

FIRST MERCHANTS CORPORATION
FORM 10Q

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
CONSOLIDATED CONDENSED BALANCE SHEETS
(Dollars in thousands)

	June 30, 2011	December 31, 2010
	(Unaudited)	
ASSETS		
Cash and due from banks	\$ 50,874	\$ 50,844
Federal funds sold		7,463
Cash and cash equivalents	50,874	58,307
Interest-bearing time deposits	15,865	65,216
Investment securities available for sale	591,212	539,370
Investment securities held to maturity	347,154	287,427
Mortgage loans held for sale	4,846	21,469
Loans, net of allowance for loan losses of \$77,133 and \$82,977	2,646,889	2,752,706
Premises and equipment	51,851	52,450
Federal Reserve and Federal Home Loan Bank stock	31,384	33,884
Interest receivable	17,001	18,674
Core deposit intangibles	10,460	12,662
Goodwill	141,357	141,357
Cash surrender value of life insurance	102,880	96,731
Other real estate owned	15,437	20,927
Tax asset, deferred and receivable	36,790	45,623
Other assets	30,218	24,045
TOTAL ASSETS	\$ 4,094,218	\$ 4,170,848
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 590,199	\$ 583,696
Interest-bearing	2,552,334	2,685,184
Total Deposits	3,142,533	3,268,880
Borrowings:		
Federal Funds purchased	22,978	
Securities sold under repurchase agreements	124,236	109,871
Federal Home Loan Bank advances	74,050	82,684
Subordinated debentures, revolving credit lines and term loans	226,580	226,440
Total Borrowings	447,844	418,995
Interest payable	3,601	4,262
Other liabilities	31,762	24,303
Total Liabilities	3,625,740	3,716,440
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY		
Preferred Stock, no-par value:		
Authorized -- 500,000 shares		

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Series A, Issued and outstanding - 69,600 shares	68,118	67,880
Cumulative Preferred Stock, \$1,000 par value, \$1,000 liquidation value:		
Authorized -- 600 shares		
Issued and outstanding -- 125 shares	125	125
Common Stock, \$.125 stated value:		
Authorized -- 50,000,000 shares		
Issued and outstanding - 25,690,649 and 25,574,251 shares	3,211	3,197
Additional paid-in capital	233,544	232,503
Retained earnings	169,313	160,860
Accumulated other comprehensive loss	(5,833)	(10,157)
Total Stockholders' Equity	468,478	454,408
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 4,094,218	\$ 4,170,848

See notes to consolidated condensed financial statements.

FIRST MERCHANTS CORPORATION
FORM 10Q

CONSOLIDATED CONDENSED STATEMENTS OF INCOME
(Dollars in thousands, except per share amounts)
(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
INTEREST INCOME				
Loans receivable:				
Taxable	\$ 37,457	\$ 43,977	\$ 76,195	\$ 89,425
Tax exempt	247	252	349	529
Investment securities:				
Taxable	5,040	3,286	9,587	6,177
Tax exempt	2,535	2,548	5,088	5,194
Federal funds sold	1	3	3	20
Deposits with financial institutions	100	95	183	155
Federal Reserve and Federal Home Loan Bank stock	341	330	682	690
Total Interest Income	45,721	50,491	92,087	102,190
INTEREST EXPENSE				
Deposits	5,864	10,520	12,730	22,015
Federal funds purchased	3	4	6	4
Securities sold under repurchase agreements	386	429	764	928
Federal Home Loan Bank advances	977	1,440	1,978	3,004
Subordinated debentures, revolving credit lines and term loans	2,644	1,919	5,285	3,845
Total Interest Expense	9,874	14,312	20,763	29,796
NET INTEREST INCOME	35,847	36,179	71,324	72,394
Provision for loan losses	5,625	15,015	11,219	28,884
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	30,222	21,164	60,105	43,510
OTHER INCOME				
Service charges on deposit accounts	2,997	3,506	5,776	6,768
Fiduciary activities	1,929	1,978	3,965	4,038
Other customer fees	2,634	2,195	4,869	4,693
Commission income	1,024	1,487	2,912	3,476
Earnings on cash surrender value of life insurance	571	526	1,149	1,034
Net gains and fees on sales of loans	1,030	1,185	2,903	2,334
Net realized gains on sales of available for sale securities	825	257	1,288	2,099
Other-than-temporary impairment on available for sale securities		(1,307)	(2,775)	(1,787)
Portion of loss recognized in other comprehensive income before taxes		907	2,375	899
Net impairment losses recognized in earnings		(400)	(400)	(888)
Other income	51	208	457	352
Total Other Income	11,061	10,942	22,919	23,906
OTHER EXPENSES				
Salaries and employee benefits	18,560	17,942	35,736	35,504

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Net occupancy	2,415	2,058	5,160	4,909
Equipment	1,677	1,861	3,460	3,714
Marketing	436	495	818	924
Outside data processing fees	1,458	1,311	2,903	2,591
Printing and office supplies	313	321	601	639
Core deposit amortization	1,101	1,192	2,202	2,399
FDIC assessments	1,451	2,243	3,555	3,965
Other real estate owned and credit-related expenses	2,843	1,503	6,038	4,188
Other expenses	4,145	5,417	7,807	10,150
Total Other Expenses	34,399	34,343	68,280	68,983
INCOME (LOSS) BEFORE INCOME TAX	6,884	(2,237)	14,744	(1,567)
Income tax expense (benefit)	1,396	(1,894)	3,795	(2,810)
NET INCOME (LOSS)	5,488	(343)	10,949	1,243
Gain on exchange of preferred stock for trust preferred debt		10,052		10,052
Preferred stock dividends and discount accretion	(990)	(1,443)	(1,978)	(2,893)
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$ 4,498	\$ 8,266	\$ 8,971	\$ 8,402
Per Share Data:				
Basic Net Income Available to Common Stockholders	\$ 0.18	\$ 0.35	\$ 0.35	\$ 0.36
Diluted Net Income Available to Common Stockholders	\$ 0.18	\$ 0.35	\$ 0.35	\$ 0.36
Cash Dividends Paid	\$ 0.01	\$ 0.01	\$ 0.02	\$ 0.02
Average Diluted Shares Outstanding (in thousands)	25,783	25,633	25,773	23,555

See notes to consolidated condensed financial statements.

FIRST MERCHANTS CORPORATION
FORM 10Q

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(Dollars in thousands)
(Unaudited)

	Three Months Ended June, 30		Six Months Ended June 30,	
	2011	2010	2011	2010
Net income	\$ 5,488	\$ (343)	\$ 10,949	\$ 1,243
Other comprehensive income net of tax:				
Unrealized holding gain on securities available for sale arising during the period, net of income tax of \$(1,099), \$(3,144), \$(3,674), and \$(3,891)	2,041	5,838	6,823	7,226
Unrealized loss on securities available for sale for which a portion of an other than temporary impairment has been recognized in income, net of tax of \$0, \$318, \$844, and \$314		(590)	(1,568)	(584)
Unrealized loss on cash flow hedges:				
Unrealized loss arising during the period, net of income tax of \$217, \$0, \$170, and \$0	(403)		(316)	
Amortization of items previously recorded in accumulated other comprehensive income/(losses), net of income tax of \$11, \$(15), \$20, and \$(30)	(20)	22	(38)	45
Reclassification adjustment for gains included in net income net of income tax expense of \$289, \$(50), \$311, and \$424	(537)	93	(577)	(787)
	1,081	5,363	4,324	5,900
Comprehensive income	\$ 6,569	\$ 5,020	\$ 15,273	\$ 7,143

The components of accumulated other comprehensive loss, included in stockholders' equity, are as follows:

	June 30, 2011	December 31, 2010
Net unrealized gain on securities available for sale	\$ 8,008	\$ 2,767
Net unrealized loss on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in income	(1,568)	(1,001)
Net unrealized loss on cash flow hedges	(29)	288
Defined benefit plans	(12,244)	(12,211)

\$ (5,833) \$ (10,157)

See notes to consolidated condensed financial statements.

