

FIRST MERCHANTS CORP
Form 10-Q
November 09, 2016

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 September 30, 2016
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE
SECURITIES EXCHANGE ACT OF 1934

For the Transition Period from _____ to _____

Commission File Number 0-17071

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

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

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

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

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

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

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

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions 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 October 31, 2016, there were 40,807,138 outstanding common shares of the registrant.

1

Table of Contents

TABLE OF CONTENTS

FIRST MERCHANTS CORPORATION

<u>Glossary of Defined Terms</u>	Page No. <u>3</u>
 <u>Part I. Financial Information</u>	
Item 1. <u>Financial Statements:</u>	
<u>Consolidated Condensed Balance Sheets</u>	<u>4</u>
<u>Consolidated Condensed Statements of Income</u>	<u>5</u>
<u>Consolidated Condensed Statements of Comprehensive Income</u>	<u>6</u>
<u>Consolidated Condensed Statement of Stockholders' Equity</u>	<u>7</u>
<u>Consolidated Condensed Statements of Cash Flows</u>	<u>8</u>
<u>Notes to Consolidated Condensed Financial Statements</u>	<u>9</u>
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>42</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>56</u>
Item 4. <u>Controls and Procedures</u>	<u>57</u>
 <u>Part II. Other Information</u>	
Item 1. <u>Legal Proceedings</u>	<u>58</u>
Item 1A. <u>Risk Factors</u>	<u>58</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>58</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>58</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>58</u>
Item 5. <u>Other Information</u>	<u>58</u>
Item 6. <u>Exhibits</u>	<u>59</u>
<u>Signatures</u>	<u>60</u>
<u>Index to Exhibits</u>	<u>61</u>

Table of Contents

GLOSSARY OF DEFINED TERMS

FIRST MERCHANTS CORPORATION

Ameriana	Ameriana Bancorp, Inc., which was acquired by the Corporation on December 31, 2015.
ASC	Accounting Standards Codification
Bank	First Merchants Bank, a wholly-owned subsidiary of the Corporation
C Financial	C Financial Corporation, which was acquired by the Corporation on April 17, 2015.
CFS	CFS Bancorp, Inc., which was acquired by the Corporation on November 12, 2013.
CMT	Constant Maturity Treasury
Community Corporation	Community Bancshares, Inc., which was acquired by the Corporation on November 7, 2014.
DSU	Deferred stock units
ESPP	Employee Stock Purchase Plan
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FMIG	First Merchants Insurance Services, Inc., an Indiana corporation
FTE	Fully taxable equivalent
GAAP	Generally Accepted Accounting Principles
Indiana DFI	Indiana Department of Financial Institutions
RSA	Restricted Stock Awards
SCB	SCB Bank, of which the Bank assumed substantially all the deposits and certain other liabilities and acquired certain other assets from the FDIC as receiver on February 10, 2012.
TEFRA	Tax Equivalent and Fiscal Responsibility Act. The TEFRA disallowance reduces the amount of interest expense an entity may deduct for the purpose of carrying tax-free investment securities.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED BALANCE SHEETS

	September 30, 2016 (Unaudited)	December 31, 2015
ASSETS		
Cash and cash equivalents	\$ 99,602	\$ 102,170
Interest-bearing time deposits	33,803	32,315
Investment securities available for sale	675,813	658,400
Investment securities held to maturity (fair value of \$647,046 and \$632,380)	624,615	618,599
Loans held for sale	1,482	9,894
Loans, net of allowance for loan losses of \$63,456 and \$62,453	4,910,388	4,631,369
Premises and equipment	95,540	97,648
Federal Reserve and Federal Home Loan Bank stock	18,044	37,633
Interest receivable	23,652	24,415
Core deposit intangibles	15,844	16,635
Goodwill	244,000	243,129
Cash surrender value of life insurance	201,856	200,539
Other real estate owned	10,242	17,257
Tax asset, deferred and receivable	31,779	46,977
Other assets	35,692	24,023
TOTAL ASSETS	\$ 7,022,352	\$ 6,761,003
LIABILITIES		
Deposits:		
Noninterest-bearing	\$ 1,307,886	\$ 1,266,027
Interest-bearing	4,136,354	4,023,620
Total Deposits	5,444,240	5,289,647
Borrowings:		
Federal funds purchased	58,358	49,721
Securities sold under repurchase agreements	138,671	155,325
Federal Home Loan Bank advances	297,022	235,652
Subordinated debentures and term loans	128,288	127,846
Total Borrowings	622,339	568,544
Interest payable	3,733	3,092
Other liabilities	51,175	49,211
Total Liabilities	6,121,487	5,910,494
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY		
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 - 40,799,025 and 40,664,259 shares	5,100	5,083
Additional paid-in capital	506,848	504,530

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Retained earnings	384,868	342,133
Accumulated other comprehensive income (loss)	3,924	(1,362)
Total Stockholders' Equity	900,865	850,509
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 7,022,352	\$ 6,761,003

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

4

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
INTEREST INCOME				
Loans receivable:				
Taxable	\$53,819	\$46,037	\$156,407	\$134,908
Tax exempt	1,649	1,190	4,429	2,174
Investment securities:				
Taxable	3,992	4,374	12,522	13,522
Tax exempt	4,668	4,412	13,760	12,478
Deposits with financial institutions	55	25	283	93
Federal Reserve and Federal Home Loan Bank stock	193	500	906	1,509
Total Interest Income	64,376	56,538	188,307	164,684
INTEREST EXPENSE				
Deposits	3,926	3,715	12,028	10,917
Federal funds purchased	27	27	62	69
Securities sold under repurchase agreements	91	96	283	264
Federal Home Loan Bank advances	853	711	2,467	2,108
Subordinated debentures and term loans	1,797	1,666	5,368	4,996
Total Interest Expense	6,694	6,215	20,208	18,354
NET INTEREST INCOME	57,682	50,323	168,099	146,330
Provision for loan losses	1,900		3,240	417
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	55,782	50,323	164,859	145,913
OTHER INCOME				
Service charges on deposit accounts	4,667	4,445	13,228	12,083
Fiduciary activities	2,448	2,242	7,318	7,058
Other customer fees	4,777	4,156	14,531	12,425
Commission income		4		4,147
Earnings on cash surrender value of life insurance	614	710	3,387	2,097
Net gains and fees on sales of loans	1,989	1,905	5,166	5,175
Net realized gains on sales of available for sale securities	839	1,115	2,542	2,047
Gain on sale of insurance subsidiary				8,265
Other income	1,527	1,755	2,911	2,540
Total Other Income	16,861	16,332	49,083	55,837
OTHER EXPENSES				
Salaries and employee benefits	26,651	25,137	79,558	76,112
Net occupancy	4,348	3,726	12,429	11,019
Equipment	2,947	2,698	9,428	8,104
Marketing	630	847	2,218	2,578
Outside data processing fees	2,382	1,992	6,476	5,477

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Printing and office supplies	314	343	1,047	1,010
Core deposit amortization	978	693	2,933	2,143
FDIC assessments	534	958	2,486	2,716
Other real estate owned and foreclosure expenses	637	1,675	2,303	2,917
Professional and other outside services	1,242	1,686	4,882	6,311
Other expenses	3,452	3,276	11,665	10,909
Total Other Expenses	44,115	43,031	135,425	129,296
INCOME BEFORE INCOME TAX	28,528	23,624	78,517	72,454
Income tax expense	7,469	6,557	19,759	21,247
NET INCOME AVAILABLE TO COMMON STOCKHOLDERS	\$21,059	\$17,067	\$58,758	\$51,207
Per Share Data:				
Basic Net Income Available to Common Stockholders	\$0.51	\$0.46	\$1.44	\$1.36
Diluted Net Income Available to Common Stockholders	\$0.51	\$0.45	\$1.43	\$1.35
Cash Dividends Paid	\$0.14	\$0.11	\$0.39	\$0.30
Average Diluted Shares Outstanding (in thousands)	41,026	38,118	40,970	38,054

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	\$21,059	\$17,067	\$58,758	\$51,207
Other comprehensive income net of tax:				
Unrealized holding gain (loss) on securities available for sale arising during the period, net of tax of \$1,627, \$2,439, \$4,234 and \$63	(3,022)	4,530	7,863	117
Unrealized gain (loss) on cash flow hedges arising during the period, net of tax of \$134, \$627, \$835 and \$792	250	(1,164)	(1,548)	(1,468)
Reclassification adjustment for net gains included in net income, net of tax of \$183, \$263, \$554 and \$340	(339)	(490)	(1,029)	(633)
	(3,111)	2,876	5,286	(1,984)
Comprehensive income	\$17,948	\$19,943	\$64,044	\$49,223

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENT OF STOCKHOLDERS' EQUITY

(Unaudited)

	Preferred Shares	Preferred Amount	Common Stock Shares	Common Stock Amount	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balances, December 31, 2015	125	\$ 125	40,664,259	\$ 5,083	\$ 504,530	\$ 342,133	\$ (1,362)	\$ 850,509
Comprehensive income								
Net income						58,758		58,758
Other comprehensive income, net of tax							5,286	5,286
Cash dividends on common stock (\$.39 per share)						(16,023)		(16,023)
Share-based compensation			110,251	14	1,869			1,883
Stock issued under employee benefit plans			15,968	2	336			338
Stock issued under dividend reinvestment and stock purchase plan			23,882	3	602			605
Stock options exercised			22,385	3	347			350
Stock redeemed			(37,720)	(5)	(836)			(841)
Balances, September 30, 2016	125	\$ 125	40,799,025	\$ 5,100	\$ 506,848	\$ 384,868	\$ 3,924	\$ 900,865

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. CONSOLIDATED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Unaudited)

	Nine Months Ended	
	September 30,	September 30,
	2016	2015
Cash Flow From Operating Activities:		
Net income	\$58,758	\$ 51,207
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,240	417
Depreciation and amortization	5,363	4,707
Change in deferred taxes	6,889	3,363
Share-based compensation	1,883	1,687
Tax benefit from stock options exercised	(41)	(70)
Loans originated for sale	(280,769)	(286,414)
Proceeds from sales of loans held for sale	293,519	296,302
Gains on sales of loans held for sale	(4,338)	(4,596)
Gain on sale of insurance subsidiary		(8,265)
Gain on cancellation of subordinated debentures		(1,250)
Gains on sales of securities available for sale	(2,542)	(2,047)
Change in interest receivable	763	(1,772)
Change in interest payable	641	480
Other adjustments	(501)	301
Net cash provided by operating activities	82,865	54,050
Cash Flows from Investing Activities:		
Net change in interest-bearing deposits	(1,488)	21,331
Purchases of:		
Securities available for sale	(161,962)	(166,645)
Securities held to maturity	(94,309)	(55,415)
Proceeds from sales of securities available for sale	104,821	70,114
Proceeds from maturities of:		
Securities available for sale	52,019	47,664
Securities held to maturity	86,281	69,629
Change in Federal Reserve and Federal Home Loan Bank stock	19,589	7,710
Net change in loans	(286,125)	(296,602)
Net cash and cash equivalents paid in acquisition		(12,004)
Net cash received from sale of insurance subsidiary		15,155
Proceeds from the sale of other real estate owned	8,105	8,294
Other adjustments	(3,800)	1,264
Net cash used in investing activities	(276,869)	(289,505)
Cash Flows from Financing Activities:		
Net change in :		
Demand and savings deposits	195,395	106,597
Certificates of deposit and other time deposits	(41,973)	(38,028)
Borrowings	647,935	414,197
Repayment of borrowings	(594,350)	(270,497)

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Cash dividends on common stock	(16,023)	(11,448)
Stock issued under employee benefit plans	338	351
Stock issued under dividend reinvestment and stock purchase plans	605	487
Stock options exercised	309	1,422
Tax benefit from stock options exercised	41	70
Stock redeemed	(841)	(1,635)
Net cash provided by financing activities	191,436	201,516
Net Change in Cash and Cash Equivalents	(2,568)	(33,939)
Cash and Cash Equivalents, January 1	102,170	118,616
Cash and Cash Equivalents, September 30	\$99,602	\$ 84,677
Additional cash flow information:		
Interest paid	\$19,567	\$ 17,845
Income tax paid	4,499	15,000
Loans transferred to other real estate owned	665	3,244
Fixed assets transferred to other real estate owned	360	1,166
Non-cash investing activities using trade date accounting	1,341	3,332
In conjunction with the acquisition, liabilities were assumed as follows:		
Fair value of assets acquired		\$ 141,724
Cash received (paid) in acquisition		(14,500)
Less: Common stock issued		
Liabilities assumed	\$—	\$ 127,224

See NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

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

NOTE 1

GENERAL

Financial Statement Preparation

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

The Consolidated Condensed Balance Sheet of the Corporation as of December 31, 2015, has been derived from the audited consolidated balance sheet of the Corporation as of that date. Certain information and note disclosures normally included in the Corporation's annual financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, have been condensed or omitted. These consolidated condensed financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the Securities and Exchange Commission. The results of operations for the three and nine months ended September 30, 2016, are not necessarily indicative of the results to be expected for the year. Reclassifications have been made to prior financial statements to conform to the current financial statement presentation. These reclassifications had no effect on net income.

NOTE 2

ACQUISITIONS AND DIVESTITURES

Acquisition - Ameriana Bancorp, Inc.

On December 31, 2015, the Corporation acquired 100 percent of Ameriana. Ameriana merged with and into the Corporation (the "Ameriana Merger") whereupon the separate corporate existence of Ameriana ceased and the Corporation survived. Immediately following the Ameriana Merger, Ameriana Bank, an Indiana bank and wholly-owned subsidiary of Ameriana, merged with and into the Bank, with the Bank continuing as the surviving bank. Ameriana was headquartered in New Castle, Indiana and had 13 banking centers serving central and east central Indiana. Pursuant to the merger agreement, each Ameriana shareholder received 0.9037 shares of the Corporation's common stock for each outstanding share of Ameriana common stock held. The Corporation issued approximately 2.8 million shares of common stock, which was valued at approximately \$70.4 million. The Corporation engaged in this transaction with the expectation that it would be accretive and expand the existing footprint in central and east central Indiana. Goodwill resulted from this transaction due to the expected synergies and economies of scale that are expected.

Under the acquisition method of accounting, the total purchase price is allocated to net tangible and intangible assets based on their current estimated fair values on the date of the acquisition. Based on preliminary valuations of the fair value of tangible and intangible assets acquired and liabilities assumed, which are based on assumptions that are subject to change, the purchase price for the Ameriana acquisition is detailed in the following table. If prior to the end of the one year measurement period for finalizing the purchase price allocation, information becomes available which would indicate adjustments are required to the purchase price allocation, such adjustments will be included in the purchase price allocation retrospectively.

	Fair Value
Cash and cash equivalents	\$4,068
Interest-bearing time deposits	8,790
Investment securities	61,754
Loans	316,929
Premises and equipment	13,946
Federal Home Loan Bank stock	2,693
Other real estate owned	5,613
Interest receivable	1,306
Cash surrender value of life insurance	28,188
Other assets	6,713
Deposits	(383,718)
Interest payable	(24)
Federal Home Loan Bank Advances	(24,884)
Subordinated debentures	(5,487)
Other liabilities	(9,451)
Net tangible assets acquired	26,436
Core deposit intangible	5,342
Goodwill	38,624
Purchase price	\$70,402

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Of the total purchase price, \$5,342,000 has been allocated to a core deposit intangible that will be amortized over its estimated life of 10 years. The remaining purchase price has been allocated to goodwill, which is not deductible for tax purposes.

