

LAKELAND FINANCIAL CORP  
Form 10-Q  
November 07, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**x QUARTERLY REPORT UNDER SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the quarterly period ended September 30, 2012**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**

**OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**LAKELAND FINANCIAL CORPORATION**

**(Exact name of registrant as specified in its charter)**

|   |                          |                                      |
|---|--------------------------|--------------------------------------|
| Indiana   | 0-11487                  | 35-1559596                           |
| (State or Other Jurisdiction<br>of Incorporation or Organization) | (Commission File Number) | (IRS Employer<br>Identification No.) |

**202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581-1387**

**(Address of Principal Executive Offices)(Zip Code)**

**(574) 267-6144**

**Registrant's Telephone Number, Including Area Code**

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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 a 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

Number of shares of common stock outstanding at October 31, 2012: 16,346,247

**LAKELAND FINANCIAL CORPORATION**

**Form 10-Q Quarterly Report**

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PART II.

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**PART 1****LAKELAND FINANCIAL CORPORATION****ITEM 1 – FINANCIAL STATEMENTS****LAKELAND FINANCIAL CORPORATION****CONSOLIDATED BALANCE SHEETS****As of September 30, 2012 and December 31, 2011****(in thousands except for share data)****(Page 1 of 2)**

|  | <b>September 30,<br/>2012</b> | December 31,<br>2011 |
|--|-------------------------------|----------------------|
|  | (Unaudited)                   |                      |
| <b>ASSETS</b>  |                               |                      |
| Cash and due from banks  | \$ 134,785                    | \$ 56,909            |
| Short-term investments   | 46,617                        | 47,675               |
| Total cash and cash equivalents                                  | 181,402                       | 104,584              |
| Securities available for sale (carried at fair value)            | 481,256                       | 467,391              |
| Real estate mortgage loans held for sale                         | 6,707                         | 2,953                |
| Loans, net of allowance for loan losses of \$51,912 and \$53,400 | 2,151,476                     | 2,180,309            |
| Land, premises and equipment, net                                | 34,969                        | 34,736               |
| Bank owned life insurance  | 40,848                        | 39,959               |
| Accrued income receivable  | 9,735                         | 9,612                |
| Goodwill   | 4,970                         | 4,970                |
| Other intangible assets  | 60                            | 99                   |
| Other assets   | 40,785                        | 45,075               |
| Total assets   | \$ 2,952,208                  | \$ 2,889,688         |

(continued)



**LAKELAND FINANCIAL CORPORATION****CONSOLIDATED BALANCE SHEETS****As of September 30, 2012 and December 31, 2011****(in thousands except for share data)****(Page 2 of 2)**

|  | September 30,<br>2012<br>(Unaudited) | December 31,<br>2011 |
|--|--------------------------------------|----------------------|
| <b>LIABILITIES AND EQUITY</b>  |                                      |                      |
| <b>LIABILITIES</b>   |                                      |                      |
| Noninterest bearing deposits   | \$ 357,531                           | \$ 356,682           |
| Interest bearing deposits  | 2,118,566                            | 2,056,014            |
| Total deposits   | 2,476,097                            | 2,412,696            |
| Short-term borrowings  |                                      |                      |
| Federal funds purchased  | 0                                    | 10,000               |
| Securities sold under agreements to repurchase                               | 118,552                              | 131,990              |
| Total short-term borrowings  | 118,552                              | 141,990              |
| Accrued expenses payable   | 15,414                               | 13,550               |
| Other liabilities  | 1,189                                | 2,195                |
| Long-term borrowings   | 15,038                               | 15,040               |
| Subordinated debentures  | 30,928                               | 30,928               |
| Total liabilities  | 2,657,218                            | 2,616,399            |
| <b>EQUITY</b>  |                                      |                      |
| Common stock: 90,000,000 shares authorized, no par value                     |                                      |                      |
| 16,346,247 shares issued and 16,260,259 outstanding as of September 30, 2012 |                                      |                      |
| 16,217,019 shares issued and 16,145,772 outstanding as of December 31, 2011  | 89,255                               | 87,380               |
| Retained earnings  | 200,615                              | 181,903              |
| Accumulated other comprehensive income                                       | 6,644                                | 5,139                |
| Treasury stock, at cost (2012 - 85,988 shares, 2011 - 71,247 shares)         | (1,613                               | ) (1,222             |
| Total stockholders' equity   | 294,901                              | 273,200              |
| Noncontrolling interest  | 89                                   | 89                   |
| Total equity   | 294,990                              | 273,289              |
| Total liabilities and equity   | \$ 2,952,208                         | \$ 2,889,688         |

The accompanying notes are an integral part of these consolidated financial statements.

**LAKELAND FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF INCOME****For the Three Months and Nine Months Ended September 30, 2012 and 2011****(in thousands except for share and per share data)****(Unaudited)****(Page 1 of 2)**

|  | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|--|-------------------------------------|---------------|------------------------------------|---------------|
|  | 2012                                | 2011          | 2012                               | 2011          |
| <b>NET INTEREST INCOME</b>                                 |                                     |               |                                    |               |
| Interest and fees on loans                                 |                                     |               |                                    |               |
| Taxable  | \$ 25,803                           | \$ 26,390     | \$ 77,789                          | \$ 78,555     |
| Tax exempt   | 109                                 | 114           | 333                                | 357           |
| Interest and dividends on securities                       |                                     |               |                                    |               |
| Taxable  | 2,034                               | 3,217         | 7,425                              | 10,635        |
| Tax exempt   | 698                                 | 692           | 2,094                              | 2,068         |
| Interest on short-term investments                         | 16                                  | 18            | 43                                 | 114           |
| Total interest income                                      | 28,660                              | 30,431        | 87,684                             | 91,729        |
| Interest on deposits                                       | 5,989                               | 7,090         | 19,352                             | 20,868        |
| Interest on borrowings                                     |                                     |               |                                    |               |
| Short-term   | 112                                 | 159           | 329                                | 477           |
| Long-term  | 399                                 | 361           | 1,198                              | 1,084         |
| Total interest expense                                     | 6,500                               | 7,610         | 20,879                             | 22,429        |
| <b>NET INTEREST INCOME</b>                                 | <b>22,160</b>                       | <b>22,821</b> | <b>66,805</b>                      | <b>69,300</b> |
| Provision for loan losses                                  | 0                                   | 2,400         | 1,299                              | 10,900        |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b> | <b>22,160</b>                       | <b>20,421</b> | <b>65,506</b>                      | <b>58,400</b> |
| <b>NONINTEREST INCOME</b>                                  |                                     |               |                                    |               |
| Wealth advisory fees                                       | 959                                 | 866           | 2,770                              | 2,613         |
| Investment brokerage fees                                  | 695                                 | 741           | 2,435                              | 2,093         |
| Service charges on deposit accounts                        | 2,045                               | 2,036         | 5,937                              | 5,938         |
| Loan, insurance and service fees                           | 1,421                               | 1,259         | 4,062                              | 3,595         |



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|  |        |       |          |        |
|--|--------|-------|----------|--------|
| Merchant card fee income   | 297    | 253   | 902      | 775    |
| Other income   | 669    | 362   | 1,614    | 1,380  |
| Mortgage banking income  | 590    | 440   | 1,574    | 594    |
| Net securities losses  | (380 ) | (1 )  | (377 )   | (167 ) |
| Other than temporary impairment loss on available-for-sale securities: |        |       |          |        |
| Total impairment losses recognized on securities                       | (67 )  | (33 ) | (1,052 ) | (154 ) |
| Loss recognized in other comprehensive income                          | 0      | 0     | 26       | 0      |
| Net impairment loss recognized in earnings                             | (67 )  | (33 ) | (1,026 ) | (154 ) |
| Total noninterest income   | 6,229  | 5,923 | 17,891   | 16,667 |

(continued)

**LAKELAND FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF INCOME****For the Three Months and Nine Months Ended September 30, 2012 and 2011****(in thousands except for share and per share data)****(Unaudited)****(Page 2 of 2)**

|   | Three Months Ended<br>September 30, |            | Nine Months Ended<br>September 30, |            |
|---|-------------------------------------|------------|------------------------------------|------------|
|   | 2012                                | 2011       | 2012                               | 2011       |
| <b>NONINTEREST EXPENSE</b>                    |                                     |            |                                    |            |
| Salaries and employee benefits                | 8,569                               | 8,611      | 26,007                             | 24,802     |
| Net occupancy expense                         | 803                                 | 746        | 2,519                              | 2,373      |
| Equipment costs                               | 641                                 | 536        | 1,854                              | 1,600      |
| Data processing fees and supplies             | 1,143                               | 729        | 3,044                              | 2,820      |
| Other expense                                 | 3,146                               | 2,857      | 9,807                              | 10,025     |
| Total noninterest expense                     | 14,302                              | 13,479     | 43,231                             | 41,620     |
| <b>INCOME BEFORE INCOME TAX EXPENSE</b>       | 14,087                              | 12,865     | 40,166                             | 33,447     |
| Income tax expense                            | 4,740                               | 4,418      | 13,374                             | 11,046     |
| <b>NET INCOME</b>                             | \$9,347                             | \$8,447    | \$26,792                           | \$22,401   |
| <b>BASIC WEIGHTED AVERAGE COMMON SHARES</b>   | 16,340,425                          | 16,208,889 | 16,312,896                         | 16,201,900 |
| <b>BASIC EARNINGS PER COMMON SHARE</b>        | \$0.57                              | \$0.52     | \$1.64                             | \$1.38     |
| <b>DILUTED WEIGHTED AVERAGE COMMON SHARES</b> | 16,490,390                          | 16,324,058 | 16,470,485                         | 16,309,814 |
| <b>DILUTED EARNINGS PER COMMON SHARE</b>      | \$0.57                              | \$0.52     | \$1.63                             | \$1.37     |

The accompanying notes are an integral part of these consolidated financial statements.



**LAKELAND FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****For the Three Months and Nine Months Ended September 30, 2012 and 2011****(in thousands)****(Unaudited)**

|   | Three months ended September 30, |           | Nine months ended September 30, |           |
|---|----------------------------------|-----------|---------------------------------|-----------|
|   | 2012                             | 2011      | 2012                            | 2011      |
| Net income  | \$ 9,347                         | \$ 8,447  | \$ 26,792                       | \$ 22,401 |
| Other comprehensive income  |                                  |           |                                 |           |
| Change in securities available for sale:  |                                  |           |                                 |           |
| Unrealized holding gain (loss) on securities available for sale arising during the period | (251 )                           | 4,857     | 818                             | 8,651     |
| Reclassification adjustment for losses included in net income                             | 380                              | 1         | 377                             | 167       |
| Reclassification adjustment for other than temporary impairment                           | 67                               | 33        | 1,026                           | 154       |
| Net securities gain activity during the period  | 196                              | 4,891     | 2,221                           | 8,972     |
| Tax effect  | (76 )                            | (1,889 )  | (880 )                          | (3,462 )  |
| Net of tax amount   | 120                              | 3,002     | 1,341                           | 5,510     |
| Defined benefit pension plans:  |                                  |           |                                 |           |
| Net gain(loss) on defined benefit pension plans   | 0                                | 0         | 110                             | (233 )    |
| Amortization of net actuarial loss  | 55                               | 62        | 164                             | 132       |
| Net gain /(loss) activity during the period   | 55                               | 62        | 274                             | (101 )    |
| Tax effect  | (22 )                            | (26 )     | (110 )                          | 41        |
| Net of tax amount   | 33                               | 36        | 164                             | (60 )     |
| Total other comprehensive income, net of tax  | 153                              | 3,038     | 1,505                           | 5,450     |
| Comprehensive income  | \$ 9,500                         | \$ 11,485 | \$ 28,297                       | \$ 27,851 |

The accompanying notes are an integral part of these consolidated financial statements.

## LAKELAND FINANCIAL CORPORATION

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

For the Nine Months Ended September 30, 2012 and 2011

(in thousands except for share and per share data)

(Unaudited)

|  | Common<br>Stock | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Treasury<br>Stock | Total<br>Stockholders'<br>Equity |
|--|-----------------|----------------------|---|-------------------|----------------------------------|
| Balance at January 1, 2011   | \$ 85,766       | \$ 161,299           | \$ 1,350  | \$(1,418 )        | \$ 246,997                       |
| Comprehensive income:  |                 |                      |   |                   |                                  |
| Net income   |                 | 22,401               |   |                   | 22,401                           |
| Other comprehensive income (loss), net of tax                                |                 |                      | 5,450   |                   | 5,450                            |
| Comprehensive income   |                 |                      |   |                   | 27,851                           |
| Common stock cash dividends declared, \$0.465 per share                      |                 | (7,546 )             |   |                   | (7,546 )                         |
| Treasury shares purchased under deferred directors' plan (10,187 shares)     | 233             |                      |   | (233 )            | 0                                |
| Treasury shares sold under deferred directors' plan (30,100 shares)          | (440 )          |                      |   | 440               | 0                                |
| Stock activity under stock compensation plans (42,200 shares)                | 395             |                      |   |                   | 395                              |
| Stock compensation expense   | 1,061           |                      |   |                   | 1,061                            |
| Balance at September 30, 2011  | \$ 87,015       | \$ 176,154           | \$ 6,800  | \$(1,211 )        | \$ 268,758                       |
| Balance at January 1, 2012   | \$ 87,380       | \$ 181,903           | \$ 5,139  | \$(1,222 )        | \$ 273,200                       |
| Comprehensive income:  |                 |                      |   |                   |                                  |
| Net income   |                 | 26,792               |   |                   | 26,792                           |
| Other comprehensive income (loss), net of tax                                |                 |                      | 1,505   |                   | 1,505                            |
| Comprehensive income   |                 |                      |   |                   | 28,297                           |
| Common stock cash dividends declared, \$0.495 per share                      |                 | (8,080 )             |   |                   | (8,080 )                         |
| Treasury shares purchased under deferred directors' plan (14,741 shares)     | 391             |                      |   | (391 )            | 0                                |
| Stock activity under stock compensation plans, net of taxes (129,228 shares) | 323             |                      |   |                   | 323                              |
| Stock compensation expense   | 1,161           |                      |   |                   | 1,161                            |
| Balance at September 30, 2012  | \$ 89,255       | \$ 200,615           | \$ 6,644  | \$(1,613 )        | \$ 294,901                       |

The accompanying notes are an integral part of these consolidated financial statements

**LAKELAND FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Nine Months Ended September 30, 2012 and 2011****(in thousands)****(Unaudited)****(Page 1 of 2)**

|   | 2012      | 2011      |
|---|-----------|-----------|
| Cash flows from operating activities:   |           |           |
| Net income  | \$26,792  | \$22,401  |
| Adjustments to reconcile net income to net cash from operating activities:              |           |           |
| Depreciation  | 2,029     | 1,660     |
| Provision for loan losses   | 1,299     | 10,900    |
| Loss on sale and write down of other real estate owned                                  | 214       | 358       |
| Amortization of intangible assets   | 39        | 41        |
| Amortization of loan servicing rights   | 541       | 427       |
| Net change in loan servicing rights valuation allowance                                 | 84        | 162       |
| Loans originated for sale   | (89,595 ) | (48,294 ) |
| Net gain on sales of loans  | (1,926 )  | (1,004 )  |
| Proceeds from sale of loans   | 87,180    | 49,086    |
| Net loss on sales of premises and equipment   | 4         | 17        |
| Net loss on sales and calls of securities available for sale                            | 377       | 167       |
| Impairment on available for sale securities   | 1,026     | 154       |
| Net securities amortization   | 5,210     | 2,255     |
| Stock compensation expense  | 1,161     | 1,061     |
| Earnings on life insurance  | (708 )    | (726 )    |
| Tax benefit of stock option exercises   | (535 )    | (96 )     |
| Net change:   |           |           |
| Accrued income receivable   | (123 )    | 179       |
| Accrued expenses payable  | 2,027     | 1,259     |
| Other assets  | 2,322     | (1,565 )  |
| Other liabilities   | (615 )    | (192 )    |
| Total adjustments   | 10,011    | 15,849    |
| Net cash from operating activities  | 36,803    | 38,250    |
| Cash flows from investing activities:   |           |           |
| Proceeds from sale of securities available for sale                                     | 27,492    | 73,318    |
| Proceeds from maturities, calls and principal paydowns of securities available for sale | 82,499    | 58,668    |
| Purchases of securities available for sale  | (128,249) | (147,042) |
| Purchase of life insurance  | (210 )    | (162 )    |
| Net (increase) decrease in total loans  | 27,238    | (95,690 ) |

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|   |          |           |
|---|----------|-----------|
| Proceeds from sales of land, premises and equipment | 2        | 33        |
| Purchases of land, premises and equipment           | (2,268 ) | (2,965 )  |
| Proceeds from sales of other real estate            | 1,698    | 1,254     |
| Net cash from investing activities                  | 8,202    | (112,586) |

(Continued)

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**LAKELAND FINANCIAL CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS****For the Nine Months Ended September 30, 2012 and 2011****(in thousands)****(Unaudited)****(Page 2 of 2)**

|  | 2012      | 2011      |
|--|-----------|-----------|
| Cash flows from financing activities:                |           |           |
| Net increase in total deposits                       | 63,401    | 155,334   |
| Net decrease in short-term borrowings                | (23,438 ) | (32,476 ) |
| Payments on long-term borrowings                     | (2 )      | (1 )      |
| Common dividends paid                                | (8,067 )  | (7,533 )  |
| Preferred dividends paid                             | (13 )     | (13 )     |
| Proceeds from stock option exercise                  | 323       | 395       |
| Purchase of treasury stock                           | (391 )    | (233 )    |
| Net cash from financing activities                   | 31,813    | 115,473   |
| Net change in cash and cash equivalents              | 76,818    | 41,137    |
| Cash and cash equivalents at beginning of the period | 104,584   | 60,141    |
| Cash and cash equivalents at end of the period       | \$181,402 | \$101,278 |
| Cash paid during the period for:                     |           |           |
| Interest   | \$19,937  | \$22,095  |
| Income taxes   | 11,028    | 14,629    |
| Supplemental non-cash disclosures:                   |           |           |
| Loans transferred to other real estate               | 296       | 807       |

The accompanying notes are an integral part of these consolidated financial statements.

**LAKELAND FINANCIAL CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**September 30, 2012**

**(Table amounts in thousands except for share and per share data)**

**(Unaudited)**

**NOTE 1. BASIS OF PRESENTATION**

This report is filed for Lakeland Financial Corporation (the “Company”) and its wholly owned subsidiary, Lake City Bank (the “Bank”). All significant inter-company balances and transactions have been eliminated in consolidation. Also included is the Bank’s wholly owned subsidiary, LCB Investments II, Inc. (“LCB Investments”). LCB Investments also owns LCB Funding, Inc. (“LCB Funding”), a real estate investment trust.

The unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) for interim financial information and with the instructions for Form 10-Q. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements and are unaudited. In the opinion of management, all adjustments (all of which are normal and recurring in nature) considered necessary for a fair presentation have been included. Operating results for the three-month and nine-month periods ending September 30, 2012 are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. The 2011 Lakeland Financial Corporation Annual Report on Form 10-K should be read in conjunction with these statements.

**NOTE 2. EARNINGS PER SHARE**

Basic earnings per common share is net income available to common shareholders divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options, stock awards and warrants.

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|   | Three Months Ended September 30,<br>2012 | 2011       | Nine Months Ended September 30,<br>2012 | 2011       |
|---|--|------------|---|------------|
| Weighted average shares outstanding for basic earnings per common share   | 16,340,425                               | 16,208,889 | 16,312,896                              | 16,201,900 |
| Dilutive effect of stock options, awards and warrants                     | 149,965                                  | 115,169    | 157,589                                 | 107,914    |
| Weighted average shares outstanding for diluted earnings per common share | 16,490,390                               | 16,324,058 | 16,470,485                              | 16,309,814 |
| Basic earnings per common share   | \$ 0.57                                  | \$ 0.52    | \$ 1.64                                 | \$ 1.38    |
| Diluted earnings per common share   | \$ 0.57                                  | \$ 0.52    | \$ 1.63                                 | \$ 1.37    |

Stock options for 0 and 70,000 shares for both the three-month and nine-month periods ended September 30, 2012 and 2011, respectively, were not considered in computing diluted earnings per common share because they were antidilutive.

### NOTE 3. LOANS

|   | September 30,<br>2012 |        | December 31,<br>2011 |        |
|---|-----------------------|--------|----------------------|--------|
| Commercial and industrial loans:                                |                       |        |                      |        |
| Working capital lines of credit loans                           | \$445,981             | 20.2 % | \$373,768            | 16.7 % |
| Non-working capital loans                                       | 382,850               | 17.4   | 377,388              | 16.9   |
| Total commercial and industrial loans                           | 828,831               | 37.6   | 751,156              | 33.6   |
| Commercial real estate and multi-family residential loans:      |                       |        |                      |        |
| Construction and land development loans                         | 87,949                | 4.0    | 82,284               | 3.7    |
| Owner occupied loans  | 363,673               | 16.5   | 346,669              | 15.5   |
| Nonowner occupied loans   | 308,146               | 14.0   | 385,090              | 17.2   |
| Multifamily loans   | 25,482                | 1.2    | 38,477               | 1.7    |
| Total commercial real estate and multi-family residential loans | 785,250               | 35.6   | 852,520              | 38.2   |
| Agri-business and agricultural loans:                           |                       |        |                      |        |
| Loans secured by farmland                                       | 119,524               | 5.4    | 118,224              | 5.3    |
| Loans for agricultural production                               | 94,563                | 4.3    | 119,705              | 5.4    |
| Total agri-business and agricultural loans                      | 214,087               | 9.7    | 237,929              | 10.7   |
| Other commercial loans  | 44,982                | 2.0    | 58,278               | 2.6    |
| Total commercial loans  | 1,873,150             | 85.0   | 1,899,883            | 85.0   |
| Consumer 1-4 family mortgage loans:                             |                       |        |                      |        |
| Closed end first mortgage loans                                 | 106,147               | 4.8    | 106,999              | 4.8    |
| Open end and junior lien loans                                  | 168,507               | 7.6    | 175,694              | 7.9    |
| Residential construction and land development loans             | 11,303                | 0.5    | 5,462                | 0.2    |
| Total consumer 1-4 family mortgage loans                        | 285,957               | 13.0   | 288,155              | 12.9   |
| Other consumer loans  | 44,691                | 2.0    | 45,999               | 2.1    |
| Total consumer loans  | 330,648               | 15.0   | 334,154              | 15.0   |
| Subtotal  | 2,203,798             | 100.0% | 2,234,037            | 100.0% |
| Less: Allowance for loan losses                                 | (51,912 )             |        | (53,400 )            |        |
| Net deferred loan fees  | (410 )                |        | (328 )               |        |
| Loans, net  | \$2,151,476           |        | \$2,180,309          |        |

**NOTE 4. ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY**

The following table presents the activity in the allowance for loan losses by portfolio segment for the three-month and nine-month periods ended September 30, 2012, and the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of September 30, 2012:

|   | Commercial<br>and<br>Industrial | Commercial<br>Real Estate<br>and<br>Multifamily<br>Residential | Agri-business<br>and<br>Agricultural | Other<br>Commercial | Consumer<br>1-4<br>Family<br>Mortgage | Other<br>Consumer | Unallocated | Total     |
|---|---------------------------------|--|--------------------------------------|---------------------|---------------------------------------|-------------------|-------------|-----------|
| Three Months<br>Ended<br>September 30,<br>2012                            | (in<br>thousands)               |  |                                      |                     |                                       |                   |             |           |
| Balance July 1,   | \$ 19,696                       | \$ 24,083  | \$ 1,419                             | \$ 176              | \$ 2,412                              | \$ 523            | \$ 3,508    | \$ 51,817 |
| Provision for<br>loan losses  | 1,532                           | (1,236 )   | (76 )                                | (207 )              | 356                                   | 114               | (483 )      | 0         |
| Loans<br>charged-off  | (98 )                           | (112 )   | 0                                    | 0                   | (196 )                                | (77 )             | 0           | (483 )    |
| Recoveries  | 224                             | 120  | 1                                    | 182                 | 21                                    | 30                | 0           | 578       |
| Net loans<br>charged-off  | 126                             | 8  | 1                                    | 182                 | (175 )                                | (47 )             | 0           | 95        |
| Balance<br>September 30,<br>Nine Months<br>Ended<br>September 30,<br>2012 | \$ 21,354                       | \$ 22,855  | \$ 1,344                             | \$ 151              | \$ 2,593                              | \$ 590            | \$ 3,025    | \$ 51,912 |
| Balance<br>January 1,   | \$ 22,830                       | \$ 23,489  | \$ 695                               | \$ 65               | \$ 2,322                              | \$ 645            | \$ 3,354    | \$ 53,400 |
| Provision for<br>loan losses  | 380                             | 158  | 648                                  | (100 )              | 417                                   | 125               | (329 )      | 1,299     |
| Loans<br>charged-off  | (2,552 )                        | (959 )   | 0                                    | 0                   | (288 )                                | (268 )            | 0           | (4,067 )  |
| Recoveries  | 696                             | 167  | 1                                    | 186                 | 142                                   | 88                | 0           | 1,280     |
| Net loans<br>charged-off  | (1,856 )                        | (792 )   | 1                                    | 186                 | (146 )                                | (180 )            | 0           | (2,787 )  |
| Balance<br>September 30,  | \$ 21,354                       | \$ 22,855  | \$ 1,344                             | \$ 151              | \$ 2,593                              | \$ 590            | \$ 3,025    | \$ 51,912 |

Allowance for  
loan losses:

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|   |           |            |            |           |           |          |          |             |
|---|-----------|------------|------------|-----------|-----------|----------|----------|-------------|
| Ending allowance balance attributable to loans: |           |            |            |           |           |          |          |             |
| Individually evaluated for impairment           | \$6,571   | \$ 8,869   | \$ 67      | \$ 0      | \$459     | \$18     | \$ 0     | \$15,984    |
| Collectively evaluated for impairment           | 14,783    | 13,986     | 1,277      | 151       | 2,134     | 572      | 3,025    | 35,928      |
| Total ending allowance balance                  | \$21,354  | \$ 22,855  | \$ 1,344   | \$ 151    | \$2,593   | \$ 590   | \$ 3,025 | \$51,912    |
| Loans:  |           |            |            |           |           |          |          |             |
| Loans individually evaluated for impairment     | \$20,319  | \$ 37,924  | \$ 820     | \$ 0      | \$2,194   | \$46     | \$ 0     | \$61,303    |
| Loans collectively evaluated for impairment     | 808,700   | 746,439    | 213,350    | 44,974    | 284,027   | 44,595   | 0        | 2,142,085   |
| Total ending loans balance                      | \$829,019 | \$ 784,363 | \$ 214,170 | \$ 44,974 | \$286,221 | \$44,641 | \$ 0     | \$2,203,388 |

The recorded investment in loans does not include accrued interest.

The following table presents the activity in the allowance for loan losses by portfolio segment for the three-month and nine-month periods ended September 30, 2011:

|                           | Commercial<br>and<br>Industrial<br>(in thousands) | Commercial<br>Real Estate<br>and<br>Multifamily<br>Residential | Agri-business<br>and<br>Agricultural | Other<br>Commercial | Consumer<br>1-4<br>Family<br>Mortgage | Other<br>Consumer | Unallocated | Total    |
|---------------------------|---|--|--------------------------------------|---------------------|---------------------------------------|-------------------|-------------|----------|
| Three Months Ended        |   |  |                                      |                     |                                       |                   |             |          |
| September 30, 2011        |   |  |                                      |                     |                                       |                   |             |          |
| Balance July 1,           | \$22,999  | \$ 20,032  | \$ 948                               | \$ 560              | \$ 2,658                              | \$ 605            | \$ 3,458    | \$51,260 |
| Provision for loan losses | 1,171   | 2,134  | (194 )                               | (536 )              | (272 )                                | 294               | (197 )      | 2,400    |
| Loans charged-off         | (883 )  | (557 )   | (103 )                               | 0                   | (292 )                                | (264 )            | 0           | (2,099 ) |
| Recoveries                | 465   | 10   | 0                                    | 0                   | 5                                     | 32                | 0           | 512      |
| Net loans charged-off     | (418 )  | (547 )   | (103 )                               | 0                   | (287 )                                | (232 )            | 0           | (1,587 ) |
| Balance September 30,     | \$23,752  | \$ 21,619  | \$ 651                               | \$ 24               | \$ 2,099                              | \$ 667            | \$ 3,261    | \$52,073 |
| Nine Months Ended         |   |  |                                      |                     |                                       |                   |             |          |
| September 30, 2011        |   |  |                                      |                     |                                       |                   |             |          |
| Balance January 1,        | \$21,479  | \$ 15,893  | \$ 1,318                             | \$ 270              | \$ 1,694                              | \$ 682            | \$ 3,671    | \$45,007 |
| Provision for loan losses | 3,048   | 7,362  | (564 )                               | (246 )              | 1,390                                 | 320               | (410 )      | 10,900   |
| Loans charged-off         | (1,470 )  | (1,973 )   | (103 )                               | 0                   | (1,009 )                              | (493 )            | 0           | (5,048 ) |
| Recoveries                | 695   | 337  | 0                                    | 0                   | 24                                    | 158               | 0           | 1,214    |
| Net loans charged-off     | (775 )  | (1,636 )   | (103 )                               | 0                   | (985 )                                | (335 )            | 0           | (3,834 ) |
| Balance September 30,     | \$23,752  | \$ 21,619  | \$ 651                               | \$ 24               | \$ 2,099                              | \$ 667            | \$ 3,261    | \$52,073 |

The recorded investment in loans does not include accrued interest.

The following table presents the activity in the allowance for loan losses by portfolio segment for the year ended December 31, 2011 and the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2011:

|  | Commercial<br>and<br>Industrial<br>(in thousands) | Commercial<br>Real Estate<br>and<br>Multifamily<br>Residential | Agri-business<br>and<br>Agricultural | Other<br>Commercial | Consumer<br>1-4<br>Family<br>Mortgage | Other<br>Consumer | Unallocated | Total     |
|--|---|--|--------------------------------------|---------------------|---------------------------------------|-------------------|-------------|-----------|
| Balance January 1  | \$21,479  | \$ 15,893  | \$ 1,318                             | \$ 270              | \$ 1,694                              | \$ 682            | \$ 3,671    | \$45,007  |
| Provision for loan losses  | 3,112   | 9,748  | (520 )                               | (205 )              | 1,632                                 | 350               | (317 )      | 13,800    |
| Loans charged-off  | (2,587 )  | (2,514 )   | (103 )                               | 0                   | (1,050 )                              | (575 )            | 0           | (6,829 )  |
| Recoveries   | 826   | 362  | 0                                    | 0                   | 46                                    | 188               | 0           | 1,422     |
| Net loans charged-off  | (1,761 )  | (2,152 )   | (103 )                               | 0                   | (1,004 )                              | (387 )            | 0           | (5,407 )  |
| Balance December 31  | \$22,830  | \$ 23,489  | \$ 695                               | \$ 65               | \$ 2,322                              | \$ 645            | \$ 3,354    | \$53,400  |
| Allowance for loan losses:<br>Ending allowance balance attributable to loans:<br>Individually evaluated for impairment | \$9,443   | \$ 8,382   | \$ 213                               | \$ -                | \$ 288                                | \$ 0              | \$ 0        | \$18,326  |
| Collectively evaluated for impairment  | 13,387  | 15,107   | 482                                  | 65                  | 2,034                                 | 645               | 3,354       | 35,074    |
| Total ending allowance balance   | \$22,830  | \$ 23,489  | \$ 695                               | \$ 65               | \$ 2,322                              | \$ 645            | \$ 3,354    | \$53,400  |
| Loans:<br>Loans individually evaluated for impairment  | \$24,204  | \$ 35,794  | \$ 853                               | \$ 0                | \$ 2,665                              | \$ 0              | \$ 0        | \$63,516  |
| Loans collectively evaluated for impairment  | 727,160   | 815,883  | 237,150                              | 58,249              | 285,791                               | 45,960            | 0           | 2,170,193 |



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|                            |           |            |            |           |            |           |      |             |
|----------------------------|-----------|------------|------------|-----------|------------|-----------|------|-------------|
| Total ending loans balance | \$751,364 | \$ 851,677 | \$ 238,003 | \$ 58,249 | \$ 288,456 | \$ 45,960 | \$ 0 | \$2,233,709 |
|----------------------------|-----------|------------|------------|-----------|------------|-----------|------|-------------|

The recorded investment in loans does not include accrued interest.

The allowance for loan losses to total loans at September 30, 2012 and 2011 was 2.36% and 2.39%, respectively. The allowance for loan losses to total loans at December 31, 2011 was 2.39%.

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The following table presents loans individually evaluated for impairment as of and for the three-month and nine-month periods ended September 30, 2012 and 2011:

|  | Three Months Ended September 30, 2012 |                     |                                     |                             |                            | Nine Months Ended September 30, 2011  |                             |                            |                                       |
|--|---------------------------------------|---------------------|-------------------------------------|-----------------------------|----------------------------|---------------------------------------|-----------------------------|----------------------------|---------------------------------------|
|  | Unpaid Principal Balance              | Recorded Investment | Allowance for Loan Losses Allocated | Average Recorded Investment | Interest Income Recognized | Cash Basis Interest Income Recognized | Average Recorded Investment | Interest Income Recognized | Cash Basis Interest Income Recognized |
| With no related allowance recorded:                        |                                       |                     |                                     |                             |                            |                                       |                             |                            |                                       |
| Commercial and industrial loans:                           |                                       |                     |                                     |                             |                            |                                       |                             |                            |                                       |
| Non-working capital loans                                  | \$70                                  | \$70                | \$0                                 | \$70                        | \$0                        | \$0                                   | \$136                       | \$0                        | \$0                                   |
| Commercial real estate and multi-family residential loans: |                                       |                     |                                     |                             |                            |                                       |                             |                            |                                       |
| Owner occupied loans                                       | 781                                   | 601                 | 0                                   | 611                         | 0                          | 0                                     | 513                         | 0                          | 0                                     |
| Nonowner occupied loans                                    | 385                                   | 385                 | 0                                   | 385                         | 10                         | 13                                    | 217                         | 10                         | 13                                    |
| Agri-business and agricultural loans:                      |                                       |                     |                                     |                             |                            |                                       |                             |                            |                                       |
| Loans secured by farmland                                  | 666                                   | 487                 | 0                                   | 489                         | 0                          | 0                                     | 252                         | 0                          | 0                                     |
| Loans for ag production                                    | 0                                     | 0                   | 0                                   | 0                           | 0                          | 0                                     | 68                          | 0                          | 0                                     |
| Consumer 1-4 family loans:                                 |                                       |                     |                                     |                             |                            |                                       |                             |                            |                                       |
| Closed end first mortgage loans                            | 277                                   | 276                 | 0                                   | 417                         | 1                          | 0                                     | 432                         | 1                          | 0                                     |
| Open end and junior lien loans                             | 0                                     | 0                   | 0                                   | 0                           | 0                          | 0                                     | 20                          | 0                          | 0                                     |
| Other consumer loans                                       | 1                                     | 1                   | 0                                   | 0                           | 0                          | 0                                     | 0                           | 0                          | 0                                     |
| With an allowance recorded:                                |                                       |                     |                                     |                             |                            |                                       |                             |                            |                                       |
| Commercial and industrial loans:                           | 5,915                                 | 3,074               | 1,417                               | 3,059                       | 13                         | 10                                    | 4,420                       | 42                         | 38                                    |

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|  |          |          |          |          |       |       |          |       |       |
|--|----------|----------|----------|----------|-------|-------|----------|-------|-------|
| Working capital lines of credit loans                      |          |          |          |          |       |       |          |       |       |
| Non-working capital loans                                  | 19,357   | 17,175   | 5,154    | 17,072   | 171   | 168   | 17,353   | 528   | 528   |
| Commercial real estate and multi-family residential loans: |          |          |          |          |       |       |          |       |       |
| Construction and land development loans                    | 3,786    | 3,396    | 672      | 2,436    | 18    | 13    | 1,814    | 35    | 30    |
| Owner occupied loans                                       | 6,900    | 6,287    | 1,527    | 5,702    | 30    | 19    | 4,859    | 48    | 35    |
| Nonowner occupied loans                                    | 27,957   | 27,255   | 6,670    | 27,382   | 78    | 77    | 28,115   | 280   | 281   |
| Agri-business and agricultural loans:                      |          |          |          |          |       |       |          |       |       |
| Loans secured by farmland                                  | 654      | 333      | 67       | 343      | 0     | 0     | 437      | 0     | 0     |
| Loans for agricultural production                          | 0        | 0        | 0        | 63       | 0     | 0     | 91       | 0     | 0     |
| Other commercial loans                                     | 0        | 0        | 0        | 0        | 0     | 0     | 0        | 0     | 0     |
| Consumer 1-4 family mortgage loans:                        |          |          |          |          |       |       |          |       |       |
| Closed end first mortgage loans                            | 1,562    | 1,564    | 267      | 1,730    | 12    | 10    | 1,787    | 32    | 32    |
| Open end and junior lien loans                             | 354      | 354      | 192      | 353      | 0     | 0     | 340      | 0     | 0     |
| Other consumer loans                                       | 45       | 45       | 18       | 30       | 1     | 1     | 14       | 1     | 1     |
| Total  | \$68,710 | \$61,303 | \$15,984 | \$60,142 | \$334 | \$311 | \$60,868 | \$977 | \$958 |

The recorded investment in loans does not include accrued interest.