5

FIRST MERCHANTS CORPORATION
FORM 10Q

CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY
(Dollars in thousands, except per share data)
(Unaudited)

	Preferred		Common Stock		Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total
	Shares	Amount	Shares	Amount			(Loss)	
Balances, December 31, 2010	69,725	\$ 68,005	25,574,251	\$ 3,197	\$ 232,503	\$ 160,860	\$ (10,157)	\$ 454,408
Comprehensive Income								
Net Income						10,949		10,949
Other Comprehensive Income, net of tax							4,324	4,324
Cash Dividends on Common Stock (\$.02 per Share)						(518)		(518)
Cash Dividends on Preferred Stock under Capital Purchase Program						(1,740)		(1,740)
Accretion of Discount on Preferred Stock		238				(238)		-
Share-based Compensation			68,205	9	709			718
Stock Issued Under Employee Benefit Plans			58,021	7	419			426
Stock Issued Under Dividend Reinvestment and Stock Purchase Plan			4,155	1	34			35
Stock Redeemed			(13,983)	(3)	(121)			(124)
Balances, June 30, 2011	69,725	\$ 68,243	25,690,649	\$ 3,211	\$ 233,544	\$ 169,313	\$ (5,833)	\$ 468,478

See notes to consolidated condensed financial statements.

FIRST MERCHANTS CORPORATION
FORM 10Q

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS
(Dollars in thousands)
(Unaudited)

	June 30,	
	2011	2010
Cash Flow From Operating Activities:		
Net income	\$ 10,949	\$ 1,243
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	11,219	28,884
Depreciation and amortization	2,571	2,889
Share-based compensation	718	933
Tax expense from stock compensation		50
Mortgage loans originated for sale	(106,979)	(84,105)
Proceeds from sales of mortgage loans	123,602	84,541
Gains on sales of securities available for sale	(1,288)	(2,099)
Recognized loss on other-than-temporary-impairment	400	888
Change in interest receivable	1,673	1,924
Change in interest payable	(661)	(800)
Other adjustments	15,250	11,862
Net cash provided by operating activities	\$ 57,454	\$ 46,210
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	\$ 49,351	\$ 33,202
Purchases of:		
Securities available for sale	(93,887)	(152,085)
Securities held to maturity	(75,971)	(34,724)
Proceeds from sales of securities available for sale	25,911	64,314
Proceeds from maturities of:		
Securities available for sale	22,237	38,407
Securities held to maturity	15,362	12,974
Proceeds from redemptions of Federal Reserve and Federal Home Loan Bank stock	2,500	2,358
Purchase of bank owned life insurance	(5,000)	
Net change in loans	80,883	169,200
Proceeds from the sale of other real estate owned	5,349	8,084
Other adjustments	7,929	(522)
Net cash provided by investing activities	\$ 34,664	\$ 141,208
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	\$ (12,918)	\$ (65,772)
Certificates of deposit and other time deposits	(113,429)	(209,801)
Proceeds from borrowings	62,351	8
Repayment of borrowings	(33,634)	(47,391)
Cash dividends on common stock	(518)	(472)
Cash dividends on preferred stock	(1,740)	(3,190)
Stock issued in private equity placement		24,150
Stock issued under dividend reinvestment and stock purchase plans	461	345

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Tax (expense) benefit from stock options exercised		(50)
Stock redeemed	(124)	(68)
Net cash used in financing activities	\$ (99,551)	\$ (302,241)
Net Change in Cash and Cash Equivalents	(7,433)	(114,823)
Cash and Cash Equivalents, January 1	58,307	179,147
Cash and Cash Equivalents, June 30	\$ 50,874	\$ 64,324
Additional cash flow information:		
Interest paid	\$ 21,424	\$ 30,597
Income tax refunded	\$ 2,977	\$ 6,044
Exchange of preferred stock for trust preferred debt		\$ 46,400
Loans transferred to other real estate owned	\$ 3,814	\$ 15,197
Non-cash investing activities using trade date accounting	\$ 1,036	\$ 1,602

See notes to consolidated condensed financial statements.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 1. General

Financial Statement Preparation

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

The consolidated condensed balance sheet of the Corporation as of December 31, 2010, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation's annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation's Form 10-K annual report filed with the Securities and Exchange Commission. The results of operations for the six months ended June 30, 2011, are not necessarily indicative of the results to be expected for the year.

NOTE 2. Investment Securities

The amortized cost and approximate fair values of securities are as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at June 30, 2011				
U.S. Government-sponsored agency securities	\$ 99	\$ 14		\$ 113
State and municipal	229,743	9,059	\$ 289	238,513
Mortgage-backed securities	342,582	7,131	568	349,145
Corporate obligations	5,610		5,434	176
Equity securities	3,265			3,265
Total available for sale	581,299	16,204	6,291	591,212
Held to maturity at June 30, 2011				
State and municipal	13,152	35	9	13,178
Mortgage-backed securities	334,002	5,799	1,114	338,687
Total held to maturity	347,154	5,834	1,123	351,865
Total Investment Securities	\$ 928,453	\$ 22,038	\$ 7,414	\$ 943,077

Amortized Cost

Fair Value

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

			Gross Unrealized Gains		Gross Unrealized Losses	
Available for sale at December 31, 2010						
U.S. Government-sponsored agency securities	\$	600	\$	16	\$	616
State and municipal		233,622		7,108	\$	740
Mortgage-backed securities		293,311		4,293		2,287
Corporate obligations		5,856				5,674
Equity securities		3,265				3,265
Total available for sale		536,654		11,417		8,701
Held to maturity at December 31, 2010						
State and municipal		10,070		389		5
Mortgage-backed securities		277,357		2,064		3,605
Total held to maturity		287,427		2,453		3,610
Total Investment Securities	\$	824,081	\$	13,870	\$	12,311
					\$	825,640

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Investment Securities continued

The amortized cost and fair value of available for sale securities and held to maturity securities at June 30, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Maturity Distribution at June 30, 2011:				
Due in one year or less	\$ 4,379	\$ 4,398	\$ 3,234	\$ 3,234
Due after one through five years	13,602	13,917	1,447	1,450
Due after five through ten years	51,766	54,546	4,883	4,901
Due after ten years	165,705	165,941	3,588	3,593
	\$ 235,452	\$ 238,802	\$ 13,152	\$ 13,178
Mortgage-backed securities	342,582	349,145	334,002	338,687
Equity securities	3,265	3,265		
Total Investment Securities	\$ 581,299	\$ 591,212	\$ 347,154	\$ 351,865

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$285,731,000 at June 30, 2011 and \$271,091,000 at December 31, 2010.

The book value of securities sold under agreements to repurchase amounted to \$98,718,000 at June 30, 2011, and \$84,965,000 at December 31, 2010.

For the three and six months ended June 30, 2011 gross gains of \$825,000 and \$1,288,000 were realized from sales and redemptions of available for sale securities. For the three and six months ended June 30, 2010 gross gains of \$482,000 and \$2,324,000 were realized from sales and redemptions of available for sale securities. There were no gross losses resulting from sales and redemptions of available for sale securities realized for the three and six months ended June 30, 2011. Gross losses of \$225,000 resulting from the sales and redemptions of available for sale securities were recognized for both the three and six months ended June 30, 2010. The Corporation did not recognize any other-than-temporary ("OTTI") loss in the three months ending June 30, 2011, but did recognize a \$400,000 OTTI loss in the three months ended June 30, 2010, equal to the credit loss, establishing a new, lower amortized cost basis. The Corporation has recognized OTTI losses of \$400,000 and \$888,000 in the six months ended June 30, 2011 and 2010, equal to the credit loss, establishing a new, lower amortized cost basis.

Certain investments in debt and equity securities are reported in the financial statements at an amount less than their historical cost. The historical cost of these investments totaled \$184,106,000 and \$273,853,000 at June 30, 2011, and December 31, 2010, respectively. Total fair value of these investments at June 30, 2011, and December 31, 2010, was \$176,691,000 and \$261,542,000, which is approximately 18.8 percent and 31.6 percent of the Corporation's available

for sale and held to maturity investment portfolio at June 30, 2011, and December 31, 2010.

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

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Investment Securities continued

The following table shows the Corporation's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2011, and December 31, 2010:

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Investment						
Securities at June 30, 2011						
State and municipal	\$ 18,760	\$ (298)			\$ 18,760	\$ (298)
Mortgage-backed securities	157,787	(1,682)			157,787	(1,682)
Corporate obligations			\$ 144	\$ (5,434)	144	(5,434)
Total Temporarily Impaired Investment Securities	\$ 176,547	\$ (1,980)	\$ 144	\$ (5,434)	\$ 176,691	\$ (7,414)

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Investment						
Securities at December 31, 2010						
State and municipal	\$ 31,796	\$ (745)			\$ 31,796	\$ (745)
Mortgage-backed securities	229,441	(5,892)	\$ 154		229,595	(5,892)
Corporate obligations			151	\$ (5,674)	151	(5,674)
Total Temporarily Impaired Investment Securities	\$ 261,237	\$ (6,637)	\$ 305	\$ (5,674)	\$ 261,542	\$ (12,311)

Mortgage-backed Securities

The unrealized losses of \$1.7 million on the Corporation's investment in mortgage-backed securities were a result of changes in interest rates. The Corporation expects to recover the amortized cost basis over the term of the securities as the decline in market value is attributable to changes in interest rates and not credit quality. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at June 30, 2011.