Acquisition - C Financial Corporation

On April 17, 2015, the Corporation acquired 100 percent of C Financial. C Financial merged with and into the Corporation (the "C Financial Merger") whereupon the separate corporate existence of C Financial ceased and the Corporation survived. Immediately following the C Financial Merger, Cooper State Bank, an Ohio state bank and wholly-owned subsidiary of C Financial, merged with and into the Bank, with the Bank continuing as the surviving bank. C Financial was headquartered in Columbus, Ohio and had 6 full service banking centers serving the Columbus, Ohio market. As part of the \$14.5 million C Financial Merger, shareholders of C Financial received \$6.738 in cash for each share of C Financial common stock held.

The Corporation expects the transaction to be accretive to income and expand the existing footprint in Columbus, Ohio. Goodwill resulted from this transaction due to the synergies and economies of scale that were expected. The purchase price of the C Financial acquisition was allocated as follows:

	Fair Value
Cash and cash equivalents	\$2,496
Federal Funds sold	7,018
Interest-bearing time deposits	922
Loans	110,625
Premises and equipment	7,290
Federal Home Loan Bank stock	855
Interest receivable	292
Other assets	119
Deposits	(105,326)
Interest payable	(29)
Federal Home Loan Bank Advances	(18,958)
Other liabilities	(2,911)
Net tangible assets acquired	2,393
Core deposit intangible	981
Goodwill	11,126
Purchase price	\$14,500

Of the total purchase price, \$981,000 has been allocated to a core deposit intangible that will be amortized over its estimated life of 10 years. The remaining purchase price has been allocated to goodwill, which is deductible over a 15 year period for tax purposes as the transaction was considered a taxable exchange.

Subsidiary Divestiture - First Merchants Insurance Services, Inc.

On June 12, 2015, the Corporation sold all of its stock in FMIG to USI Insurance Services LLC, a Delaware limited liability company. The sale price was \$18 million, of which \$16 million was paid at closing with the remaining \$2 million paid through a two-year promissory note. The sale of FMIG generated a gain on sale of \$8.3 million.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 3

INVESTMENT SECURITIES

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

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at September 30, 2016				
U.S. Government-sponsored agency securities	\$ 100	\$ 1		\$ 101
State and municipal	348,557	20,852	\$ 324	369,085
U.S. Government-sponsored mortgage-backed securities	297,557	7,040	17	304,580
Corporate obligations	31			31
Equity securities	2,016			2,016
Total available for sale	648,261	27,893	341	675,813
Held to maturity at September 30, 2016				
Federal agencies	29,499	10	51	29,458
State and municipal	209,857	9,682	14	219,525
U.S. Government-sponsored mortgage-backed securities	385,259	12,804		398,063
Total held to maturity	624,615	22,496	65	647,046
Total Investment Securities	\$ 1,272,876	\$ 50,389	\$ 406	\$ 1,322,859
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale at December 31, 2015				
U.S. Government-sponsored agency securities	\$ 100	\$ 4		\$ 104
State and municipal	291,730	14,241	\$ 60	305,911
U.S. Government-sponsored mortgage-backed securities	342,550	4,234	518	346,266
Corporate obligations	31			31
Equity securities	3,912			3,912
Certificates of deposit	2,176			2,176
Total available for sale	640,499	18,479	578	658,400
Held to maturity at December 31, 2015				
State and municipal	219,767	6,982	15	226,734
U.S. Government-sponsored mortgage-backed securities	398,832	7,601	787	405,646
Total held to maturity	618,599	14,583	802	632,380
Total Investment Securities	\$ 1,259,098	\$ 33,062	\$ 1,380	\$ 1,290,780

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

The amortized cost and fair value of available for sale and held to maturity securities at September 30, 2016 and December 31, 2015, 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 September 30, 2016:				
Due in one year or less	\$2,336	\$2,353	\$2,512	\$2,533
Due after one through five years	22,195	23,463	53,530	55,764
Due after five through ten years	66,314	70,278	76,023	77,338
Due after ten years	257,843	273,123	107,291	113,348
	\$348,688	\$369,217	\$239,356	\$248,983
U.S. Government-sponsored mortgage-backed securities	297,557	304,580	385,259	398,063
Equity securities	2,016	2,016		
Total Investment Securities	\$648,261	\$675,813	\$624,615	\$647,046

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Maturity Distribution at December 31, 2015				
Due in one year or less	\$4,658	\$4,704	\$4,144	\$4,148
Due after one through five years	13,725	14,295	28,054	29,175
Due after five through ten years	52,878	55,375	81,483	83,646
Due after ten years	220,600	231,672	106,086	109,765
	\$291,861	\$306,046	\$219,767	\$226,734
U.S. Government-sponsored mortgage-backed securities	342,550	346,266	398,832	405,646
Equity securities	3,912	3,912		
Certificates of deposit	2,176	2,176		
Total Investment Securities	\$640,499	\$658,400	\$618,599	\$632,380

The carrying value of securities pledged as collateral, to secure borrowings and for other purposes, was \$587,806,000 at September 30, 2016, and \$637,358,000 at December 31, 2015.

The book value of securities sold under agreements to repurchase amounted to \$134,248,000 at September 30, 2016, and \$153,789,000 at December 31, 2015.

Gross gains on the sales and redemptions of available for sale securities for the three and nine months ended September 30, 2016 and 2015 are shown below.

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
	2016	2015	2016	2015
Sales and Redemptions of Available for Sale Securities:				
Gross gains	\$839	\$1,115	\$2,542	\$2,147
Gross losses				100

The following table shows investment securities with unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at September 30, 2016, and December 31, 2015:

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

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Temporarily Impaired Available for Sale Securities at September 30, 2016

State and municipal	\$22,468	\$ 324			\$22,468	\$ 324
U.S. Government-sponsored mortgage-backed securities	9,543	17			9,543	17
Total Temporarily Impaired Available for Sale Securities	32,011	341	—	—	32,011	341

Temporarily Impaired Held to Maturity Securities at September 30, 2016

Federal agencies	15,469	51			15,469	51
State and municipal	6,941	14			6,941	14
Total Temporarily Impaired Held to Maturity Securities	22,410	65			22,410	65
Total Temporarily Impaired Investment Securities	\$54,421	\$ 406	\$ -	\$ -	-\$54,421	\$ 406

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Temporarily Impaired Available for Sale Securities at December 31, 2015						
State and municipal	\$7,558	\$ 60			\$7,558	\$ 60
U.S. Government-sponsored mortgage-backed securities	83,396	445	\$2,101	\$ 73	85,497	518
Total Temporarily Impaired Available for Sale Securities	90,954	505	2,101	73	93,055	578
Temporarily Impaired Held to Maturity Securities at December 31, 2015						
State and municipal			1,982	15	1,982	15
U.S. Government-sponsored mortgage-backed securities	69,641	519	12,906	268	82,547	787
Total Temporarily Impaired Held to Maturity Securities	69,641	519	14,888	283	84,529	802
Total Temporarily Impaired Investment Securities	\$160,595	\$ 1,024	\$16,989	\$ 356	\$177,584	\$ 1,380

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

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

	September 30, 2016	December 31, 2015	
Investments reported at less than historical cost:			
Historical cost	\$ 54,826	\$ 178,964	
Fair value	\$ 54,421	\$ 177,584	
Percent of the Corporation's available for sale and held to maturity portfolio	4.2	% 13.9	%

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

The Corporation's management has evaluated all securities with unrealized losses for other-than temporary impairment as of September 30, 2016. The evaluations are based on the nature of the securities, the extent and duration of the loss and the intent and ability of the Corporation to hold these securities either to maturity or through the expected recovery period.

In determining the fair value of the investment securities portfolio, the Corporation utilizes a third party for portfolio accounting services, including market value input, for those securities classified as Level 1 and Level 2 in the fair value hierarchy. The Corporation has obtained an understanding of what inputs are being used by the vendor in pricing the portfolio and how the vendor was classifying these securities based upon these inputs. From these discussions, the Corporation's management is comfortable that the classifications are proper. The Corporation has gained trust in the data for two reasons: (a) independent spot testing of the data is conducted by the Corporation through obtaining market quotes from various brokers on a periodic basis and (b) actual gains or losses resulting from the sale of certain securities has proven the data to be accurate over time. The fair value of securities classified as Level 3 in the valuation hierarchy was determined using a discounted cash flow model that incorporated market estimates of interest rates and volatility in markets that have not been active.

State and Municipal and U.S. Government-Sponsored Mortgage-Backed Securities

The unrealized losses on the Corporation's investments in securities of state and political subdivisions and U.S. Government-sponsored mortgage-backed securities were caused by changes in interest rates and not credit quality. 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 investments and more likely than not the Corporation won't be required to sell the investments before recovery of its lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at September 30, 2016.

Credit Losses Recognized on Investments

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

	Accumulated Credit Losses in 2016	Accumulated Credit Losses in 2015
Credit losses on debt securities held:		
Balance, January 1	\$	—\$ 500
Reductions for previous other-than-temporary losses realized on securities sold during the year	—	(500)
Balance, September 30	\$	—\$ —

In the first quarter of 2015, the Corporation sold its remaining trust preferred security which had no remaining book value as a result of other than temporary impairment of approximately \$500,000 taken in 2009. The sale of this security resulted in a gain of \$45,000, which is included in the Consolidated Condensed Statement of Income for the nine months ended September 30, 2015.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 4

LOANS AND ALLOWANCE

The Corporation's primary lending focus is small business and middle market commercial, commercial real estate, residential real estate and consumer, which results in portfolio diversification. The following tables show the composition of the loan portfolio, the allowance for loan losses and certain credit quality aspects, all excluding loans held for sale. Loans held for sale as of September 30, 2016, and December 31, 2015, were \$1,482,000 and \$9,894,000, respectively.

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

	September 30, 2016	December 31, 2015
Commercial and industrial loans	\$ 1,146,538	\$ 1,057,075
Agricultural production financing and other loans to farmers	93,169	97,711
Real estate loans:		
Construction	368,241	366,704
Commercial and farmland	1,941,739	1,802,921
Residential	739,855	786,105
Home Equity	398,837	348,613
Individuals' loans for household and other personal expenditures	76,497	74,717
Lease financing receivables, net of unearned income	380	588
Other commercial loans	208,588	159,388
Loans	\$ 4,973,844	\$ 4,693,822
Allowance for loan losses	(63,456)	(62,453)
Net Loans	\$ 4,910,388	\$ 4,631,369

Allowance, Credit Quality and Loan Portfolio

The Corporation maintains an allowance for loan losses to cover probable credit losses identified during its loan review process. Management believes the allowance for loan losses is adequate to cover probable losses inherent in the loan portfolio at September 30, 2016. The process for determining the adequacy of the allowance for loan losses is critical to the Corporation's financial results. It requires management to make difficult, subjective and complex judgments, to estimate the effect of uncertain matters. The allowance for loan losses considers current factors, including economic conditions and ongoing internal and external examinations, and will increase or decrease as deemed necessary to ensure it remains adequate. In addition, the allowance as a percentage of charge offs and nonperforming loans will change at different points in time based on credit performance, portfolio mix and collateral values.

The allowance for loan losses is maintained through the provision for loan losses, which is a charge against earnings. The allowance is increased by provision expense and decreased by charge offs less recoveries. All charge offs are approved by the Bank's senior loan officers or loan committees, depending on the amount of the charge off. The Bank

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

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

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

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

In conformance with ASC 805 and ASC 820, loans purchased after December 31, 2008 are recorded at the acquisition date fair value. Such loans are included in the allowance to the extent a specific impairment is identified that exceeds the fair value adjustment on an impaired loan or the historical loss and environmental factor analysis indicates losses inherent in a purchased portfolio exceeds the fair value adjustment on the portion of the purchased portfolio not deemed impaired.

The following tables summarize changes in the allowance for loan losses by loan segment for the three and nine months ended September 30, 2016, and September 30, 2015:

Three Months Ended September 30, 2016

	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, June 30, 2016	\$26,321	\$22,280	\$2,684	\$10,899	\$2	\$62,186
Provision for losses	727	578	115	480		1,900
Recoveries on loans	175	651	101	324		1,251
Loans charged off	(720)	(572)	(114)	(475)		(1,881)
Balances, September 30, 2016	\$26,503	\$22,937	\$2,786	\$11,228	\$2	\$63,456

Nine Months Ended September 30, 2016

	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, December 31, 2015	\$26,478	\$22,145	\$2,689	\$11,139	\$2	\$62,453
Provision for losses	1,266	992	192	790		3,240
Recoveries on loans	1,150	1,879	286	909		4,224
Loans charged off	(2,391)	(2,079)	(381)	(1,610)		(6,461)
Balances, September 30, 2016	\$26,503	\$22,937	\$2,786	\$11,228	\$2	\$63,456

Three Months Ended September 30, 2015

Commercial	Consumer	Residential	Total
------------	----------	-------------	-------

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

	Commercial Real Estate		Finance Leases			
Allowance for loan losses:						
Balances, June 30, 2015	\$31,479	\$ 15,828	\$ 2,927	\$ 12,311	\$ 5	\$62,550
Provision for losses	3,202	(2,966)	(102)	(132)	(2)	
Recoveries on loans	281	1,510	67	513		2,371
Loans charged off	(1,026)	(386)	(169)	(479)		(2,060)
Balances, September 30, 2015	\$33,936	\$ 13,986	\$ 2,723	\$ 12,213	\$ 3	\$62,861

Nine Months Ended September 30, 2015

	Commercial Real Estate	Commercial Real Estate	Consumer	Residential	Finance Leases	Total
Allowance for loan losses:						
Balances, December 31, 2014	\$28,824	\$ 19,327	\$ 2,658	\$ 13,152	\$ 3	\$63,964
Provision for losses	6,226	(6,364)	225	330		417
Recoveries on loans	1,168	2,069	246	1,392		4,875
Loans charged off	(2,282)	(1,046)	(406)	(2,661)		(6,395)
Balances, September 30, 2015	\$33,936	\$ 13,986	\$ 2,723	\$ 12,213	\$ 3	\$62,861

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

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

	September 30, 2016					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance Balances:						
Individually evaluated for impairment	\$555	\$760		\$312		\$1,627
Collectively evaluated for impairment	25,948	22,177	\$2,786	10,916	\$2	61,829
Loans Acquired with Deteriorated Credit Quality						
Total Allowance for Loan Losses	\$26,503	\$22,937	\$2,786	\$11,228	\$2	\$63,456
Loan Balances:						
Individually evaluated for impairment	\$5,764	\$23,904		\$4,158		\$33,826
Collectively evaluated for impairment	1,436,065	2,242,862	\$76,497	1,132,385	\$380	4,888,189
Loans Acquired with Deteriorated Credit Quality	6,466	43,214		2,149		51,829
Loans	\$1,448,295	\$2,309,980	\$76,497	\$1,138,692	\$380	\$4,973,844

	December 31, 2015					Total
	Commercial	Commercial Real Estate	Consumer	Residential	Finance Leases	
Allowance Balances:						
Individually evaluated for impairment	\$1,277	\$243		\$169		\$1,689
Collectively evaluated for impairment	25,201	21,753	\$2,689	10,966	\$2	60,611
Loans Acquired with Deteriorated Credit Quality		149		4		153
Total Allowance for Loan Losses	\$26,478	\$22,145	\$2,689	\$11,139	\$2	\$62,453
Loan Balances:						
Individually evaluated for impairment	\$7,877	\$16,670		\$4,020		\$28,567
Collectively evaluated for impairment	1,298,988	2,096,089	\$74,717	1,125,316	\$588	4,595,698
Loans Acquired with Deteriorated Credit Quality	7,309	56,866		5,382		69,557
Loans	\$1,314,174	\$2,169,625	\$74,717	\$1,134,718	\$588	\$4,693,822

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.