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2011:

|  | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance<br>for<br>Loan Losses<br>Allocated | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Cash<br>Basis<br>Interest<br>Income<br>Recognized |
|--|--------------------------------|------------------------|--|-----------------------------------|----------------------------------|---|
| With no related allowance recorded:                        |                                |                        |  |                                   |                                  |   |
| Commercial and industrial loans:                           |                                |                        |  |                                   |                                  |   |
| Non-working capital loans                                  | \$ 116                         | \$ 116                 | \$ 0   | \$ 30                             | \$ 0                             | \$ 0  |
| Commercial real estate and multi-family residential loans: |                                |                        |  |                                   |                                  |   |
| Nonowner occupied loans                                    | 0                              | 0                      | 0  | 425                               | 0                                | 0   |
| With an allowance recorded:                                |                                |                        |  |                                   |                                  |   |
| Commercial and industrial loans:                           |                                |                        |  |                                   |                                  |   |
| Working capital lines of credit loans                      | 7,831                          | 5,969                  | 3,206  | 5,649                             | 23                               | 25  |
| Non-working capital loans                                  | 20,867                         | 18,119                 | 6,237  | 17,202                            | 616                              | 625   |
| Commercial real estate and multi-family residential loans: |                                |                        |  |                                   |                                  |   |
| Construction and land development loans                    | 816                            | 429                    | 125  | 1,319                             | 0                                | 0   |
| Owner occupied loans                                       | 5,874                          | 5,082                  | 1,566  | 3,082                             | 41                               | 45  |
| Nonowner occupied loans                                    | 30,769                         | 30,283                 | 6,691  | 24,108                            | 246                              | 252   |
| Multifamily loans  | 0                              | 0                      | 0  | 0                                 | 0                                | 0   |
| Agri-business and agricultural loans:                      |                                |                        |  |                                   |                                  |   |
| Loans secured by farmland                                  | 1,126                          | 628                    | 195  | 610                               | 0                                | 0   |
| Loans for agricultural production                          | 225                            | 225                    | 18   | 410                               | 0                                | 0   |
| Other commercial loans                                     | 0                              | 0                      | 0  | 129                               | 0                                | 0   |
| Consumer 1-4 family mortgage loans:                        |                                |                        |  |                                   |                                  |   |
| Closed end first mortgage loans                            | 2,461                          | 2,256                  | 285  | 1,872                             | 44                               | 48  |
| Open end and junior lien loans                             | 409                            | 409                    | 3  | 118                               | 0                                | 0   |
| Residential construction loans                             | 0                              | 0                      | 0  | 0                                 | 0                                | 0   |
| Other consumer loans                                       | 0                              | 0                      | 0  | 0                                 | 0                                | 0   |

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|       |          |           |           |           |        |        |
|-------|----------|-----------|-----------|-----------|--------|--------|
| Total | \$70,494 | \$ 63,516 | \$ 18,326 | \$ 54,954 | \$ 970 | \$ 995 |
|-------|----------|-----------|-----------|-----------|--------|--------|

The recorded investment in loans does not include accrued interest.

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The following table presents the recorded investment in nonaccrual and loans past due over 90 days still on accrual by class of loans as of September 30, 2012 and December 31, 2011:

|  | September 30, 2012                      |          | December 31, 2011                       |          |
|--|---|----------|---|----------|
|  | Loans Past Due<br>Over 90 Days<br>Still |          | Loans Past Due<br>Over 90 Days<br>Still |          |
|  | Nonaccrual                              | Accruing | Nonaccrual                              | Accruing |
| Commercial and industrial loans:                           |   |          |   |          |
| Working capital lines of credit loans                      | \$ 2,012                                | \$ 0     | \$ 4,743                                | \$ 0     |
| Non-working capital loans                                  | 5,349                                   | 0        | 5,433                                   | 0        |
| Commercial real estate and multi-family residential loans: |   |          |   |          |
| Construction and land development loans                    | 1,890                                   | 0        | 429                                     | 0        |
| Owner occupied loans                                       | 2,876                                   | 0        | 4,371                                   | 0        |
| Nonowner occupied loans                                    | 19,575                                  | 0        | 21,971                                  | 0        |
| Multifamily loans  | 0                                       | 0        | 0                                       | 0        |
| Agri-business and agricultural loans:                      |   |          |   |          |
| Loans secured by farmland                                  | 820                                     | 0        | 628                                     | 0        |
| Loans for agricultural production                          | 0                                       | 0        | 225                                     | 0        |
| Other commercial loans                                     | 0                                       | 0        | 0                                       | 0        |
| Consumer 1-4 family mortgage loans:                        |   |          |   |          |
| Closed end first mortgage loans                            | 459                                     | 107      | 1,193                                   | 52       |
| Open end and junior lien loans                             | 424                                     | 2        | 452                                     | 0        |
| Residential construction loans                             | 0                                       | 0        | 0                                       | 0        |
| Other consumer loans                                       | 54                                      | 0        | 7                                       | 0        |
| Total  | \$ 33,459                               | \$ 109   | \$ 39,452                               | \$ 52    |

The recorded investment in loans does not include accrued interest.



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The following table presents the aging of the recorded investment in past due loans as of September 30, 2012 by class of loans:

|   | 30-89<br>Days<br>Past Due | Greater than<br>90 Days<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due | Total        |
|---|---------------------------|-------------------------------------|-------------------|-----------------------|--------------|
| Commercial and industrial loans:                              |                           |                                     |                   |                       |              |
| Working capital lines of credit loans                         | \$ 332                    | \$ 2,012                            | \$ 2,344          | \$ 443,804            | \$ 446,148   |
| Non-working capital loans                                     | 246                       | 5,349                               | 5,595             | 377,276               | 382,871      |
| Commercial real estate and multi-family residential<br>loans: |                           |                                     |                   |                       |              |
| Construction and land development loans                       | 0                         | 1,890                               | 1,890             | 85,856                | 87,746       |
| Owner occupied loans  | 860                       | 2,876                               | 3,736             | 359,747               | 363,483      |
| Nonowner occupied loans                                       | 0                         | 19,575                              | 19,575            | 288,125               | 307,700      |
| Multifamily loans   | 0                         | 0                                   | 0                 | 25,434                | 25,434       |
| Agri-business and agricultural loans:                         |                           |                                     |                   |                       |              |
| Loans secured by farmland                                     | 0                         | 820                                 | 820               | 118,717               | 119,537      |
| Loans for agricultural production                             | 0                         | 0                                   | 0                 | 94,633                | 94,633       |
| Other commercial loans  | 0                         | 0                                   | 0                 | 44,974                | 44,974       |
| Consumer 1-4 family mortgage loans:                           |                           |                                     |                   |                       |              |
| Closed end first mortgage loans                               | 2,123                     | 566                                 | 2,689             | 103,210               | 105,899      |
| Open end and junior lien loans                                | 197                       | 426                                 | 623               | 168,424               | 169,047      |
| Residential construction loans                                | 44                        | 0                                   | 44                | 11,231                | 11,275       |
| Other consumer loans  | 235                       | 54                                  | 289               | 44,352                | 44,641       |
| Total   | \$ 4,037                  | \$ 33,568                           | \$ 37,605         | \$ 2,165,783          | \$ 2,203,388 |

The recorded investment in loans does not include accrued interest.



The following table presents the aging of the recorded investment in past due loans as of December 31, 2011 by class of loans:

|  | 30-89<br>Days<br>Past Due | Greater<br>than<br>90 Days<br>Past Due | Total<br>Past Due<br>(in<br>thousands) | Loans Not<br>Past Due | Total       |
|--|---------------------------|--|--|-----------------------|-------------|
| Commercial and industrial loans:                           |                           |  |  |                       |             |
| Working capital lines of credit loans                      | \$ 1,051                  | \$ 4,743                               | \$ 5,794                               | \$368,098             | \$373,892   |
| Non-working capital loans                                  | 21                        | 5,433                                  | 5,454                                  | 372,018               | 377,472     |
| Commercial real estate and multi-family residential loans: |                           |  |  |                       |             |
| Construction and land development loans                    | 0                         | 429                                    | 429                                    | 81,650                | 82,079      |
| Owner occupied loans                                       | 104                       | 4,371                                  | 4,475                                  | 342,068               | 346,543     |
| Nonowner occupied loans                                    | 0                         | 21,971                                 | 21,971                                 | 362,710               | 384,681     |
| Multifamily loans  | 0                         | 0                                      | 0                                      | 38,374                | 38,374      |
| Agri-business and agricultural loans:                      |                           |  |  |                       |             |
| Loans secured by farmland                                  | 0                         | 628                                    | 628                                    | 117,619               | 118,247     |
| Loans for agricultural production                          | 0                         | 225                                    | 225                                    | 119,531               | 119,756     |
| Other commercial loans                                     | 0                         | 0                                      | 0                                      | 58,249                | 58,249      |
| Consumer 1-4 family mortgage loans:                        |                           |  |  |                       |             |
| Closed end first mortgage loans                            | 2,569                     | 1,245                                  | 3,814                                  | 102,970               | 106,784     |
| Open end and junior lien loans                             | 254                       | 452                                    | 706                                    | 175,517               | 176,223     |
| Residential construction loans                             | 34                        | 0                                      | 34                                     | 5,415                 | 5,449       |
| Other consumer loans                                       | 192                       | 7                                      | 199                                    | 45,761                | 45,960      |
| Total  | \$ 4,225                  | \$ 39,504                              | \$ 43,729                              | \$2,189,980           | \$2,233,709 |

The recorded investment in loans does not include accrued interest.

**Troubled Debt Restructurings:**

Troubled debt restructured loans are included in the totals for impaired loans. The Company has allocated \$14.7 million and \$15.7 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2012 and December 31, 2011. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

|   | September 30,<br>2012 | December 31,<br>2011 |
|---|-----------------------|----------------------|
| Accruing troubled debt restructured loans   | \$ 26,106             | \$ 22,177            |
| Nonaccrual troubled debt restructured loans | 28,979                | 34,273               |
| Total troubled debt restructured loans      | \$ 55,085             | \$ 56,450            |

During the three and nine months ending September 30, 2012 certain loans were modified as troubled debt restructurings. The modified terms of these loans include one or a combination of the following: inadequate compensation for the terms of the restructure or renewal; a reduction in the interest rate on a loan to one that would not be readily available in the marketplace for borrowers with a similar risk profile; a modification of the repayment terms which delays principal repayment for some period; or renewal terms offered to borrowers in financial distress where no additional credit enhancements were obtained at the time of renewal.

There were renewal terms on several loans offered to borrowers under financial distress which did not require additional compensation or consideration and would not have been readily available in the marketplace for loans bearing similar risk profiles. In this instance, it was determined that a concession had been granted. It is difficult to quantify the concession granted due to an absence in market terms to be used for comparison. The renewals during the first three months were to one borrower engaged in construction and land development, where the aggregate recorded investment totaled \$1.6 million. The renewal during the three months ended June 30, 2012, was a non-working capital term loan with a recorded investment of \$1.1 million. During the three months ended September 30, 2012, the Bank renegotiated terms on a loan where the collateral securing the original note was sold for an amount that did not satisfy the balance. The Bank agreed to release its collateral interest to facilitate the sale, and renegotiated another consumer loan with a recorded investment of \$17,000 for the remaining balance of the loan. The terms offered in the renegotiated unsecured loan were an exception to bank policy, therefore it was determined that a concession had been granted. These loans are included in the table of all modifications below.

Renegotiated interest rates include loans with a reduction in rate for a short-term (part of the remaining life of the loan) or long-term (life of loan). There were modifications to borrowers at rates that were readily available in the market, but to borrowers who would not have qualified for the terms offered in the modification without a concession being granted. Also included are borrowers who received interest rate concessions that were below market rates.



Delays in principal repayment include loans which were intended to be amortizing during the period, but due to financial hardship the borrowers under these loans were unable to meet the original or intended repayment terms. These include loans with principal deferrals for a prolonged period or those with modified payments which are an exception to bank policy.

The following table presents loans by class modified as troubled debt restructurings that occurred during the nine month and three month periods ending September 30, 2012:

|  | Modifications                        |                  |                   |
|--|--------------------------------------|------------------|-------------------|
|  | Nine Months Ended September 30, 2012 |                  |                   |
|  | All Modifications                    |                  |                   |
|  |                                      | Pre-Modification | Post-Modification |
|  |                                      | Outstanding      | Outstanding       |
|  | Number                               | Recorded         | Recorded          |
|  | of                                   | Investment       | Investment        |
|  | Loans                                |                  |                   |
| Troubled Debt Restructurings                               |                                      |                  |                   |
| Commercial and industrial loans:                           |                                      |                  |                   |
| Non-working capital loans                                  | 1                                    | \$ 942           | \$ 1,060          |
| Commercial real estate and multi-family residential loans: |                                      |                  |                   |
| Construction and land development loans                    | 5                                    | 1,638            | 1,638             |
| Owner occupied loans                                       | 2                                    | 2,260            | 2,260             |
| Nonowner occupied loans                                    | 1                                    | 385              | 385               |
| Consumer 1-4 family loans:                                 |                                      |                  |                   |
| Closed end first mortgage loans                            | 1                                    | 39               | 39                |
| Other consumer loans                                       | 1                                    | 17               | 17                |
| Total  | 11                                   | \$ 5,281         | \$ 5,399          |

|  | Interest Rate Reductions |                                   | Modified Repayment Terms           |                 |                                       |
|--|--------------------------|-----------------------------------|------------------------------------|-----------------|---------------------------------------|
|  | Number of Loans          | Interest at Pre-Modification Rate | Interest at Post-Modification Rate | Number of Loans | Extension Period or Range (in months) |
| Troubled Debt Restructurings                               |                          |                                   |                                    |                 |                                       |
| Commercial and industrial loans:                           |                          |                                   |                                    |                 |                                       |
| Non-working capital loans                                  | 0                        | \$ 0                              | \$ 0                               | 0               | 0                                     |
| Commercial real estate and multi-family residential loans: |                          |                                   |                                    |                 |                                       |
| Owner occupied loans                                       | 1                        | 440                               | 117                                | 1               | 18                                    |
| Nonowner occupied loans                                    | 0                        | 0                                 | 0                                  | 1               | 14                                    |
| Consumer 1-4 family loans:                                 |                          |                                   |                                    |                 |                                       |
| Closed end first mortgage loans                            | 1                        | 76                                | 15                                 | 0               | 0                                     |
| Other consumer loans                                       | 0                        | 0                                 | 0                                  | 0               | 0                                     |
| Total  | 2                        | \$ 516                            | \$ 132                             | 2               | 14-18                                 |

|  | Modifications<br>Three Months Ended September 30, 2012 |  |   |
|--|--|--|---|
|  | All Modifications                                      |  |   |
|  | Number of Loans  | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Troubled Debt Restructurings                               |  |  |   |
| Commercial real estate and multi-family residential loans: |  |  |   |
| Owner occupied loans                                       | 1  | \$ 1,411   | \$ 1,411  |
| Other consumer loans                                       | 1  | 17   | 17  |
| Total  | 2  | \$ 1,428   | \$ 1,428  |

| Troubled Debt Restructurings                               | Modified<br>Repayment<br>Terms |   |
|--|--------------------------------|---|
|  | Number<br>of<br>Loans          | Extension<br>Period or<br>Range<br>(in<br>months) |
| Commercial real estate and multi-family residential loans: |                                |   |
| Owner occupied loans                                       | 1                              | 18  |
| Other consumer loans                                       | 0                              | 0   |
| Total  | 1                              | 18  |

For the three month period ending September 30, 2012 the commercial and industrial loan troubled debt restructurings described above decreased the allowance for loan losses by \$15,000, the commercial real estate and multi-family residential loan troubled debt restructuring described above increased the allowance for loan losses by \$11,000, the consumer 1-4 family loan troubled debt restructurings described above decreased the allowance for loan losses by \$1,000 and the other consumer loan troubled debt restructuring described above increased the allowance for loan losses by \$4,000.

For the nine month period ending September 30, 2012 the commercial and industrial loan troubled debt restructurings described above decreased the allowance for loan losses by \$534,000, the commercial real estate and multi-family residential loan troubled debt restructurings described above decreased the allowance for loan losses by \$18,000, the consumer 1-4 family loan troubled debt restructurings described above increased the allowance for loan losses by \$5,000 and other consumer loan trouble debt restructuring described above increased the allowance for loan losses by \$4,000.

No charge offs resulted from any troubled debt restructurings described above during the three and nine month periods ending September 30, 2012.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification which occurred during the three month and nine month periods ending September 30, 2012:

|  | Modifications                         |                     |                                      |                     |
|--|---------------------------------------|---------------------|--------------------------------------|---------------------|
|  | Three months ended September 30, 2012 |                     | Nine months ended September 30, 2012 |                     |
|  | Number of Loans                       | Recorded Investment | Number of Loans                      | Recorded Investment |
| Troubled Debt Restructurings that Subsequently Defaulted |                                       |                     |                                      |                     |
| Consumer 1-4 family loans:                               |                                       |                     |                                      |                     |
| Closed end first mortgage loans                          | 0                                     | \$ 0                | 1                                    | \$ 65               |
| Total  | 0                                     | \$ 0                | 1                                    | \$ 65               |

A loan is considered to be in payment default once it is 30 days contractually past due under the modified terms.

The troubled debt restructurings that subsequently defaulted described above increased the allowance for loan losses by \$17,000 and did not result in any charge offs during the three and nine month periods ending September 30, 2012.

During the year ending December 31, 2011, the terms of certain loans were modified as troubled debt restructurings. The modified terms of these loans included one or a combination of the following: a reduction of the stated interest rate of the loan below market rates; principal and interest forgiveness; a modification of repayment terms that delays principal repayment for some period; or inadequate compensation for the terms of the restructure. Clarifications in the accounting guidance for troubled debt restructurings that became effective in the third quarter of 2011 resulted in \$15.6 million being added to total troubled debt restructured loans in 2011. Of the \$15.6 million added, \$15.3 million was included in nonperforming and impaired loans at December 31, 2010.