State and Municipal

The unrealized losses of \$298,000 on the Corporation's investment in securities of state and political subdivisions were caused by changes in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at June 30, 2011.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Investment Securities continued

Corporate Obligations

The Corporation's unrealized losses on pooled trust preferred securities total \$5.4 million on a book value of \$5.6 million at June 30, 2011. The decline in value is attributable to temporary illiquidity and the financial crisis affecting these markets coupled with the potential credit loss resulting from the adverse change in expected cash flows. Due to the illiquidity in the market, it is unlikely that the Corporation would be able to recover its investment in these securities if the Corporation sold the securities at this time. Management has analyzed the cash flow characteristics of the securities and this analysis included utilizing the most recent trustee reports and any other relevant market information, including announcements of deferrals or defaults of trust preferred securities. The Corporation did not recognize any OTTI losses in the three months ending June 30, 2011. The Corporation has recognized an OTTI loss of \$400,000 in the six months ended June 30, 2011, equal to the credit loss, establishing a new, lower amortized cost basis. The credit loss was calculated by comparing expected discounted cash flows based on performance indicators of the underlying assets in the security to the carrying value of the investment. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the remainder of the investment securities, which are classified as Level 3 inputs in the fair value hierarchy, to be other-than-temporarily impaired at June 30, 2011.

Credit Losses Recognized on Investments

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

	Accumulated Credit Losses in 2011	Accumulated Credit Losses in 2010
Credit losses on debt securities held:		
Balance, January 1	\$ 10,955	\$ 9,411
Additions related to other-than-temporary losses not previously recognized	400	888
Balance, June 30	\$ 11,355	\$ 10,299

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance

The Corporation's primary lending focus is small business and middle market commercial and residential real estate, auto and small consumer lending, which results in portfolio diversification. The following tables show the composition in our loan portfolio, loan grades and the allowance for loan losses excluding loans held for sale. Residential real estate loans held for sale at June 30, 2011 and December 31, 2010 were \$4,846,000 and \$21,469,000, respectively.

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

	June 30, 2011	December 31, 2010
Loans:		
Commercial and industrial loans	\$ 529,742	\$ 530,322
Agricultural production financing and other loans to farmers	99,360	95,516
Real estate loans:		
Construction	96,308	106,615
Commercial and farm land	1,171,901	1,229,037
Residential	495,256	522,051
Home Equity	191,839	201,969
Individual's loans for household and other personal expenditures	94,123	115,295
Lease financing receivables, net of unearned income	4,399	5,157
Other loans	41,094	29,721
	2,724,022	2,835,683
Allowance for loan losses	(77,133)	(82,977)
Total Loans	\$ 2,646,889	\$ 2,752,706

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

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

Management believes that the allowance for loan losses is adequate to cover probable incurred losses inherent in the loan portfolio at June 30, 2011. The process for determining the adequacy of the allowance for loan losses is critical

to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments, as estimates about the effect of uncertain matters are needed. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examination processes and will increase or decrease as deemed necessary to ensure the allowance for loan losses remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, loan mix and collateral values.

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

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

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

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

Commercial

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

Commercial real estate

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

Residential and Consumer

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

is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

The following tables summarize changes in the allowance for loan losses by loan segment for the three and six months ended June 30, 2011:

	Three Months Ended June 30, 2011					Total
	Commercial	Real Estate Commercial	Consumer	Residential	Finance Leases	
Allowance for loan losses:						
Balances, April 1	\$ 30,206	\$ 37,240	\$ 3,098	\$ 10,371	\$ 21	\$ 80,936
Provision for losses	(11,993)	14,264	(253)	3,617	(10)	5,625
Recoveries on loans	6,351	545	332	225	3	7,456
Loans charged off	(849)	(13,381)	(318)	(2,336)	-	(16,884)
Balances, June 30, 2011	\$ 23,715	\$ 38,668	\$ 2,859	\$ 11,877	\$ 14	\$ 77,133

	Six Months Ended June 30, 2011					Total
	Commercial	Real Estate Commercial	Consumer	Residential	Finance Leases	
Allowance for loan losses:						
Balances, January 1	\$ 32,508	\$ 36,341	\$ 3,622	\$ 10,408	\$ 98	\$ 82,977
Provision for losses	(13,875)	21,190	(468)	4,459	(87)	11,219
Recoveries on loans	6,998	866	618	697	3	9,182
Loans charged off	(1,916)	(19,729)	(913)	(3,687)	-	(26,245)
Balances, June 30, 2011	\$ 23,715	\$ 38,668	\$ 2,859	\$ 11,877	\$ 14	\$ 77,133

The following tables summarize changes in the allowance for loan losses for the year ended December 31, 2010:

	2010
Allowance for loan losses:	
Balance, January 1	\$ 92,131
Provision for losses	46,483
Recoveries on loans	11,935
Loans charged off	(67,572)
Balance, December 31, 2010	\$ 82,977

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

The following table shows the Corporation's allowance for credit losses and loan portfolio by loan segment for the periods indicated:

	June 30, 2011						Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases		
Allowance Balances:							
Individually evaluated for impairment	\$ 7,882	\$ 4,995	\$ -	\$ 838	\$ -		\$ 13,715
Collectively evaluated for impairment	15,833	33,673	2,859	11,039	14		63,418
Total Allowance for Loan Losses	\$ 23,715	\$ 38,668	\$ 2,859	\$ 11,877	\$ 14		\$ 77,133
Loan Balances (includes loans held for sale):							
Individually evaluated for impairment	\$ 34,584	\$ 62,718	\$ -	\$ 11,022	\$ -		\$ 108,324
Collectively evaluated for impairment	635,612	1,205,491	94,123	676,073	4,399		2,615,698
Total Loans	\$ 670,196	\$ 1,268,209	\$ 94,123	\$ 687,095	\$ 4,399		\$ 2,724,022
	December 31, 2010						Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases		
Allowance Balances:							
Individually evaluated for impairment	\$ 5,726	\$ 7,545	\$ -	\$ 643	\$ -		\$ 13,914
Collectively evaluated for impairment	26,782	28,796	3,622	9,765	98		69,063
Total Allowance for Loan Losses	\$ 32,508	\$ 36,341	\$ 3,622	\$ 10,408	\$ 98		\$ 82,977
Loan Balances (includes loans held for sale):							
Individually evaluated for impairment	\$ 28,965	\$ 77,705	\$ -	\$ 9,534	\$ -		\$ 116,204
Collectively evaluated for impairment	626,594	1,257,947	115,295	714,486	5,157		2,719,479
Total Loans	\$ 655,559	\$ 1,335,652	\$ 115,295	\$ 724,020	\$ 5,157		\$ 2,835,683

Information on non-performing assets, including non-accruing, real estate owned and renegotiated loans, plus accruing loans contractually past due 90 days or more, is summarized below:

	June 30, 2011	December 31, 2010
Non-Performing Assets:		
Non-accrual loans	\$ 87,583	\$ 90,591
Renegotiated loans	6,269	7,139
Non-performing loans (NPL)	93,852	97,730
Real estate owned and repossessed assets	15,437	20,927
Non-performing assets (NPA)	109,289	118,657
90+ days delinquent and still accruing	227	1,330
NPAs & 90+ days delinquent	\$ 109,516	\$ 119,987

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

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

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

Non Accruals by Class

	June 30, 2011	December 31, 2010
Commercial and Industrial	\$ 21,097	\$ 9,812
Agriculture production financing and other loans	306	544
Real Estate Loans:		
Construction	14,121	17,164
Commercial and farm land	33,787	45,308
Residential	14,948	15,115
Home Equity	2,723	2,648
Individuals loans for household and other personal expenditures		
Lease financing receivables, net of unearned income		
Other Loans	601	
Total	\$ 87,583	\$ 90,591

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

Impaired loans are measured by the present value of expected future cash flows or the fair value of the collateral of the loans, if collateral dependent. The fair value for impaired loans is measured based on the value of the collateral securing those loans and is determined using several methods. The fair value of real estate is generally based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically valued by using the financial information such as financial statements and aging reports provided by the borrower and is discounted as considered appropriate.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

The following table shows the composition of the Corporation's impaired loans by loan class as of June 30, 2011, and December 31, 2010:

