

FIRST MERCHANTS CORP  
Form 10-Q  
May 10, 2011

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

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

For the quarterly period ended March 31, 2011

OR

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0-17071

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

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

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

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

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

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

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

Yes  No

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

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

As of April 29, 2011, there were 25,651,581 outstanding common shares, of the registrant.

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

|  | March 31,<br>2011<br>(Unaudited) | December<br>31,<br>2010 |
|--|----------------------------------|-------------------------|
| <b>ASSETS</b>  |                                  |                         |
| Cash and due from banks  | \$ 44,283                        | \$ 50,844               |
| Federal funds sold   | 6,092                            | 7,463                   |
| Cash and cash equivalents  | 50,375                           | 58,307                  |
| Interest-bearing time deposits                                   | 61,843                           | 65,216                  |
| Investment securities available for sale                         | 575,546                          | 539,370                 |
| Investment securities held to maturity                           | 310,483                          | 287,427                 |
| Mortgage loans held for sale                                     | 2,111                            | 21,469                  |
| Loans, net of allowance for loan losses of \$80,936 and \$82,977 | 2,683,192                        | 2,752,706               |
| Premises and equipment   | 51,818                           | 52,450                  |
| Federal Reserve and Federal Home Loan Bank stock                 | 33,801                           | 33,884                  |
| Interest receivable  | 17,583                           | 18,674                  |
| Core deposit intangibles   | 11,561                           | 12,662                  |
| Goodwill   | 141,357                          | 141,357                 |
| Cash surrender value of life insurance                           | 102,309                          | 96,731                  |
| Other real estate owned  | 17,056                           | 20,927                  |
| Tax asset, deferred and receivable                               | 38,224                           | 45,623                  |
| Other assets   | 19,916                           | 24,045                  |
| <b>TOTAL ASSETS</b>  | <b>\$ 4,117,175</b>              | <b>\$ 4,170,848</b>     |
| <b>LIABILITIES</b>   |                                  |                         |
| Deposits:  |                                  |                         |
| Noninterest-bearing  | \$ 586,973                       | \$ 583,696              |
| Interest-bearing   | 2,565,363                        | 2,685,184               |
| <b>Total Deposits</b>  | <b>3,152,336</b>                 | <b>3,268,880</b>        |
| Borrowings:  |                                  |                         |
| Securities sold under repurchase agreements                      | 115,684                          | 109,871                 |
| Federal Home Loan Bank advances                                  | 104,697                          | 82,684                  |
| Subordinated debentures, revolving credit lines and term loans   | 226,400                          | 226,440                 |
| <b>Total Borrowings</b>  | <b>446,781</b>                   | <b>418,995</b>          |
| Interest payable   | 3,117                            | 4,262                   |
| Other liabilities  | 52,419                           | 24,303                  |
| <b>Total Liabilities</b>   | <b>3,654,653</b>                 | <b>3,716,440</b>        |
| <b>COMMITMENTS AND CONTINGENT LIABILITIES</b>                    |                                  |                         |
| <b>STOCKHOLDERS' EQUITY</b>                                      |                                  |                         |
| Preferred Stock, no-par value:                                   |                                  |                         |
| Authorized -- 500,000 shares                                     |                                  |                         |
| Series A, Issued and outstanding - 69,600 shares                 | 67,998                           | 67,880                  |

|   |                     |                     |
|---|---------------------|---------------------|
| Cumulative Preferred Stock, \$1,000 par value, \$1,000 liquidation value: |                     |                     |
| Authorized -- 600 shares  |                     |                     |
| Issued and outstanding -- 125 shares                                      | 125                 | 125                 |
| Common Stock, \$.125 stated value:  |                     |                     |
| Authorized -- 50,000,000 shares   |                     |                     |
| Issued and outstanding - 25,650,057 and 25,574,251 shares                 | 3,206               | 3,197               |
| Additional paid-in capital  | 233,032             | 232,503             |
| Retained earnings   | 165,075             | 160,860             |
| Accumulated other comprehensive loss                                      | (6,914)             | (10,157)            |
| Total Stockholders' Equity  | 462,522             | 454,408             |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>                         | <b>\$ 4,117,175</b> | <b>\$ 4,170,848</b> |

See notes to consolidated condensed financial statements.