Loans with renegotiated interest rates include reductions in rate for a short-term (part of the remaining life of the loan) or long-term (life of loan). Included are modifications to borrowers at a rate that is readily available in the market, but for borrowers who would not have otherwise qualified for the terms offered in the modification without a concession being granted. Also included are borrowers who received interest rate concessions that are below market rates.





Delays in principal repayment include loans that were intended to be amortizing during the period, but, due to financial hardship, these borrowers were unable to meet the original or intended repayment terms. These include loans with principal deferrals for a prolonged period or those with modified payments, which are an exception to bank policy.

Inadequate compensation for the terms of the restructure were identified in some loans where terms offered would not have been readily available in the marketplace for loans bearing similar risk profiles, including loans that were renewed under terms similar to original terms. In some instances it was determined that a concession had been granted; however, it is difficult to quantify these concessions due to an absence in market terms to be used for comparison. These loans included two non-working capital loans with a recorded investment of \$636,000, one non-owner occupied loan with a recorded investment of \$642,000 and one loan secured by farmland with a recorded investment of \$413,000. These loans are included in the table of all modifications below.

The following tables present loans by class modified as troubled debt restructurings that occurred during the period ending December 31, 2011:

|  | All Modifications Classified as Troubled Debt Restructurings |  |   |
|--|--|--|---|
|  | Number of Loans  | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Troubled Debt Restructurings                               |  |  |   |
| Commercial and industrial loans:                           |  |  |   |
| Working capital lines of credit loans                      | 3  | \$ 639   | \$ 639  |
| Non-working capital loans                                  | 6  | 6,187  | 6,261   |
| Commercial real estate and multi-family residential loans: |  |  |   |
| Construction and land development loans                    |  |  |   |
| Owner occupied loans                                       | 8  | 6,648  | 6,651   |
| Nonowner occupied loans                                    | 8  | 23,767   | 23,767  |
| Agri-business and agricultural loans:                      |  |  |   |
| Loans secured by farmland                                  | 2  | 683  | 683   |
| Consumer 1-4 family loans:                                 |  |  |   |
| Closed end first mortgage loans                            | 6  | 942  | 849   |
| Total  | 33   | \$ 38,866  | \$ 38,850   |



|  | Interest Rate Reductions             |   | Principal and Interest Forgiveness       |   |  |   |  | Modified Repayment Terms |   |       |
|--|--------------------------------------|---|--|---|--|---|--|--------------------------|---|-------|
|  | Interest at<br>Number<br>of<br>Loans | Interest at<br>Pre-Modification<br>Rate | Interest at<br>Post-Modification<br>Rate | Principal<br>at<br>Pre-Modification<br>Rate | Principal<br>at<br>Post-Modification<br>Rate | Interest at<br>Pre-Modification<br>Rate | Interest at<br>Post-Modification<br>Rate | Number<br>of<br>Loans    | Extension<br>Period or<br>Range<br>(in<br>months) |       |
| Troubled Debt Restructurings                               |                                      |   |  |   |  |   |  |                          |   |       |
| Commercial and industrial loans:                           |                                      |   |  |   |  |   |  |                          |   |       |
| Working capital lines of credit loans                      | 0                                    | \$ 0                                    | \$ 0                                     | 0   | \$0  | \$ 0                                    | \$ 0                                     | \$ 0                     | 3   | 11-60 |
| Non-working capital loans                                  | 0                                    | 0                                       | 0  | 0   | 0  | 0                                       | 0  | 0                        | 4   | 12-36 |
| Commercial real estate and multi-family residential loans: |                                      |   |  |   |  |   |  |                          |   |       |
| Owner occupied loans                                       | 0                                    | 0                                       | 0  | 1   | 2,125  | 2,125                                   | 641                                      | 429                      | 7   | 20-70 |
| Nonowner occupied loans                                    | 0                                    | 0                                       | 0  | 0   | 0  | 0                                       | 0  | 0                        | 7   | 6-36  |
| Agri-business and agricultural loans:                      |                                      |   |  |   |  |   |  |                          |   |       |
| Loans secured by farmland                                  | 0                                    | 0                                       | 0  | 0   | 0  | 0                                       | 0  | 0                        | 1   | 22    |
| Consumer 1-4 family loans:                                 |                                      |   |  |   |  |   |  |                          |   |       |
| Closed end first mortgage loans                            | 5                                    | 402                                     | 324                                      | 1   | 550  | 450                                     | 66                                       | 57                       | 0   | 0     |
| Total  | 5                                    | \$ 402                                  | \$ 324                                   | 2   | \$2,675                                      | \$ 2,575                                | \$ 707                                   | \$ 486                   | 22  | 6-70  |

All of the commercial and industrial loan troubled debt restructurings described above also had inadequate compensation of additional collateral as part of the restructuring.

For the period ending December 31, 2011, the commercial and industrial loan troubled debt restructurings described above decreased the allowance for loan losses by \$112,000, the commercial real estate and multi-family residential loan troubled debt restructurings described above increased the allowance for loan losses by \$3.2 million, the agri-business and agricultural loan troubled debt restructurings described above decreased the allowance for loan losses by \$11,000 and the consumer 1-4 family loan troubled debt restructurings described above increased the allowance for loan losses by \$76,000. The five commercial and industrial loans and one agri-business and agricultural loan that decreased the provision during 2011 had modifications during the first five months of the year and had improved their positions during the remainder of the year warranting the decrease in allocation.

The commercial real estate and multi-family residential loan troubled debt restructurings described above also resulted in charge offs of \$667,000 during the period ending December 31, 2011. No charge offs resulted from any other troubled debt restructurings described above during the period ending December 31, 2011.

**Credit Quality Indicators:**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes commercial loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for Special Mention, Substandard and Doubtful grade loans and annually on Pass grade loans over \$250,000.

The Company uses the following definitions for risk ratings:

**Special Mention.** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be Pass rated loans with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans. Loans listed as Not Rated are consumer loans included in groups of homogenous loans which are analyzed for credit quality indicators utilizing delinquency status. As of September 30, 2012 and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

|  | Pass        | Special<br>Mention<br>(in thousands) | Substandard | Doubtful | Not<br>Rated |
|--|-------------|--------------------------------------|-------------|----------|--------------|
| Commercial and industrial loans:                           |             |                                      |             |          |              |
| Working capital lines of credit loans                      | \$420,757   | \$12,274                             | \$13,117    | \$0      | \$0          |
| Non-working capital loans                                  | 342,447     | 7,664                                | 31,484      | 0        | 1,276        |
| Commercial real estate and multi-family residential loans: |             |                                      |             |          |              |
| Construction and land development loans                    | 71,130      | 5,520                                | 11,096      | 0        | 0            |
| Owner occupied loans                                       | 334,835     | 7,161                                | 21,437      | 0        | 50           |
| Nonowner occupied loans                                    | 271,419     | 9,827                                | 26,454      | 0        | 0            |
| Multifamily loans  | 24,235      | 1,199                                | 0           | 0        | 0            |
| Agri-business and agricultural loans:                      |             |                                      |             |          |              |
| Loans secured by farmland                                  | 118,012     | 70                                   | 1,436       | 0        | 19           |
| Loans for agricultural production                          | 94,633      | 0                                    | 0           | 0        | 0            |
| Other commercial loans                                     | 44,856      | 0                                    | 118         | 0        | 0            |
| Consumer 1-4 family mortgage loans:                        |             |                                      |             |          |              |
| Closed end first mortgage loans                            | 21,380      | 329                                  | 423         | 0        | 83,767       |
| Open end and junior lien loans                             | 11,494      | 300                                  | 0           | 0        | 157,253      |
| Residential construction loans                             | 0           | 0                                    | 0           | 0        | 11,275       |
| Other consumer loans                                       | 8,282       | 356                                  | 497         | 0        | 35,506       |
| Total  | \$1,763,480 | \$44,700                             | \$106,062   | \$0      | \$289,146    |

The recorded investment in loans does not include accrued interest.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be Pass rated loans with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans. Loans listed as Not Rated are consumer loans included in groups of homogenous loans which are analyzed for credit quality indicators utilizing delinquency status. As of December 31, 2011 and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

|  | Pass        | Special<br>Mention<br>(in thousands) | Substandard | Doubtful | Not<br>Rated |
|--|-------------|--------------------------------------|-------------|----------|--------------|
| Commercial and industrial loans:                           |             |                                      |             |          |              |
| Working capital lines of credit loans                      | \$352,055   | \$5,625                              | \$ 16,212   | \$ 0     | \$0          |
| Non-working capital loans                                  | 331,881     | 7,437                                | 36,751      | 0        | 1,403        |
| Commercial real estate and multi-family residential loans: |             |                                      |             |          |              |
| Construction and land development loans                    | 64,808      | 3,296                                | 13,976      | 0        | 0            |
| Owner occupied loans                                       | 318,191     | 5,913                                | 22,400      | 0        | 38           |
| Nonowner occupied loans                                    | 337,090     | 8,875                                | 38,716      | 0        | 0            |
| Multifamily loans  | 37,127      | 1,247                                | 0           | 0        | 0            |
| Agri-business and agricultural loans:                      |             |                                      |             |          |              |
| Loans secured by farmland                                  | 116,742     | 70                                   | 1,415       | 0        | 20           |
| Loans for agricultural production                          | 119,531     | 0                                    | 225         | 0        | 0            |
| Other commercial loans                                     | 58,061      | 66                                   | 120         | 0        | 2            |
| Consumer 1-4 family mortgage loans:                        |             |                                      |             |          |              |
| Closed end first mortgage loans                            | 17,307      | 53                                   | 974         | 0        | 88,450       |
| Open end and junior lien loans                             | 11,569      | 319                                  | 0           | 0        | 164,335      |
| Residential construction loans                             | 0           | 0                                    | 0           | 0        | 5,449        |
| Other consumer loans                                       | 7,416       | 375                                  | 497         | 0        | 37,672       |
| Total  | \$1,771,778 | \$33,276                             | \$ 131,286  | \$ 0     | \$297,369    |

The recorded investment in loans does not include accrued interest.

**NOTE 5. SECURITIES**

Information related to the fair value and amortized cost of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) is provided in the tables below.

|   | Fair Value | Gross Unrealized Gain | Gross Unrealized Losses | Amortized Cost |
|---|------------|-----------------------|-------------------------|----------------|
| September 30, 2012                                |            |                       |                         |                |
| U.S. Treasury securities                          | \$1,042    | \$ 40                 | \$ 0                    | \$ 1,002       |
| U.S. government sponsored agencies                | 5,316      | 288                   | 0                       | 5,028          |
| Agency residential mortgage-backed securities     | 385,298    | 9,051                 | (1,511 )                | 377,758        |
| Non-agency residential mortgage-backed securities | 6,982      | 267                   | 0                       | 6,715          |
| State and municipal securities                    | 82,618     | 5,740                 | (43 )                   | 76,921         |
| Total   | \$481,256  | \$ 15,386             | \$ (1,554 )             | \$ 467,424     |
| December 31, 2011                                 |            |                       |                         |                |
| U.S. Treasury securities                          | \$1,055    | \$ 52                 | \$ 0                    | \$ 1,003       |
| U.S. government sponsored agencies                | 5,277      | 244                   | 0                       | 5,033          |
| Agency residential mortgage-backed securities     | 350,102    | 8,989                 | (923 )                  | 342,036        |
| Non-agency residential mortgage-backed securities | 32,207     | 191                   | (2,225 )                | 34,241         |
| State and municipal securities                    | 78,750     | 5,292                 | (9 )                    | 73,467         |
| Total   | \$467,391  | \$ 14,768             | \$ (3,157 )             | \$ 455,780     |

Total other-than-temporary impairment recognized in accumulated other comprehensive income was \$0 at September 30, 2012 and \$213,000 at December 31, 2011.

Information regarding the fair value and amortized cost of available for sale debt securities by maturity as of September 30, 2012 is presented below. Maturity information is based on contractual maturity for all securities other than mortgage-backed securities. Actual maturities of securities may differ from contractual maturities because borrowers may have the right to prepay the obligation without prepayment penalty.

|  | Amortized Cost | Fair Value |
|--|----------------|------------|
| Due in one year or less                | \$2,118        | \$2,106    |
| Due after one year through five years  | 23,461         | 25,108     |
| Due after five years through ten years | 35,516         | 38,272     |
| Due after ten years                    | 21,856         | 23,490     |
|  | 82,951         | 88,976     |



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|                            |            |            |
|----------------------------|------------|------------|
| Mortgage-backed securities | 384,473    | 392,280    |
| Total debt securities      | \$ 467,424 | \$ 481,256 |

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Security proceeds, gross gains and gross losses are presented below.

|  | Nine months ended September 30, |           |
|--|---------------------------------|-----------|
|  | 2012                            | 2011      |
| Sales of securities available for sale |                                 |           |
| Proceeds                               | \$ 28,877                       | \$ 73,318 |
| Gross gains                            | 823                             | 4,005     |
| Gross losses                           | (1,203 )                        | (4,171 )  |

|  | Three months ended September 30, |      |
|--|----------------------------------|------|
|  | 2012                             | 2011 |
| Sales of securities available for sale |                                  |      |
| Proceeds                               | \$ 28,877                        | \$ 0 |
| Gross gains                            | 823                              | 0    |
| Gross losses                           | (1,203 )                         | 0    |

The Company sold eleven securities with a total book value of \$29.3 million and a total fair value of \$28.9 million during the first nine months of 2012. The sales included nine non-agency residential mortgage backed securities, including all five on which the Company had previously recognized other-than-temporary impairment. The remaining gains during the first nine months of 2012 were from calls. The Company sold 36 securities with a total book value of \$73.5 million and a total fair value of \$73.3 million during the first nine months of 2011. The sales in 2011 included eight non-agency residential mortgage backed securities. The securities sales in both 2012 and 2011 were related to a strategic realignment of the securities portfolio.

Purchase premiums or discounts are recognized in interest income using the interest method over the terms of the securities or over estimated lives for mortgage-backed securities. Gains and losses on sales are based on the amortized cost of the security sold and recorded on the trade date.

Securities with carrying values of \$199.3 million and \$249.8 million were pledged as of September 30, 2012 and 2011, as collateral for deposits of public funds, securities sold under agreements to repurchase, borrowings from the Federal Home Loan Bank and for other purposes as permitted or required by law.

Information regarding securities with unrealized losses as of September 30, 2012 and December 31, 2011 is presented below. The tables distribute the securities between those with unrealized losses for less than twelve months and those with unrealized losses for twelve months or more.

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|   | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| <u>September 30, 2012</u>                     |                     |                   |                   |                   |            |                   |
| Agency residential mortgage-backed securities | \$85,988            | \$ (998 )         | \$31,206          | \$ (513 )         | \$117,194  | \$ (1,511 )       |
| State and municipal securities                | 4,250               | (42 )             | 50                | (1 )              | 4,300      | (43 )             |
| Total temporarily impaired                    | \$90,238            | \$ (1,040 )       | \$31,256          | \$ (514 )         | \$121,494  | \$ (1,554 )       |

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|   | Less than 12 months |                   | 12 months or more |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| <u>December 31, 2011</u>                          |                     |                   |                   |                   |            |                   |
| Agency residential mortgage-backed securities     | \$74,463            | \$ (860 )         | \$4,813           | \$ (63 )          | \$79,276   | \$ (923 )         |
| Non-agency residential mortgage-backed securities | 3,379               | (4 )              | 23,885            | (2,221 )          | 27,264     | (2,225 )          |
| State and municipal securities                    | 341                 | (2 )              | 1,003             | (7 )              | 1,344      | (9 )              |
| Total temporarily impaired                        | \$78,183            | \$ (866 )         | \$29,701          | \$ (2,291 )       | \$107,884  | \$ (3,157 )       |

The number of securities with unrealized losses as of September 30, 2012 and December 31, 2011 is presented below.

|   | Less than 12 months | 12 months or more | Total |
|---|---------------------|-------------------|-------|
| <u>September 30, 2012</u>                     |                     |                   |       |
| Agency residential mortgage-backed securities | 21                  | 11                | 32    |
| State and municipal securities                | 22                  | 1                 | 23    |
| Total temporarily impaired                    | 43                  | 12                | 55    |

|   | Less than 12 months | 12 months or more | Total |
|---|---------------------|-------------------|-------|
| <u>December 31, 2011</u>                          |                     |                   |       |
| Agency residential mortgage-backed securities     | 21                  | 1                 | 22    |
| Non-agency residential mortgage-backed securities | 2                   | 9                 | 11    |
| State and municipal securities                    | 3                   | 2                 | 5     |
| Total temporarily impaired                        | 26                  | 12                | 38    |

All of the following are considered to determine whether or not the impairment of these securities is other-than-temporary. Ninety-eight percent of the securities are backed by the U.S. government, government agencies, government sponsored agencies or are A rated or better, except for certain non-local municipal securities which are not rated. Mortgage-backed securities which are not issued by the U.S. government or government sponsored agencies (non-agency residential mortgage-backed securities) met specific criteria set by the Asset Liability Management Committee at their time of purchase, including having the highest rating available by either Moody's or S&P. None of the securities have call provisions (with the exception of the municipal securities) and all payments on the securities have been received on their original terms. For the government, government-sponsored agency and municipal securities, management was not concerned about the risk of credit losses, and there was nothing to indicate that full

payment of the principal will not be received. Management considered the unrealized losses on these securities to be primarily interest rate driven and does not expect material losses given current market conditions unless the securities are sold. However, at this time management does not have the intent to sell and it is more likely than not that it will not be required to sell these securities before the recovery of their amortized cost basis.

As of September 30, 2012, the Company had \$7.0 million of non-agency residential mortgage-backed securities which were not issued by the federal government or government sponsored agencies, but were rated AAA by S&P and/or Aaa by Moody's at the time of purchase. At December 31, 2011, the Company had \$32.2 million of these non-agency residential mortgage-backed securities. During the third quarter of 2012 the Company sold nine of the non-agency residential mortgage backed securities as part of a strategic realignment of the investment portfolio. The securities sold had a book value of \$20.7 million and a fair value of \$19.5 million. The sales included all five of the securities on which the Company had previously recognized other-than-temporary impairment. None of the five remaining non-agency residential mortgage backed securities were still rated AAA/Aaa as of September 30, 2012 by at least one of the rating agencies S&P, Moody's and Fitch, however, none of the five have been downgraded to below investment grade by any of those rating agencies.