Consumer and Residential

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

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. Uncollected interest previously recorded, but not deemed collectible, is reversed and charged against current income. Payments subsequently received on non-accrual loans are applied to principal. A loan is returned to accrual status when principal and interest are no longer past due and collectability is probable, typically after a minimum of six consecutive months of performance. Payments received on impaired accruing or delinquent loans are applied to interest income as accrued.

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

	September 30, December	
	2016	31, 2015
Commercial and industrial loans	\$ 2,381	\$ 4,634
Agriculture production financing and other loans to farmers	1,530	827
Real estate Loans:		
Construction	271	736
Commercial and farmland	16,983	11,277
Residential	10,608	11,818
Home Equity	2,216	1,952
Individuals' loans for household and other personal expenditures	116	145
Total	\$ 34,105	\$ 31,389

Commercial impaired loans include non-accrual loans, loans accounted for under ASC 310-30, and loans risk graded as substandard, doubtful and loss that were still accruing but deemed impaired according to the guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more and troubled debt restructurings.

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

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

	September 30, 2016		
	Unpaid	Recorded	Related
	Principal Investment Allowance		

	Balance		
Impaired loans with no related allowance:			
Commercial and industrial loans	\$ 18,096	\$ 9,996	
Agriculture production financing and other loans to farmers	649	611	
Real estate Loans:			
Construction	6,492	3,545	
Commercial and farmland	82,551	61,536	
Residential	8,252	4,934	
Home equity	82	44	
Other commercial loans	13		
Total	\$ 116,135	\$ 80,666	
Impaired loans with related allowance:			
Commercial and industrial loans	\$ 779	\$ 467	\$ 379
Agriculture production financing and other loans to farmers	1,186	1,156	175
Real estate Loans:			
Commercial and farmland	2,070	1,835	760
Residential	65	34	22
Total	\$ 4,100	\$ 3,492	\$ 1,336
Total Impaired Loans	\$ 120,235	\$ 84,158	\$ 1,336

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

	December 31, 2015			
	Unpaid Principal Balance	Recorded Investment	Related Allowance	
Impaired loans with no related allowance:				
Commercial and industrial loans	\$22,151	\$ 11,669		
Agriculture production financing and other loans to farmers	370	361		
Real estate Loans:				
Construction	4,551	2,336		
Commercial and farmland	95,930	69,024		
Residential	11,262	7,338		
Home equity	297	247		
Other commercial loans	20			
Total	\$134,581	\$ 90,975		
Impaired loans with related allowance:				
Commercial and industrial loans	\$3,043	\$ 2,690	\$ 1,247	
Agriculture production financing and other loans to farmers	466	466	30	
Real estate Loans:				
Commercial and farmland	2,144	1,933	392	
Residential	2,300	1,463	173	
Total	\$7,953	\$ 6,552	\$ 1,842	
Total Impaired Loans	\$142,534	\$ 97,527	\$ 1,842	
		Three Months Ended September 30, 2016	Nine Months Ended September 30, 2016	
		Average Recorded Investment	Average Interest Recorded Income Recognized	
Impaired loans with no related allowance:				
Commercial and industrial loans	\$10,025	\$ 89	\$10,436	\$ 261
Agriculture production financing and other loans to farmers	636	3	644	3
Real estate Loans:				
Construction	3,526	72	3,572	215
Commercial and farmland	61,903	854	63,722	2,576
Residential	5,081	40	5,453	118
Home equity	44		57	
Total	\$81,215	\$ 1,058	\$83,884	\$ 3,173
Impaired loans with related allowance:				
Commercial and industrial loans	\$469		\$471	
Agriculture production financing and other loans to farmers	1,164	6	1,236	6
Real estate Loans:				
Commercial and farmland	1,850		1,894	
Residential	34		39	
Total	\$3,517	\$ 6	\$3,640	\$ 6

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Total Impaired Loans	\$84,732	\$ 1,064	\$87,524	\$ 3,179
	Three Months Ended		Nine Months Ended	
	September 30, 2015		September 30, 2015	
	Average	Interest	Average	Interest
	Recorded	Income	Recorded	Income
	Investment	Recognized	Investment	Recognized
Impaired loans with no related allowance:				
Commercial and industrial loans	\$11,863	\$ 137	\$12,676	\$ 368
Agriculture production financing and other loans to farmers	675		699	
Real estate Loans:				
Construction	2,855	41	3,407	123
Commercial and farmland	64,186	932	65,310	2,661
Residential	9,028	47	9,272	177
Home equity	194		197	
Total	\$88,801	\$ 1,157	\$91,561	\$ 3,329
Impaired loans with related allowance:				
Commercial and industrial loans	\$2,731	\$ 10	\$2,774	\$ 29
Agriculture production financing and other loans to farmers	547		547	
Real estate Loans:				
Commercial and farmland	2,459		2,613	
Residential	625		626	
Total	\$6,362	\$ 10	\$6,560	\$ 29
Total Impaired Loans	\$95,163	\$ 1,167	\$98,121	\$ 3,358

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

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

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

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

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

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

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

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

repayment is known.

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

The following tables summarize the credit quality of the Corporation's loan portfolio, by loan class for the periods indicated. Consumer non-performing loans include accruing consumer loans 90 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. Loans that evidenced deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected are included in the applicable categories below.

	September 30, 2016							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$ 1,075,134	\$ 34,937	\$ 36,467					\$ 1,146,538
Agriculture production financing and other loans to farmers	30,491	35,075	27,603					93,169
Real estate Loans:								
Construction	344,737	5,381	966			\$ 17,081	\$ 76	368,241
Commercial and farmland	1,805,513	52,864	83,362					1,941,739
Residential	148,251	5,532	6,573			570,838	8,661	739,855
Home equity	7,713	69	520			388,069	2,466	398,837
Individuals' loans for household and other personal expenditures						76,351	146	76,497
Lease financing receivables, net of unearned income	295		85					380
Other commercial loans	208,028		560					208,588
Loans	\$ 3,620,162	\$ 133,858	\$ 156,136			\$ 1,052,339	\$ 11,349	\$ 4,973,844

	December 31, 2015							
	Commercial Pass	Commercial Special Mention	Commercial Substandard	Commercial Doubtful	Commercial Loss	Consumer Performing	Consumer Non-Performing	Total
Commercial and industrial loans	\$ 962,340	\$ 48,432	\$ 45,984	\$ 319				\$ 1,057,075
Agriculture production financing and other loans	77,884	6,665	13,162					97,711

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

to farmers							
Real estate Loans:							
Construction	345,449	1,271	1,790		\$ 18,114	\$ 80	366,704
Commercial and farmland	1,679,141	46,442	77,338				1,802,921
Residential	171,576	3,107	10,428		593,533	7,461	786,105
Home equity	8,218	48	600		337,718	2,029	348,613
Individuals' loans for household and other personal expenditures					74,491	226	74,717
Lease financing receivables, net of unearned income	495		93				588
Other commercial loans	159,388						159,388
Loans	\$3,404,491	\$ 105,965	\$ 149,395	\$ 319	\$ 1,023,856	\$ 9,796	\$4,693,822

The tables below show a past due aging of the Corporation's loan portfolio, by loan class, as of September 30, 2016, and December 31, 2015.

	September 30, 2016					Total Past Due & Non-Accrual	Total
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual		
Commercial and industrial loans	\$1,143,456	\$701			\$ 2,381	\$ 3,082	\$1,146,538
Agriculture production financing and other loans to farmers	91,639				1,530	1,530	93,169
Real estate Loans:							
Construction	367,969			\$ 1	271	272	368,241
Commercial and farmland	1,919,826	976	\$2,737	1,217	16,983	21,913	1,941,739
Residential	724,200	3,390	1,574	83	10,608	15,655	739,855
Home equity	394,977	841	510	293	2,216	3,860	398,837
Individuals' loans for household and other personal expenditures	75,948	295	107	31	116	549	76,497
Lease financing receivables, net of unearned income	380						380
Other commercial loans	208,588						208,588
Loans	\$4,926,983	\$6,203	\$4,928	\$ 1,625	\$ 34,105	\$ 46,861	\$4,973,844

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

	December 31, 2015						Total Past Due & Non-Accrual	Total
	Current	30-59 Days Past Due	60-89 Days Past Due	Loans > 90 Days And Accruing	Non-Accrual			
Commercial and industrial loans	\$ 1,052,275	\$ 166			\$ 4,634	\$ 4,800	\$ 1,057,075	
Agriculture production financing and other loans to farmers	96,884				827	827	97,711	
Real estate Loans:								
Construction	362,084	3,884			736	4,620	366,704	
Commercial and farmland	1,786,092	5,552			11,277	16,829	1,802,921	
Residential	765,634	6,090	\$ 2,061	\$ 502	11,818	20,471	786,105	
Home equity	344,344	1,433	560	324	1,952	4,269	348,613	
Individuals' loans for household and other personal expenditures	73,990	445	56	81	145	727	74,717	
Lease financing receivables, net of unearned income	588						588	
Other commercial loans	159,324		64			64	159,388	
Loans	\$ 4,641,215	\$ 17,570	\$ 2,741	\$ 907	\$ 31,389	\$ 52,607	\$ 4,693,822	

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 Quarterly Report on Form 10-Q.

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

The following tables summarize troubled debt restructurings in the Corporation's loan portfolio that occurred during the periods indicated:

	Three Months Ended September 30, 2016			Nine Months Ended September 30, 2016		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and industrial loans				\$ 260	\$ 260	3

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Agriculture production financing and other loans to farmers				1,606	1,472	5
Real estate Loans:						
Commercial and farmland	\$ 87	\$ 95	1	3,978	3,955	7
Residential	611	678	11	724	811	14
Home Equity	55	58	2	229	204	3
Total	\$ 753	\$ 831	14	\$ 6,797	\$ 6,702	32

	Three Months Ended September 30, 2015			Nine Months Ended September 30, 2015		
	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans	Pre-Modification Recorded Balance	Post-Modification Recorded Balance	Number of Loans
Commercial and industrial loans	\$ 363	\$ 218	2	\$ 4,111	\$ 2,115	7
Real estate Loans:						
Construction				79	80	1
Commercial and farmland	744	744	1	1,281	3,025	3
Residential	11	13	1	55	908	4
Home Equity	239	242	1	239	242	1
Total	\$ 1,357	\$ 1,217	5	\$ 5,765	\$ 6,370	16

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

The following tables summarize the recorded investment of troubled debt restructurings as of September 30, 2016 and 2015, by modification type, that occurred during the periods indicated:

Three Months Ended September 30, 2016

	Term Modification	Rate Modification	Combination	Total Modification
Real estate Loans:				
Commercial and farmland			\$ 95	\$ 95
Residential		\$ 663		663
Home Equity		56		56
Total		\$ 719	\$ 95	\$ 814

Nine Months Ended September 30, 2016

	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans			\$ 197	\$ 197
Agriculture production financing and other loans to farmers			\$ 898	898
Real estate Loans:				
Commercial and farmland			416	3,487
Residential		\$ 773		773
Home Equity		197		197
Total		\$ 970	\$ 3,684	\$ 5,968

Three Months Ended September 30, 2015

	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans	\$ 138		\$ 75	\$ 213
Real estate Loans:				
Commercial and farmland			744	744
Residential		\$ 13		13
Home Equity		242		242
Total	\$ 138	\$ 255	\$ 819	\$ 1,212

Nine Months Ended September 30, 2015

	Term Modification	Rate Modification	Combination	Total Modification
Commercial and industrial loans	\$ 806		\$ 1,080	\$ 1,886
Real estate Loans:				
Commercial and farmland	1,337		1,004	2,341
Residential	850	\$ 59		909
Home Equity		242		242
Total	\$ 2,993	\$ 301	\$ 2,084	\$ 5,378

Commercial and farmland real estate loans made up 59 percent of the post-modification balance of troubled debt restructured loans made in the nine months ended September 30, 2016.

The following tables summarize troubled debt restructures that occurred during the three and nine months ended September 30, 2016 and September 30, 2015, that subsequently defaulted during the period indicated and remained in default at period end. For purposes of this discussion, a loan is considered in default if it is 30 or more days past due.

	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2016
	Number of Recorded Loans of Balance	Number of Recorded Loans of Balance
Commercial and industrial loans		3 \$ 197
Real estate Loans:		
Residential	1 \$ 54	1 \$ 54
Total	1 \$ 54	4 \$ 251

	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2015
	Number of Recorded Loans	Number of Recorded Loans
Real estate Loans:		
Residential	1 \$ 21	1 \$ 21
Total	1 \$ 21	1 \$ 21

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

For potential consumer loan restructures, impairment evaluation occurs prior to modification. Any subsequent impairment is typically addressed through the charge off process, or may be addressed through a specific reserve. Consumer troubled debt restructurings are generally included in the general historical allowance for loan loss at the post modification balance. Consumer non-accrual and delinquent troubled debt restructurings are also considered in the calculation of the non-accrual and delinquency trend environmental allowance allocation. Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process totaled \$2,818,000 and \$1,391,000 at September 30, 2016 and December 31, 2015, respectively.

Commercial troubled debt restructured loans risk graded special mention, substandard, doubtful and loss are individually evaluated for impairment under ASC 310. Any resulting specific reserves are included in the allowance for loan losses. Commercial 30 - 89 day delinquent troubled debt restructurings are included in the calculation of the delinquency trend environmental allowance allocation. All commercial non-impaired loans, including non-accrual and 90+ day delinquents, are included in the ASC 450 loss migration analysis.

NOTE 5

ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE

The acquired loans detailed in the tables below are included in NOTE 4. LOANS AND ALLOWANCE, in the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q. As described in NOTE 4, loans purchased after December 31, 2008 are recorded at the acquisition date fair value, which could result in a fair value discount or premium. Purchased loans with evidence of credit deterioration since origination and for which it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments are accounted for under ASC 310-30, Loans Acquired with Deteriorated Credit Quality. The difference between contractually required payments and the cash flows expected to be collected at acquisition is referred to as the nonaccretable portion of the fair value discount or premium. The accretable portion of the fair value discount or premium is the difference between the expected cash flows and the net present value of expected cash flows, with such difference accreted into earnings over the term of the loans. All other loans not accounted for under ASC 310-30 are accounted for under ASC 310-20.

The Corporation's recent acquisitions are detailed in NOTE 2, ACQUISITIONS AND DIVESTITURES, in the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q. In addition, the Corporation acquired Community in November 2014 and CFS in November 2013. The Corporation also acquired certain loans from SCB in February 2012. The following table includes the outstanding balance and carrying amount of all acquired loans which were included in the Corporation's balance sheet at September 30, 2016, and December 31, 2015.