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

|   | Three Months Ended<br>March 31, |               |
|---|---------------------------------|---------------|
|   | 2011                            | 2010          |
| <b>INTEREST INCOME</b>  |                                 |               |
| Loans receivable:   |                                 |               |
| Taxable   | \$ 38,738                       | \$ 45,448     |
| Tax exempt  | 102                             | 277           |
| Investment securities:  |                                 |               |
| Taxable   | 4,547                           | 2,891         |
| Tax exempt  | 2,553                           | 2,646         |
| Federal funds sold  | 2                               | 17            |
| Deposits with financial institutions                                  | 83                              | 60            |
| Federal Reserve and Federal Home Loan Bank stock                      | 341                             | 360           |
| Total Interest Income   | 46,366                          | 51,699        |
| <b>INTEREST EXPENSE</b>   |                                 |               |
| Deposits  | 6,866                           | 11,495        |
| Federal funds purchased   | 3                               |               |
| Securities sold under repurchase agreements                           | 378                             | 499           |
| Federal Home Loan Bank advances                                       | 1,001                           | 1,564         |
| Subordinated debentures, revolving credit lines and term loans        | 2,641                           | 1,926         |
| Total Interest Expense  | 10,889                          | 15,484        |
| <b>NET INTEREST INCOME</b>  | <b>35,477</b>                   | <b>36,215</b> |
| Provision for loan losses   | 5,594                           | 13,869        |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>            | <b>29,883</b>                   | <b>22,346</b> |
| <b>OTHER INCOME</b>   |                                 |               |
| Service charges on deposit accounts                                   | 2,779                           | 3,262         |
| Fiduciary activities  | 2,036                           | 2,060         |
| Other customer fees   | 2,235                           | 2,498         |
| Commission income   | 1,888                           | 1,989         |
| Earnings on cash surrender value of life insurance                    | 578                             | 508           |
| Net gains and fees on sales of loans                                  | 1,873                           | 1,149         |
| Net realized gains on sales of available for sale securities          | 463                             | 1,842         |
| Other-than-temporary impairment on available for sale securities      | (5,687)                         | (1,179)       |
| Portion of loss recognized in other comprehensive income before taxes | 5,287                           | 691           |
| Net impairment losses recognized in earnings                          | (400)                           | (488)         |
| Other income  | 406                             | 144           |
| Total Other Income  | 11,858                          | 12,964        |
| <b>OTHER EXPENSES</b>   |                                 |               |
| Salaries and employee benefits  | 17,176                          | 17,562        |
| Net occupancy   | 2,745                           | 2,851         |
| Equipment   | 1,783                           | 1,853         |
| Marketing   | 382                             | 429           |

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|   |          |         |
|---|----------|---------|
| Outside data processing fees                        | 1,445    | 1,280   |
| Printing and office supplies                        | 288      | 318     |
| Core deposit amortization                           | 1,101    | 1,207   |
| FDIC assessments                                    | 2,104    | 1,722   |
| Other real estate owned and credit-related expenses | 3,195    | 2,685   |
| Other expenses                                      | 3,662    | 4,733   |
| Total Other Expenses                                | 33,881   | 34,640  |
| INCOME BEFORE INCOME TAX                            | 7,860    | 670     |
| Income tax expense (benefit)                        | 2,399    | (916)   |
| NET INCOME  | 5,461    | 1,586   |
| Preferred stock dividends and discount accretion    | (988)    | (1,450) |
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS         | \$ 4,473 | \$ 136  |

Per Share Data:

|   |         |         |
|---|---------|---------|
| Basic Net Income Available to Common Stockholders   | \$ 0.17 | \$ 0.01 |
| Diluted Net Income Available to Common Stockholders | \$ 0.17 | \$ 0.01 |
| Cash Dividends Paid                                 | \$ 0.01 | \$ 0.01 |
| Average Diluted Shares Outstanding (in thousands)   | 25,763  | 21,462  |

See notes to consolidated condensed financial statements.