For these non-agency residential mortgage-backed securities, additional analysis is performed to determine if the impairment is temporary or other-than-temporary in which case impairment would need to be recorded for these securities. The Company performs an independent analysis of the cash flows of the individual securities based upon assumptions as to collateral defaults, prepayment speeds, expected losses and the severity of potential losses. Based upon the initial review, securities may be identified for further analysis by computing the net present value using an appropriate discount rate (the current accounting yield) and comparing it to the book value of the security to determine if there is any other-than-temporary impairment that must be recorded. Based on this analysis of the non-agency residential mortgage-backed securities, the Company recorded an other-than-temporary impairment of \$67,000 and \$1.0 million, respectively, relating to four securities in the three-months and nine-months ended September 30, 2012, which is equal to the credit loss, establishing a new, lower amortized cost basis. All of the securities on which the Company had recognized other-than-temporary impairment were sold during the third quarter of 2012. None of the five remaining non-agency mortgage backed securities had any unrealized losses at September 30, 2012.

The following table provides information about debt securities for which only a credit loss was recognized in income and other losses are recorded in other comprehensive income. The table represents the three months and nine months ended September 30, 2012 and 2011.

|   | Three Months<br>Ended<br>September 30, |       |
|---|--|-------|
|   | 2012                                   | 2011  |
| Balance July 1,   | \$1,318                                | \$194 |
| Additions related to other-than-temporary impairment losses not previously recognized                                 | 0                                      | 0     |
| Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized | 67                                     | 33    |
| Reductions for previous credit losses realized on securities sold during the year                                     | (1,385)                                | 0     |
| Balance September 30,   | \$0                                    | \$227 |

|   | Nine Months<br>Ended September<br>30, |         |
|---|---------------------------------------|---------|
|   | 2012                                  | 2011    |
| Balance January 1,  | \$359                                 | \$1,812 |
| Additions related to other-than-temporary impairment losses not previously recognized                                 | 747                                   | 0       |
| Additional increases to the amount of credit loss for which other-than-temporary impairment was previously recognized | 279                                   | 154     |
| Reductions for previous credit losses realized on securities sold during the year                                     | (1,385)                               | (1,739) |
| Balance September 30,   | \$0                                   | \$227   |

The Company does not have a history of actively trading securities, but keeps the securities available for sale should liquidity or other needs develop that would warrant the sale of securities. While these securities are held in the available for sale portfolio, it is management's current intent and ability to hold them until a recovery in fair value or maturity.

#### NOTE 6. EMPLOYEE BENEFIT PLANS

Components of net periodic benefit cost:

|                                | Nine Months Ended<br>September 30, |       |                  |      |
|--------------------------------|------------------------------------|-------|------------------|------|
|                                | Pension<br>Benefits                |       | SERP<br>Benefits |      |
|                                | 2012                               | 2011  | 2012             | 2011 |
| Interest cost                  | \$95                               | \$105 | \$38             | \$46 |
| Expected return on plan assets | (102)                              | (119) | (56)             | (60) |
| Recognized net actuarial loss  | 102                                | 80    | 62               | 52   |
| Net pension expense            | \$95                               | \$66  | \$44             | \$38 |

|                                | Three Months Ended<br>September 30, |      |                  |      |
|--------------------------------|-------------------------------------|------|------------------|------|
|                                | Pension<br>Benefits                 |      | SERP<br>Benefits |      |
|                                | 2012                                | 2011 | 2012             | 2011 |
| Interest cost                  | \$31                                | \$33 | \$12             | \$12 |
| Expected return on plan assets | (34)                                | (41) | (18)             | (20) |
| Recognized net actuarial loss  | 35                                  | 40   | 20               | 22   |
| Net pension expense            | \$32                                | \$32 | \$14             | \$14 |

The Company previously disclosed in its financial statements for the year ended December 31, 2011 that it expected to contribute \$170,000 to its pension plan and \$114,000 to its SERP plan in 2012. The Company has contributed \$121,000 to its pension plan and \$114,000 to its SERP plan as of September 30, 2012. The Company expects to contribute an additional \$49,000 to its pension plan during the remainder of 2012. The Company does not expect to make any additional contributions to its SERP plan during the remainder of 2012.



## NOTE 7. NEW ACCOUNTING PRONOUNCEMENTS

In May 2011, the FASB issued an amendment to achieve common fair value measurement and disclosure requirements between U.S. and international accounting principles. The amendment results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between U.S. GAAP and International Financial Reporting Standards (“IFRS”). The changes to U.S. GAAP as a result of the amendment are as follows: (1) The concepts of highest and best use and valuation premise are only relevant when measuring the fair value of nonfinancial assets (that is, it does not apply to financial assets or any liabilities); (2) U.S. GAAP currently prohibits application of a blockage factor in valuing financial instruments with quoted prices in active markets. The amendment extends that prohibition to all fair value measurements; (3) An exception is provided to the basic fair value measurement principles for an entity that holds a group of financial assets and financial liabilities with offsetting positions in market risks or counterparty credit risk that are managed on the basis of the entity’s net exposure to either of those risks. This exception allows the entity, if certain criteria are met, to measure the fair value of the net asset or liability position in a manner consistent with how market participants would price the net risk position; (4) The exception aligns the fair value measurement of instruments classified within an entity’s stockholders’ equity with the guidance for liabilities; and (5) Disclosure requirements have been enhanced for recurring Level 3 fair value measurements to disclose quantitative information about unobservable inputs and assumptions used, to describe the valuation processes used by the entity, and to describe the sensitivity of fair value measurements to changes in unobservable inputs and interrelationships between those inputs. In addition, entities must report the level in the fair value hierarchy of items that are not measured at fair value in the statement of condition but whose fair value must be disclosed. The provisions of the amendment are effective for the Company’s interim and annual periods beginning on or after December 15, 2011. The adoption of this standard did not have a material impact on the Company’s statements of income and condition and the disclosure requirements are already included.

In June 2011, the FASB amended existing guidance and eliminated the option to present the components of other comprehensive income as part of the statement of changes in stockholders’ equity. The amendment requires that comprehensive income be presented in either a single continuous statement or in two separate consecutive statements. In December 2011, the FASB deferred the effective date for amendments to the presentation of reclassifications of items out of accumulated other comprehensive income. The adoption of the remaining amendments changed the presentation of the components of comprehensive income for the Company as part of Note 9 into two consecutive statements. These amendments are effective for interim and annual periods beginning on or after December 15, 2011. The adoption of this standard did not have a material impact on the Company’s statements of income and condition.

In September 2011, the FASB amended existing guidance relating to goodwill impairment testing. The amendment permits an assessment of qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing these events or circumstances, it is concluded that it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. The amendments in this guidance are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The adoption of this standard did not have a material impact on the Company’s statements of income and condition.



## NOTE 8. FAIR VALUE DISCLOSURES

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1 Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value of each type of financial instrument:

**Securities:** Securities available for sale are valued primarily by a third party pricing service. The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or pricing models utilizing significant observable inputs such as matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). These models utilize the market approach with standard inputs that include, but are not limited to benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. For certain municipal securities that are not rated and observable inputs about the specific issuer are not available, fair values are estimated using observable data from other municipal securities presumed to be similar or other market data on other non-rated municipal securities (Level 3 inputs). There were no transfers from or into Level 1, Level 2 or Level 3 during the first nine months of 2012.

**Mortgage banking derivatives:** The fair value of derivatives are based on observable market data as of the measurement date (Level 2).

**Impaired loans:** Impaired loans with specific allocations of the allowance for loan losses are generally based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Fair value is determined using several methods. Generally, the fair value of real estate is based on appraisals by qualified third party appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and result in a Level 3 classification of the inputs for determining fair value. In addition, the Company's management routinely applies internal discount factors to the value of appraisals used in the fair value evaluation of impaired loans. The deductions to the appraisals take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. Commercial real estate is generally discounted from its appraised value by 0-50% with the higher discounts applied to real estate that is determined to have a thin trading market or to be specialized collateral. In addition to real estate, the Company's management evaluates other types of collateral as follows: Raw and finished inventory is discounted from its cost or book value by 35-65%, depending on the marketability of the goods. Finished goods are generally discounted by 30-60%, depending on the ease of marketability, cost of transportation or scope of use of the finished good. Work in process inventory is typically discounted by 50-100%, depending on the length of manufacturing time, types of components used in the completion process, and the breadth of the user base. Equipment is valued at a percentage of depreciated book value or recent appraised value, if available, and is typically discounted at 30-70% after various considerations including age and condition of the equipment, marketability, breadth of use, and whether the equipment includes unique components or add-ons. Marketable securities are discounted by 10-30%, depending on the type of investment, age of valuation report and general market conditions. This methodology is based on a market approach and typically results in a Level 3 classification of the inputs for determining fair value.

**Mortgage servicing rights:** As of September 30, 2012 the fair value of the Company's Level 3 servicing assets for residential mortgage loans was \$2.0 million, some of which are not currently impaired and therefore carried at amortized cost. These residential mortgage loans have a weighted average interest rate of 4.58%, a weighted average maturity of 19 years and are secured by homes generally within the Company's market area, which is primarily Northern Indiana. A valuation model is used to estimate fair value, which is based on an income approach. The inputs used include estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income. The most significant assumption used to value mortgage servicing rights is prepayment rate. Prepayment rates are estimated based on published industry consensus prepayment rates. The most significant unobservable assumption is the discount rate. At September 30, 2012 the constant prepayment speed (PSA) used was 447 and the discount rate used was 9.2%. At December 31, 2011 the constant prepayment speed (PSA) used was 387 and the discount rate used was 9.2%.

**Other real estate owned:** Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate owned are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property and are reviewed by the Company's internal appraisal officer. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales. Such adjustments are usually significant and result in a Level 3 classification. In addition, the Company's management may apply discount factors to the appraisals to take into account changing business factors and market conditions, as well as value impairment in cases where the appraisal date predates a likely change in market conditions. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

Real estate mortgage loans held for sale: Real estate mortgage loans held for sale are carried at the lower of cost or fair value, as determined by outstanding commitments, from third party investors, and results in a Level 2 classification.

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The table below presents the balances of assets measured at fair value on a recurring basis:

| Assets  | September 30, 2012                             |           |         | Assets<br>at Fair Value |
|---|--|-----------|---------|-------------------------|
|   | Fair Value Measurements<br>Using<br>Level<br>1 | Level 2   | Level 3 |                         |
| U.S. Treasury securities                          | \$1,042  | \$0       | \$ 0    | \$ 1,042                |
| U.S. Government sponsored agencies                | 0  | 5,316     | 0       | 5,316                   |
| Residential mortgage-backed securities            | 0  | 385,298   | 0       | 385,298                 |
| Non-agency residential mortgage-backed securities | 0  | 6,982     | 0       | 6,982                   |
| State and municipal securities                    | 0  | 81,981    | 637     | 82,618                  |
| Total Securities                                  | 1,042  | 479,577   | 637     | 481,256                 |
| Mortgage banking derivative                       | 0  | 917       | 0       | 917                     |
| Total assets                                      | \$1,042  | \$480,494 | \$ 637  | \$ 482,173              |
| Liabilities                                       |  |           |         |                         |
| Mortgage banking derivative                       | \$0  | \$(319 )  | \$ 0    | \$(319 )                |
|   |  |           |         |                         |
| Assets  | December 31, 2011                              |           |         | Assets<br>at Fair Value |
|   | Fair Value Measurements<br>Using<br>Level<br>1 | Level 2   | Level 3 |                         |
| U.S. Treasury securities                          | \$1,055  | \$0       | \$ 0    | \$ 1,055                |
| U.S. Government sponsored agencies                | 0  | 5,277     | 0       | 5,277                   |
| Residential mortgage-backed securities            | 0  | 350,102   | 0       | 350,102                 |
| Non-agency residential mortgage-backed securities | 0  | 32,207    | 0       | 32,207                  |
| State and municipal securities                    | 0  | 78,064    | 686     | 78,750                  |
| Total Securities                                  | 1,055  | 465,650   | 686     | 467,391                 |
| Mortgage banking derivative                       | 0  | 406       | 0       | 406                     |
| Total assets                                      | \$1,055  | \$466,056 | \$ 686  | \$ 467,797              |
| Liabilities                                       |  |           |         |                         |
| Mortgage banking derivative                       | \$0  | \$(81 )   | \$ 0    | \$(81 )                 |

There were no transfers from or into Level 1, Level 2 or Level 3 during 2012 and there were no transfers from or into Level 1 or Level 2 during the nine months ended September 30, 2011.

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2012:

|   | State and<br>Municipal<br>Securities<br>September 30, 2012 |     |
|---|--|-----|
| Balance or recurring Level 3 assets at January 1    | \$   | 686 |
| Change in fair value of securities                  | (4   | )   |
| Principal payments                                  | (45  | )   |
| Balance or recurring Level 3 assets at September 30 | \$   | 637 |

The fair value of 3 state and municipal securities with a fair value of \$686,000 as of December 31, 2011 were transferred out of Level 2 and into Level 3 because of a lack of observable market data for these investments. The Company's policy is to recognize transfers as of the end of the reporting period. As a result, the fair value for these state and municipal securities was transferred on December 31, 2011.

The securities measured at fair value included below are nonrated Indiana municipal revenue bonds and are not actively traded.

#### Quantitative Information about Level 3 Fair Value Measurements

|                                | Fair Value at<br>9/30/2012<br>(in thousands) | Valuation Technique      | Unobservable<br>Input             | Range<br>(Weighted<br>Average) |
|--------------------------------|--|--------------------------|-----------------------------------|--------------------------------|
| State and municipal securities | \$ 637                                       | Price to type, par, call | Discount to<br>benchmark<br>index | 1 %                            |

The Company's Controlling Department, which is responsible for all accounting and SEC compliance and the Company's Treasury Department, which is responsible for investment portfolio management and asset/liability modeling, are the two areas that decide the Company's valuation policies and procedures. Both of these areas report directly to the President and Chief Financial Officer of the Company. For assets or liabilities that may be considered for Level 3 fair value measurement on a recurring basis, these two areas and the President and Chief Financial Officer determine the appropriate level of the assets or liabilities under consideration. If there are assets or liabilities that are determined as Level 3 by this group, the Risk Management Committee of the Company and the Audit Committee of the Board of Directors are made aware of such assets at their next scheduled meeting.



Securities pricing is obtained from a third party pricing service and is tested at least annually against prices from another third party provider and reviewed with a market value tolerance variance of 3%. If any securities fall above this tolerance threshold, they are reviewed in more detail to determine why the variance exists. Changes in market value are reviewed monthly in aggregate yield by security type and any material differences are reviewed to determine why they exist. At least annually, the pricing methodology of the pricing service is received and reviewed to support the fair value levels used by the Company. A detailed pricing evaluation is requested and reviewed on any security determined to be fair value using unobservable inputs by the pricing service.

The primary methodology used in the fair value measurement of the Company's state and municipal securities classified as Level 3 is a discount to the AAA municipal benchmark index. Significant increases or (decreases) in this index as well as the degree to which the security differs in ratings, coupon, call and duration will result in a higher or (lower) fair value measurement for those securities that are not callable. For those securities that are continuously callable, a slight premium to par is used.

The table below presents the balances of assets measured at fair value on a nonrecurring basis:

| Assets   | September 30, 2012                  |            |          | Assets<br>at Fair Value |
|--|-------------------------------------|------------|----------|-------------------------|
|  | Fair Value<br>Measurements<br>Using |            |          |                         |
|  | Level<br>1                          | Level<br>2 | Level 3  |                         |
|  | (in<br>thousands)                   |            |          |                         |
| Impaired loans:  |                                     |            |          |                         |
| Commercial and industrial loans:                           |                                     |            |          |                         |
| Working capital lines of credit loans                      | \$0                                 | \$0        | \$1,657  | \$ 1,657                |
| Non-working capital loans                                  | 0                                   | 0          | 5,275    | 5,275                   |
| Commercial real estate and multi-family residential loans: |                                     |            |          |                         |
| Construction and land development loans                    | 0                                   | 0          | 2,724    | 2,724                   |
| Owner occupied loans                                       | 0                                   | 0          | 4,760    | 4,760                   |
| Nonowner occupied loans                                    | 0                                   | 0          | 20,585   | 20,585                  |
| Multifamily loans  | 0                                   | 0          | 0        | 0                       |
| Agri-business and agricultural loans:                      |                                     |            |          |                         |
| Loans secured by farmland                                  | 0                                   | 0          | 266      | 266                     |
| Loans for agricultural production                          | 0                                   | 0          | 0        | 0                       |
| Other commercial loans                                     | 0                                   | 0          | 0        | 0                       |
| Consumer 1-4 family mortgage loans:                        |                                     |            |          |                         |
| Closed end first mortgage loans                            | 0                                   | 0          | 241      | 241                     |
| Open end and junior lien loans                             | 0                                   | 0          | 162      | 162                     |
| Residential construction loans                             | 0                                   | 0          | 0        | 0                       |
| Other consumer loans                                       | 0                                   | 0          | 27       | 27                      |
| Total impaired loans                                       | \$0                                 | \$0        | \$35,697 | \$ 35,697               |
| Mortgage servicing rights                                  | 0                                   | 0          | 1,969    | 1,969                   |
| Other real estate owned                                    | 0                                   | 0          | 81       | 81                      |

|              |     |     |          |           |
|--------------|-----|-----|----------|-----------|
| Total assets | \$0 | \$0 | \$37,747 | \$ 37,747 |
|--------------|-----|-----|----------|-----------|

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The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at September 30, 2012:

|                                 | Fair Value | Valuation Methodology         | Unobservable Inputs   | Range of Inputs (Average) |
|---------------------------------|------------|-------------------------------|---|---------------------------|
| Impaired Loans:                 |            |                               |   |                           |
| Commercial and industrial:      | \$ 6,932   | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 83% (25)%            |
| Impaired loans:                 |            |                               |   |                           |
| Commercial real estate:         | 28,069     | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 88% (40)%            |
| Impaired loans:                 |            |                               |   |                           |
| Agri-business and agricultural: | 266        | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 9% - 24% (16)%            |
| Impaired loans:                 |            |                               |   |                           |
| Consumer 1-4 family mortgage    | 403        | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 0% - 20% (8)%             |
| Impaired loans:                 |            |                               |   |                           |
| Other consumer                  | 27         | Collateral based measurements | Discount to reflect current market conditions and ultimate collectability | 40%                       |
| Mortgage servicing rights       | 1,969      | Discounted cash flows         | Discount rate   | 9.1% - 9.5% (9.2)%        |
| Other real estate owned         | 81         | Appraisals                    | Discount to reflect current market conditions                             | 49% - 61% (50)%           |

| Assets   | December 31, 2011 |         |               |          |
|--|-------------------|---------|---------------|----------|
|  | Fair Value        |         |               |          |
|  | Measurements      |         |               | Assets   |
|  | Using             |         |               |          |
| Level 1  | Level 2           | Level 3 | at Fair Value |          |
| (in thousands)   |                   |         |               |          |
| Impaired loans:  |                   |         |               |          |
| Commercial and industrial loans:                           |                   |         |               |          |
| Working capital lines of credit loans                      | \$0               | \$0     | \$2,762       | \$2,762  |
| Non-working capital loans                                  | 0                 | 0       | 11,885        | 11,885   |
| Commercial real estate and multi-family residential loans: |                   |         |               |          |
| Construction and land development loans                    | 0                 | 0       | 303           | 303      |
| Owner occupied loans                                       | 0                 | 0       | 3,515         | 3,515    |
| Nonowner occupied loans                                    | 0                 | 0       | 23,591        | 23,591   |
| Multifamily loans  | 0                 | 0       | 0             | 0        |
| Agri-business and agricultural loans:                      |                   |         |               |          |
| Loans secured by farmland                                  | 0                 | 0       | 433           | 433      |
| Loans for agricultural production                          | 0                 | 0       | 207           | 207      |
| Other commercial loans                                     | 0                 | 0       | 0             | 0        |
| Consumer 1-4 family mortgage loans:                        |                   |         |               |          |
| Closed end first mortgage loans                            | 0                 | 0       | 878           | 878      |
| Open end and junior lien loans                             | 0                 | 0       | 406           | 406      |
| Residential construction loans                             | 0                 | 0       | 0             | 0        |
| Other consumer loans                                       | 0                 | 0       | 0             | 0        |
| Total impaired loans                                       | \$0               | \$0     | \$43,980      | \$43,980 |
| Mortgage servicing rights                                  | 0                 | 0       | 1,734         | 1,734    |
| Other real estate owned                                    | 0                 | 0       | 730           | 730      |
| Total assets   | \$0               | \$0     | \$46,444      | \$46,444 |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a gross carrying amount of \$50.2 million, with a valuation allowance of \$14.5 million at September 30, 2012, resulting in a net recovery in the provision for loan losses of \$200,000 and \$3.8 million, respectively, for the three months and nine months ended September 30, 2012. At September 30, 2011, impaired loans had a carrying amount of \$56.4 million, with a valuation allowance of \$16.6 million, resulting in an additional provision for loans losses of \$7.8 million and \$5.3 million, respectively, for the three months and nine months ending September 30, 2011.