	September 30, 2016					
	Ameriana Financial ^C	Community	CFS	SCB	Total	
Commercial and industrial loans	\$ 16,731	\$ 90	\$ 3,239	\$ 30,553	\$ 3,790	\$ 54,403
Agricultural production financing and other loans to farmers			2,223	50	1,305	3,578

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Real estate loans:						
Construction	30,800	3,260	5,953	489		40,502
Commercial and farmland	110,195	22,449	39,765	147,890	10,933	331,232
Residential	105,173	46,696	10,091	101,663	4,478	268,101
Home Equity	12,301	8,511	7,038	28,101	12,282	68,233
Individuals' loans for household and other personal expenditures	938	3	203	238	34	1,416
Other commercial loans	1,825			67		1,892
Total	\$277,963	\$ 81,009	\$ 68,512	\$309,051	\$32,822	\$769,357
Carrying Amount	\$266,592	\$ 78,972	\$ 64,149	\$294,759	\$29,243	\$733,715
Allowance			22	642		664
Carrying Amount Net of Allowance	\$266,592	\$ 78,972	\$ 64,127	\$294,117	\$29,243	\$733,051

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

	December 31, 2015					
	Ameriana	C Financial	Community	CFS	SCB	Total
Commercial and industrial loans	\$21,888	\$ 104	\$ 6,769	\$52,060	\$4,620	\$85,441
Agricultural production financing and other loans to farmers			1,761		1,288	3,049
Real estate loans:						
Construction	23,365	6,214	10,436	976		40,991
Commercial and farmland	144,514	27,838	49,997	189,372	13,293	425,014
Residential	123,231	55,856	21,886	118,105	6,063	325,141
Home Equity	14,261	9,144	8,231	31,986	13,431	77,053
Individuals' loans for household and other personal expenditures	1,731	10	461	443	48	2,693
Other commercial loans	1,928			72		2,000
Total	\$330,918	\$ 99,166	\$ 99,541	\$393,014	\$38,743	\$961,382
Carrying Amount	\$319,664	\$96,829	\$ 93,355	\$373,649	\$34,092	\$917,589
Allowance			4	149		153
Carrying Amount Net of Allowance	\$319,664	\$96,829	\$ 93,351	\$373,500	\$34,092	\$917,436

The outstanding balance and related carrying amount of loans acquired and accounted for under ASC 310-30 as of September 30, 2016 were \$71.1 million and \$51.8 million, respectively. Additionally, the outstanding balance and related carrying amount of those loans as of December 31, 2015 were \$95.8 million and \$69.6 million, respectively.

As customer cash flow expectations improve, nonaccretable yield can be reclassified to accretable yield. The accretable yield, or income expected to be collected, and reclassifications from nonaccretable yield, are identified in the table below. The table reflects only purchased loans accounted for under ASC 310-30 and not the entire portfolio of purchased loans.

	Three Months Ended September 30, 2016					
	Ameriana	C Financial	Community	CFS	SCB	Total
Beginning balance	\$1,846	\$ 81	\$ 1,345	\$904	\$451	\$4,627
Additions						
Accretion	(67)	(18)	(63)	(665)	(199)	(1,012)
Reclassification from nonaccretable	4	15	22	585	72	698
Disposals						
Ending balance	\$1,783	\$ 78	\$ 1,304	\$824	\$324	\$4,313

	Nine Months Ended September 30, 2016					
	Ameriana	C Financial	Community	CFS	SCB	Total
Beginning balance	\$2,160	\$ 114	\$ 1,508	\$1,188	\$642	\$5,612
Additions						

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Accretion	(154)	(104)	(975)	(2,810)	(580)	(4,623)
Reclassification from nonaccretable	9	68	771	2,457	262	3,567
Disposals	(232)			(11)		(243)
Ending balance	\$1,783	\$ 78	\$ 1,304	\$824	\$324	\$4,313

Three Months Ended September 30, 2015

	C Financial	Community	CFS	SCB	Total
Beginning balance	\$133	\$ 1,818	\$1,732	\$758	\$4,441
Additions					
Accretion	(8)	(139)	(1,058)	(285)	(1,490)
Reclassification from nonaccretable		21	704	235	960
Disposals		(140)	(3)		(143)
Ending balance	\$125	\$ 1,560	\$1,375	\$708	\$3,768

Nine Months Ended September 30, 2015

	C Financial	Community	CFS	SCB	Total
Beginning balance		\$ 2,122	\$2,400	\$868	\$5,390
Additions	\$145				145
Accretion	(20)	(671)	(2,977)	(774)	(4,442)
Reclassification from nonaccretable		249	1,963	614	2,826
Disposals		(140)	(11)		(151)
Ending balance	\$125	\$ 1,560	\$1,375	\$708	\$3,768

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 6

GOODWILL

Goodwill is recorded on the acquisition date of an entity. During the measurement period, the Corporation may record subsequent adjustments to goodwill for provisional amounts recorded at the acquisition date. The Ameriana acquisition on December 31, 2015 resulted in \$38,624,000 of goodwill, of which, \$871,000 was recorded during the first quarter of 2016 as a measurement period adjustment. The C Financial acquisition on April 17, 2015 resulted in goodwill of \$11,126,000. On June 12, 2015, the sale of FMIG resulted in a goodwill reduction of \$8,474,000. Details regarding the acquisitions and sale are discussed in NOTE 2. ACQUISITIONS AND DIVESTITURES, in the Notes to Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

	2016
Balance, January 1	\$243,129
Measurement period adjustment	871
Balance, September 30	\$244,000

	2015
Balance, January 1	\$202,724
Goodwill acquired	48,879
Goodwill reduction	(8,474)
Balance, December 31	\$243,129

NOTE 7

CORE DEPOSIT AND OTHER INTANGIBLES

Core deposit and other intangibles are recorded on the acquisition date of an entity. During the measurement period, the Corporation may record subsequent adjustments to core deposit and other intangibles for provisional amounts recorded at the acquisition date. The Ameriana acquisition on December 31, 2015 resulted in a core deposit intangible of \$5,342,000, of which, \$2,142,000 was recorded as a measurement period adjustment in the first quarter of 2016. The C Financial acquisition on April 17, 2015 resulted in a core deposit intangible of \$981,000. On June 12, 2015, the sale of FMIG resulted in an other intangible reduction of \$742,000. Details regarding the acquisitions and sale are discussed in NOTE 2. ACQUISITIONS AND DIVESTITURES, in the Notes to Consolidated Financial Statements of this Quarterly Report on Form 10-Q.

The carrying basis and accumulated amortization of recognized core deposit and other intangibles are noted below.

	September 30,	December 31,
	2016	2015
Gross carrying amount	\$ 61,799	\$ 58,360
Core deposit and other intangibles acquired		4,181

Accumulated amortization	(48,097	) (45,164)
Measurement period adjustment	2,142		
Core deposit and other intangibles reduction		(742)
Core deposit and other intangibles	\$ 15,844	\$ 16,635	

Estimated future amortization expense is summarized as follows:

	Amortization Expense
2016	\$ 978
2017	3,614
2018	2,299
2019	1,914
2020	1,733
After 2020	5,306
	\$ 15,844

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 8

DERIVATIVE FINANCIAL INSTRUMENTS

Risk Management Objective of Using Derivatives

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

Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish these objectives, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up-front premium. As of September 30, 2016 and December 31, 2015, the Corporation had five interest rate swaps with a notional amount of \$56.0 million and one interest rate cap with a notional amount of \$13.0 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation expects to reclassify \$1,130,000 from accumulated other comprehensive income to interest expense.

During 2016, \$26.0 million of the interest rate swaps and the \$13.0 million interest rate cap were used to hedge the LIBOR-based variable cash outflows associated with existing trust preferred securities when the outflows converted from a fixed rate to variable rate in September of 2012. In addition, the remaining \$30.0 million of interest rate swaps were used to hedge the LIBOR-based variable cash outflows associated with three Federal Home Loan Bank advances. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

During the nine months ended September 30, 2016, and 2015, the Corporation did not recognize any ineffectiveness.

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 September 30, 2016, the notional amount of customer-facing swaps was approximately \$240,285,000. This amount is offset with third party counterparties, as described above.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Corporation's derivative financial instruments, as well as their classification on the Balance Sheet, as of September 30, 2016, and December 31, 2015.

	Asset Derivatives				Liability Derivatives			
	September 30, 2016		December 31, 2015		September 30, 2016		December 31, 2015	
	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	\$4	Other Assets	\$36	Other Liabilities	\$4,433	Other Liabilities	\$2,921
Derivatives not designated as hedging instruments:								
Interest rate contracts	Other Assets	\$12,102	Other Assets	\$4,938	Other Liabilities	\$12,102	Other Liabilities	\$5,149

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

Derivatives in Cash Flow Hedging Relationships	Amount of Gain (Loss) Recognized in Other Comprehensive Income on Derivative (Effective Portion)			
	Three Months Ended		Nine Months Ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Interest Rate Products	\$384	\$(1,791)	\$(2,383)	\$(2,260)

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 nine months ended September 30, 2016, and 2015.

Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized on Derivative	Amount of Gain (Loss) Recognized in Income on Derivative	
		September 30, 2016	September 30, 2015

		Three Months Ended September 30, 2016	Three Months Ended September 30, 2015
Interest rate contracts	Other income	\$211	\$ (194)

		Amount of Gain (Loss) Recognized in Income on	Derivative
Derivatives Not Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Interest rate contracts	Other income	\$698	\$ (139)

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

		Amount of Gain (Loss) Reclassified from Other Comprehensive Income into	Income (Effective Portion)
Derivatives Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015
Interest rate contracts	Interest Expense	(317)	(362)

		Amount of Gain (Loss) Reclassified from Other Comprehensive Income into	Income (Effective Portion)
Derivatives Designated as Hedging Instruments under FASB ASC 815-10	Location of Gain (Loss) Recognized Income on Derivative	Nine Months Ended	Nine Months Ended

		September 30, 2015	September 30, 2016
Interest rate contracts	Interest Expense	\$ (959)	\$ (1,074)

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 level of risk is monitored by performing quarterly financial reviews, comparing mark-to-mark values with policy limitations, monitoring credit ratings and pledging of collateral.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Credit-risk-related Contingent Features

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

The Corporation also 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 September 30, 2016, the termination value of derivatives in a net liability position related to these agreements was \$16,813,000. As of September 30, 2016, the Corporation had minimum collateral posting thresholds with certain of its derivative counterparties and had posted collateral of \$19,021,000. If the Corporation had breached any of these provisions at September 30, 2016, it could have been required to settle its obligations under the agreements at their termination value.

NOTE 9

DISCLOSURES ABOUT FAIR VALUE OF ASSETS AND LIABILITIES

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

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

Valuation inputs refer to the assumptions market participants would use in pricing a given asset or liability. Inputs can be observable or unobservable. Observable inputs are those assumptions which market participants would use in pricing the particular asset or liability. These inputs are based on market data and are obtained from a source independent of the Corporation. Unobservable inputs are assumptions based on the Corporation's own information or estimate of assumptions used by market participants in pricing the asset or liability. Unobservable inputs are based on the best and most current information available on the measurement date. All inputs, whether observable or

unobservable, are ranked in accordance with a prescribed fair value hierarchy which gives the highest ranking to quoted prices (unadjusted) in active markets for identical assets or liabilities (Level 1) and the lowest ranking to unobservable inputs for which there is little or no market activity (Level 3). Fair values for assets or liabilities classified as Level 2 are based on one or a combination of the following factors: (i) quoted prices for similar assets; (ii) observable inputs for the asset or liability, such as interest rates or yield curves; or (iii) inputs derived principally from or corroborated by observable market data. The level in the fair value hierarchy within which the fair value measurement in its entirety falls is determined based on the lowest level input that is significant to the fair value measurement in its entirety. The Corporation considers an input to be significant if it drives 10 percent or more of the total fair value of a particular asset or liability.

Recurring Measurements

The following is a description of the valuation methodologies and inputs used for instruments measured at fair value on a recurring basis and recognized in the accompanying Consolidated Condensed Balance Sheets, as well as the general classification of such instruments pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques as of September 30, 2016.

Available for Sale Investment Securities

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

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Interest Rate Derivative Agreements

See information regarding the Corporation's interest rate derivative products in NOTE 8. DERIVATIVE FINANCIAL INSTRUMENTS, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

The following table presents the fair value measurements of assets and liabilities recognized in the Consolidated Condensed Balance Sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2016, and December 31, 2015.

September 30, 2016	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	\$ 101		\$ 101	
State and municipal	369,050		363,643	\$ 5,407
U.S. Government-sponsored mortgage-backed securities	304,580		304,580	
Corporate obligations	31			31
Equity securities	2,016		2,012	4
Interest rate swap asset	12,102		12,102	
Interest rate cap	4		4	
Interest rate swap liability	16,535		16,535	

December 31, 2015	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	\$ 104		\$ 104	
State and municipal	305,911		300,014	\$ 5,897
U.S. Government-sponsored mortgage-backed securities	346,266		346,266	
Certificates of deposit	2,176		2,176	
Corporate obligations	31			31
Equity securities	3,912		3,908	4
Interest rate swap asset	4,938		4,938	

Interest rate cap	36	36
Interest rate swap liability	8,070	8,070

Level 3 Reconciliation

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the Consolidated Condensed Balance Sheets using significant unobservable (Level 3) inputs for the three and nine months ended September 30, 2016 and 2015.

	Available for Sale Securities			
	Three Months Ended		Nine Months ended	
	September 30, 2016	September 30, 2015	September 30, 2016	September 30, 2015
Balance at beginning of the period	\$5,564	\$ 6,028	\$5,932	\$ 6,646
Total realized and unrealized gains and losses:				
Included in net income				
Included in other comprehensive income	(45	) 24	52	165
Purchases, issuances and settlements				
Transfers in/(out) of Level 3				
Principal payments	(77	) (156	) (542	) (915
Ending balance	\$5,442	\$ 5,896	\$5,442	\$ 5,896

There were no gains or losses for the period included in earnings that were attributable to the changes in unrealized gains or losses related to assets or liabilities held at September 30, 2016 or December 31, 2015.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Transfers Between Levels

There were no transfers in or out of Level 3 for the three and nine months ended September 30, 2016 and 2015.

Nonrecurring Measurements

The following table presents the fair value measurement of assets and liabilities measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2016, and December 31, 2015.

September 30, 2016	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans (collateral dependent)	\$15,763			\$ 15,763
Other real estate owned	2,213			2,213

December 31, 2015	Fair Value	Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans (collateral dependent)	\$7,066			\$ 7,066
Other real estate owned	5,529			5,529

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

Impaired Loans (collateral dependent)

Loans for which it is probable that the Corporation will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for determining the amount of impairment include estimating fair value of the collateral for collateral dependent loans. If the impaired loan is identified as collateral dependent, then the fair value method of measuring the amount of impairment is utilized. This method requires obtaining a current independent appraisal of the collateral and applying a discount factor to the value. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance. If these allocations cause the allowance for loan losses to increase, such increase is reported as a component of the provision for loan losses. Loan losses are charged against the allowance when management believes the uncollectability of the loan is confirmed. During 2016, certain impaired loans were partially charged off or

re-evaluated. Impaired loans that are collateral dependent are classified within Level 3 of the fair value hierarchy when impairment is determined using the fair value method.

Other Real Estate Owned

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

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements, other than goodwill, at September 30, 2016 and December 31, 2015.

September 30, 2016	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
State and municipal securities	\$5,407	Discounted cash flow	Maturity/Call date Blend of US Municipal Bank Qualified curve Discount rate	1 month to 20 yrs A- to BBB- .69% - 5%
Corporate obligations and Equity securities	\$35	Discounted cash flow	Risk free rate plus premium for illiquidity	3 month LIBOR plus 200bps
Impaired loans (collateral dependent)	\$15,763	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 10% (1%)
Other real estate owned	\$2,213	Appraisals	Discount to reflect current market conditions	0% - 10% (4%)
December 31, 2015	Fair Value	Valuation Technique	Unobservable Inputs	Range (Weighted-Average)
State and municipal securities	\$5,897	Discounted cash flow	Maturity/Call date Blend of US Municipal Bank Qualified curve Discount rate	1 month to 15 yrs A- to BBB- .80% - 5%
Corporate obligations and Equity securities	\$35	Discounted cash flow	Risk free rate plus premium for illiquidity	3 month LIBOR plus 200bps
Impaired loans (collateral dependent)	\$7,066	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	0% - 50% (2%)
Other real estate owned	\$5,529	Appraisals	Discount to reflect current market conditions	0% - 20% (2%)

Sensitivity of Significant Unobservable Inputs

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

State and Municipal Securities, Corporate Obligations and Equity Securities

The significant unobservable inputs used in the fair value measurement of the Corporation's state and municipal securities, corporate obligations and equity securities are premiums for unrated securities and marketability discounts. Significant increases or decreases in either of those inputs in isolation would result in a significantly lower or higher fair value measurement.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

Fair Value of Financial Instruments

The following table presents estimated fair values of the Corporation's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at September 30, 2016, and December 31, 2015.