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

|   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2011                            | 2010     |
| Net income  | \$ 5,461                        | \$ 1,586 |
| Other comprehensive income net of tax:  |                                 |          |
| Unrealized holding gain on securities available for sale arising during the period, net of income tax of \$(2,570) and \$(994)  | 4,773                           | 1,846    |
| Unrealized loss on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in income, net of tax of \$840 and \$243 | (1,560)                         | (452)    |
| Unrealized gains on cash flow hedges:   |                                 |          |
| Unrealized gains arising during the period, net of income tax of \$(51) and \$0   | 87                              |          |
| Amortization of items previously recorded in accumulated other comprehensive income/(losses), net of income tax of \$10 and \$(15)                                      | (17)                            | 23       |
| Reclassification adjustment for gains included in net income net of income tax expense of \$22 and \$474  | (40)                            | (880)    |
|   | 3,243                           | 537      |
| Comprehensive income  | \$ 8,704                        | \$ 2,123 |

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

|  | March 31,<br>2011 | March 31,<br>2010 |
|--|-------------------|-------------------|
| Net unrealized gain on securities available for sale   | \$ 6,499          | \$ 5,140          |
| Net unrealized loss on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in income | (1,560)           | (452)             |
| Net unrealized gain on cash flow hedges  | 375               |                   |
| Defined benefit plans  | (12,228)          | (12,977)          |
|  | \$ (6,914)        | \$ (8,289)        |

See notes to consolidated condensed financial statements.





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

|  | Preferred |           | Common Stock |          |                                  | Accumulated<br>Other<br>Comprehensive |                  | Total      |
|--|-----------|-----------|--------------|----------|----------------------------------|---------------------------------------|------------------|------------|
|  | Shares    | Amount    | Shares       | Amount   | Additional<br>Paid in<br>Capital | Retained<br>Earnings                  | Income<br>(Loss) |            |
| Balances,<br>December 31, 2010   | 69,725    | \$ 68,005 | 25,574,251   | \$ 3,197 | \$ 232,503                       | \$ 160,860                            | \$ (10,157)      | \$ 454,408 |
| Comprehensive<br>Income  |           |           |              |          |                                  |                                       |                  |            |
| Net Income   |           |           |              |          |                                  | 5,461                                 |                  | 5,461      |
| Other<br>Comprehensive<br>Income, net of tax                                 |           |           |              |          |                                  |                                       | 3,243            | 3,243      |
| Cash Dividends on<br>Common Stock<br>(\$0.01 per Share)                      |           |           |              |          |                                  | (258)                                 |                  | (258)      |
| Cash Dividends on<br>Preferred Stock<br>under Capital<br>Purchase Program    |           |           |              |          |                                  | (870)                                 |                  | (870)      |
| Accretion of<br>Discount on<br>Preferred Stock                               |           | 118       |              |          |                                  | (118)                                 |                  |            |
| Share-based<br>Compensation  |           |           | 50,220       | 6        | 362                              |                                       |                  | 368        |
| Stock Issued Under<br>Employee Benefit<br>Plans                              |           |           | 37,244       | 5        | 269                              |                                       |                  | 274        |
| Stock Issued Under<br>Dividend<br>Reinvestment and<br>Stock Purchase<br>Plan |           |           | 2,186        |          | 18                               |                                       |                  | 18         |
| Stock Redeemed   |           |           | (13,844)     | (2)      | (120)                            |                                       |                  | (122)      |
| Balances, March<br>31, 2011  | 69,725    | \$ 68,123 | 25,650,057   | \$ 3,206 | 233,032                          | \$ 165,075                            | (6,914)          | \$ 462,522 |

See notes to consolidated condensed financial statements.