Mortgage servicing rights, which are carried at the lower of cost or fair value, included a portion carried at their fair value of \$2.0 million, which is made up of the outstanding balance of \$2.2 million, net of a valuation allowance of \$192,000 at September 30, 2012, resulting in impairment of \$84,000 for the nine months ended September 30, 2012. The Company realized impairment of mortgage servicing rights of \$162,000 for the nine months ended September 30, 2011.

The Company also recognized a \$72,000 reduction in the value of other real estate owned during the nine months ended September 30, 2012. During the nine months ended September 30, 2011, the Company recognized a \$76,000 reduction in the value of other real estate owned.

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments. Items which are not financial instruments are not included.

|  | September 30, 2012 |                      |           |           | Total       |
|--|--------------------|----------------------|-----------|-----------|-------------|
|  | Carrying Value     | Estimated Fair Value |           |           |             |
|  |                    | Level 1              | Level 2   | Level 3   |             |
| <b>Financial Assets:</b>                       |                    |                      |           |           |             |
| Cash and cash equivalents                      | \$ 181,402         | \$ 181,402           | \$ 0      | \$ 0      | \$ 181,402  |
| Securities available for sale                  | 481,256            | 1,042                | 479,577   | 637       | 481,256     |
| Real estate mortgages held for sale            | 6,707              | 0                    | 6,826     | 0         | 6,826       |
| Loans, net                                     | 2,151,476          | 0                    | 0         | 2,179,321 | 2,179,321   |
| Federal Home Loan Bank stock                   | 7,313              | N/A                  | N/A       | N/A       | N/A         |
| Federal Reserve Bank stock                     | 3,420              | N/A                  | N/A       | N/A       | N/A         |
| Accrued interest receivable                    | 9,729              | 4                    | 1,774     | 7,951     | 9,729       |
| <b>Financial Liabilities:</b>                  |                    |                      |           |           |             |
| Certificates of deposit                        | (948,410 )         | 0                    | (964,427) | 0         | (964,427 )  |
| All other deposits                             | (1,527,687)        | (1,527,687)          | 0         | 0         | (1,527,687) |
| Securities sold under agreements to repurchase | (118,552 )         | 0                    | (118,552) | 0         | (118,552 )  |
| Long-term borrowings                           | (15,038 )          | 0                    | (15,690 ) | 0         | (15,690 )   |
| Subordinated debentures                        | (30,928 )          | 0                    | 0         | (31,232 ) | (31,232 )   |
| Standby letters of credit                      | (360 )             | 0                    | 0         | (360 )    | (360 )      |
| Accrued interest payable                       | (5,718 )           | (289 )               | (5,426 )  | (3 )      | (5,718 )    |

|  | December 31, 2011 |                         |
|--|-------------------|-------------------------|
|  | Carrying<br>Value | Estimated<br>Fair Value |
| Financial Assets:                              |                   |                         |
| Cash and cash equivalents                      | \$ 104,584        | \$ 104,584              |
| Securities available for sale                  | 467,391           | 467,391                 |
| Real estate mortgages held for sale            | 2,953             | 2,998                   |
| Loans, net                                     | 2,180,309         | 2,141,459               |
| Federal Home Loan Bank stock                   | 7,313             | N/A                     |
| Federal Reserve Bank stock                     | 3,420             | N/A                     |
| Accrued interest receivable                    | 9,604             | 9,604                   |
| Financial Liabilities:                         |                   |                         |
| Certificates of deposit                        | (910,381 )        | (925,619 )              |
| All other deposits                             | (1,502,315 )      | (1,502,315 )            |
| Securities sold under agreements to repurchase | (131,990 )        | (131,990 )              |
| Other short-term borrowings                    | (10,000 )         | (10,000 )               |
| Long-term borrowings                           | (15,040 )         | (16,079 )               |
| Subordinated debentures                        | (30,928 )         | (31,240 )               |
| Standby letters of credit                      | (247 )            | (247 )                  |
| Accrued interest payable                       | (5,574 )          | (5,574 )                |

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

Cash and cash equivalents - The carrying amount of cash and cash equivalents approximate fair value and are classified as Level 1.

Loans, net – Fair values of loans, excluding loans held for sale, are estimated as follows: For variable rate loans, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using current market rates applied to the estimated life resulting in a Level 3 classification. Impaired loans are valued at the lower of cost or fair value as described previously. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

Federal Home Loan Bank stock and Federal Reserve Bank stock– It is not practical to determine the fair value of Federal Home Loan Bank stock and Federal Reserve Bank stock due to restrictions placed on its transferability.

Certificates of deposit - Fair values of certificates of deposit are estimated using discounted cash flow analyses using current market rates applied to the estimated life resulting in a Level 2 classification.



All other deposits- The fair values for all other deposits other than certificates of deposit are equal to the amount payable on demand (the carrying value) resulting in a Level 1 classification.

Securities sold under agreements to repurchase – The carrying amount of borrowings under repurchase agreements approximate their fair values resulting in a Level 2 classification.

Long-term borrowings – The fair value of long-term borrowings is estimated using discounted cash flow analyses based on current borrowing rates resulting in a Level 2 classification.

Subordinated debentures- The fair value of subordinated debentures is based on the rates currently available to the Company with similar term and remaining maturity and credit spread resulting in a Level 3 classification.

Standby letters of credit – The fair value of off-balance sheet items is based on the current fees and costs that would be charged to enter into or terminate such arrangements resulting in a Level 3 classification.

Accrued interest receivable/payable – The carrying amounts of accrued interest approximate fair value resulting in a Level 1, Level 2 or Level 3 classification which is consistent with its associated asset/liability.

#### NOTE 9. ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table summarizes the changes within each classification of accumulated other comprehensive income for the nine months ended September 30, 2012 and 2011:

|  | Balance<br>at December 31,<br>2011 | Current<br>Period<br>Change | Balance<br>at September 30,<br>2012 |   |
|--|------------------------------------|-----------------------------|-------------------------------------|---|
| Unrealized loss on securities available for sale without other than temporary impairment | \$ 7,688                           | \$818                       | \$ 8,506                            |   |
| Unrealized loss on securities available for sale with other than temporary impairment    | (523                               | ) 523                       | 0                                   |   |
| Total unrealized loss on securities available for sale                                   | 7,165                              | 1,341                       | 8,506                               |   |
| Unrealized loss on defined benefit pension plans   | (2,026                             | ) 164                       | (1,862                              | ) |
| Total  | \$ 5,139                           | \$1,505                     | \$ 6,644                            |   |
|  | Balance                            | Current<br>Period           | Balance                             |   |

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|  | at December 31,<br>2010 | Change  | at September 30,<br>2011 |
|--|-------------------------|---------|--------------------------|
| Unrealized loss on securities available for sale without other than temporary impairment | \$ 4,285                | \$4,372 | \$ 8,657                 |
| Unrealized loss on securities available for sale with other than temporary impairment    | (1,425                  | ) 1,138 | (287 )                   |
| Total unrealized loss on securities available for sale                                   | 2,860                   | 5,510   | 8,370                    |
| Unrealized loss on defined benefit pension plans   | (1,510                  | ) (60 ) | (1,570 )                 |
| Total  | \$ 1,350                | \$5,450 | \$ 6,800                 |

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**NOTE 10. SUBSEQUENT EVENTS**

There were no subsequent events that would have a material impact to the financial statements presented in this Form 10-Q.

**NOTE 11. RECLASSIFICATIONS**

Certain amounts appearing in the financial statements and notes thereto for prior periods have been reclassified to conform with the current presentation. The reclassification had no effect on net income or stockholders' equity as previously reported.

**Part 1**

**LAKELAND FINANCIAL CORPORATION**

**ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION**

**and**

**RESULTS OF OPERATIONS**

**September 30, 2012**

**OVERVIEW**

Lakeland Financial Corporation is the holding company for Lake City Bank. The Company is headquartered in Warsaw, Indiana and operates 45 offices in 13 counties in Northern and Central Indiana. The Company earned \$26.8 million for the first nine months of 2012, versus \$22.4 million in the same period of 2011, an increase of 19.6%. Net income was positively impacted by a \$9.6 million decrease in the provision for loan losses and an increase in noninterest income of \$1.2 million. Offsetting these positive impacts were a decrease in net interest income of \$2.5 million and an increase of \$1.6 million in noninterest expense. Basic earnings per common share for the first nine months of 2012 were \$1.64 per share, versus \$1.38 per share for the first nine months of 2011, an increase of 18.8%. Diluted earnings per common share reflect the potential dilutive impact of stock options, stock awards and warrants. Diluted earnings per common share for the first nine months of 2012 were \$1.63 per share, versus \$1.37 for the first nine months of 2011, an increase of 19.0%.

Net income for the third quarter of 2012 was \$9.3 million, an increase of 10.7% versus \$8.4 million for the comparable period of 2011. The increase was driven by a \$2.4 million decrease in the provision for loan losses and an increase in noninterest income of \$306,000. Offsetting these positive impacts was an increase of \$823,000 in noninterest expense as well as a decrease of \$661,000 in net interest income. Basic earnings per common share for the third quarter of 2012 were \$0.57 per share, versus \$0.52 per share for the third quarter of 2011. Diluted earnings per common share for the third quarter of 2012 were \$0.57 per share, versus \$0.52 per share for the third quarter of 2011, an increase of 9.6%.

**RESULTS OF OPERATIONS**

**Net Interest Income**

For the nine-month period ended September 30, 2012, net interest income totaled \$66.8 million, a decrease of 3.6%, or \$2.5 million, versus the first nine months of 2011. This decrease was primarily due to a 26 basis point decrease in the Company's net interest margin to 3.34% for the nine month period ended September 30, 2012, versus 3.60% comparable period of 2011. During the nine-month period ended September 30, 2012, average earning assets increased by \$101.0 million, or 3.9%, to \$2.717 billion. For the third quarter of 2012, net interest income totaled \$22.2 million, a decrease of 2.9%, or \$661,000, versus the third quarter of 2011. This decrease was primarily due to an 18 basis point decrease in the Company's net interest margin to 3.30% for the third quarter of 2012, versus 3.48% for the third quarter of 2011. Average earning assets increased \$78.0 million, or 3.0%, to \$2.718 billion in the third quarter of 2012, versus the third quarter of 2011.

Given the Company's mix of interest earning assets and interest bearing liabilities at September 30, 2012, the Company would generally be considered to have a relatively neutral balance sheet structure. The Company's balance sheet structure would normally be expected to produce a stable or declining net interest margin in a declining rate environment. As the Company's balance sheet has become more neutral in structure, management believes rate movements and other factors such as deposit mix, market deposit rate pricing and non-bank deposit products could have an impact on net interest margin. As a result of the prolonged and unprecedented low interest rate environment, and given recent indications by the Federal Reserve Bank regarding its intentions to maintain current target rate levels, the Company expects to experience continued pressure on its net interest margin. Also contributing to this net interest margin compression is a recent trend of aggressive loan pricing by the Company's competitors in its markets on both variable and fixed rate commercial loans. As a result of this competitive pricing influence, the Company believes that its yields on the commercial loan portfolio will continue to experience downward pressure. Over time, the Company's mix of deposits has shifted to more reliance on transaction accounts such as Rewards Checking, as well as Rewards Savings and corporate and public fund money market and repurchase agreements, which generally carry a higher interest rate cost than other types of interest bearing deposits. The Company believes that this deposit strategy provides for an appropriate funding strategy.

During the first nine months of 2012, total interest and dividend income decreased by \$4.0 million, or 4.4%, to \$87.7 million, versus \$91.7 million during the first nine months of 2011. This decrease was primarily the result of a 38 basis point decrease in the tax equivalent yield on average earning assets to 4.4%, versus 4.8% for the same period of 2011. Average earning assets increased by \$101.0 million, or 3.9%, during the first nine months of 2012 versus the same period of 2011. During the third quarter of 2012, total interest and dividend income decreased by \$1.8 million, or 5.8%, to \$28.7 million, versus \$30.4 million during the third quarter of 2011. This decrease was primarily the result of a 38 basis point decrease in the tax equivalent yield on average earning assets to 4.3% in the third quarter of 2012, versus 4.6% for the same period of 2011. Average earning assets increased by \$78.0 million, or 3.0%, in the third quarter of 2012 versus the same period of 2011.

During the first nine months of 2012, loan interest income decreased by \$790,000, or 1.0%, to \$78.1 million, versus \$78.9 million during the first nine months of 2011. The decrease was driven by a 24 basis point decrease in the tax equivalent yield on loans, to 4.7%, versus 5.0% in the first nine months of 2011. During the third quarter of 2012, loan interest income decreased by \$592,000, or 2.2%, to \$25.9 million, versus \$26.5 million during the third quarter of 2011. The decrease was driven by a 22 basis point decrease in the tax equivalent yield on loans, to 4.7%, versus 4.9% in the third quarter of 2011.

The average daily securities balances for the first nine months of 2012 increased \$33.3 million, or 7.5%, to \$475.0 million, versus \$441.8 million for the same period of 2011. During the same periods, income from securities decreased by \$3.2 million, or 25.1%, to \$9.5 million versus \$12.7 million during the first nine months of 2011. The decrease was primarily the result of a 119 basis point decrease in the tax equivalent yield on securities, to 3.0%, versus 4.2% in the first nine months of 2011. The average daily securities balances for the third quarter of 2012 increased \$18.5 million, or 4.1%, to \$475.9 million, versus \$457.4 million for the same period of 2011. During the same periods, income from securities decreased by \$1.2 million, or 30.1%, to \$2.7 million versus \$3.9 million during the third quarter of 2011. The decrease was primarily the result of a 112 basis point decrease in the tax equivalent yield on securities, to 2.6%, versus 3.7% in the third quarter of 2011. The prolonged low interest rate environment has driven

accelerated prepayments in the Company's portfolio of mortgage backed securities. Those prepayments must then be reinvested in securities at current, lower market yields, resulting in less income from securities despite the higher average securities balances. Due to the unprecedented low interest rate environment, the Company is currently reevaluating its investment strategy. The reevaluation includes considering the purchase of good quality, higher yielding alternative investments. Given the strength of the Company's balance sheet and the likelihood of the low interest rate environment persisting into the future, the Company believes that this would be an appropriate and prudent strategy.



Total interest expense decreased \$1.6 million, or 6.9%, to \$20.9 million for the nine-month period ended September 30, 2012, from \$22.4 million for the comparable period in 2011. The decrease was primarily the result of a 16 basis point decrease in the Company's daily cost of funds to 1.1%, versus 1.2% for the same period of 2011. Total interest expense decreased \$1.1 million, or 14.6%, to \$6.5 million for the third quarter of 2012, versus \$7.6 million for the third quarter of 2011. The decrease was primarily the result of a 23 basis point decrease in the Company's cost of funds to 1.0%, from 1.2% for the same period of 2011.

On an average daily basis, total deposits (including demand deposits) increased \$198.5 million, or 8.7%, to \$2.491 billion for the nine-month period ended September 30, 2012, versus \$2.293 billion during the same period in 2011. The average daily balances for the third quarter of 2012 increased \$175.7 million, or 7.6%, to \$2.492 billion from \$2.316 billion during the third quarter of 2011. On an average daily basis, noninterest bearing demand deposits were \$348.3 million for the nine-month period ended September 30, 2012, versus \$302.2 million for the same period in 2011. The average daily noninterest bearing demand deposit balances for the third quarter of 2012 were \$364.6 million, versus \$317.9 million for the third quarter of 2011. On an average daily basis, interest bearing transaction accounts increased \$147.6 million, or 17.5%, to \$992.0 million for the nine-month period ended September 30, 2012, versus the same period in 2011. Average daily interest bearing transaction accounts increased \$131.4 million, or 15.5%, to \$981.8 million for the third quarter of 2012, versus \$850.3 million for the third quarter of 2011. When comparing the nine months ended September 30, 2012 with the same period of 2011, the average daily balance of time deposits, which pay a higher rate of interest compared to demand deposits and non-Rewards Checking transaction accounts, decreased \$21.4 million. The average rate paid on time deposit accounts decreased three basis points to 1.6% for the nine-month period ended September 30, 2012, versus the same period in 2011. During the third quarter of 2012, the average daily balance of time deposits decreased \$30.4 million, and the rate paid decreased 12 basis points to 1.5%, versus the third quarter of 2011. Despite the low interest rate environment, the Company has been able to attract and retain retail deposit customers through offering innovative deposit products such as Rewards Checking and Savings. These products pay somewhat higher interest rates but also encourage certain customer behaviors such as using debit cards and electronic statements, which have the effect of generating additional related fee income and reducing the Company's processing costs.