		September 30, 2016		
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Cash and cash equivalents	\$99,602	\$99,602		
Interest-bearing time deposits	33,803	33,803		
Investment securities available for sale	675,813		\$670,371	\$ 5,442
Investment securities held to maturity	624,615		631,255	15,791
Loans held for sale	1,482		1,482	
Loans	4,910,388			4,871,640
Federal Home Loan Bank stock	18,044		18,044	
Interest rate swap and cap asset	12,106		12,106	
Interest receivable	23,652		23,652	
Liabilities:				
Deposits	\$5,444,240	\$4,290,400	\$1,143,837	
Borrowings:				
Federal funds purchased	58,358		58,358	
Securities sold under repurchase agreements	138,671		138,656	
Federal Home Loan Bank advances	297,022		295,834	
Subordinated debentures and term loans	128,288		105,604	
Interest rate swap liability	16,535		16,535	
Interest payable	3,733		3,733	
		December 31, 2015		
	Carrying Amount	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

		(Level 1)	(Level 2)	(Level 3)
Assets:				
Cash and cash equivalents	\$102,170	\$102,170		
Interest-bearing time deposits	32,315	32,315		
Investment securities available for sale	658,400		\$652,468	\$ 5,932
Investment securities held to maturity	618,599		598,082	34,298
Loans held for sale	9,894		9,894	
Loans	4,631,369			4,539,940
Federal Reserve Bank and Federal Home Loan Bank stock	37,633		37,633	
Interest rate swap and cap asset	4,974		4,974	
Interest receivable	24,415		24,415	
Liabilities:				
Deposits	\$5,289,647	\$4,095,004	\$1,177,142	
Borrowings:				
Federal funds purchased	49,721		49,721	
Securities sold under repurchase agreements	155,325		155,325	
Federal Home Loan Bank advances	235,652		236,375	
Subordinated debentures and term loans	127,846		103,643	
Interest rate swap liability	8,070		8,070	
Interest payable	3,092		3,092	

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

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

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

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

Investment securities: Fair value is based on quoted market prices, if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. The fair value of certain Level 3 securities is estimated using discounted cash flow analysis, using interest rates currently being offered on investments with similar maturities and investment quality.

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

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

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

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

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

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

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

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

NOTE 10

TRANSFERS ACCOUNTED FOR AS SECURED BORROWINGS

The collateral pledged for all repurchase agreements that are accounted for as secured borrowings as of September 30, 2016 and December 31, 2015 were:

September 30, 2016
 Remaining Contractual Maturity of the
 Agreements

Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
--------------------------------	---------------------	---------------	-------------------------------	-------

U.S. Government-sponsored mortgage-backed securities	\$ 119,326	\$ 1,336	\$ 10,432	\$ 7,577	\$ 138,671
--	------------	----------	-----------	----------	------------

December 31, 2015
 Remaining Contractual Maturity of the
 Agreements

Overnight and Continuous	Up to 30 Days	30-90 Days	Greater Than 90 Days	Total
--------------------------------	---------------------	---------------	-------------------------------	-------

U.S. Government-sponsored mortgage-backed securities	\$ 131,537	\$ 5,680	\$ 8,892	\$ 9,216	\$ 155,325
--	------------	----------	----------	----------	------------

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 11

ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following table summarizes the changes in the balances of each component of accumulated other comprehensive income (loss), net of tax, as of September 30, 2016 and 2015:

	Accumulated Other Comprehensive Income (Loss)			
	Unrealized Gains (Losses) on Securities Available for Sale	Unrealized Gains (Losses) on Cash Flow Hedges	Unrealized Gains (Losses) on Defined Benefit Plans	Total
Balance at December 31, 2015	\$12,325	\$ (2,347)	\$ (11,340)	\$ (1,362)
Other comprehensive income before reclassifications	7,863	(1,548)		6,315
Amounts reclassified from accumulated other comprehensive income	(1,652)	623		(1,029)
Period change	6,211	(925)	—	5,286
Balance at September 30, 2016	\$18,536	\$ (3,272)	\$ (11,340)	\$3,924
Balance at December 31, 2014	\$14,098	\$ (2,182)	\$ (13,546)	\$ (1,630)
Other comprehensive income before reclassifications	117	(1,468)		(1,351)
Amounts reclassified from accumulated other comprehensive income	(1,331)	698		(633)
Period change	(1,214)	(770)	—	(1,984)
Balance at September 30, 2015	\$12,884	\$ (2,952)	\$ (13,546)	\$ (3,614)

The following table presents the reclassification adjustments out of accumulated other comprehensive income (loss) that were included in net income in the Consolidated Condensed Statements of Income for the three and nine months ended September 30, 2016 and 2015:

Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Three Months Ended September 30, 2016	2015
--	------

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Details about Accumulated Other Comprehensive Income (Loss) Components			Affected Line Item in the Statements of Income
Unrealized gains (losses) on available for sale securities ⁽¹⁾			
Realized securities gains reclassified into income	\$839	\$1,115	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(294)	(390)	Income tax expense
	\$545	\$725	
Unrealized gains (losses) on cash flow hedges ⁽²⁾			
Interest rate contracts	\$(317)	\$(362)	Interest expense - subordinated debentures and term loans
Related income tax benefit	111	127	Income tax expense
	\$(206)	\$(235)	
Total reclassifications for the period, net of tax	\$339	\$490	
	Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Nine Months Ended September 30,		
Details about Accumulated Other Comprehensive Income (Loss) Components	2016	2015	Affected Line Item in the Statements of Income
Unrealized gains (losses) on available for sale securities ⁽¹⁾			
Realized securities gains reclassified into income	\$2,542	\$2,047	Other income - net realized gains on sales of available for sale securities
Related income tax expense	(890)	(716)	Income tax expense
	\$1,652	\$1,331	
Unrealized gains (losses) on cash flow hedges ⁽²⁾			
Interest rate contracts	\$(959)	\$(1,074)	Interest expense - subordinated debentures and term loans
Related income tax benefit	336	376	Income tax expense
	\$(623)	\$(698)	
Total reclassifications for the period, net of tax	\$1,029	\$633	

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

⁽²⁾ For additional detail related to unrealized gains (losses) on cash flow hedges and related amounts reclassified from accumulated other comprehensive income see NOTE 8. DERIVATIVE FINANCIAL INSTRUMENTS.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 12

SHARE-BASED COMPENSATION

Stock options and 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 six months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs issued to employees and non-employee directors provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after 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. For non-employee directors, the RSAs vest only if the non-employee director remains as an active board member on the vesting date and, therefore, any unvested shares are forfeited. RSAs for employees and non-employee directors retired from the Corporation are either immediately vested at retirement or continue to vest after retirement, depending on the plan under which the shares were granted. DSUs can be credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of September 30, 2016, there were no outstanding DSUs.

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

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three and nine months ended September 30, 2016 was \$648,000 and \$1,883,000, respectively, compared to \$556,000 and \$1,687,000, respectively, for the three and nine months ended September 30, 2015. 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 2014 and in prior years was calculated using a Black Scholes option pricing model. There have been no stock options granted since 2014.

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 3.8 percent for the nine months ended September 30, 2016, based on historical experience.

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

	Three Months Ended September 30, 2016		Nine Months Ended September 30, 2015	
Stock and ESPP Options				
Pre-tax compensation expense	\$18	\$23	\$54	\$78
Income tax expense (benefit)	3	5	12	4
Stock and ESPP option expense, net of income taxes	\$21	\$28	\$66	\$82
Restricted Stock Awards				
Pre-tax compensation expense	\$630	\$533	\$1,829	\$1,609
Income tax benefit	(221)	(187)	(640)	(552)
Restricted stock awards expense, net of income taxes	\$409	\$346	\$1,189	\$1,057
Total Share-Based Compensation				
Pre-tax compensation expense	\$648	\$556	\$1,883	\$1,687
Income tax benefit	(218)	(182)	(628)	(548)
Total share-based compensation expense, net of income taxes	\$430	\$374	\$1,255	\$1,139

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

As of September 30, 2016, unrecognized compensation expense related to RSAs was \$4,129,000 and is expected to be recognized over a weighted-average period of 1.51 years. The Corporation did not have any unrecognized compensation expense related to stock options as of September 30, 2016.

Stock option activity under the Corporation's stock option plans as of September 30, 2016 and changes during the nine months ended September 30, 2016, were as follows:

	Number of Shares	Weighted-Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
Outstanding at January 1, 2016	442,012	\$ 19.99		
Granted	—			
Exercised	(22,385)	\$ 13.80		
Canceled	(52,953)	\$ 25.09		
Outstanding September 30, 2016	366,674	\$ 19.63	2.79	2,691,404
Vested and Expected to Vest at September 30, 2016	366,674	\$ 19.63	2.79	2,691,404
Exercisable at September 30, 2016	366,674	\$ 19.63	2.79	2,691,404

There were no options granted during the nine months ended September 30, 2016 and September 30, 2015.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of the first nine months of 2016 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their stock options on September 30, 2016. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock. The aggregate intrinsic value of stock options exercised during the nine months ended September 30, 2016 and 2015 was \$245,000 and \$812,000, respectively. Cash receipts of stock options exercised during this same period were \$309,000 and \$1,422,000, respectively.

The following table summarizes information on unvested RSAs outstanding as of September 30, 2016:

	Number of Shares	Weighted-Average Grant Date Fair Value
Unvested RSAs at January 1, 2016	354,504	\$ 19.65
Granted	121,034	\$ 23.61
Vested	(110,251)	\$ 15.46
Forfeited	(7,711)	\$ 21.96
Unvested RSAs at September 30, 2016	357,576	\$ 22.54

The grant date fair value of ESPP options was estimated at the beginning of the July 1, 2016 quarterly offering period of approximately \$18,000. The ESPP options vested during the three months ending September 30, 2016, leaving no unrecognized compensation expense related to unvested ESPP options at September 30, 2016.

NOTE 13

INCOME TAX

The following table summarizes the major components creating differences between income taxes at the federal statutory and the effective tax rate recorded in the consolidated statements of income for the three and nine months ended September 30, 2016 and 2015:

	Three Months Ended September 30,		Nine Months Ended September 30,		
	2016	2015	2016	2015	
Reconciliation of Federal Statutory to Actual Tax Expense:					
Federal statutory income tax at 35%	\$9,985	\$8,268	\$27,481	\$25,359	
Tax-exempt interest income	(2,198)	(1,949)	(6,328)	(5,116)	
Basis difference on sale of insurance subsidiary				2,252	
Stock compensation	6	8	19	26	
Earnings on life insurance	(216)	(249)	(1,186)	(734)	
Tax credits	(165)	(145)	(423)	(437)	
Other	57	624	196	(103)	
Actual Tax Expense	\$7,469	\$6,557	\$19,759	\$21,247	
Effective Tax Rate	26.2	%27.8	% 25.2	%29.3	%

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 14

NET INCOME PER SHARE

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

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

The following table reconciles basic and diluted net income per share for the three and nine months ended September 30, 2016 and 2015.

	Three Months Ended September 30, 2016			2015		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Net income available to common stockholders	21,059	40,779,423	\$ 0.51	17,067	37,850,827	\$ 0.46
Effect of dilutive stock options and warrants		246,361			267,372	
Diluted net income per share	\$21,059	41,025,784	\$ 0.51	\$17,067	38,118,199	\$ 0.45

	Nine Months Ended September 30, 2016			2015		
	Net Income	Weighted-Average Shares	Per Share Amount	Net Income	Weighted-Average Shares	Per Share Amount
Net income available to common stockholders	58,758	40,740,714	\$ 1.44	51,207	37,785,236	\$ 1.36
Effect of dilutive stock options and warrants		229,501			268,750	
Diluted net income per share	\$58,758	40,970,215	\$ 1.43	\$51,207	38,053,986	\$ 1.35

Stock options to purchase 53,550 and 225,180 shares for the three months ended September 30, 2016 and 2015, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average

market price.

Stock options to purchase 119,157 and 335,550 shares for the nine months ended September 30, 2016 and 2015, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

37

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 15

IMPACT OF ACCOUNTING CHANGES

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

FASB Accounting Standards Update No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments

Summary - The FASB has issued Accounting Standards Update (ASU) No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows.

The amendments provide guidance on the following eight specific cash flow issues:

- Debt Prepayment or Debt Extinguishment Costs;
- Settlement of Zero-Coupon Debt Instruments or Other Debt Instruments with Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate of the Borrowing;
- Contingent Consideration Payments Made after a Business Combination;
- Proceeds from the Settlement of Insurance Claims;
- Proceeds from the Settlement of Corporate-Owned Life Insurance Policies, including Bank-Owned; Life Insurance Policies;
- Distributions Received from Equity Method Investees;
- Beneficial Interests in Securitization Transactions; and

Separately Identifiable Cash Flows and Application of the Predominance Principle.

The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period.

The amendments should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. Adoption of this ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

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

Summary - The FASB has issued Accounting Standards Update (ASU) No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations.

The ASU requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other

organizations will now use forward-looking information to better inform their credit loss estimates.

Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances.

The ASU requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization's portfolio. These disclosures include qualitative and quantitative requirements that provide additional information about the amounts recorded in the financial statements.

In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration.

The ASU is effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (i.e., January 1, 2020, for calendar year entities). For public companies that are not SEC filers, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For all other organizations, the ASU on credit losses will take effect for fiscal years beginning after December 15, 2020, and for interim periods within fiscal years beginning after December 15, 2021. Early application will be permitted for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Corporation is evaluating the effects of this ASU on its consolidated financial statements.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

FASB Accounting Standards Update No. 2016-09, Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting

Summary - The amendments in ASU 2016-09 simplify several aspects of accounting for employee share-based payments including income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. Some areas of the simplification apply only to nonpublic entities. The new guidance will require all income tax effects of awards to be recognized as income tax expense or benefit in the income statement when the awards vest or are settled and additional paid in capital pools will be eliminated. The guidance requires companies to present excess tax benefits as an operating activity on the statement of cash flows rather than as a financing activity. Companies will be required to account for forfeitures of share-based payments by recognizing forfeitures of awards as they occur or estimating the number of awards expected to be forfeited and adjusting the estimate when it is likely to change, as currently required, through an accounting policy election. The guidance will increase the amount an employer can withhold to cover income taxes on awards and still qualify for the exception to liability classification for shares used to satisfy the employer's income tax withholding obligation. The guidance requires an employer to classify the cash paid to a tax authority when shares are withheld to satisfy its statutory income tax withholding obligation as a financing activity on the statement of cash flows. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2016, including interim periods within those fiscal years. Early adoption will be permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance, however all of the guidance must be adopted in the same period. If early adoption is elected in an interim period, any adjustments should be reflected as of the beginning of the annual period that includes that interim period. Adoption of this ASU is not expected to have a significant effect on the Corporation's consolidated financial statements.

The amendments clarify what steps are required when assessing whether the economic characteristics and risks of call (put) options are clearly and closely related to the economic characteristics and risks of their debt hosts, which is one of the criteria for bifurcating an embedded derivative. Consequently, when a call (put) option is contingently exercisable, an entity does not have to assess whether the event that triggers the ability to exercise a call (put) option is related to interest rates or credit risks.

Public business entities must apply the new requirements for fiscal years beginning after December 15, 2016 and interim periods within those fiscal years. If an entity early adopts the new requirements in an interim period, it must reflect any adjustments as of the beginning of the fiscal year that includes that interim period. The Corporation is evaluating the effects of this ASU on its consolidated financial statements.