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

|  | March 31,   |             |
|--|-------------|-------------|
|  | 2011        | 2010        |
| <b>Cash Flow From Operating Activities:</b>  |             |             |
| Net income   | \$ 5,461    | \$ 1,586    |
| <b>Adjustments to reconcile net income to net cash provided by operating activities:</b> |             |             |
| Provision for loan losses  | 5,594       | 13,869      |
| Depreciation and amortization  | 1,316       | 1,447       |
| Share-based compensation   | 368         | 485         |
| Tax expense (benefit) from stock compensation  |             | 48          |
| Mortgage loans originated for sale   | (66,489)    | (37,492)    |
| Proceeds from sales of mortgage loans  | 85,847      | 41,882      |
| Gains on sales of securities available for sale  | (463)       | (1,842)     |
| Recognized loss on other-than-temporary-impairment                                       | 400         | 488         |
| Change in interest receivable  | 1,091       | 1,286       |
| Change in interest payable   | (1,145)     | (899)       |
| Other adjustments  | 12,858      | 10,002      |
| Net cash provided by operating activities  | \$ 44,838   | \$ 30,860   |
| <b>Cash Flows from Investing Activities:</b>   |             |             |
| Net change in interest-bearing deposits  | \$ 3,373    | \$ (83,710) |
| <b>Purchases of:</b>   |             |             |
| Securities available for sale  | (54,983)    | (95,265)    |
| Securities held to maturity  | (2,451)     | (17,120)    |
| Proceeds from sales of securities available for sale                                     | 10,536      | 42,743      |
| <b>Proceeds from maturities of:</b>  |             |             |
| Securities available for sale  | 12,729      | 20,757      |
| Securities held to maturity  | 7,772       | 2,825       |
| Proceeds from redemptions of Federal Reserve and Federal Home Loan Bank stock            | 83          | 1,855       |
| Purchase of bank owned life insurance  | (5,000)     |             |
| Net change in loans  | 59,345      | 107,709     |
| Proceeds from the sale of other real estate owned  | 6,182       | 5,543       |
| Other adjustments  | (684)       | (74)        |
| Net cash provided by (used in) investing activities                                      | \$ 36,902   | \$ (14,737) |
| <b>Cash Flows from Financing Activities:</b>   |             |             |
| <b>Net change in :</b>   |             |             |
| Demand and savings deposits  | \$ (43,550) | \$ (41,836) |
| Certificates of deposit and other time deposits  | (72,994)    | (96,914)    |
| Borrowings   | 30,817      | 4           |
| Repayment of borrowings  | (2,987)     | (19,349)    |
| Cash dividends on common stock   | (258)       | (215)       |
| Cash dividends on preferred stock  | (870)       | (1,450)     |
| Stock issued in private equity placement   |             | 24,150      |
| Stock issued under dividend reinvestment and stock purchase plans                        | 292         | 180         |

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|   |             |              |
|---|-------------|--------------|
| Tax (expense) benefit from stock options exercised        |             | (48)         |
| Stock redeemed  | (122)       | (69)         |
| Net cash used in financing activities                     | \$ (89,672) | \$ (135,547) |
| Net Change in Cash and Cash Equivalents                   | (7,932)     | (119,424)    |
| Cash and Cash Equivalents, January 1                      | 58,307      | 179,147      |
| Cash and Cash Equivalents, March 31                       | \$ 50,375   | \$ 59,723    |
| Additional cash flow information:                         |             |              |
| Interest paid   | \$ 12,042   | \$ 16,383    |
| Income tax refunded                                       | \$ (3,486)  | \$ (6,054)   |
| Loans transferred to other real estate owned              | \$ 4,575    | \$ 10,107    |
| Non-cash investing activities using trade date accounting | \$ 28,829   | \$ 28,308    |

See notes to consolidated condensed financial statements.

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

## NOTE 1. General

## Financial Statement Preparation

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

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

## NOTE 2. Investment Securities

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

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------|
| Available for sale at March 31, 2011        |                   |                              |                               |            |
| U.S. Government-sponsored agency securities | \$ 99             | \$ 12                        |                               | \$ 111     |
| State and municipal                         | 229,337           | 10,642                       | \$ 158                        | 239,821    |
| Mortgage-backed securities                  | 329,725           | 4,540                        | 2,085                         | 332,180    |
| Corporate obligations                       | 5,521             |                              | 5,352                         | 169        |
| Equity securities                           | 3,265             |                              |                               | 3,265      |
| Total available for sale                    | 567,947           | 15,194                       | 7,595                         | 575,546    |
| Held to maturity at March 31, 2011          |                   |                              |                               |            |
| State and municipal                         | 12,260            | 601                          | 2                             | 12,859     |
| Mortgage-backed securities                  | 298,223           | 2,901                        | 2,996                         | 298,128    |
| Total held to maturity                      | 310,483           | 3,502                        | 2,998                         | 310,987    |
| Total Investment Securities                 | \$ 878,430        | \$ 18,696                    | \$ 10,593                     | \$ 886,533 |