The Company's funding strategy is generally focused on leveraging its retail branch network to grow traditional retail deposits and on its presence with commercial customers and public fund entities in its Indiana markets to generate deposits. In addition, the Company has utilized the Certificate of Deposit Account Registry Service (CDARS) program and out-of-market brokered certificates of deposit. Due to the Company's historical loan growth, the Company sought these deposits and has expanded its funding strategy over time to include these types of non-core deposit programs, although its reliance on these types of deposits has reduced significantly over the past several years. The Company believes that these deposit programs represent an appropriate tool in the overall liquidity and funding strategy but will continue to focus on funding loan and investment growth with in-market deposits whenever possible. On an average daily basis, total brokered certificates of deposit decreased \$107.2 million to \$42.5 million for the nine-month period ended September 30, 2012, versus \$149.7 million for the same period in 2011. During the third quarter of 2012, average daily brokered certificates of deposit were \$30.4 million, versus \$125.1 million during the third quarter of 2011. On an average daily basis, total public fund certificates of deposit decreased \$4.8 million to \$97.9 million for the nine-month period ended September 30, 2012, versus \$102.7 million for the same period in 2011. During the third quarter of 2012, average daily public fund certificates of deposit were \$108.2 million, versus \$104.6 million during the third quarter of 2011. In addition, the Company had average public fund interest bearing transaction accounts of \$190.5 million and \$189.5 million, respectively, in the nine months and three months ended

September 30, 2012, versus \$105.6 million and \$108.9 million for the comparable periods of 2011. Availability of public fund deposits can be cyclical, primarily due to the timing differences between when real estate property taxes are collected versus when those tax revenues are spent, as well as the intense competition for these funds.

Average daily balances of borrowings were \$163.0 million during the nine months ended September 30, 2012, versus \$193.2 million during the same period of 2011, and the rate paid on borrowings increased 17 basis points to 1.3%. During the third quarter of 2012 the average daily balances of borrowings decreased \$35.1 million to \$158.7 million, versus \$193.7 million for the same period of 2011, and the rate paid on borrowings increased 22 basis points to 1.3%. On an average daily basis, total deposits (including demand deposits) and purchased funds increased 6.8% and 5.6%, respectively, during the nine-month and three-month periods ended September 30, 2012 versus the same periods in 2011.

The Board of Directors and management recognize the importance of liquidity during times of normal operations and in times of stress. In 2010, the Company formalized and expanded upon its extensive Contingency Funding Plan (“CFP”). The formal CFP was developed to help ensure that the multiple liquidity sources available to the Company are detailed. The CFP identifies the potential funding sources, which include the Federal Home Loan Bank of Indianapolis, The Federal Reserve Bank, brokered certificates of deposit, certificates of deposit available from the CDARS program, repurchase agreements, and Fed Funds. The CFP also addresses the role of the securities portfolio in liquidity.

Further, the plan identifies CFP team members and expressly details their respective roles. Potential risk scenarios are identified and the plan includes multiple scenarios, including short-term and long-term funding crisis situations. Under the long-term funding crisis, two additional scenarios are identified: a moderate risk scenario and a highly stressed scenario. The CFP indicates the responsibilities and the actions to be taken by the CFP team under each scenario. Monthly reports to management and the Board of Directors under the CFP include an early warning indicator matrix and pro forma cash flows for the various scenarios. The Company will continue to carefully monitor its liquidity planning and will consider adjusting its plans as circumstances warrant.

The following tables set forth consolidated information regarding average balances and rates:

## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;

## INTEREST RATES AND INTEREST DIFFERENTIAL

(in thousands of dollars)

|                                | Nine Months Ended September 30,<br>2012 |                    |           | 2011               |                    |           |   |  |
|--------------------------------|---|--------------------|-----------|--------------------|--------------------|-----------|---|--|
|                                | Average<br>Balance                      | Interest<br>Income | Yield (1) | Average<br>Balance | Interest<br>Income | Yield (1) |   |  |
| <b>ASSETS</b>                  |   |                    |           |                    |                    |           |   |  |
| Earning assets:                |   |                    |           |                    |                    |           |   |  |
| Loans:                         |   |                    |           |                    |                    |           |   |  |
| Taxable (2)(3)                 | \$2,207,594                             | \$77,789           | 4.71      | % \$2,121,294      | \$78,555           | 4.95      | % |  |
| Tax exempt (1)                 | 9,634                                   | 498                | 6.91      | 10,471             | 529                | 6.76      |   |  |
| Investments: (1)               |   |                    |           |                    |                    |           |   |  |
| Available for sale             | 475,028                                 | 10,562             | 2.97      | 441,771            | 13,745             | 4.16      |   |  |
| Short-term investments         | 22,891                                  | 16                 | 0.09      | 17,219             | 18                 | 0.14      |   |  |
| Interest bearing deposits      | 2,178                                   | 27                 | 1.66      | 25,606             | 96                 | 0.50      |   |  |
| Total earning assets           | 2,717,325                               | 88,892             | 4.37      | % 2,616,361        | 92,943             | 4.75      | % |  |
| Nonearning assets:             |   |                    |           |                    |                    |           |   |  |
| Cash and due from banks        | 162,385                                 | 0                  |           | 65,115             | 0                  |           |   |  |
| Premises and equipment         | 34,995                                  | 0                  |           | 30,752             | 0                  |           |   |  |
| Other nonearning assets        | 94,853                                  | 0                  |           | 95,007             | 0                  |           |   |  |
| Less allowance for loan losses | (53,076 )                               | 0                  |           | (49,469 )          | 0                  |           |   |  |
| Total assets                   | \$2,956,482                             | \$88,892           |           | \$2,757,766        | \$92,943           |           |   |  |

Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2012 and 2011.

(1) The tax equivalent rate for tax exempt loans and tax exempt securities included the TEFRA adjustment applicable to nondeductible interest expenses.

(2) Loan fees, which are immaterial in relation to total taxable loan interest income for the nine months ended September 30, 2012 and 2011, are included as taxable loan interest income.

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

## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;

## INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)

(in thousands of dollars)

|  | Nine Months Ended September 30, |                     |        |                    |                     |        |
|--|---------------------------------|---------------------|--------|--------------------|---------------------|--------|
|  | 2012                            |                     |        | 2011               |                     |        |
|  | Average<br>Balance              | Interest<br>Expense | Yield  | Average<br>Balance | Interest<br>Expense | Yield  |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                          |                                 |                     |        |                    |                     |        |
| Interest bearing liabilities:  |                                 |                     |        |                    |                     |        |
| Savings deposits   | \$192,969                       | \$530               | 0.37 % | \$166,740          | \$686               | 0.55 % |
| Interest bearing checking accounts                                   | 992,045                         | 7,139               | 0.96   | 844,488            | 7,994               | 1.27   |
| Time deposits:   |                                 |                     |        |                    |                     |        |
| In denominations under \$100,000                                     | 395,807                         | 5,384               | 1.82   | 348,557            | 5,125               | 1.97   |
| In denominations over \$100,000                                      | 562,157                         | 6,299               | 1.50   | 630,820            | 7,063               | 1.50   |
| Miscellaneous short-term borrowings                                  | 117,002                         | 329                 | 0.38   | 147,263            | 477                 | 0.43   |
| Long-term borrowings and subordinated debentures                     | 45,966                          | 1,198               | 3.48   | 45,968             | 1,084               | 3.15   |
| Total interest bearing liabilities                                   | 2,305,946                       | 20,879              | 1.21 % | 2,183,836          | 22,429              | 1.37 % |
| Noninterest bearing liabilities and stockholders'<br>equity:         |                                 |                     |        |                    |                     |        |
| Demand deposits  | 348,280                         | 0                   |        | 302,170            | 0                   |        |
| Other liabilities  | 17,760                          | 0                   |        | 14,931             | 0                   |        |
| Stockholders' equity   | 284,496                         | 0                   |        | 256,829            | 0                   |        |
| Total liabilities and stockholders' equity                           | \$2,956,482                     | \$20,879            |        | \$2,757,766        | \$22,429            |        |
| Net interest differential - yield on average daily<br>earning assets |                                 | \$68,013            | 3.34 % |                    | \$70,514            | 3.60 % |

## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;

## INTEREST RATES AND INTEREST DIFFERENTIAL

(in thousands of dollars)

|                                | Three Months Ended September 30, |                    |           |      |                    |                    |           |   |
|--------------------------------|----------------------------------|--------------------|-----------|------|--------------------|--------------------|-----------|---|
|                                | 2012                             |                    |           | 2011 |                    |                    |           |   |
|                                | Average<br>Balance               | Interest<br>Income | Yield (1) |      | Average<br>Balance | Interest<br>Income | Yield (1) |   |
| <b>ASSETS</b>                  |                                  |                    |           |      |                    |                    |           |   |
| Earning assets:                |                                  |                    |           |      |                    |                    |           |   |
| Loans:                         |                                  |                    |           |      |                    |                    |           |   |
| Taxable (2)(3)                 | \$2,206,051                      | \$25,803           | 4.65      | %    | \$2,150,201        | \$26,390           | 4.87      | % |
| Tax exempt (1)                 | 9,406                            | 164                | 6.93      |      | 9,806              | 170                | 6.88      |   |
| Investments: (1)               |                                  |                    |           |      |                    |                    |           |   |
| Available for sale             | 475,899                          | 3,074              | 2.57      |      | 457,360            | 4,254              | 3.69      |   |
| Short-term investments         | 24,595                           | 6                  | 0.10      |      | 12,082             | 3                  | 0.10      |   |
| Interest bearing deposits      | 2,367                            | 10                 | 1.68      |      | 10,849             | 15                 | 0.55      |   |
| Total earning assets           | 2,718,318                        | 29,057             | 4.25      | %    | 2,640,298          | 30,832             | 4.63      | % |
| Nonearning assets:             |                                  |                    |           |      |                    |                    |           |   |
| Cash and due from banks        | 165,790                          | 0                  |           |      | 77,111             | 0                  |           |   |
| Premises and equipment         | 35,043                           | 0                  |           |      | 31,203             | 0                  |           |   |
| Other nonearning assets        | 93,258                           | 0                  |           |      | 93,763             | 0                  |           |   |
| Less allowance for loan losses | (52,046 )                        | 0                  |           |      | (52,184 )          | 0                  |           |   |
| Total assets                   | \$2,960,363                      | \$29,057           |           |      | \$2,790,191        | \$30,832           |           |   |

Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2012 and 2011.

(1) The tax equivalent rate for tax exempt loans and tax exempt securities included the TEFRA adjustment applicable to nondeductible interest expenses.

(2) Loan fees, which are immaterial in relation to total taxable loan interest income for the three months ended September 30, 2012 and 2011, are included as taxable loan interest income.

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

## DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS' EQUITY;

## INTEREST RATES AND INTEREST DIFFERENTIAL (Cont.)

(in thousands of dollars)

|  | Three Months Ended September 30, |                     |               |                    |                     |               |
|--|----------------------------------|---------------------|---------------|--------------------|---------------------|---------------|
|  | 2012                             |                     |               | 2011               |                     |               |
|  | Average<br>Balance               | Interest<br>Expense | Yield         | Average<br>Balance | Interest<br>Expense | Yield         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                              |                                  |                     |               |                    |                     |               |
| Interest bearing liabilities:  |                                  |                     |               |                    |                     |               |
| Savings deposits   | \$197,322                        | \$160               | 0.32 %        | \$169,281          | \$239               | 0.56 %        |
| Interest bearing checking accounts                                       | 981,770                          | 2,174               | 0.88          | 850,343            | 2,769               | 1.29          |
| Time deposits:   |                                  |                     |               |                    |                     |               |
| In denominations under \$100,000   | 388,516                          | 1,684               | 1.72          | 360,060            | 1,773               | 1.95          |
| In denominations over \$100,000  | 559,855                          | 1,971               | 1.40          | 618,718            | 2,309               | 1.48          |
| Miscellaneous short-term borrowings                                      | 112,722                          | 112                 | 0.40          | 147,771            | 159                 | 0.43          |
| Long-term borrowings and subordinated debentures                         | 45,966                           | 399                 | 3.45          | 45,967             | 361                 | 3.12          |
| <b>Total interest bearing liabilities</b>                                | <b>2,286,151</b>                 | <b>6,500</b>        | <b>1.13 %</b> | <b>2,192,140</b>   | <b>7,610</b>        | <b>1.38 %</b> |
| Noninterest bearing liabilities and stockholders' equity:                |                                  |                     |               |                    |                     |               |
| Demand deposits  | 364,579                          | 0                   |               | 317,921            | 0                   |               |
| Other liabilities  | 18,120                           | 0                   |               | 15,670             | 0                   |               |
| Stockholders' equity   | 291,513                          | 0                   |               | 264,460            | 0                   |               |
| <b>Total liabilities and stockholders' equity</b>                        | <b>\$2,960,363</b>               | <b>\$6,500</b>      |               | <b>\$2,790,191</b> | <b>\$7,610</b>      |               |
| <b>Net interest differential - yield on average daily earning assets</b> |                                  | <b>\$22,557</b>     | <b>3.30 %</b> |                    | <b>\$23,222</b>     | <b>3.48 %</b> |





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|  |         |         |       |
|--|---------|---------|-------|
| Service charges on deposit accounts  | 2,045   | 2,036   | 0.4   |
| Loan, insurance and service fees   | 1,421   | 1,259   | 12.9  |
| Merchant card fee income   | 297     | 253     | 17.4  |
| Other income   | 669     | 362     | 84.8  |
| Mortgage banking income  | 590     | 440     | 34.1  |
| Net securities losses  | (380 )  | (1 )    | N/A   |
| Impairment on available-for-sale securities (includes total losses of \$67 and \$33, net of \$0 and \$0 recognized in other comprehensive income, pre-tax) | (67 )   | (33 )   | 103.0 |
| Total noninterest income   | \$6,229 | \$5,923 | 5.2 % |

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Noninterest income increased \$1.2 million and \$306,000 respectively, for the nine-month and three-month periods ended September 30, 2012 versus the same periods in 2011. Mortgage banking income increased by \$980,000 and \$150,000, respectively, driven by a larger pipeline of refinance mortgage loans due to the continued low interest rate environment. Loan, insurance and service fees increased \$467,000 and \$162,000, respectively, driven by greater debit and credit card usage and ancillary fees. In addition, other income was positively impacted by gains on the sale of other real estate during the third quarter of 2012, versus write downs of other real estate during the third quarter of 2011. Noninterest income was negatively impacted by \$380,000 in net losses on securities sales related to a strategic realignment in the investment portfolio, which included the sale of nine non-agency mortgage backed securities. The sale included all five of the non-agency mortgage backed securities on which the Company had previously recognized other-than-temporary impairment.

### Noninterest Expense

Noninterest expense categories for the nine-month and three-month periods ended September 30, 2012 and 2011 are shown in the following table:

|                                   | Nine Months Ended<br>September 30, |          | Percent<br>Change |   |
|-----------------------------------|------------------------------------|----------|-------------------|---|
|                                   | 2012                               | 2011     |                   |   |
| Salaries and employee benefits    | \$26,007                           | \$24,802 | 4.9               | % |
| Occupancy expense                 | 2,519                              | 2,373    | 6.2               |   |
| Equipment costs                   | 1,854                              | 1,600    | 15.9              |   |
| Data processing fees and supplies | 3,044                              | 2,820    | 7.9               |   |
| Other expense                     | 9,807                              | 10,025   | (2.2)             | ) |
| Total noninterest expense         | \$43,231                           | \$41,620 | 3.9               | % |

|                                   | Three Months Ended<br>September 30, |          | Percent<br>Change |    |
|-----------------------------------|-------------------------------------|----------|-------------------|----|
|                                   | 2012                                | 2011     |                   |    |
| Salaries and employee benefits    | \$8,569                             | \$8,611  | (0.5)             | )% |
| Occupancy expense                 | 803                                 | 746      | 7.6               |    |
| Equipment costs                   | 641                                 | 536      | 19.6              |    |
| Data processing fees and supplies | 1,143                               | 729      | 56.8              |    |
| Other expense                     | 3,146                               | 2,857    | 10.1              |    |
| Total noninterest expense         | \$14,302                            | \$13,479 | 6.1               | %  |

The Company's noninterest expense increased \$1.6 million and \$823,000, respectively, in the nine-month and three-month periods ended September 30, 2012 versus the same periods of 2011. Salaries and employee benefits increased by \$1.2 million and decreased \$42,000, respectively, in the nine-month and three-month periods ended September 30, 2012 versus the same period of 2011. The increase in the nine month period was driven by staff additions, normal merit increases and employee health insurance increases. In addition, the Company's performance based compensation expense increased due to performance versus corporate objectives and increased recognition levels. Other factors behind the increase in noninterest expense included higher data processing fees driven by a larger customer base as well as greater utilization of services priced on a per unit basis by the Company's core processor, and higher equipment costs due to higher depreciation expense.

## **Income Tax Expense**

Income tax expense increased \$2.3 million, or 21.1%, for the first nine months of 2012, compared to the same period in 2011. The combined state franchise tax expense and the federal income tax expense, as a percentage of income before income tax expense, increased to 33.3% during the first nine months of 2012 compared to 33.0% during the same period of 2011. The combined tax expense decreased to 33.6% in the third quarter of 2012, versus 34.3% during the same period of 2011. The changes were driven by fluctuations in the percentage of revenue being derived from tax-advantaged sources in the nine-month and three-month periods of 2012, compared to the same periods in 2011.

## **CRITICAL ACCOUNTING POLICIES**

Certain of the Company's accounting policies are important to the portrayal of the Company's financial condition, since they require management to make difficult, complex or subjective judgments, some of which may relate to matters that are inherently uncertain. Estimates associated with these policies are susceptible to material changes as a result of changes in facts and circumstances. Some of the facts and circumstances which could affect these judgments include changes in interest rates, in the performance of the economy or in the financial condition of borrowers. Management believes that its critical accounting policies include determining the allowance for loan losses, the valuation of mortgage servicing rights and the valuation and other-than-temporary impairment of investment securities. The Company's critical accounting policies are discussed in detail in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

## **FINANCIAL CONDITION**

Total assets of the Company were \$2.952 billion as of September 30, 2012, an increase of \$62.5 million, or 2.2%, when compared to \$2.890 billion as of December 31, 2011.

Total cash and cash equivalents increased by \$76.8 million, or 73.5%, to \$181.4 million at September 30, 2012 from \$104.6 million at December 31, 2011. The increase resulted from an increase in total deposits, primarily transaction accounts. In addition, the Company experienced seasonal reductions in agri-business loans as well as an anticipated reduction in the portfolio of commercial real estate loans.