FASB Accounting Standards Update No. 2016-02 -Leases (Topic 842)

Summary - The FASB has issued its new lease accounting guidance in Accounting Standards Update (ASU) No. 2016-02, Leases (Topic 842).

Under the new guidance, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date:

• A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and

• A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term.

Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with

Customers.

The new lease guidance simplified the accounting for sale and leaseback transactions primarily because lessees must recognize lease assets and lease liabilities. Lessees will no longer be provided with a source of off-balance sheet financing.

Public business entities should apply the amendments in ASU 2016-02 for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years (i.e., January 1, 2019, for a calendar year entity). Nonpublic business entities should apply the amendments for fiscal years beginning after December 15, 2019 (i.e., January 1, 2020, for a calendar year entity), and interim periods within fiscal years beginning after December 15, 2020. Early application is permitted for all public business entities and all nonpublic business entities upon issuance.

Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Corporation is evaluating the effect of this ASU on its consolidated financial statements.

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

FASB Accounting Standards Updates No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities

Summary - The FASB has issued Accounting Standards Update (ASU) No. 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance is intended to improve the recognition and measurement of financial instruments. The ASU affects public and private companies, not-for-profit organizations, and employee benefit plans that hold financial assets or owe financial liabilities.

The new guidance makes targeted improvements to existing U.S. GAAP by:

- Requiring equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income;

- Requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes;

- Requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements;

- Eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities;

- Eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and

- Requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk (also referred to as “own credit”) when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

The new guidance is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For private companies, not-for-profit organizations, and employee benefit plans, the new guidance becomes effective for fiscal years beginning after December 15, 2018, and for interim periods within fiscal years beginning after December 15, 2019. The Corporation is evaluating the effects of this ASU on its consolidated financial statements.

FASB Accounting Standards Update No. 2014-09 - Revenue from Contracts with Customers (Topic 606)

Summary - The FASB issued Accounting Standards Update (ASU) No. 2014-09, Revenue from Contracts with Customers, which implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation. ASU 2014-09 is effective on January 1, 2018. The Corporation is evaluating the effects of this ASU on its consolidated financial statements.

NOTE 16

GENERAL LITIGATION AND REGULATORY EXAMINATIONS

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

40

Table of Contents

PART I. FINANCIAL INFORMATION

ITEM 1. NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(table dollar amounts in thousands, except share data)

(Unaudited)

NOTE 17

SUBSEQUENT EVENTS

On September 20, 2016, the Corporation entered into a Stock Purchase Agreement (the "Purchase Agreement") with Leland Boren and certain shareholders affiliated with Mr. Boren (collectively, the "Sellers") pursuant to which the Corporation will acquire approximately 12.11 percent of the issued and outstanding shares of common stock (the "Shares") of Independent Alliance Banks, Inc., an Indiana corporation ("IAB"). IAB is a financial holding company and the parent of iAB Financial Bank, an Indiana commercial bank. The purchase price per share will be \$40.00, and the aggregate purchase price for the Shares to be paid to the Sellers will be \$19,804,480. The Federal Reserve Bank of Chicago has approved the transaction under delegated authority which is expected to close in November 2016.

The policy of the Federal Reserve Board (FRB), who examines the Corporation, is that bank holding companies are expected to act as a source of financial and managerial strength to their subsidiary banks, including committing capital to support such subsidiary banks. This is often referred to as the Source of Strength doctrine. Failure to adequately support a subsidiary bank in the event of financial distress can lead to the bank holding company itself being found to operate in a safe and unsound manner. Once the Corporation acquires 12.11 percent of the outstanding stock of IAB, the FRB is likely to consider IAB and its wholly-owned subsidiary bank, iAB Financial Bank, as covered under the Corporation's Source of Strength. As a result, in the event IAB or its subsidiary bank become financially distressed in the future, the Corporation may be called upon by the FRB to provide capital to it or them. Based on a review of IAB's current regulatory capital position, the Corporation does not anticipate any capital support will be necessary.

Table of Contents

PART I: FINANCIAL INFORMATION

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

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

FORWARD-LOOKING STATEMENTS

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

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

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

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

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

CRITICAL ACCOUNTING POLICIES

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

2015. 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 nine months ended September 30, 2016, 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, 2015.

BUSINESS SUMMARY

First Merchants Corporation (the "Corporation") is a financial holding company headquartered in Muncie, Indiana and was organized in September 1982. The Corporation's Common Stock is traded on NASDAQ's Global Select Market System under the symbol FRME. The Corporation has one full-service bank charter, First Merchants Bank (the "Bank"), which opened for business in Muncie, Indiana, in March 1893. The Bank also operates Lafayette Bank and Trust and First Merchants Private Wealth Advisors as divisions of First Merchants Bank. The Bank includes 106 banking locations in twenty-seven Indiana, two Illinois and two Ohio counties. In addition to its branch network, the Corporation's delivery channels include ATMs, check cards, remote deposit capture, interactive voice response systems and internet technology. The Corporation's business activities are currently limited to one significant business segment, which is community banking.

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

The Corporation operated FMIG, a full-service property, casualty, personal lines, and employee benefit insurance agency headquartered in Muncie, Indiana. On June 12, 2015, the Corporation sold all of its stock in FMIG to USI Insurance Services, LLC for \$18,000,000. Additional details of the transaction are included in NOTE 2.

ACQUISITIONS AND DIVESTITURES, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

Table of Contents

PART I: FINANCIAL INFORMATION

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

On April 1, 2016, the Board of Directors of the Bank adopted final resolutions approving the conversion of the Bank's banking charter from a national association to an Indiana state-chartered bank. The initial application to convert was filed with the Indiana DFI on February 9, 2016. Between the date of initial application and adoption of the final resolutions by the Bank's Board, the Indiana DFI and the FDIC conducted a joint exam of the Bank and its banking activities. Final regulatory approval of the application was obtained at the meeting of the Members of the Indiana DFI on April 14, 2016. The Bank filed official conversion documents effective April 15, 2016.

Along with economic benefits, the Board and management of the Bank feel the state charter is more consistent with the community banking philosophy embraced by the Bank. As a result of the conversion, the Indiana DFI became the Bank's primary regulator and the FDIC became the Bank's primary federal regulator. Upon conversion, the Bank's official name changed from "First Merchants Bank, National Association" to "First Merchants Bank." The Bank intends to continue operating under the following trade names in certain geographic markets: Lafayette Bank and Trust and First Merchants Private Wealth Advisors (each as a division of First Merchants Bank). The conversion is not expected to affect the Bank's operations or customers in any way, and Bank customers will continue to receive identical protection on deposits through the FDIC's deposit insurance program.

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported third quarter 2016 net income of \$21.1 million, compared to \$17.1 million during the third quarter of 2015. Diluted earnings per share for the period totaled \$.51 per share, an increase of \$.06 per share, or 13.3 percent, over the same period in 2015. Year-to-date net income totaled \$58.8 million, compared to \$51.2 million during the same period in 2015. Diluted earnings per share for the nine months ended September 30, 2016 totaled \$1.43 per share, an increase of \$.08 per share, or 5.9%, over the same period in 2015.

On April 17, 2015, the Corporation acquired C Financial and on December 31, 2015, the Corporation acquired Ameriana. Additionally, on June 12, 2015, the Corporation sold all of its stock in FMIG, resulting in a gain of \$8.3 million. Details of these transactions are included in NOTE 2. ACQUISITIONS AND DIVESTITURES, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

As of September 30, 2016, total assets equaled \$7.0 billion, an increase of \$261.3 million, or 3.9 percent, from December 31, 2015. The Corporation's loan portfolio increased \$271.6 million, with the largest increase in real estate commercial and farmland and commercial and industrial loans. Additional details of the changes in the Corporation's loans and other earning assets are discussed within NOTE 4. LOANS AND ALLOWANCE, included within the Notes to Consolidated Condensed Financial Statements, and the "EARNING ASSETS" section of Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

The Corporation's allowance for loan losses totaled \$63.5 million as of September 30, 2016. The allowance provided 186.1 percent coverage of all non-accrual loans and 1.28 percent of total loans. The Corporation's provision expense totaled \$1.9 million and \$3.2 million during the three and nine months ended September 30, 2016, as net charge-offs totaled \$630,000 and \$2.2 million, for the same periods, respectively. For the three months ended September 30, 2015, the Corporation had no provision expense and net recoveries of \$311,000. The Corporation had \$417,000 of provision expense for the nine months ended September 30, 2015, with net charge offs during the period of \$1.5 million. Additional details are discussed within the "LOAN QUALITY/PROVISION FOR LOAN LOSSES" section of

Management's Discussion and Analysis of Financial Condition and Results of Operations of this Quarterly Report on Form 10-Q.

As of September 30, 2016, total deposits equaled \$5.4 billion, an increase of \$154.6 million from December 31, 2015. The largest increases were in demand deposits and brokered deposits, which accounted for \$168.7 million and \$44.3 million of the overall increase, respectively. This increase was offset by decreases in other certificates and time deposits and certificates and other time deposits of \$100,000 or more of \$58.3 million and \$26.9 million, respectively, compared to December 31, 2015.

Total borrowings increased \$53.8 million as of September 30, 2016 compared to December 31, 2015 as Federal Home Loan Bank advances increased \$61.4 million, which was offset by a decrease in securities sold under repurchase agreements of \$16.7 million.

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

NET INTEREST INCOME

Net interest income is the most significant component of our earnings, comprising 77 percent of revenues for the three and nine months ended September 30, 2016. Net interest income and margin are influenced by many factors, primarily the volume and mix of earnings assets, funding sources, and interest rate fluctuations. Other factors include the level of accretion income on purchased loans, prepayment risk on mortgage and investment-related assets, and the composition and maturity of earning assets and interest-bearing liabilities. Loans typically generate more interest income than investment securities with similar maturities. Funding from client deposits generally costs less than wholesale funding sources. Factors such as general economic activity, Federal Reserve Board monetary policy, and price volatility of competing alternative investments, can also exert significant influence on our ability to optimize the mix of assets and funding and the net interest income and margin.

Net interest income is the excess of interest received from earning assets over interest paid on interest-bearing liabilities. For analytical purposes, net interest income is also presented on an FTE basis in the table that follows to reflect what our tax-exempt assets would need to yield in order to achieve the same after-tax yield as a taxable asset. The federal statutory rate in effect of 35 percent was used for all periods, adjusted for the TEFRA interest disallowance applicable to certain tax-exempt obligations. This analysis portrays the income tax benefits associated in tax-exempt assets and helps to facilitate a comparison between taxable and tax-exempt assets. Management believes that it is a standard practice in the banking industry to present net interest margin and net interest income on a fully taxable equivalent basis. Therefore, management believes these measures provide useful information for both management and investors by allowing them to make peer comparisons.

For the periods presented, the increases in net interest income were primarily driven by core organic loan growth and an increase in earning assets attributable to acquisitions of C Financial in April 2015 and Ameriana in December 2015.

Net interest margin for the third quarter of 2016 increased to 3.94 percent compared to the third quarter of 2015 of 3.85 percent. Asset yields increased 7 basis points FTE and interest costs decreased 2 basis points, resulting in a 9 basis point FTE increase in net interest income as compared to the same period in 2015. As a result of the acquisitions, earning assets increased \$660,004,000 in the third quarter of 2016 compared to the third quarter 2015. The Corporation recognized fair value accretion income on purchased loans, which is included in interest income, of \$3,806,000 and \$2,012,000, respectively, for the three months ended September 30, 2016 and 2015.

Net interest margin for the nine months ended September 30, 2016 increased to 3.88 percent compared to the nine months ended September 30, 2015 of 3.82 percent. Asset yields increased 5 basis points FTE and interest costs decreased 1 basis point, resulting in a 6 basis point FTE increase in net interest income as compared to the same period in 2015. As a result of the acquisitions, earning assets increased by \$723,977,000 for the nine months ended September 30, 2016 compared to the nine months ended September 30, 2015. The Corporation recognized fair value accretion income on purchased loans, which is included in interest income, of \$9,508,000 and \$6,340,000, respectively, for the nine months ended September 30, 2016 and 2015.

Additional details of the Corporation's acquisitions, remaining loan fair value discount, accretable and nonaccretable yield can be found in NOTE 2. ACQUISITIONS AND DIVESTITURES and NOTE 5. ACCOUNTING FOR CERTAIN LOANS ACQUIRED IN A PURCHASE, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

Table of Contents

PART I: FINANCIAL INFORMATION

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

The following table presents the Corporation's average balance sheet, interest income/interest expense, and the average rate as a percent of average earning assets/liabilities for the three months ended September 30, 2016, and 2015.

(Dollars in Thousands)

	Three Months Ended					
	September 30, 2016			September 30, 2015		
	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate
Assets:						
Interest-bearing time deposits	\$54,120	\$55	0.40 %	\$34,343	\$25	0.29 %
Federal Reserve and Federal Home Loan Bank stock	18,095	193	4.24	34,627	500	5.78
Investment Securities: ⁽¹⁾						
Taxable	729,223	3,992	2.18	692,583	4,374	2.53
Tax-Exempt ⁽²⁾	559,845	7,182	5.10	503,174	6,787	5.40
Total Investment Securities	1,289,068	11,174	3.45	1,195,757	11,161	3.73
Loans held for sale	742	73	39.14	2,163	125	23.12
Loans: ⁽³⁾						
Commercial	3,556,187	41,653	4.66	3,247,336	36,582	4.51
Real Estate Mortgage	567,015	6,521	4.58	447,733	4,803	4.29
Installment	493,807	5,572	4.49	403,399	4,526	4.49
Tax-Exempt ⁽²⁾	219,172	2,537	4.60	172,844	1,832	4.24
Total Loans	4,836,923	56,356	4.64	4,273,475	47,868	4.48
Total Earning Assets	6,198,206	67,778	4.37	5,538,202	59,554	4.30
Net unrealized gain on securities available for sale	11,738			10,379		
Allowance for loan losses	(62,453)			(62,521)		
Cash and cash equivalents	102,023			93,542		
Premises and equipment	95,541			84,880		
Other assets	562,248			489,467		
Total Assets	\$6,907,303			\$6,153,949		
Liabilities:						
Interest-bearing deposits:						
Interest-bearing NOW deposits	\$1,454,992	\$669	0.18 %	\$1,112,161	\$359	0.13 %
Money market deposits	793,173	384	0.19	837,963	448	0.21
Savings deposits	754,401	171	0.09	628,020	155	0.10
Certificates and other time deposits	1,128,595	2,702	0.95	1,122,964	2,753	0.98
Total Interest-bearing Deposits	4,131,161	3,926	0.38	3,701,108	3,715	0.40
Borrowings	521,125	2,768	2.11	523,814	2,500	1.91
Total Interest-bearing Liabilities	4,652,286	6,694	0.57	4,224,922	6,215	0.59
Noninterest-bearing deposits	1,297,292			1,123,575		
Other liabilities	60,791			46,308		
Total Liabilities	6,010,369			5,394,805		
Stockholders' Equity	896,934			759,144		
Total Liabilities and Stockholders' Equity	\$6,907,303	6,694	0.43	\$6,153,949	6,215	0.45
Net Interest Income		\$61,084			\$53,339	
Net Interest Margin			3.94 %			3.85 %

- (1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments. Annualized amounts are computed utilizing a 30/360 day basis.
- (2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2016 and 2015. The fully taxable equivalent adjustments equal \$3,402 and \$3,016 for the three months ended September 30, 2016 and 2015, respectively.
- (3) Non-accruing loans have been included in the average balances.