	June 30, 2011			Three Months Ended June 30, 2011		Six Months Ended June 30, 2011	
	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Impaired loans with no related allowance:							
Commercial and industrial	\$ 30,307	\$ 18,532		\$ 19,087	\$ 152	\$ 19,857	\$ 285
Agriculture production financing and other loans to farmers	705	306		312	-	385	-
Real Estate Loans:							
Construction	20,435	13,286		14,485	-	15,661	-
Commercial and farm land	53,747	33,538		35,939	205	37,301	401
Residential	8,495	6,151		6,391	2	6,566	5
Home equity	5,272	2,026		1,816	4	1,816	8
Individuals loans for household and other personal expenditures	-	-		-	-	-	-
Lease financing receivables, net of unearned income	-	-		-	-	-	-
Other loans	94	12		12	-	13	-
Total	\$ 119,055	\$ 73,851		\$ 78,042	\$ 363	\$ 81,599	\$ 699
Impaired loans with related allowance:							
Commercial and industrial	\$ 15,284	\$ 15,144	\$ 7,284	\$ 15,262	\$ 44	\$ 15,324	\$ 127
Agriculture production financing and other loans to farmers	-	-	-	-	-	-	-
Real Estate Loans:							

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Construction	677	677	301	697	-	707	-
Commercial and farm land	16,982	15,214	4,694	16,378	43	16,797	67
Residential	2,907	2,846	838	2,944	8	2,991	15
Home equity	-	-	-	-	-	-	-
Individuals loans for household and other personal expenditures	-	-	-	-	-	-	-
Lease financing receivables, net of unearned income	-	-	-	-	-	-	-
Other loans	604	592	598	601	-	605	-
Total	\$ 36,454	\$ 34,473	\$ 13,715	\$ 35,882	\$ 95	\$ 36,424	\$ 209
Total Impaired Loans	\$ 155,509	\$ 108,324	\$ 13,715	\$ 113,924	\$ 458	\$ 118,023	\$ 908

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

	December 31, 2010		
	Unpaid Principal Balance	Recorded Investment	Related Allowance
Impaired loans with no related allowance recorded:			
Commercial and industrial	\$ 30,006	\$ 16,572	
Agriculture production financing and other loans to farmers	966	530	
Real Estate Loans:			
Construction	12,598	9,150	
Commercial and farm land	64,064	43,653	
Residential	7,909	5,153	
Home equity	4,460	1,245	
Individuals loans for household and other personal expenditures			
Lease financing receivables, net of unearned income			
Other loans	101	14	
Total	\$ 120,104	\$ 76,317	
Impaired loans with an allowance recorded:			
Commercial and industrial	\$ 11,477	\$ 11,374	\$ 5,250
Agriculture production financing and other loans to farmers			
Real Estate Loans:			
Construction	9,353	7,824	2,049
Commercial and farm land	17,984	17,076	5,496
Residential	2,740	2,691	465
Home equity	458	446	178
Individuals loans for household and other personal expenditures			
Lease financing receivables, net of unearned income			
Other loans	476	476	476
Total	\$ 42,488	\$ 39,887	\$ 13,914
Total Impaired Loans	\$ 162,592	\$ 116,204	\$ 13,914

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

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

The Corporation utilizes a risk grading of pass, special mention, substandard, doubtful and loss to assess the overall credit quality of large commercial loans. A description of the general characteristics of these grades is as follows:

- Pass – Loans that are considered to be of acceptable credit quality.
- Special Mention – Loans which possess some credit deficiency or potential weakness, which deserves close attention. A special mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Corporation’s credit position at some future date. Special mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification. Such loans pose an unwarranted financial risk that, if not corrected, could weaken the loan adversely impacting the future repayment ability of the borrower. The key distinctions of this category’s classification are that it is indicative of an unwarranted level of risk; and weaknesses are considered “potential”, not “defined”, impairments to the primary source of repayment. Examples include businesses that may be suffering from inadequate management, loss of key personnel or significant customer or litigation.
- Substandard – A substandard loan is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness that jeopardizes the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Other characteristics may include:
 - o the likelihood that a loan will be paid from the primary source of repayment is uncertain or financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss,
 - o the primary source of repayment is gone, and the Corporation is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees,
 - o loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
 - o unusual courses of action are needed to maintain a high probability of repayment,
 - o the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
 - o the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
 - o loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
 - o the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
 - o there is significant deterioration in market conditions to which the borrower is highly vulnerable.
- Doubtful – Loans that have all of the weaknesses of those classified as Substandard. However, based on currently existing facts, conditions and values, these weaknesses make full collection of principal highly questionable and improbable. Other credit characteristics may include the primary source of repayment is gone or there is considerable doubt as to the quality of the secondary sources of repayment. The possibility of loss is high, but because of certain important pending factors that may strengthen the loan, loss classification is deferred until the exact status of repayment is known.
 - Loss – Loans that are considered uncollectible and of such little value that continuing to carry them as an asset is not warranted. Loans will be classified as Loss when it is neither practical nor desirable to defer writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be

possible at some time in the future.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

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

	June 30, 2011							
	Commercial							
	Commercial Pass	Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total Loans
Commercial and industrial	\$ 459,932	\$ 18,628	\$ 49,110	\$ 2,072	\$ -	\$ -	\$ -	\$ 529,742
Agriculture production financing and other loans	94,721	2,308	2,331	-	-	-	-	99,360
Real Estate Loans:								-
Construction	65,630	6,415	19,321	4,785	-	-	157	96,308
Commercial and farm land	997,215	38,929	131,089	4,628	-	-	40	1,171,901
Residential	134,058	11,904	19,190	678	-	322,710	6,716	495,256
Home equity	15,488	25	3,605	12	-	171,697	1,012	191,839
Individuals loans for household and other personal expenditures	-	-	-	-	-	94,122	1	94,123
Lease financing receivables, net of unearned income	162	-	9	-	-	4,228	-	4,399
Other loans	40,324	76	102	592	-	-	-	41,094
Total	\$ 1,807,530	\$ 78,285	\$ 224,757	\$ 12,767	\$ -	\$ 592,757	\$ 7,926	\$ 2,724,022

	December 31, 2010							
	Commercial							
	Commercial Pass	Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total Loans
Commercial and industrial	\$ 454,305	\$ 19,928	\$ 53,199	\$ 2,870	\$ 20			\$ 530,322
Agriculture production financing and other	92,293	574	2,649					95,516

loans

Real Estate Loans:								
Construction	66,918	10,100	28,167	1,430				106,615
Commercial and farm land	1,038,861	38,676	146,213	5,287				1,229,037
Residential	144,163	9,220	18,747	1,169	\$ 340,932	\$ 7,820		522,051
Home equity	17,913	283	2,872	524	178,470	1,907		201,969
Individuals loans for household and other personal expenditures						115,239	56	115,295
Lease financing receivables, net of unearned income	280		18		4,859			5,157
Other loans	27,642	1,295	784					29,721
Total	\$ 1,842,375	\$ 80,076	\$ 252,649	\$ 11,280	\$ 20	\$ 639,500	\$ 9,783	\$ 2,835,683

20

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

The following table shows a past due aging of the Corporation's loan portfolio, by loan class for June 30, 2011, and December 31, 2010:

	June 30, 2011						
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total Loans
Commercial and industrial	\$ 506,817	\$ 1,664	\$ 149	\$ 15	\$ 21,097	\$ 22,925	\$ 529,742
Agriculture production financing and other loans	98,930	124	-	-	306	430	99,360
Real Estate Loans:							
Construction	81,819	138	230	-	14,121	14,489	96,308
Commercial and farm land	1,120,389	6,056	11,669	-	33,787	51,512	1,171,901
Residential	472,620	5,327	2,248	113	14,948	22,636	495,256
Home equity	186,969	1,451	598	98	2,723	4,870	191,839
Individuals loans for household and other personal expenditures	92,812	1,139	171	1	-	1,311	94,123
Lease financing receivables, net of unearned income	4,399	-	-	-	-	-	4,399
Other loans	40,493	-	-	-	601	601	41,094
Total	\$ 2,605,248	\$ 15,899	\$ 15,065	\$ 227	\$ 87,583	\$ 118,774	\$ 2,724,022

	December 31, 2010						
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual	Total Past Due & Non-Accrual	Total Loans
Commercial and industrial	\$ 518,683	\$ 1,477	\$ 211	\$ 139	\$ 9,812	\$ 11,639	\$ 530,322
Agriculture production financing and other loans	94,972				544	544	95,516
Real Estate Loans:							
Construction	86,710	1,543	996	202	17,164	19,905	106,615

Commercial and farm land	1,171,580	6,769	5,380	-	45,308	57,457	1,229,037
Residential	498,066	5,261	3,363	246	15,115	23,985	522,051
Home equity	196,276	1,825	534	686	2,648	5,693	201,969
Individuals loans for household and other personal expenditures	112,760	1,989	489	57		2,535	115,295
Lease financing receivables, net of unearned income	5,157					-	5,157
Other loans	29,721					-	29,721
Total	\$ 2,713,925	\$ 18,864	\$ 10,973	\$ 1,330	\$ 90,591	\$ 121,758	\$ 2,835,683

See the information regarding the analysis of loan loss experience in the Loan Quality/Provision for Loan Losses section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as ITEM 2 of this Form 10-Q.