Total securities available-for-sale increased by \$13.9 million, or 3.0%, to \$481.3 million at September 30, 2012 from \$467.4 million at December 31, 2011. The increase was a result of a number of transactions in the securities portfolio. Securities purchases totaled \$128.2 million. Offsetting this increase were securities paydowns totaling \$78.7 million,

securities sales totaling \$27.9 million, maturities and calls of securities totaling \$3.8 million, securities amortization net of accretion was \$5.2 million and other-than-temporary impairment of \$1.0 million was recognized on four non-agency residential mortgage-backed securities. In addition, the net unrealized gain of the securities portfolio increased by \$2.2 million. The increase in fair market value was primarily driven by higher market values for agency residential mortgage-backed securities, due to the lower interest rate environment. The investment portfolio is generally managed to limit the Company's exposure to risk by containing mostly mortgage-backed securities backed by the federal government, other securities which are either directly or indirectly backed by the federal government or a local municipal government and collateralized mortgage obligations rated AAA by S&P and/or Aaa by Moody's at the time of purchase. As of September 30, 2012, the Company had \$7.0 million of non-agency residential mortgage-backed securities which were not backed by the federal government, but were rated AAA by S&P and/or Aaa by Moody's at the time of purchase.

None of the five remaining non-agency residential mortgage backed securities were still rated AAA/Aaa as of September 30, 2012 by at least one of the rating agencies S&P, Moody's and Fitch, however, none of the five have been downgraded to below investment grade by any of those rating agencies. On a monthly basis, the Company performs an analysis of the cash flows of these securities based on assumptions as to collateral defaults, prepayment speeds, expected losses and the severity of potential losses. Based upon the initial analysis, securities may be identified for further analysis computing the net present value and comparing it to the book value to determine if there is any other-than-temporary impairment to be recorded. Based on the analyses as of September 30, 2012, there was no other-than-temporary-impairment or any unrealized loss on any of the five remaining non-agency residential mortgage backed securities.

Real estate mortgage loans held-for-sale increased by \$3.8 million, or 127.1%, to \$6.7 million at September 30, 2012 from \$3.0 million at December 31, 2011. The balance of this asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. During the nine months ended September 30, 2012, \$89.6 million in real estate mortgages were originated for sale and \$85.3 million in mortgages were sold.

Total loans, excluding real estate mortgage loans held for sale, decreased by \$30.3 million to \$2.203 billion at September 30, 2012 from \$2.234 billion at December 31, 2011. During the nine months ended September 30, 2012, the Company experienced seasonal reductions in agri-business loans as favorable commodity prices and overall performance resulted in strong results for these borrowers. In addition, the portfolio of commercial real estate was reduced through the anticipated and successful placement of interim project financings with long-term, non-bank institutional lenders. Management expects loan growth to be moderate as the economic recovery moves along. The portfolio breakdowns at both September 30, 2012 and December 31, 2011 reflected 85% commercial and industrial, including commercial real estate and agri-business, 13% residential real estate and home equity and 2% consumer loans.

The Company has a high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses. Commercial loans represent higher dollar loans to fewer customers and therefore higher credit risk than other types of loans. Pricing is adjusted to manage the higher credit risk associated with these types of loans. The Company also generally requires new and renewed variable rate commercial loans to have floor rates. The majority of fixed rate residential mortgage loans, which represent increased interest rate risk, are sold in the secondary market, as well as some variable rate mortgage loans. The remainder of the variable rate mortgage loans and a small number of fixed rate mortgage loans are retained.

Loans are charged against the allowance for loan losses when management believes that the principal is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation, as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined after considering the following factors: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentrations, new industry lending activity and current economic conditions. Federal regulations require insured institutions to classify their own assets on a regular basis. The regulations provide for three categories of classified loans – substandard, doubtful and loss. The regulations also contain a special mention category. Special mention is defined as loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification, but do possess credit deficiencies or potential weaknesses deserving management's close attention. The Company's policy is to establish a specific allowance for loan losses for any assets where management has identified conditions or circumstances that indicate an asset is impaired. If an asset or portion thereof is classified as loss, the Company's policy is to either establish specified allowances for loan losses in the amount of 100% of the portion of the asset classified loss, or charge off such amount. At September 30, 2012, on the basis of management's review of the loan portfolio, the Company had loans totaling \$150.1 million on the classified loan list versus \$164.6 million on December 31, 2011, a decrease of 8.3%. As of September 30, 2012, the Company had \$44.7 million of assets classified special mention, \$106.1 million classified as substandard, \$0 classified as doubtful and \$0 classified as loss as compared to \$35.4 million, \$131.3 million, \$0 and \$0 at December 31, 2011. In addition, the Company has allocated \$14.7 million and \$15.7 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of September 30, 2012 and December 31, 2011. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

Allowance estimates are developed by management taking into account actual loss experience, adjusted for current economic conditions. The Company generally has regular discussions regarding this methodology with regulatory authorities. Allowance estimates are considered a prudent measurement of the risk in the Company's loan portfolio and are applied to individual loans based on loan type. In accordance with current accounting guidance, the allowance is provided for losses that have been incurred as of the balance sheet date and is based on past events and current economic conditions, and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions.

Net recoveries totaled \$96,000 in the third quarter of 2012, versus net charge-offs of \$1.6 million during the third quarter of 2011 and \$1.4 million during the second quarter of 2012.

The allowance for loan losses decreased 2.8%, or \$1.5 million, from \$53.4 million at December 31, 2011 to \$51.9 million at September 30, 2012. Pooled loan allocations increased from \$31.7 million at December 31, 2011 to \$32.9 million at September 30, 2012, which was primarily a result of management's overall view on current credit quality. Impaired loan allocations decreased \$2.1 million from \$18.3 million at December 31, 2011 to \$16.2 million at September 30, 2012. This decrease in impaired allocations was primarily due to decreases in the allocations of existing impaired loans as well as reductions to the impaired loans category. The unallocated component of the allowance for loan losses decreased slightly from \$3.4 million at December 31, 2011 to \$3.0 million at September 30, 2012, based on management's assessment of economic and other qualitative factors impacting the loan portfolio, including the ongoing general economic challenges in the Company's market areas. While management has begun to see some positive trends, including general stabilization and a decline in watchlist credits and a decline in non-performing loans, management anticipates a continued slow recovery. Management believes the allowance for loan losses at September 30, 2012 was at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions do not continue to improve, certain borrowers may experience difficulty and the level of nonperforming loans, charge-offs and delinquencies could rise and require further increases in the provision for loan losses.

Total impaired loans decreased by \$2.2 million, or 3.5%, to \$61.3 million at September 30, 2012 from \$63.5 million at December 31, 2011. A loan is impaired when full payment under the original loan terms is not expected. Impairment is evaluated in the aggregate for smaller-balance loans of similar nature such as residential mortgage, and consumer loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. The decrease in the impaired loans category was primarily due to charge-offs of \$3.0 million taken on four commercial credits. In addition, one commercial credit of \$989,000 paid off. The following table summarizes nonperforming assets at September 30, 2012 and December 31, 2011.

|   | September<br>30,<br>2012 | December 31,<br>2011 |      |   |
|---|--------------------------|----------------------|------|---|
|   | (in thousands)           |                      |      |   |
| <b>NONPERFORMING ASSETS:</b>  |                          |                      |      |   |
| Nonaccrual loans including nonaccrual troubled debt restructured loans        | \$33,226                 | \$ 39,425            |      |   |
| Loans past due over 90 days and still accruing                                | 109                      | 52                   |      |   |
| Total nonperforming loans   | \$33,335                 | \$ 39,477            |      |   |
| Other real estate owned   | 681                      | 2,075                |      |   |
| Repossessions   | 5                        | 33                   |      |   |
| Total nonperforming assets  | \$34,021                 | \$ 41,585            |      |   |
| <br>  |                          |                      |      |   |
| Impaired loans including troubled debt restructurings                         | \$61,294                 | \$ 63,518            |      |   |
| <br>  |                          |                      |      |   |
| Nonperforming loans to total loans  | 1.51                     | %                    | 1.77 | % |
| Nonperforming assets to total assets  | 1.15                     | %                    | 1.44 | % |
| <br>  |                          |                      |      |   |
| Nonperforming troubled debt restructured loans (included in nonaccrual loans) | \$28,979                 | \$ 34,272            |      |   |



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|   |          |           |
|---|----------|-----------|
| Performing troubled debt restructured loans | 26,106   | 22,177    |
| Total troubled debt restructured loans      | \$55,085 | \$ 56,449 |

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Total nonperforming assets decreased by \$7.6 million, or 18.2%, to \$34.0 million during the nine-month period ended September 30, 2012. The decrease was primarily due to the aforementioned charge-offs and pay-off as well as sales of other real estate owned. In addition, a commercial relationship consisting of two loans totaling \$2.3 million was upgraded to performing status, although the loans are still considered impaired. The loan upgrades also shifted the two loans from the nonperforming troubled debt restructured loan category to the performing troubled debt restructured loan category.

Four commercial relationships represented 78.5% of total nonperforming loans. A \$13.2 million commercial relationship consisting of four loans represents the largest exposure in the nonperforming category. The borrower is engaged in real estate development. Borrower collateral, including real estate and the personal guarantees of its principals, support the credit. The Company took a \$1.7 million charge-off related to this credit in the fourth quarter of 2009, and no charge-offs were taken in 2010 or 2011. The Company took a \$601,000 charge-off related to this credit in the first quarter of 2012.

A commercial relationship consisting of three loans totaling \$7.1 million represented the second largest exposure in the nonperforming category. The borrower is engaged in commercial real estate development. Borrower collateral, including real estate and the personal guarantees of its principals, support the credit. The Company has not taken any charge-offs related to this credit.

A \$3.9 million credit to a manufacturer tied to the housing industry represented the third largest exposure in the nonperforming category. The credit is accounted for as a troubled debt restructuring. Borrower collateral including real estate, receivables, inventory and equipment support the credit, however, there are no guarantors. The Company took a \$906,000 charge-off related to this credit in 2008, and a \$1.7 million charge-off related to this credit in the second quarter of 2012.

A commercial relationship consisting of three loans totaling \$2.0 million represented the fourth largest exposure in the nonperforming category. The borrower is engaged in commercial real estate development. Borrower collateral, including real estate and the personal guarantees of its principals, support the credit. The Company has not taken any charge-offs related to this credit.

There can be no assurances that full repayment of the loans discussed above will result. Although economic conditions in the Company's markets have stabilized and in some areas improved, management does not foresee a rapid recovery as certain industries, including residential and commercial real estate development, recreational vehicle and mobile home manufacturing and other regional industries continue to experience slow growth. The Company's growth strategy has promoted diversification among industries as well as a continued focus on enforcement of a strong credit environment and an aggressive position on loan work-out situations. While the Company believes that the impact on the Company of these industry-specific issues affecting real estate development and recreational vehicle and mobile home manufacturers will be somewhat mitigated by the Company's overall growth strategy, the economic

factors impacting its entire geographic footprint will continue to present challenges. Additionally, the Company's overall asset quality position can be influenced by a small number of credits due to the focus on commercial lending activity and the granularity inherent in this strategy.

Total deposits increased by \$63.4 million, or 2.6%, to \$2.476 billion at September 30, 2012 from \$2.413 billion at December 31, 2011. The increase resulted from increases of \$58.5 million in public fund certificates of deposit of \$100,000 or more, \$42.7 million in interest bearing transaction accounts, \$19.3 million in savings accounts, \$12.4 million in certificates of deposit of \$100,000 and over, \$5.6 million in CDARS certificates of deposit and \$849,000 in demand deposits. Offsetting these increases were decreases of \$37.5 million in money market accounts, \$30.4 million in brokered deposits and \$8.0 million in other certificates of deposit.

Total short-term borrowings decreased by \$23.4 million, or 16.5%, to \$118.6 million at September 30, 2012 from \$142.0 million at December 31, 2011. The decrease resulted primarily from decreases of \$13.4 million in securities sold under agreements to repurchase. In addition, federal funds purchased decreased by \$10.0 million.

Total equity increased by \$21.7 million, or 7.9%, to \$295.0 million at September 30, 2012 from \$273.3 million at December 31, 2011. The increase in total equity resulted from net income of \$26.8 million, plus the increase in the accumulated other comprehensive income of \$1.5 million, less dividends of \$8.1 million, plus \$1.2 million in stock compensation expense, plus \$323,000 for stock issued through options exercised (including tax benefit).

The FDIC's risk-based capital regulations require that all insured banking organizations maintain an 8.0% total risk-based capital ratio. The FDIC has also established definitions of "well capitalized" as a 5.0% Tier I leverage capital ratio, a 6.0% Tier I risk-based capital ratio and a 10.0% total risk-based capital ratio. As of September 30, 2012, the Bank had regulatory capital in excess of these minimum requirements with a Tier 1 leverage capital ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 10.4%, 13.1% and 14.4%, respectively. The Federal Reserve also has established minimum regulatory capital requirements for bank holding companies. As of September 30, 2012, the Company had regulatory capital in excess of these minimum requirements with a Tier 1 leverage capital ratio, Tier 1 risk-based capital ratio and total risk-based capital ratio of 10.6%, 13.3% and 14.6%, respectively.

In June 2012, the federal bank regulatory agencies issued joint proposed rules that would increase minimum capital ratios, add a new minimum common equity ratio, add a new capital conservation buffer, and change the risk-weightings of certain assets. The proposed changes, if implemented, would be phased in from 2013 through 2019. The comment period on the proposed rules expired on October 22, 2012. Various community bank associations have provided comments for the regulatory agencies regarding the additional regulatory burdens the proposals would place on community banks, and it is currently uncertain when and in what form the proposed rules will ultimately be adopted. Management is currently assessing the effect of the proposed rules on the Company and the Bank's capital position and will continue to monitor developments with respect to the proposed rules.

## **FORWARD-LOOKING STATEMENTS**

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

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

Legislative or regulatory changes or actions, including the "Dodd-Frank Wall Street Reform and Consumer Protection Act" and the regulations required to be promulgated thereunder, as well as rules recently proposed by the federal banking regulatory agencies concerning certain increased capital requirements, which may adversely affect the business of the Company and its subsidiaries.

The costs, effects and outcomes of existing or future litigation.

Changes in accounting policies and practices, as may be adopted by state and federal regulatory agencies, the Financial Accounting Standards Board, the Securities and Exchange Commission and the Public Company Accounting Oversight Board.

The ability of the Company to manage risks associated with the foregoing as well as anticipated.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

### **ITEM 3 – QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Interest rate risk represents the Company's primary market risk exposure. The Company does not have a material exposure to foreign currency exchange risk, does not have any material amount of derivative financial instruments and does not maintain a trading portfolio. The board of directors annually reviews and approves the policy used to manage interest rate risk. The policy was last reviewed and approved in May 2012. The policy sets guidelines for balance sheet structure, which are designed to protect the Company from the impact that interest rate changes could have on net income, but does not necessarily indicate the effect on future net interest income. The Company, through its Asset and Liability Committee, manages interest rate risk by monitoring the computer simulated earnings impact of various rate scenarios and general market conditions. The Company then modifies its long-term risk parameters by attempting to generate the type of loans, investments, and deposits that currently fit the Company's needs, as determined by the Asset and Liability Committee. This computer simulation analysis measures the net interest income impact of various interest rate scenario changes during the next twelve months. If the change in net interest income is less than 3% of primary capital, the balance sheet structure is considered to be within acceptable risk levels. As of September 30, 2012, the Company's potential pretax exposure was within the Company's policy limit, and not significantly different from December 31, 2011.

#### **ITEM 4 – CONTROLS AND PROCEDURES**

As required by Rules 13a-15(b) and 15d-15(b) under the Securities Exchange Act of 1934, management has evaluated, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures as of the end of the period covered by this report. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures (as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e)) were effective as of September 30, 2012. Disclosure controls and procedures are designed to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms. These disclosure controls and procedures include controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Securities Exchange Act is accumulated and communicated to management, including the Company's Chief Executive Officer and Chief Financial Officer, or persons performing similar functions, as appropriate, to allow timely decisions regarding required disclosure.

During the quarter ended September 30, 2012, there were no changes to the Company's internal control over financial reporting that have materially affected or are reasonably likely to materially affect its internal control over financial reporting.

**LAKELAND FINANCIAL CORPORATION**

**FORM 10-Q**

**September 30, 2012**

**Part II - Other Information**

Item 1. Legal proceedings

There are no material pending legal proceedings to which the Company or its subsidiaries is a party other than ordinary routine litigation incidental to their respective businesses.

Item 1A. Risk Factors

There have been no material changes to the risk factors disclosed in Item 1A of Part I of the Company's 2011 Form 10-K. Please refer to that section of the Company's Form 10-K for disclosures regarding the risks and uncertainties related to the Company's business.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information as of September 30, 2012 with respect to shares of common stock repurchased by the Company during the quarter then ended:

Issuer Purchases of Equity Securities(a)



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| Period         | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs |
|----------------|----------------------------------|------------------------------|--|--|
| July 1-31      | 7,004                            | \$ 27.29                     | 0  | \$ 0   |
| August 1-31    | 533                              | 27.14                        | 0  | 0  |
| September 1-30 | 0                                | 0                            | 0  | 0  |
| Total          | 7,537                            | \$ 27.28                     | 0  | \$ 0   |

The shares purchased during the periods were credited to the deferred share accounts of (a) non-employee directors under the Company's directors' deferred compensation plan. These shares were purchased in the ordinary course of business and consistent with past practice.

Item 3. Defaults Upon Senior Securities

None

Item 4. Mine Safety Disclosures

N/A

Item 5. Other Information

None

Item 6. Exhibits

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101\* Interactive Data File

Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets as of September 30, 2012 and December 31, 2011; (ii) Consolidated Statements of Income for the three and nine months ended September 30, 2012 and September 30, 2011; (iii) Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2012 and September 30, 2011; (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2012 and September 30, 2011; and (v) Notes to Unaudited Consolidated Financial Statements.

\*As provided in Rule 406T of Regulation S-T, this information shall not be deemed “filed” for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934, or otherwise subject to liability under those sections.

**LAKELAND FINANCIAL CORPORATION**

**FORM 10-Q**

**September 30, 2012**

**Part II - Other Information**

**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.

LAKELAND FINANCIAL CORPORATION

(Registrant)

Date: November 7, 2012 /s/ Michael L. Kubacki  
Michael L. Kubacki – Chief  
Executive Officer

Date: November 7, 2012 /s/ David M. Findlay  
David M. Findlay –President  
and Chief Financial Officer

Date: November 7, 2012 /s/ Teresa A. Bartman  
Teresa A. Bartman – Senior  
Vice President-  
Finance and Controller