Table of Contents

PART I: FINANCIAL INFORMATION

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

(Dollars in Thousands)	Nine Months Ended September 30, 2016			September 30, 2015		
	Average Balance	Interest Income / Expense	Average Rate	Average Balance	Interest Income / Expense	Average Rate
Assets:						
Federal Funds Sold						
Interest-bearing time deposits	\$76,440	\$283	0.49 %	\$50,327	\$93	0.25 %
Federal Reserve and Federal Home Loan Bank stock	26,359	906	4.59	38,367	1,509	5.24
Investment Securities: ⁽¹⁾						
Taxable	725,311	12,522	2.31	708,328	13,522	2.55
Tax-Exempt ⁽²⁾	539,996	21,169	5.24	474,004	19,197	5.40
Total Investment Securities	1,265,307	33,691	3.56	1,182,332	32,719	3.69
Loans held for sale	3,541	291	10.98	4,364	380	11.61
Loans: ⁽³⁾						
Commercial	3,502,715	121,017	4.62	3,161,385	106,412	4.49
Real Estate Mortgage	570,330	19,032	4.46	454,288	14,614	4.29
Installment	473,645	16,067	4.53	397,981	13,502	4.52
Tax-Exempt ⁽²⁾	198,615	6,814	4.58	103,931	3,344	4.29
Total Loans	4,748,846	163,221	4.59	4,121,949	138,252	4.47
Total Earning Assets	6,116,952	198,101	4.32 %	5,392,975	172,573	4.27 %
Net unrealized gain on securities available for sale	10,892			12,463		
Allowance for loan losses	(62,633)			(62,940)		
Cash and cash equivalents	102,767			96,671		
Premises and equipment	96,284			82,342		
Other assets	572,150			491,542		
Total Assets	\$6,836,412			\$6,013,053		
Liabilities:						
Interest-bearing deposits:						
Interest-bearing NOW deposits	\$1,395,036	\$1,850	0.18 %	\$1,077,463	\$894	0.11 %
Money market deposits	835,968	1,377	0.22	838,552	1,305	0.21
Savings deposits	720,375	455	0.08	604,436	481	0.11
Certificates and other time deposits	1,157,992	8,346	0.96	1,132,497	8,237	0.97
Total Interest-bearing Deposits	4,109,371	12,028	0.39	3,652,948	10,917	0.40
Borrowings	506,077	8,180	2.16	478,030	7,437	2.07
Total Interest-bearing Liabilities	4,615,448	20,208	0.58	4,130,978	18,354	0.59
Noninterest-bearing deposits	1,279,404			1,090,158		
Other liabilities	63,258			45,215		
Total Liabilities	5,958,110			5,266,351		
Stockholders' Equity	878,302			746,702		
Total Liabilities and Stockholders' Equity	\$6,836,412	20,208	0.44	\$6,013,053	18,354	0.45
Net Interest Income		\$177,893			\$154,219	
Net Interest Margin			3.88 %			3.82 %

- (1) Average balance of securities is computed based on the average of the historical amortized cost balances without the effects of the fair value adjustments. Annualized amounts are computed utilizing a 30/360 day basis.
- (2) Tax-exempt securities and loans are presented on a fully taxable equivalent basis, using a marginal tax rate of 35 percent for 2016 and 2015. The fully taxable equivalent adjustments equal \$9,794 and \$7,889 for the nine months ended September 30, 2016 and 2015, respectively.
- (3) Non-accruing loans have been included in the average balances.

Table of Contents

PART I: FINANCIAL INFORMATION

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

NON-INTEREST INCOME

Non-interest income increased \$529,000, or 3.2 percent, in the third quarter of 2016, compared to the third quarter of 2015. In December 2015, the Corporation acquired Ameriana. This acquisition contributed to a larger customer base, which in addition to organic growth, resulted in an increase in other customer fees, service charges, and fiduciary income of \$621,000, \$222,000 and \$206,000, respectively, in the third quarter of 2016 when compared to the same period in 2015. Additional details of the acquisition can be found in NOTE 2. ACQUISITIONS AND DIVESTITURES, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

These increases were partially offset by decreases in net gains on the sale of available for sale securities and other income of \$276,000 and \$228,000, respectively, in the third quarter of 2016 when compared to the same period in 2015. The decline in other income was a result of the third quarter of 2015 containing a gain of \$1.3 million from the Corporation's cancellation of \$5.0 million of subordinated debentures. This decline was partially offset by the third quarter of 2016 containing \$1.0 million more of derivative hedge income than the third quarter of 2015.

During the first nine months of 2016, non-interest income decreased \$6.8 million, or 12.1 percent, from the same period in 2015. In June 2015, the sale of FMIG resulted in a gain of \$8.3 million, and also accounted for a \$4.1 million decline in insurance commission income compared to the first nine months of 2015. Meanwhile, the larger customer base resulting from the C Financial and Ameriana acquisitions as well as organic growth contributed to increases in other customer fees, service charges and derivative hedge income of \$2.1 million, \$1.1 million and \$1.0 million, respectively. Additional details of the divestiture and acquisitions can be found in NOTE 2. ACQUISITIONS AND DIVESTITURES, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

Additionally, the first nine months of 2016 contained an increase of \$1.3 million in earnings on cash surrender value of life insurance when compared to the same period in 2015. The increase was primarily due to death benefits from Bank Owned Life Insurance of \$603,000 as well as earnings on a larger portfolio resulting from the Ameriana acquisition, which included a \$28.2 million Bank Owned Life Insurance portfolio.

Finally, offsetting the increases noted above was a decline resulting from the 2015 gain of \$1.3 million from the Corporation's cancellation of \$5.0 million of subordinated debentures.

NON-INTEREST EXPENSE

Non-interest expense increased \$1.1 million, or 2.5 percent, in the third quarter of 2016, compared to the third quarter of 2015. The largest increases were salaries and employee benefits and net occupancy which increased \$1.5 million and \$622,000, respectively. The increases were primarily driven by the additional personnel and banking centers resulting from the Ameriana acquisition. These increases were offset by decreases in other real estate owned and foreclosure expenses, professional and other outside services and FDIC assessments of \$1.0 million, \$444,000 and \$424,000, respectively.

During the first nine months of 2016, non-interest expense increased \$6.1 million, or 4.7 percent, when compared to the first nine months of 2015. The sale of FMIG resulted in \$3.2 million less in expense compared to the first nine months of 2015, of which \$2.5 million was salaries and employee benefits. This decrease was offset by a \$6.0 million

increase in salaries and employee benefits primarily due to the addition of personnel from C Financial and Ameriana. Furthermore, as a result of the larger franchise size from the acquisitions, the Corporation experienced increases in net occupancy, equipment and data processing expenses of \$1.4 million, \$1.3 million and \$999,000, respectively. Offsetting these increases was a \$1.4 million decrease in professional and other outside services due primarily to the prior year containing acquisition and divestiture expenses not repeated in the current year.

INCOME TAXES

Income tax expense for the third quarter of 2016 was \$7,469,000 on pre-tax net income of \$28,528,000. For the same period in 2015, income tax expense was \$6,557,000 on pre-tax net income of \$23,624,000. The effective income tax rates for the third quarter of 2016 and 2015 were 26.2 percent and 27.8 percent, respectively.

Income tax expense for the nine months ended September 30, 2016 was \$19,759,000 on pre-tax net income of \$78,517,000. For the same period in 2015, income tax expense was \$21,247,000 on pre-tax net income of \$72,454,000. The effective income tax rates for the nine months ended September 30, 2016 and 2015 were 25.2 percent and 29.3 percent, respectively.

The lower effective income tax rate during the three months ended September 30, 2016 when compared to the same period in 2015 was primarily the result of an increase in tax-exempt interest income. The lower effective income tax rate during the nine months ended September 30, 2016 when compared to the same period in 2015 was the result of increases in tax-exempt interest income and earnings on life insurance in addition to a permanent book-to-tax difference associated with the gain on sale of FMIG in 2015.

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

CAPITAL

Capital adequacy is an important indicator of financial stability and performance. The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by four ratios that are calculated according to the regulations: total risk-based capital, tier 1 risk-based capital, common equity 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.

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

Basel III was effective for the Corporation on January 1, 2015. Basel III requires the Corporation and the Bank to maintain minimum amounts and ratio of common equity tier 1 capital to risk weighted assets, as defined in the regulation. Under the new Basel III rules, in order to avoid limitations on capital distributions, including dividends, the Corporation must hold a capital conservation buffer above the adequately capitalized common equity tier 1 capital to risk-weighted assets ratio. The capital conservation buffer is being phased in from zero percent to 2.50 percent by 2019. As of January 1, 2016, the Corporation is required to hold a capital conservation buffer of 0.625 percent, increasing by that amount each successive year until 2019. Under Basel III, the Corporation and Bank elected to opt-out of including accumulated other comprehensive income in regulatory capital.

As of September 30, 2016, the Bank met all capital adequacy requirements to be considered well capitalized. There is no threshold for well capitalized status for bank holding companies. The Corporation's and Bank's actual and required capital ratios as of September 30, 2016 and December 31, 2015 were as follows:

	Actual		Prompt Corrective Action Thresholds			
			Adequately Capitalized		Well Capitalized	
September 30, 2016	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital to risk-weighted assets						
First Merchants Corporation	\$827,485	14.18 %	\$446,944	8.00 %	N/A	N/A
First Merchants Bank	777,865	13.23	470,468	8.00	\$588,086	10.00 %
Tier 1 capital to risk-weighted assets						
First Merchants Corporation	\$699,029	11.98 %	\$350,208	6.00 %	N/A	N/A
First Merchants Bank	714,409	12.15	352,851	6.00	\$470,468	8.00 %
Common equity tier 1 capital to risk-weighted assets						

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

First Merchants Corporation	\$645,114	11.05 %	\$262,656	4.50 %	N/A	N/A
First Merchants Bank	714,409	12.15	264,638	4.50	\$382,256	6.50 %
Tier 1 capital to average assets						
First Merchants Corporation	\$699,029	10.62 %	\$263,331	4.00 %	N/A	N/A
First Merchants Bank	714,409	10.73	266,239	4.00	\$332,799	5.00 %

	Prompt Corrective Action Thresholds					
	Actual		Adequately Capitalized		Well Capitalized	
December 31, 2015	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total risk-based capital to risk-weighted assets						
First Merchants Corporation	\$783,776	14.94 %	\$419,809	8.00 %	N/A	N/A
First Merchants Bank	739,793	13.98	423,242	8.00	\$529,052	10.00 %
Tier 1 capital to risk weighted assets						
First Merchants Corporation	\$656,323	12.51 %	\$314,857	6.00 %	N/A	N/A
First Merchants Bank	677,340	12.80	317,431	6.00	\$423,242	8.00 %
Common equity tier 1 capital to risk-weighted assets						
First Merchants Corporation	\$603,063	11.49 %	\$236,143	4.50 %	N/A	N/A
First Merchants Bank	677,340	12.80	238,074	4.50	\$343,884	6.50 %
Tier 1 capital to average assets						
First Merchants Corporation	\$656,323	10.85 %	\$242,001	4.00 %	N/A	N/A
First Merchants Bank	677,340	11.22	241,423	4.00	\$301,779	5.00 %

Table of Contents

PART I: FINANCIAL INFORMATION

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

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

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

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

	September 30, 2016		December 31, 2015	
	First	First	First	First
	Merchants	Merchants	Merchants	Merchants
	Corporation	Bank	Corporation	Bank
Total Risk-Based Capital				
Total Stockholders' Equity (GAAP)	\$900,865	\$972,182	\$850,509	\$927,774
Adjust for Accumulated Other Comprehensive (Income) Loss (1)	(3,924)	(6,332)	1,362	(579)
Less: Preferred Stock	(125)	(125)	(125)	(125)
Add: Qualifying Capital Securities	55,355		55,776	
Less: Tier 1 Capital Deductions	(1,440)	(889)	(2,516)	(1,903)
Less: Disallowed Goodwill and Intangible Assets	(249,541)	(249,093)	(247,006)	(246,558)
Less: Disallowed Servicing Assets				
Less: Disallowed Deferred Tax Assets	(2,161)	(1,334)	(1,677)	(1,269)
Total Tier 1 Capital (Regulatory)	699,029	714,409	656,323	677,340
Qualifying Subordinated Debentures	65,000		65,000	
Allowance for Loan Losses Includible in Tier 2 Capital	63,456	63,456	62,453	62,453
Total Risk-Based Capital (Regulatory)	\$827,485	\$777,865	\$783,776	\$739,793
Net Risk-Weighted Assets (Regulatory)	\$5,836,806	\$5,880,855	\$5,247,617	\$5,290,524

Edgar Filing: FIRST MERCHANTS CORP - Form 10-Q

Average Assets	\$6,583,270	\$6,655,987	\$6,050,023	\$6,035,575	
Total Risk-Based Capital Ratio (Regulatory)	14.18	% 13.23	% 14.94	% 13.98	%
Tier 1 Capital to Risk-Weighted Assets	11.98	% 12.15	% 12.51	% 12.80	%
Tier 1 Capital to Average Assets	10.62	% 10.73	% 10.85	% 11.22	%
Common Equity Tier 1 Capital Ratio					
Total Tier 1 Capital (Regulatory)	\$699,029	\$714,409	\$656,323	\$677,340	
Less: Qualified Capital Securities	(55,355)		(55,776)		
Add: Additional Tier 1 Capital Deductions	1,440		2,516		
Common Equity Tier 1 Capital (Regulatory)	\$645,114	\$714,409	\$603,063	\$677,340	
Net Risk-Weighted Assets (Regulatory)	\$5,836,806	\$5,880,855	\$5,247,617	\$5,290,524	
Common Equity Tier 1 Capital Ratio (Regulatory)	11.05	% 12.15	% 11.49	% 12.80	%

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

The Corporation had a strong capital position as evidenced by the tangible common equity to tangible assets ratio of 9.48 percent at September 30, 2016, and 9.08 percent at December 31, 2015.

(Dollars in Thousands, Except Per Share Amounts)	Tangible Common Equity to Tangible Assets (non-GAAP)	
	September 30, 2016	December 31, 2015
Total Stockholders' Equity (GAAP)	\$900,865	\$850,509
Less: Cumulative preferred stock (GAAP)	(125)	(125)
Less: Intangible assets (GAAP)	(259,844)	(259,764)
Tangible common equity (non-GAAP)	\$640,896	\$590,620
Total assets (GAAP)	\$7,022,352	\$6,761,003
Less: Intangible assets (GAAP)	(259,844)	(259,764)
Tangible assets (non-GAAP)	\$6,762,508	\$6,501,239
Tangible common equity to tangible assets (non-GAAP)	9.48 %	9.08 %

The following table details and reconciles tangible earnings per share, return on tangible capital and tangible assets to traditional GAAP measures for the three and nine months ended September 30, 2016 and 2015.