Note 4. Goodwill

During 2009, the impact of deteriorating economic conditions had significantly impacted the banking industry and the financial results of the Corporation. As a result, while only required to test goodwill annually, the Corporation decided to test its goodwill for impairment on three separate occasions during 2009. In 2010, the Corporation returned to its annual testing of goodwill for impairment, most recently as of November 30, 2010.

The Corporation used an independent, outside firm to help determine the fair value of the Corporation for purposes of the first step of the impairment test. The Discounted Earnings method (an Income Approach) as well as the Guideline Publicly Traded Company Method and the Transaction Method (both Market Approaches that apply market multiples to various financial metrics to derive value) were used and weighted to form the conclusion of fair value. The Discounted Earnings method was given primary weight in the fair value analysis.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

Note 4. Goodwill continued

The Discounted Earnings method was based primarily on: 1) management projections derived from expected balance sheet and income statement assumptions, based on current economic conditions, which continue to show signs of stabilization from 2009, improvements in 2010 and continued improvements going forward; 2) present value factors based on an implied market cost of equity, and 3) historic (long-term) price-to-earnings multiples for comparable companies. Determining the Corporation's fair value using the Discounted Earnings method involves a significant amount of judgment. The methodology is largely based on unobservable level three inputs. The test results are dependent upon attaining actual financial results consistent with the forecasts and assumptions used in the valuation model. The Discounted Earnings method relied on a terminal Price/Earnings ("P/E") multiple. The P/E multiple used to determine terminal value was notably lower than the historic P/E multiple observed for the Corporation, the peer group, and the NASDAQ community banking index (ABAQ). Based on the results of the step one analysis, the fair value exceeded the Corporation's carrying value; therefore, it was concluded goodwill is not impaired.

Additionally, a sensitivity analysis was performed on the Discounted Earnings methodology by testing a range of the following metrics: 1) implied market cost of equity; and 2) historic (long-term) price-to-earnings multiples for comparable companies. Based on the sensitivity testing, at the low-end of the sensitivity test range (for both metrics), the fair value of the Corporation exceeded its carrying value. For reasons that include but are not limited to the aforementioned, management believes the Corporation's recently traded stock price is not indicative of fair value.

NOTE 5. Derivative Financial Instruments

Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. As of June 30, 2011, the Corporation had one interest rate swap with a notional amount of \$13 million and one interest rate cap with a notional amount of \$13 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2011, such derivatives were used to hedge the forecasted LIBOR-based outflows associated with existing trust preferred securities when the outflows convert from a fixed rate to variable rate in September 2012. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the six months ended June 30, 2011, the Corporation did not recognize any ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation does not expect to reclassify any amounts from accumulated other comprehensive income to interest expense.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 5. Derivative Financial Instruments continued

Non-designated Hedges

The Corporation does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Corporation provides to certain customers. The Corporation executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Corporation executes with a third party, such that the Corporation minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of June 30, 2011, the notional amount of customer-facing swaps was approximately \$80,058,000. This amount is offset with third party counterparties, as described above.

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Corporation's derivative financial instruments as well as their classification on the Balance Sheet as of June 30, 2011 and December 31, 2010.

	Asset Derivatives				Liability Derivatives			
	June 30, 2011		December 31, 2010		June 30, 2011		December 31, 2010	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:								
Interest rate contracts	Other Assets	\$ 954	Other Assets	\$ 1,393	Other Liabilities	\$ 47	Other Liabilities	\$
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	\$ 3,783	Other Assets	\$ 3,718	Other Liabilities	\$ 3,939	Other Liabilities	\$ 3,876

Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Corporation's derivative financial instruments on the Income Statement for the three and six months ended June 30, 2011 and June 30, 2010.

Derivatives Not Designated as	Location of Gain (Loss)	Amount of Gain (Loss) Recognized	Amount of Gain (Loss) Recognized
-------------------------------	-------------------------	----------------------------------	----------------------------------

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Hedging Instruments under ASC 815-10	Recognized Income on Derivative	Income on Derivative	Income on Derivative
		Three Months Ended June 30, 2011	Six Months Ended June 30, 2011
Interest rate contracts	Other income	\$ (21)	\$ 2

Derivatives Not Designated as Hedging Instruments under ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative	Amount of Gain (Loss) Recognized Income on Derivative
		Three Months Ended June 30, 2010	Six Months Ended June 30, 2010
Interest rate contracts	Other income	\$ (207)	\$ (213)

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

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 5. Derivative Financial Instruments continued

Credit-risk-related Contingent Features

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

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

As of June 30, 2011, the termination value of derivatives in a net liability position related to these agreements was \$4,196,000. As of June 30, 2011, the Corporation has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$4,120,000. If the Corporation had breached any of these provisions at June 30, 2011, it could have been required to settle its obligations under the agreements at their termination value.

Note 6. Disclosures About Fair Value of Assets and Liabilities

The Corporation has adopted fair value accounting guidance that defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This guidance defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. This guidance also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

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

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

Investment securities

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

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

Pooled Trust Preferred Securities

Pooled trust preferred securities in the portfolio amount to \$5.6 million in amortized cost, with a fair value of \$144,000; all of which are classified as Level 3 inputs in the fair value hierarchy. These securities were rated A or better at inception, but at June 30, 2011, Moody's ratings on these securities now range from Ca to C. The issuers in these securities are primarily banks, but some of the pools do include a limited number of insurance companies. On a quarterly basis, the Corporation uses an other-than-temporary impairment ("OTTI") evaluation process to compare the present value of expected cash flows to determine whether an adverse change in cash flows has occurred. The OTTI process considers the structure and term of the collateralized debt obligation ("CDO"), interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. Assumptions used in the process include expected future default rates and prepayments as well as recovery assumptions on defaults and deferrals. In addition, the process is used to "stress" each CDO, or make assumptions more severe than expected activity, to determine the degree to which assumptions could deteriorate before the CDO could no longer fully support repayment of the Corporation's note class. Upon completion of the June 30, 2011, quarterly analysis, the conclusion was no additional OTTI impairment for the three months ending June 30, 2011. The Corporation recognized OTTI impairment of \$400,000 and \$888,000 for the six months ended June 30, 2011 and June 30, 2010.

Interest rate swap agreements

See information regarding the Corporation's interest rate derivative products in Note 5. Derivative Financial Instruments, included within the Notes to Consolidated Condensed Financial Statements of this Form 10Q.

The fair value is estimated by a third party using inputs that are primarily unobservable and cannot be corroborated by observable market data and, therefore, are classified within Level 3 of the valuation hierarchy.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

The following presents the fair value measurements of assets and liabilities recognized in the Consolidated Condensed Balance Sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at June 30, 2011, and December 31, 2010.

June 30, 2011	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$ 113		\$ 113	
State and municipal	238,513		238,513	
Mortgage-backed securities	349,145		349,145	
Corporate obligations	176			\$ 176
Equity securities	3,265		3,261	4
Interest rate swap asset	3,783			3,783
Interest rate cap	954			954
Interest rate swap liability	(3,986)			(3,986)

December 31, 2010	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale securities:				
U.S. Government-sponsored agency securities	\$ 616		\$ 616	
State and municipal	239,990		239,990	
Mortgage-backed securities	295,317		295,317	
Corporate obligations	182			\$ 182
Equity securities	3,265		3,261	4
Interest rate swap asset	4,002			4,002
Interest rate cap	1,109			1,109
Interest rate swap liability	(3,876)			(3,876)

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the Consolidated Condensed Balance Sheets using significant unobservable Level 3 inputs for the three and six months ended June 30, 2011, and 2010.