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
|--|-------------------|------------------------------|-------------------------------|------------|
|--|-------------------|------------------------------|-------------------------------|------------|

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| Available for sale at December 31, 2010     |    |         |    |        |    |        |         |         |
|---|----|---------|----|--------|----|--------|---------|---------|
| U.S. Government-sponsored agency securities | \$ | 600     | \$ | 16     | \$ | 616    |         |         |
| State and municipal                         |    | 233,622 |    | 7,108  | \$ | 740    | 239,990 |         |
| Mortgage-backed securities                  |    | 293,311 |    | 4,293  |    | 2,287  | 295,317 |         |
| Corporate obligations                       |    | 5,856   |    |        |    | 5,674  | 182     |         |
| Equity securities                           |    | 3,265   |    |        |    |        | 3,265   |         |
| Total available for sale                    |    | 536,654 |    | 11,417 |    | 8,701  | 539,370 |         |
| Held to maturity at December 31, 2010       |    |         |    |        |    |        |         |         |
| State and municipal                         |    | 10,070  |    | 389    |    | 5      | 10,454  |         |
| Mortgage-backed securities                  |    | 277,357 |    | 2,064  |    | 3,605  | 275,816 |         |
| Total held to maturity                      |    | 287,427 |    | 2,453  |    | 3,610  | 286,270 |         |
| Total Investment Securities                 | \$ | 824,081 | \$ | 13,870 | \$ | 12,311 | \$      | 825,640 |

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Investment Securities continued

The amortized cost and fair value of available for sale securities and held to maturity securities at March 31, 2011, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

|   | Available for Sale |                   | Held to Maturity  |                   |
|---|--------------------|-------------------|-------------------|-------------------|
|   | Amortized Cost     | Fair Value        | Amortized Cost    | Fair Value        |
| <b>Maturity Distribution at March 31, 2011:</b> |                    |                   |                   |                   |
| Due in one year or less                         | \$ 4,868           | \$ 4,904          | \$ 3,704          | \$ 3,731          |
| Due after one through five years                | 16,261             | 16,904            | 1,075             | 1,114             |
| Due after five through ten years                | 49,409             | 52,515            | 4,836             | 5,113             |
| Due after ten years                             | 164,420            | 165,779           | 2,645             | 2,901             |
|   | \$ 234,958         | \$ 240,102        | \$ 12,260         | \$ 12,859         |
| Mortgage-backed securities                      | 329,724            | 332,179           | 298,223           | 298,128           |
| Equity securities                               | 3,265              | 3,265             |                   |                   |
| <b>Total Investment Securities</b>              | <b>\$ 567,947</b>  | <b>\$ 575,546</b> | <b>\$ 310,483</b> | <b>\$ 310,987</b> |

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$634,492,000 at March 31, 2011, and \$271,091,000 at December 31, 2010.

The book value of securities sold under agreements to repurchase amounted to \$91,346,000 at March 31, 2011, and \$84,965,000 at December 31, 2010.

For the three months ended March 31, 2011 and 2010 gross gains of \$463,000 and \$1,842,000 were realized from sales and redemptions of available for sale securities. There were no gross losses resulting from sales and redemptions of available for sale securities realized for the three months ended March 31, 2011 and 2010. The Corporation has recognized an other-than-temporary impairment (“OTTI”) loss of \$400,000 and \$488,000 in the three months ended March 31, 2011 and 2010, equal to the credit loss, establishing a new, lower amortized cost basis.

Certain investments in debt and equity securities are reported in the financial statements at an amount less than their historical cost. The historical cost of these investments totaled \$279,691,000 and \$273,853,000 at March 31, 2011, and December 31, 2010, respectively. Total fair value of these investments at March 31, 2011, and December 31, 2010, was \$269,098,000 and \$261,542,000, which is approximately 30.4 percent and 31.6 percent of the Corporation’s available for sale and held to maturity investment portfolio at March 31, 2011, and December 31, 2010.