(Dollars in Thousands, Except Per Share Amounts)	Three Months Ended September 30,		Nine Months Ended September 30,		
	2016	2015	2016	2015	
Average goodwill (GAAP)	\$244,000	\$205,375	\$244,000	\$206,115	
Average core deposit intangible (GAAP)	16,288	14,447	17,303	15,221	
Average deferred tax on CDI (GAAP)	(6,324)	(5,494)	(6,608)	(5,724)	
Intangible adjustment (non-GAAP)	\$253,964	\$214,328	\$254,695	\$215,612	
Average stockholders' equity (GAAP)	\$896,934	\$759,144	\$878,302	\$746,702	
Average cumulative preferred stock (GAAP)	(125)	(125)	(125)	(125)	
Intangible adjustment (non-GAAP)	(253,964)	(214,328)	(254,695)	(215,612)	
Average tangible capital (non-GAAP)	\$642,845	\$544,691	\$623,482	\$530,965	
Average assets (GAAP)	\$6,907,303	\$6,153,949	\$6,836,412	\$6,013,053	
Intangible adjustment (non-GAAP)	(253,964)	(214,328)	(254,695)	(215,613)	
Average tangible assets (non-GAAP)	\$6,653,339	\$5,939,621	\$6,581,717	\$5,797,440	
Net income available to common stockholders (GAAP)	\$21,059	\$17,067	\$58,758	\$51,207	
CDI amortization, net of tax (GAAP)	636	436	1,906	1,284	
Tangible net income available to common stockholders (non-GAAP)	\$21,695	\$17,503	\$60,664	\$52,491	
Per Share Data:					
Diluted net income available to common stockholders (GAAP)	\$0.51	\$0.45	\$1.43	\$1.35	
Diluted tangible net income available to common stockholders (non-GAAP)	\$0.53	\$0.46	\$1.48	\$1.39	
Ratios:					
Return on average GAAP capital (ROE)	9.39	% 8.99	% 8.92	% 9.14	%
Return on average tangible capital	13.50	% 12.85	% 12.97	% 13.18	%

Return on average assets (ROA)	1.22	% 1.11	% 1.15	% 1.14	%
Return on average tangible assets	1.30	% 1.18	% 1.23	% 1.21	%

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

LOAN QUALITY/PROVISION FOR LOAN LOSSES

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

Loan Quality

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

At September 30, 2016, non-performing loans totaled \$38,045,000, an increase of \$181,000 from June 30, 2016 and \$4,733,000 from December 31, 2015. Non-accrual loans increased \$540,000 from June 30, 2016, remaining above the \$31,389,000 balance at December 31, 2015. The Corporation's coverage ratio of allowance for loan losses to non-accrual loans increased from 185.3 percent at June 30, 2016 to 186.1 percent at September 30, 2016. This non-accrual coverage ratio at December 31, 2015 was 199.0 percent. See additional information regarding the allowance for loan losses in the "Provision for Loan Losses" section of Management's Discussion and Analysis of Financial Condition and Results of Operations included as ITEM 2 of this Quarterly Report on Form 10-Q.

Other real estate owned, totaling \$10,242,000 at September 30, 2016, declined \$2,977,000 from June 30, 2016 and \$7,015,000 from December 31, 2015. For other real estate owned, current appraisals are obtained to determine fair value as management continues to aggressively market these real estate assets.

Accruing loans delinquent 90 or more days of \$1,625,000 at September 30, 2016 increased \$1,263,000 from June 30, 2016 and \$718,000 from December 31, 2015. A single Owner Occupied Commercial Real Estate relationship accounted for 75.0 percent of the total at September 30, 2016.

Commercial impaired loans include non-accrual loans, loans accounted for under ASC 310-30, and loans risk graded as substandard, doubtful and loss that were still accruing but deemed impaired according to the guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more and troubled debt restructurings.

A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected substantially within the contractual terms of the note. At September 30, 2016, commercial impaired loans totaled \$84,158,000 a decrease of \$13,369,000 from the December 31, 2015 balance of \$97,527,000. At September 30, 2016, a specific allowance for losses was not deemed necessary for commercial impaired loans totaling \$80,666,000 as there was no identified loss on these credits. A specific allowance of \$1,336,000 was recorded for the remaining balance of these impaired loans totaling \$3,492,000 and is included in the Corporation's allowance for loan losses.

At September 30, 2016, non-performing assets, which includes non-accrual loans, renegotiated loans, and other real estate owned, plus loans 90-days delinquent, totaled \$49,912,000; a decrease of \$1,564,000 from December 31, 2015 as noted in the table below.

(Dollars in Thousands)	September 30,	December
	2016	31, 2015
Non-Performing Assets:		
Non-accrual loans	\$ 34,105	\$ 31,389
Renegotiated loans	3,940	1,923
Non-performing loans (NPL)	38,045	33,312
Other real estate owned	10,242	17,257
Non-performing assets (NPA)	48,287	50,569
90+ days delinquent	1,625	907
Non-performing assets plus 90+ days delinquent	\$ 49,912	\$ 51,476
Impaired Loans	\$ 84,158	\$ 97,527

The non-accrual balances in the table above include troubled debt restructurings totaling \$6,224,000 and \$5,339,000 as of September 30, 2016 and December 31, 2015, respectively.

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

(Dollars in Thousands)	September 30, 2016	December 31, 2015
Non-Performing Assets plus loans 90+ Days Delinquent:		
Commercial and industrial loans	\$ 2,381	\$ 5,544
Agricultural production financing and other loans to farmers	1,767	827
Real estate loans:		
Construction	6,907	9,345
Commercial and farmland	24,348	18,243
Residential	11,845	14,528
Home Equity	2,509	2,665
Individuals' loans for household and other personal expenditures	155	324
Non-performing assets plus 90+ days delinquent	\$ 49,912	\$ 51,476

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

Provision for Loan Losses

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

In conformance with ASC 805 and ASC 820, loans purchased after December 31, 2008, are recorded at the acquisition date fair value. Such loans are only included in the allowance when deemed impaired in accordance with ASC 310-30.

At September 30, 2016, the allowance for loan losses was \$63,456,000, an increase of \$1,003,000 from December 31, 2015. As a percent of loans, the allowance was 1.28 percent at September 30, 2016, compared to 1.33 percent at December 31, 2015. The provision for loan losses for the nine months ended September 30, 2016 was \$3,240,000. Comparatively, the provision for loan losses for the nine months ended September 30, 2015 was \$417,000. Specific reserves on impaired loans decreased \$215,000 from \$1,842,000 at December 31, 2015, to \$1,627,000 at September 30, 2016.

Net charge offs for the nine months ended September 30, 2016, were \$2,237,000. Comparatively, the same period in 2015 had net charge offs of \$1,520,000. For the nine months ended September 30, 2016, there were two charge offs greater than \$500,000 totaling \$1,917,000 and one recovery totaling \$604,000. For the nine months ended September 30, 2015, there were two charge offs greater than \$500,000 totaling \$1,635,000 and one recovery totaling \$931,000. The distribution of the net charge offs or recoveries for the three and nine months ended September 30, 2016 and 2015 are reflected in the following table:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in Thousands)	2016	2015	2016	2015
Net Charge Offs (Recoveries):				
Commercial and industrial loans	\$545	\$738	\$1,189	\$355
Agricultural production financing and other loans to farmers		9	53	769
Real estate loans:				
Construction	(21)	)63	(3)	)102
Commercial and farmland	(58)	)(1,187)	203	(1,125)
Residential	80	53	502	842
Home Equity	71	(87)	)199	427
Individuals' loans for household and other personal expenditures	13	102	95	160
Other commercial loans		(2)	)(1)	)(10)
Total Net Charge Offs	\$630	\$(311)	\$2,237	\$1,520

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

LIQUIDITY

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

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

The principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$675,813,000 at September 30, 2016, an increase of \$17,413,000, or 2.64 percent, from December 31, 2015. Securities classified as held to maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held to maturity and that are maturing in one year or less totaled \$2,512,000 at September 30, 2016. In addition, other types of assets such as cash and interest-bearing deposits with other banks, federal funds sold and loans maturing within one year are sources of liquidity.

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. Federal funds purchased and securities sold under agreements to repurchase are also considered a source of liquidity. In addition, FHLB advances are utilized as funding sources. At September 30, 2016, total borrowings from the FHLB were \$297,022,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at September 30, 2016 was \$295,813,000.

Table of Contents

PART I: FINANCIAL INFORMATION

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

On April 11, 2014, the Corporation entered into a line of credit agreement with U.S. Bank, N.A. with a maximum borrowing capacity of \$20 million. The line of credit matured on April 8, 2016 and the agreement was not renewed. Interest was payable quarterly based on one-month LIBOR plus 2.00 percent. The line of credit had a quarterly facility fee of 0.25 percent on the unused balance. The line of credit agreement contained certain customary representations and warranties and financial and negative covenants.

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

The Bank provides customers with off-balance sheet credit support through loan commitments and standby and commercial letters of credit. Summarized credit-related financial instruments at September 30, 2016 are as follows:

(Dollars in Thousands)	September 30, 2016
Amounts of commitments:	
Loan commitments to extend credit	\$ 2,076,045
Standby and commercial letters of credit	44,206
	\$ 2,120,251

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

In addition to owned banking facilities, the Corporation has entered into a number of long-term leasing arrangements to support ongoing activities. The required payments under such commitments and borrowings at September 30, 2016, are as follows:

(Dollars in Thousands)	Remaining 2016	2017	2018	2019	2020	2021	2022 and after	ASC 805 fair value adjustments at acquisition	Total
Operating leases	\$ 850	\$3,200	\$1,888	\$1,530	\$1,369	\$1,049	\$6,185		\$16,071
Federal funds purchased	58,358								58,358
Securities sold under repurchase agreements	138,671								138,671
Federal Home Loan Bank advances	128,098	37,069	26,717	13,828	31,310	25,000	35,000		297,022
Subordinated debentures and term loans	920						132,012	(4,644)	128,288
Total	\$ 326,897	\$40,269	\$28,605	\$15,358	\$32,679	\$26,049	\$173,197	\$ (4,644)	\$ 638,410

INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK

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

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

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

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

Table of Contents

PART I: FINANCIAL INFORMATION

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

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of September 30, 2016, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In the current rate environment, many driver rates are at or near historical lows, thus total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management have the following results:

Driver Rates	September 30, 2016	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	(25)
Federal funds	200	(25)
One-year CMT	200	(51)
Three-year CMT	200	(59)
Five-year CMT	200	(57)
CD's	200	(16)
FHLB advances	200	(42)

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at September 30, 2016. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

(Dollars in Thousands)	September 30, 2016		
	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$217,454	\$235,736	\$206,399
Variance from base		\$18,282	\$(11,055)
Percent of change from base		8.41	%(5.08)%

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2015, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management in the base simulation are as follows:

Driver Rates	December 31, 2015	
	RISING (200 Basis Points)	FALLING (100 Basis Points)
Prime	200	(25)
Federal funds	200	(25)
One-year CMT	200	(56)
Three-year CMT	200	(100)
Five-year CMT	200	(100)
CD's	200	(21)

FHLB advances 200 (83)

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

December 31, 2015			
(Dollars in Thousands)	Base	RISING (200 Basis Points)	FALLING (100 Basis Points)
Net interest income	\$198,711	\$213,758	\$188,921
Variance from base		\$15,047	\$(9,790)
Percent of change from base		7.57	%(4.93)%

Table of Contents

PART I: FINANCIAL INFORMATION

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

EARNING ASSETS

The following table presents the earning asset mix as of September 30, 2016, and December 31, 2015. Earning assets increased by \$276,938,000 during the nine months ended September 30, 2016. Interest-bearing time deposits and investment securities increased \$1,488,000 and \$23,429,000, respectively. Loans and loans held for sale increased by \$271,610,000. The four loan classes experiencing the largest increase from December 31, 2015, were real estate commercial and farmland, commercial and industrial, real estate home equity and other commercial loans. These increases were primarily offset by decreases in real estate residential and agricultural production financing and other loans to farmers. Additional details of the changes in the Corporation's loans are discussed within NOTE 4. LOANS AND ALLOWANCE, included within the Notes to Consolidated Condensed Financial Statements of this Quarterly Report on Form 10-Q.

The decrease in Federal Reserve and Federal Home Loan Bank stock of \$19,589,000 was mainly due to the sale of the Corporation's Federal Reserve Bank stock after the conversion to an Indiana state-chartered bank.

(Dollars in Thousands)	September 30, December	
	2016	31, 2015
Interest-bearing time deposits	\$ 33,803	\$32,315
Investment securities available for sale	675,813	658,400
Investment securities held to maturity	624,615	618,599
Mortgage loans held for sale	1,482	9,894
Loans	4,973,844	4,693,822
Federal Reserve and Federal Home Loan Bank stock	18,044	37,633
Total	\$ 6,327,601	\$6,050,663

OTHER

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

Table of Contents

PART I: FINANCIAL INFORMATION

ITEM 3. QUANTITATIVE AND QUALITATIVE
DISCLOSURES ABOUT MARKET RISK

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

56

Table of Contents

PART I: FINANCIAL INFORMATION

ITEM 4. CONTROLS AND PROCEDURES

ITEM 4. CONTROLS AND PROCEDURES

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

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

Table of Contents

PART II: OTHER INFORMATION

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

(table dollar amounts in thousands, except share data)

ITEM 1. LEGAL PROCEEDINGS

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

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

ITEM 1A. RISK FACTORS

There have been no material changes to the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2015,

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

a. None

b. None

c. None

There were no purchases of the Corporation's common stock by or on behalf of the Corporation during the three months ended September 30, 2016.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not Applicable

ITEM 5. OTHER INFORMATION

a. None

b. None

Table of Contents

PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

ITEM 6. EXHIBITS

Exhibit No:	Description of Exhibits:
3.1	First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2011) (SEC No. 000-17071)
3.2	Bylaws of First Merchants Corporation, as amended (1)
3.3	First Merchants Corporation Articles of Amendment of the Articles of Incorporation for the Series B Preferred Stock (Incorporated by reference to registrant's Form 8-K filed on September 23, 2011) (SEC No. 000-17071)
4.1	First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.2	Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.3	Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.4	Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.5	First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009) (SEC No. 033-45393)
4.6	Upon request, the registrant agrees to furnish supplementally to the Commission a copy of the instruments defining the rights of holders of its (a) 5.00% Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million and (b) 6.75% Fixed-to-Floating Rate Subordinated Notes due 2028 in aggregate principal amount of \$65 million.
10.1	Stock Purchase Agreement among First Merchants Corporation and Leland Boren as Sellers' Representative, dated September 20, 2016 (Incorporated by reference to registrant's Form 8-K filed on September 26, 2016) (SEC No. 000-17071)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)
101.INS	XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkebase Document (2)

(1) Filed herewith.

(2) Furnished herewith.

Table of Contents

PART II: OTHER INFORMATION

ITEM 6. EXHIBITS

SIGNATURES

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

First Merchants Corporation
(Registrant)

Date: November 9, 2016 by /s/ Michael C. Rechin
Michael C. Rechin
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 9, 2016 by /s/ Mark K. Hardwick
Mark K. Hardwick
Executive Vice President,
Chief Financial Officer and Chief Operating Officer
(Principal Financial and Accounting Officer)

Table of Contents

PART II: OTHER INFORMATION
ITEM 6. EXHIBITS

INDEX TO EXHIBITS

Exhibit No:	Description of Exhibits:
3.1	First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2011) (SEC No. 000-17071)
3.2	Bylaws of First Merchants Corporation, as amended (1)
3.3	First Merchants Corporation Articles of Amendment of the Articles of Incorporation for the Series B Preferred Stock (Incorporated by reference to registrant's Form 8-K filed on September 23, 2011) (SEC No. 000-17071)
4.1	First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.2	Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.3	Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.4	Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007) (SEC No. 000-17071)
4.5	First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009) (SEC No. 033-45393)
4.6	Upon request, the registrant agrees to furnish supplementally to the Commission a copy of the instruments defining the rights of holders of its (a) 5.00% Fixed-to-Floating Rate Senior Notes due 2028 in the aggregate principal amount of \$5 million and (b) 6.75% Fixed-to-Floating Rate Subordinated Notes due 2028 in aggregate principal amount of \$65 million.
10.1	Stock Purchase Agreement among First Merchants Corporation and Leland Boren as Sellers' Representative, dated September 20, 2016 (Incorporated by reference to registrant's Form 8-K filed on September 26, 2016) (SEC No. 000-17071)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
32	Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)
101.INS	XBRL Instance Document (2)
101.SCH	XBRL Taxonomy Extension Schema Document (2)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (2)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (2)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (2)
101.PRE	XBRL Taxonomy Extension Presentation Linkebase Document (2)

(1) Filed herewith.

(2) Furnished herewith.