	Three Months Ended June 30, 2011				Six Months Ended June 30, 2011			
	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Cap	Interest Rate Swap Liability
Balance at beginning of the period	\$ 173	\$ 3,647	\$ 1,124	\$ (3,379)	\$ 186	\$ 4,002	\$ 1,109	\$ (3,876)
Total realized and unrealized gains and losses:								
Included in net income (loss)		586		(607)	(400)	112		(110)
Included in other comprehensive income	(82)	\$ (450)	\$ (170)		240	\$ (331)	\$ (155)	
Purchases, issuances and settlements								
Transfers in/(out) of Level 3								
Principal payments	89				154			
Ending balance at June 30, 2011	\$ 180	\$ 3,783	\$ 954	\$ (3,986)	\$ 180	\$ 3,783	\$ 954	\$ (3,986)

	Three Months Ended June 30, 2010			Six Months Ended June 30, 2010		
	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Swap Liability	Available for Sale Securities	Interest Rate Swap Asset	Interest Rate Swap Liability
Balance at beginning of the period	\$ 1,394	\$ 2,843	\$ (2,873)	\$ 2,483	\$ 2,624	\$ (2,648)
Total realized and unrealized gains and losses:						
Included in net income (loss)	(400)	1,081	(1,288)	(888)	1,300	(1,513)
Included in other comprehensive income	345			(324)		
Purchases, issuances and settlements						
Transfers in/(out) of Level 3						
Principal payments	92			160		
Ending balance at June 30, 2010	\$ 1,431	\$ 3,924	\$ (4,161)	\$ 1,431	\$ 3,924	\$ (4,161)

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

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

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
June 30, 2011				
Impaired loans	\$ 37,957			\$ 37,957
Other real estate owned (collateral dependent)	\$ 7,830			\$ 7,830

	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
December 31, 2010				
Impaired loans	\$ 45,432			\$ 45,432
Other real estate owned (collateral dependent)	\$ 6,314			\$ 6,314

Impaired Loans (collateral dependent) and Other Real Estate Owned

Loan impairment is reported when substantial doubt about the collectability of scheduled payments exists. Impaired loans are carried at the present value of estimated future cash flows using the loan's existing rate, or the fair value of collateral if the loan is collateral dependent. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. During the first six months of 2011, certain impaired loans were partially charged-off or re-evaluated. The valuation would be considered Level 3, consisting of appraisals of underlying collateral and discounted cash flow analysis.

The fair value for impaired loans and other real estate owned is measured based on the value of the collateral securing those loans or real estate and is determined using several methods. The fair value of real estate is generally determined based on appraisals by qualified licensed appraisers. The appraisers typically determine the value of the real estate by utilizing an income or market valuation approach. If an appraisal is not available, the fair value may be determined by using a cash flow analysis. Fair value on other collateral such as business assets is typically calculated by using financial information such as financial statements and aging reports provided by the borrower and is discounted as considered appropriate.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 6. Disclosures About Fair Value of Assets and Liabilities continued

The estimated fair values of the Corporation's financial instruments are as follows:

	June 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Assets:				
Cash and due from banks	\$ 50,874	\$ 50,874	\$ 50,844	\$ 50,844
Federal funds sold			7,463	7,463
Interest-bearing time deposits	15,865	15,865	65,216	65,216
Investment securities available for sale	591,212	591,212	539,370	539,370
Investment securities held to maturity	347,154	351,865	287,427	286,270
Mortgage loans held for sale	4,846	4,846	21,469	21,469
Loans	2,646,889	2,649,114	2,752,706	2,715,924
FRB and FHLB stock	31,384	31,384	33,884	33,884
Interest Rate Swap Asset	4,737	4,737	5,111	5,111
Interest receivable	17,001	17,001	18,674	18,674
Liabilities:				
Deposits	\$ 3,142,533	\$ 3,147,704	\$ 3,268,880	\$ 3,280,489
Borrowings:				
Federal funds purchased	22,978	22,978		
Securities sold under repurchase agreements	124,236	124,774	109,871	110,494
Federal Home Loan Bank advances	74,050	77,702	82,684	87,463
Subordinated debentures, revolving credit lines and term loans	226,580	178,832	226,440	176,259
Interest Rate Swap Liability	3,986	3,986	3,876	3,876
Interest Payable	3,601	3,601	4,262	4,262

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

Federal Funds Sold: The fair value of Federal funds sold approximates carrying value.

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

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

Mortgage loans held for sale: The fair value of mortgage loans held for sale approximates carrying value.

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

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

Interest receivable and Interest payable: The fair value of interest receivable/payable approximates carrying value.

Derivative instruments: The fair value of the derivatives, consisting of interest rate swaps, reflects the estimated amounts that would have been received to terminate these contracts at the reporting date based upon pricing or valuation models applied to current market information.

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

Federal funds purchased: The fair value of federal funds purchased approximates carrying value.

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

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 7. Share-Based Compensation

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten-year life, become 100 percent vested ranging from three months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. RSAs for employees retired from the Corporation are either immediately vested at retirement or continue to vest after retirement, depending on which plan the shares were granted under. Deferred stock units ("DSUs") have been credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of June 30, 2011, all outstanding DSUs were converted to RSA's due to director retirements.

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

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three months and six months ended June 30, 2011, was \$350,000 and \$718,000, respectively compared to \$448,000 and \$933,000, respectively, for the three months and six months ended June 30, 2010. Share-based compensation has been recognized as a component of salaries and benefits expense in the accompanying Consolidated Condensed Statements of Income.

The estimated fair value of the stock options granted during 2011, and in prior years, was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2011 Black Scholes model:

Risk-free interest rate	2.74%
Expected price volatility	45.43%
Dividend yield	3.65%
Forfeiture rate	5.00%
	6.91 years

Weighted-average expected life, until
exercise

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

Share-based compensation expense recognized in the Consolidated Condensed Statements of Income is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately five percent for the six months ended June 30, 2011, based on historical experience.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 7. Share-Based Compensation continued

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Stock and ESPP Options				
Pre-tax compensation expense	\$ 38	\$ 162	\$ 109	\$ 345
Income tax benefit		(14)	(1)	(31)
Stock and ESPP option expense, net of income taxes	\$ 38	\$ 148	\$ 108	\$ 314
Restricted Stock Awards				
Pre-tax compensation expense	\$ 312	\$ 286	\$ 609	\$ 588
Income tax benefit	(111)	(100)	(213)	(206)
Restricted stock awards expense, net of income taxes	\$ 201	\$ 186	\$ 396	\$ 382
Total Share-Based Compensation:				
Pre-tax compensation expense	\$ 350	\$ 448	\$ 718	\$ 933
Income tax benefit	(111)	(114)	(214)	(237)
Total share-based compensation expense, net of income taxes	\$ 239	\$ 334	\$ 504	\$ 696

As of June 30, 2011, unrecognized compensation expense related to stock options and RSAs totaling \$101,000 and \$1,584,000, respectively, is expected to be recognized over weighted-average periods of 1.09 and 1.75 years, respectively.

Stock option activity under the Corporation's stock option plans, as of June 30, 2011, and changes during the six months ended June 30, 2011, were as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2011	1,061,429	\$ 23.01		
Granted/ Converted	40,296	\$ 9.17		
Exercised	-	-		
Cancelled	(6,180)	\$ 26.13		
Outstanding June, 2011	1,095,545	\$ 22.54	4.82	119,704
Vested and Expected to Vest at June 30, 2011	1,095,545	\$ 22.54	4.55	119,704
Exercisable at June 30, 2011	1,024,745	\$ 23.57	4.52	12,555

The weighted-average grant date fair value was \$3.08 for stock options granted during the six months ended June 30, 2011.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value that would have been received by the option holders had all option holders exercised their stock options on June 30, 2011. The intrinsic value is the difference between the Corporation's closing stock price on the last trading day of the first six months of 2011 and the exercise price, multiplied by the number of in-the-money options. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock. There were no stock options exercised during the first six months of 2011.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 7. Share-Based Compensation continued

The following table summarizes information on unvested RSAs outstanding as of June 30, 2011:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2011	272,737	\$ 12.46
Granted	128,013	\$ 9.04
Forfeited	(2,635)	\$ 8.45
Vested	(68,205)	\$ 23.54
Unvested RSAs at June 30, 2011	329,910	\$ 8.87

The grant date fair value of ESPP options was estimated at the beginning of the April 1, 2011, quarterly offering period of approximately \$16,000. The ESPP options vested during the three months ending June 30, 2011, leaving no unrecognized compensation expense related to unvested ESPP options at June 30, 2011.