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





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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Investment Securities continued

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

|   | Less than 12 Months |                   | 12 Months or Longer |                   | Total             |                    |
|---|---------------------|-------------------|---------------------|-------------------|-------------------|--------------------|
|   | Gross               |                   | Gross               |                   | Gross             |                    |
|   | Unrealized          | Unrealized        | Unrealized          | Unrealized        | Unrealized        | Unrealized         |
|   | Fair Value          | Losses            | Fair Value          | Losses            | Fair Value        | Losses             |
| <b>Temporarily Impaired Investment</b>                  |                     |                   |                     |                   |                   |                    |
| Securities at March 31, 2011                            |                     |                   |                     |                   |                   |                    |
| State and municipal                                     | \$ 17,070           | \$ (160)          |                     |                   | \$ 17,070         | \$ (160)           |
| Mortgage-backed securities                              | 251,890             | (5,081)           |                     |                   | 251,890           | (5,081)            |
| Corporate obligations                                   |                     |                   | \$ 138              | \$ (5,352)        | 138               | (5,352)            |
| <b>Total Temporarily Impaired Investment Securities</b> | <b>\$ 268,960</b>   | <b>\$ (5,241)</b> | <b>\$ 138</b>       | <b>\$ (5,352)</b> | <b>\$ 269,098</b> | <b>\$ (10,593)</b> |

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

**Mortgage-backed Securities**

The unrealized losses of \$5.1 million on the Corporation's investment in mortgage-backed securities were a result of changes in interest rates. The Corporation expects to recover the amortized cost basis over the term of the securities as the decline in market value is attributable to changes in interest rates and not credit quality. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at March 31, 2011.

**State and Political Subdivisions**

The unrealized losses of \$160,000 on the Corporation's investments in securities of state and political subdivisions were caused by changes in interest rates. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the investment securities to be other-than-temporarily impaired at March 31, 2011.

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## NOTE 2. Investment Securities continued

## Corporate Obligations

The Corporation's unrealized losses on pooled trust preferred securities total \$5.4 million on a book value of \$5.5 million at March 31, 2011. The decline in value is attributable to temporary illiquidity and the financial crisis affecting these markets coupled with the potential credit loss resulting from the adverse change in expected cash flows. Due to the illiquidity in the market, it is unlikely that the Corporation would be able to recover its investment in these securities if the Corporation sold the securities at this time. Management has analyzed the cash flow characteristics of the securities and this analysis included utilizing the most recent trustee reports and any other relevant market information including announcements of deferrals or defaults of trust preferred securities. The Corporation has recognized an OTTI loss of \$400,000 in the first quarter of 2011, equal to the credit loss, establishing a new, lower amortized cost basis. The credit loss was calculated by comparing expected discounted cash flows based on performance indicators of the underlying assets in the security to the carrying value of the investment. The Corporation does not intend to sell the investment and it is not more likely than not that the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity. The Corporation does not consider the remainder of the investment securities, which are classified as Level 3 inputs in the fair value hierarchy, to be other-than-temporarily impaired at March 31, 2011.

## Credit Losses Recognized on Investments

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

|  | Accumulated<br>Credit<br>Losses in<br>2011 | Accumulated<br>Credit<br>Losses in<br>2010 |
|--|--|--|
| Credit losses on debt securities held:                                     |  |  |
| Balance, January 1   | \$ 10,955                                  | \$ 9,411                                   |
| Additions related to other-than-temporary losses not previously recognized | 400  | 488  |
| Balance, March 31  | \$ 11,355                                  | \$ 9,899                                   |

## NOTE 3. Loans and Allowance

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

|        | March 31,<br>2011 | December<br>31,<br>2010 |
|--------|-------------------|-------------------------|
| Loans: |                   |                         |