NOTE 8. Income tax

	2011	2010
Income Tax Expense for the Six Months Ended June 30:		
Currently Payable:		
Federal	\$ (902)	\$ (17,029)
State		(379)
Deferred:		
Federal	4,697	14,219
State		379
Total Income Tax Expense	\$ 3,795	\$ (2,810)
Reconciliation of Federal Statutory to Actual Tax Expense:		
Federal Statutory income Tax at 35%	\$ 5,160	\$ (549)
Tax-exempt Interest Income	(1,877)	(1,960)
Non-deductible Interest Expense	419	2
Stock Compensation	37	89
Earnings on Life Insurance	(402)	(362)
Tax Credits	(26)	(53)
Other	484	23
Actual Tax Expense	\$ 3,795	\$ (2,810)

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS
(Table dollars in thousands)
(Unaudited)

NOTE 9. Net Income Per Share

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

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

	Three Months Ended June 30,					
	2011			2010		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income (Loss)	Weighted-Average Shares	Per Share Amount
Basic net income (loss) per share:	\$ 5,488			\$ (343)		
Gain on exchange of preferred stock for trust preferred debt				10,052		
Less: Preferred stock dividends and discount accretion	990			1,443		
Net income available to common stockholders	4,498	25,656,826	\$ 0.18	8,266	25,523,145	\$ 0.35
Effect of dilutive stock options and warrants		125,973			110,307	
Diluted net income per share:						
Net income available to common stockholders	\$ 4,498	25,782,799	\$ 0.18	\$ 8,266	25,633,452	\$ 0.35

Stock options to purchase 1,033,546 and 1,075,864 shares for the three months ended June 30, 2011, and 2010, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

Six Months Ended June 30,
2011 2010

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Basic net income per share:	\$ 10,949			\$ 1,243		
Gain on exchange of preferred stock for trust preferred debt				10,052		
Less: Preferred stock dividends and discount accretion	1,978			2,893		
Net income available to common stockholders	8,971	25,631,340	\$ 0.35	8,402	23,459,738	\$ 0.36
Effect of dilutive stock options and warrants		141,523			95,487	
Diluted net income per share:						
Net income available to common stockholders	\$ 8,971	25,772,863	\$ 0.35	\$ 8,402	23,555,225	\$ 0.36

Stock options to purchase 1,026,177 and 1,100,760 shares for the six months ended June 30, 2011, and 2010, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

FIRST MERCHANTS CORPORATION
FORM 10Q

NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

Note 10. Impact of Accounting Changes

ASU No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. In July 2010, the Financial Accounting Standards board (“FASB”) issued ASU No. 2010-20, Receivables (Topic 310): Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses. ASU 2010-20 requires that more information be disclosed about the credit quality of a company’s loans and the allowance for loan losses held against those loans. A company is required to disaggregate new and existing disclosure based on how it develops its allowance for loan losses and how it manages credit exposures. Existing disclosures to be presented on a disaggregated basis include a roll-forward of the allowance for loan losses, the related recorded investment in such loans, the nonaccrual status of loans, and impaired loans. Additional disclosure is also required about the credit quality indicators of loans by class at the end of the reporting period, the aging of past due loans, information about troubled debt restructurings, and significant purchases and sales of loans during the reporting period by class. For public companies, ASU 2010-20 required certain disclosures as of the end of a reporting period effective for periods ending on or after December 15, 2010. Other required disclosures about activity that occurs during a reporting period are effective for periods beginning on or after December 15, 2010. The Corporation adopted the applicable required additional disclosures effective December 31, 2010. The additional disclosures are included in Note 3. Loans and Allowance, included within the Notes to Consolidated Condensed Financial Statements of this Form 10-Q

In April 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-02 “Receivables (Topic 310) – A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring.” ASU 2011-02 clarifies whether loan modifications constitute troubled debt restructuring. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 is effective for the first interim and annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. Management is assessing the impact of ASU 2011-02 on the Corporation’s financial condition, results of operations, and disclosures.

ASU No. 2011-05; Amendments to Topic 220, Comprehensive Income. In June, 2011, FASB issued ASU No. 2011-05. Under the amendments in this ASU, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. This ASU eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in this ASU do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income.

The amendments in this ASU should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted, because compliance with the amendments is already permitted. The amendments do not require any transition disclosures. Due to the recency of this pronouncement, the Corporation is evaluating its timing of adoption of ASU

2011-05, but will adopt the ASU retrospectively by the due date.

FIRST MERCHANTS CORPORATION
FORM 10Q

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

FORWARD-LOOKING STATEMENTS

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

statements of our goals, intentions and expectations;

statements regarding our business plan and growth strategies;

statements regarding the asset quality of our loan and investment portfolios; and

estimates of our risks and future costs and benefits.

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

fluctuations in market rates of interest and loan and deposit pricing, which could negatively affect our net interest margin, asset valuations and expense expectations;

adverse changes in the economy, which might affect our business prospects and could cause credit-related losses and expenses;

adverse developments in our loan and investment portfolios;

competitive factors in the banking industry, such as the trend towards consolidation in our market;

changes in the banking legislation or the regulatory requirements of federal and state agencies applicable to bank holding companies and banks like our affiliate banks;

acquisitions of other businesses by us and integration of such acquired businesses;

changes in market, economic, operational, liquidity, credit and interest rate risks associated with our business; and

the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends.

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

FIRST MERCHANTS CORPORATION
FORM 10Q

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

CRITICAL ACCOUNTING POLICIES

Generally accepted accounting principles are complex and require us to apply significant judgments to various accounting, reporting and disclosure matters. We must use assumptions and estimates to apply these principles where actual measurement is not possible or practical. For a complete discussion of our significant accounting policies, see "Notes to the Consolidated Financial Statements" in our Annual Report on Form 10-K for the year ended December 31, 2010. Certain policies are considered critical because they are highly dependent upon subjective or complex judgments, assumptions and estimates. Changes in such estimates may have a significant impact on the financial statements. We have reviewed the application of these policies with the Audit Committee of our Board of Directors.

We believe there have been no significant changes during the six months ended June 30, 2011 to the items that we disclosed as our critical accounting policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2010.

BUSINESS SUMMARY

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

The Bank services the following Indiana counties: Adams, Brown, Carroll, Clinton, Delaware, Fayette, Hamilton, Hendricks, Henry, Howard, Jasper, Jay, Johnson, Madison, Miami, Montgomery, Morgan, Randolph, Tippecanoe, Union, Wabash, Wayne and White counties. Ohio counties include Butler and Franklin.

The Corporation's business activities are currently limited to one significant business segment, which is community banking. Through the Bank, the Corporation offers a broad range of financial services, including accepting time deposits, savings and demand deposits; making consumer, commercial, agri-business and real estate mortgage loans; renting safe deposit facilities; providing personal and corporate trust services; providing full-service brokerage; and providing other corporate services, letters of credit and repurchase agreements.

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

FIRST MERCHANTS CORPORATION
FORM 10Q

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

REGULATORY DEVELOPMENTS

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law. The Dodd-Frank Act is likely to have a broad impact on the financial services industry, including significant regulatory and compliance changes. Many of the requirements called for in the Dodd-Frank Act will be implemented over time and most will be subject to various federal agencies implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies through regulatory guidance, the full extent of the impact such requirements will have on the financial services industry, and on operations specifically, is currently unclear. The changes resulting from the Dodd-Frank Act may materially impact the profitability of the Corporation's business activities, require changes to certain business practices, impose more stringent capital, liquidity and leverage requirements or otherwise adversely affect the business. At a minimum, the Dodd-Frank Act is likely to:

- increase the cost of operations due to greater regulatory oversight, supervision and examination of banks and bank holding companies, including higher deposit insurance premiums;
- limit the Corporation's ability to raise additional capital through the use of trust preferred securities as new issuances of these securities may no longer be included as Tier 1 capital;
- reduce the flexibility to generate or originate certain revenue-producing assets based on increased regulatory capital standards; and
- limit the ability to expand consumer product and service offerings due to anticipated stricter consumer protection laws and regulations.

The timing and extent of these increases and limitations will remain unclear until the underlying implementing regulations are promulgated by the applicable federal agencies. In the interim, the Corporation's management is currently taking steps to best prepare for the implementation and to minimize the adverse impact on the business, financial condition and results of operation.

On February 7, 2011, the FDIC adopted final rules implementing a portion of the Dodd-Frank Act relating to deposit insurance assessments. The rules modify the base amount for a financial institution's insurance assessments from an institution's insured deposits to the difference between an institution's daily average consolidated assets and its daily average tangible equity. The rules also eliminated the requirement that the FDIC provide rebates to institutions on their deposit premiums once the reserve ratio exceeded 1.50 percent. These new rules became effective on April 1, 2011.