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|  |              |              |
|--|--------------|--------------|
| Commercial and industrial loans                                  | \$ 529,110   | \$ 530,322   |
| Agricultural production financing and other loans to farmers     | 89,032       | 95,516       |
| Real estate loans:   |              |              |
| Construction   | 103,956      | 106,615      |
| Commercial and farm land   | 1,199,078    | 1,229,037    |
| Residential  | 699,773      | 724,020      |
| Individual's loans for household and other personal expenditures | 104,701      | 115,295      |
| Lease financing receivables, net of unearned income              | 4,706        | 5,157        |
| Other loans  | 33,772       | 29,721       |
|  | 2,764,128    | 2,835,683    |
| Allowance for loan losses  | (80,936)     | (82,977)     |
| Total Loans  | \$ 2,683,192 | \$ 2,752,706 |

Residential Real Estate Loans Held for Sale at March 31, 2011 and December 31, 2010 were \$2,111,000 and \$21,469,000, respectively.

FIRST MERCHANTS CORPORATION  
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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
(Table dollars in thousands)  
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## NOTE 3. Loans and Allowance continued

The following tables summarize changes in the allowance for loan losses by loan segment for the periods indicated:

|                            | Three Months Ended March 31, 2011 |                           |          |             |                   |  | Total     |
|----------------------------|-----------------------------------|---------------------------|----------|-------------|-------------------|--|-----------|
|                            | Commercial                        | Real Estate<br>Commercial | Consumer | Residential | Finance<br>Leases |  |           |
| Allowance for loan losses: |                                   |                           |          |             |                   |  |           |
| Balances, January 1        | \$ 32,508                         | \$ 36,341                 | \$ 3,622 | \$ 10,408   | \$ 98             |  | \$ 82,977 |
| Provision for losses       | (1,881)                           | 6,926                     | (215)    | 842         | (78)              |  | 5,594     |
| Recoveries on loans        | 646                               | 321                       | 286      | 472         | 1                 |  | 1,726     |
| Loans charged off          | (1,067)                           | (6,348)                   | (595)    | (1,351)     |                   |  | (9,361)   |
| Balances, March 31, 2011   | \$ 30,206                         | \$ 37,240                 | \$ 3,098 | \$ 10,371   | \$ 21             |  | \$ 80,936 |

|                            | Three Months Ended March 31, 2010 |                           |          |             |                   |  | Total     |
|----------------------------|-----------------------------------|---------------------------|----------|-------------|-------------------|--|-----------|
|                            | Commercial                        | Real Estate<br>Commercial | Consumer | Residential | Finance<br>Leases |  |           |
| Allowance for loan losses: |                                   |                           |          |             |                   |  |           |
| Balances, January 1        | \$ 48,771                         | \$ 30,188                 | \$ 2,242 | \$ 10,751   | \$ 179            |  | \$ 92,131 |
| Provision for losses       | (618)                             | 12,787                    | 245      | 1,422       | 33                |  | 13,869    |
| Recoveries on loans        | 263                               | 114                       | 215      | 240         |                   |  | 832       |
| Loans charged off          | (13,199)                          | (3,113)                   | (596)    | (1,302)     | (54)              |  | (18,264)  |
| Balances, March 31, 2010   | \$ 35,217                         | \$ 39,976                 | \$ 2,106 | \$ 11,111   | \$ 158            |  | \$ 88,568 |

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

|   | March 31, 2011 |                           |          |             |                   |  | Total      |
|---|----------------|---------------------------|----------|-------------|-------------------|--|------------|
|   | Commercial     | Commercial<br>Real Estate | Consumer | Residential | Finance<br>Leases |  |            |
| Allowance Balances:                           |                |                           |          |             |                   |  |            |
| Individually evaluated for impairment         | \$ 8,187       | \$ 7,155                  | \$       | \$ 507      | \$                |  | \$ 15,849  |
| Collectively evaluated for impairment         | 22,019         | 30,085                    | 3,098    | 9,864       | 21                |  | 65,087     |
| Total Allowance for Loan Losses               | \$ 30,206      | \$ 37,240                 | \$ 3,098 | \$ 10,371   | \$ 21             |  | \$ 80,936  |
| Loan Balances (includes loans held for sale): |                |                           |          |             |                   |  |            |
| Individually evaluated for impairment         | \$ 27,317      | \$ 71,047                 | \$       | \$ 8,515    | \$                |  | \$ 106,879 |