FIRST MERCHANTS CORPORATION
FORM 10Q

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

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported second quarter earnings of \$.18 per fully diluted common share and net income available to stockholders of \$4,498,000, compared to \$.35 per common share and net income available to stockholders of \$8,266,000 for the quarter ended June 30, 2010.

In the second quarter of 2010, an after-tax gain of \$10.1 million applicable to income available to common stockholders was recorded. The gain was a result of favorable accounting treatment attributed to the exchange of 46,400 shares of the Corporation's fixed rate cumulative perpetual preferred stock for \$46.4 million of trust preferred securities. Also, as a result of this transaction, a \$5.4 million deferred tax liability was recorded resulting in a net decrease of the tax asset.

Net charge offs were \$9.4 million for the quarter, exceeding provision expense of \$5.6 million by \$3.8 million as a large recovery was recorded and certain charge offs were preceded by specific reserves. The specific reserves at June 30, 2011 were \$13.7 million compared to \$13.9 million at December 31, 2010. Non-performing assets plus 90 days delinquent loans were \$109.5 million or 2.7 percent of total assets at June 30, 2011, compared to \$120.0 million, or 2.9 percent of total assets at December 31, 2010. The Corporation's allowance for loan losses decreased to 2.83 percent of total loans from 2.90 percent of loans at December 31, 2010.

Assets decreased by \$76.6 million during the first six months of 2011. Loans, including loans held for sale, decreased \$128.3 million during the first six months of 2011, or 4.5 percent, due to normal loan run-off coupled with a reduction in both consumer and commercial demand for borrowing. The combined cash and cash equivalents and interest bearing deposits declined by \$56.8 million. These declines have generated excess liquidity of \$185.1 million, of which \$111.6 million has been invested in the investment securities portfolio.

Deposits decreased \$126.3 million during the first six months of 2011, or 3.9 percent. CDs below \$100,000 and CDs over \$100,000 accounted for \$64.2 million and \$42.1 million of the decline, respectively. Another \$13.6 million of the decline was a result of declining savings deposits. Management continues to focus on maximizing deposit pricing in an effort to balance maintaining strong customer relationships, remaining competitive in the local markets while still allowing higher cost deposits to mature.

Net deferred and refundable taxes have declined by \$8.8 million in the first six months of 2011. The decline is primarily a result of receiving \$3.0 million in net tax refunds during 2011, utilization of \$3.4 million of deferred tax asset associated with net operating loss carryforwards and \$2.7 million reduction in deferred tax asset related to the allowance for loan losses.

The Corporation continues to maintain all regulatory capital ratios in excess of the regulatory definition of "well capitalized" as discussed in the section entitled "CAPITAL" below.

FIRST MERCHANTS CORPORATION
FORM 10Q

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

NET INTEREST INCOME

Net interest income is the primary source of the Corporation's earnings. It is a function of net interest margin and the level of average earning assets. Net interest income and net interest margin are presented in the following table on a fully taxable equivalent basis, which adjusts tax-exempt or nontaxable interest income to an amount that would be comparable to interest subject to income taxes using the federal statutory tax rate of 35% in effect for all periods. Net interest margin increased 9 basis points from 3.90 percent in the second quarter of 2010 to 3.99 percent in the second quarter of 2011, while earning assets decreased by \$118 million. The table below presents the Corporation's asset yields, interest expense, and net interest income as a percent of average earning assets for the three and six months ended June 30, 2011 and 2010.

During the six months ended June 30, 2011, asset yields decreased 31 basis points on a fully taxable equivalent basis (FTE) and interest costs decreased 41 basis points, resulting in a 10 basis point (FTE) increase in net interest income as compared to the same period in 2010.

(Dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Annualized net interest income	\$ 143,389	\$ 144,714	\$ 142,649	\$ 144,787
Annualized FTE adjustment	\$ 5,993	\$ 6,031	\$ 5,856	\$ 6,163
Annualized net interest income on a fully taxable equivalent basis	\$ 149,382	\$ 150,745	\$ 148,505	\$ 150,950
Average earning assets	\$ 3,751,241	\$ 3,868,749	\$ 3,747,738	\$ 3,912,442
Interest income (FTE) as a percent of average earning assets	5.04%	5.38%	5.07%	5.38%
Interest expense as a percent of average earning assets	1.05%	1.48%	1.11%	1.52%
Net interest income (FTE) as a percent of average earning assets	3.99%	3.90%	3.96%	3.86%

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

NON-INTEREST INCOME

Non-interest income increased by \$119,000 or 1.1% during the second quarter of 2011, compared to the second quarter of 2010. During the second quarter of 2011, gains recognized on the sale of investment securities totaled \$825,000 with no other-than-temporary impairment losses on pooled trust preferred investments. In comparison, during second quarter of 2010, gains recognized on the sale of investment securities totaled \$257,000 while other-than-temporary impairment losses on pooled trust preferred investments of \$400,000 were recognized. Additionally, interchange income from electronic card transactions was \$226,000 higher in the second quarter of 2011 when compared to the second quarter of 2010. Declines in service charges were recognized due to a decrease in the volume of customer overdrafts and returned items. Insurance commissions also declined by \$463,000 when compared

to the second quarter of 2010, due to a one-time adjustment.

During the first six months of 2011, non-interest income was \$22.9 million or 4.1% lower than the same period in 2010. The sale of investment securities resulted in net gains of approximately \$888,000 when netted against other-than-temporary impairment charges of \$400,000 recognized on pooled trust preferred investments, a decrease of \$323,000 from the same period in 2010. Service charges declined \$992,000 from the same period in 2010 due to a decrease in the volume of customer overdrafts and returned items. Additionally, insurance commissions were \$564,000 lower in the first half of 2011 than 2010. The largest increases over the prior period were gains on the sale of mortgage loans totaling \$569,000 more than the first six months of 2010.

NON-INTEREST EXPENSE

Non-interest expenses for the second quarter of 2011, compared with the same period in 2010, increased by \$56,000 or .2%. Non-interest expenses in the first six months of 2011 decreased \$703,000 or 1.0%, compared to the same period in 2010.

FIRST MERCHANTS CORPORATION
FORM 10Q

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

INCOME TAX

The income tax expense for the six months ended June 30, 2011 was \$3,795,000 on pre-tax net income of \$14,744,000. For the same period in 2010, the income tax benefit was \$2,810,000 on a pre-tax net loss of \$1,567,000.

CAPITAL

Capital adequacy is an important indicator of financial stability and performance. The Corporation maintained a strong capital position as tangible common equity to tangible assets was 6.36% at June 30, 2011 and 5.86% at December 31, 2010.

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk-based capital, Tier 1 capital, and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios. At June 30, 2011, the management of the Corporation believes that it meets all capital adequacy requirements to which it is subject. The most recent notifications from the regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

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

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

As of June 30, 2011, the Corporation, on a consolidated basis, as well as the Bank, exceeded the minimum capital levels of the well capitalized category.

(Dollars in thousands)	June 30, 2011		December 31, 2010	
	Amount	Ratio	Amount	Ratio
Consolidated				
Total capital (to risk-weighted assets)	\$ 471,790	16.05%	\$ 476,490	15.74%
	394,543	13.42%	388,090	12.82%

Tier 1 capital (to risk-weighted assets)				
Tier 1 capital (to average assets)	394,543	9.94%	388,090	9.50%
First Merchants Bank				
Total capital (to risk-weighted assets)	\$ 455,190	15.55%	\$ 450,629	14.89%
Tier 1 capital (to risk-weighted assets)	418,317	14.29%	412,654	13.64%
Tier 1 capital (to average assets)	418,317	10.57%	412,654	10.14%

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

FIRST MERCHANTS CORPORATION
FORM 10Q

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

CAPITAL continued

The United States Department of the Treasury (the “Treasury”) holds 69,600 shares of Series A Preferred Stock, which were issued to the Treasury in connection with the Troubled Assets Relief Program’s Capital Purchase Program (“TARP”), along with warrants to purchase up to 991,453 shares of the Corporation’s common stock also issued pursuant to TARP. The Treasury also holds 46,400 shares of trust preferred securities, having a liquidation amount of \$1,000 per share, issued by the Corporation’s wholly owned subsidiary trust, First Merchants Capital Trust III, a Delaware Statutory Trust. The trust preferred securities qualify as Tier 1 capital, subject to the 25 percent aggregate limitation on Tier 1 capital for these and similar securities.

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

(Dollars in thousands, except per share amounts)	June 30, 2011	December 31, 2010
Average goodwill	\$ 141,357	\$ 141,357
Average core deposit intangible (CDI)	11,596	15,026
Average deferred tax on CDI	(2,651)	