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|                                       |                   |                     |                   |                   |                 |                     |
|---------------------------------------|-------------------|---------------------|-------------------|-------------------|-----------------|---------------------|
| Collectively evaluated for impairment | 624,597           | 1,231,987           | 104,701           | 691,258           | 4,706           | 2,657,249           |
| <b>Total Loans</b>                    | <b>\$ 651,914</b> | <b>\$ 1,303,034</b> | <b>\$ 104,701</b> | <b>\$ 699,773</b> | <b>\$ 4,706</b> | <b>\$ 2,764,128</b> |

|  | December 31, 2010 |                        |                   |                   |                 |                     |
|--|-------------------|------------------------|-------------------|-------------------|-----------------|---------------------|
|  | Commercial        | Commercial Real Estate | Consumer          | Residential       | Finance Leases  | Total               |
| <b>Allowance Balances:</b>                           |                   |                        |                   |                   |                 |                     |
| Individually evaluated for impairment                | \$ 5,726          | \$ 7,545               | \$                | \$ 643            | \$              | \$ 13,914           |
| Collectively evaluated for impairment                | 26,782            | 28,796                 | 3,622             | 9,765             | 98              | 69,063              |
| <b>Total Allowance for Loan Losses</b>               | <b>\$ 32,508</b>  | <b>\$ 36,341</b>       | <b>\$ 3,622</b>   | <b>\$ 10,408</b>  | <b>\$ 98</b>    | <b>\$ 82,977</b>    |
| <b>Loan Balances (includes loans held for sale):</b> |                   |                        |                   |                   |                 |                     |
| Individually evaluated for impairment                | \$ 28,965         | \$ 77,705              | \$                | \$ 9,534          | \$              | \$ 116,204          |
| Collectively evaluated for impairment                | 626,594           | 1,257,947              | 115,295           | 714,486           | 5,157           | 2,719,479           |
| <b>Total Loans</b>                                   | <b>\$ 655,559</b> | <b>\$ 1,335,652</b>    | <b>\$ 115,295</b> | <b>\$ 724,020</b> | <b>\$ 5,157</b> | <b>\$ 2,835,683</b> |

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

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

|  | March 31,<br>2011 | December<br>31,<br>2010 |
|--|-------------------|-------------------------|
| <b>Non-Performing Assets:</b>            |                   |                         |
| Non-accrual loans                        | \$ 87,712         | \$ 90,591               |
| Renegotiated loans                       | 2,125             | 7,139                   |
| Non-performing loans (NPL)               | 89,837            | 97,730                  |
| Real estate owned and repossessed assets | 17,056            | 20,927                  |
| Non-performing assets (NPA)              | 106,893           | 118,657                 |
| 90+ days delinquent and still accruing   | 752               | 1,330                   |
| NPAs & 90+ days delinquent               | \$ 107,645        | \$ 119,987              |

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

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

|   | March 31,<br>2011 | December<br>31,<br>2010 |
|---|-------------------|-------------------------|
| Commercial and Industrial                                       | \$ 8,742          | \$ 9,812                |
| Agriculture production financing and other loans                | 943               | 544                     |
| <b>Real Estate Loans:</b>                                       |                   |                         |
| Construction  | 15,343            | 17,164                  |
| Commercial and farm land  | 43,849            | 45,308                  |
| Residential   | 16,246            | 15,115                  |
| Home Equity   | 2,552             | 2,648                   |
| Individuals loans for household and other personal expenditures | 37                |                         |
| Total   | \$ 87,712         | \$ 90,591               |

Impaired loans include all non-accrual loans and renegotiated loans as well as substandard, doubtful and loss grade loans that were still accruing but deemed impaired according to guidance set forth in ASC 310. Also included in impaired loans are accruing loans that are contractually past due 90 days or more. A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the



contractual terms of the loan agreement will not be collected.

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

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NOTE 3. Loans and Allowance continued

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

|   | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | March 31, 2011<br>Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized <sup>1</sup> | Related<br>Allowance |
|---|--------------------------------|------------------------|---|---|----------------------|
| Impaired loans with no related allowance recorded:          |                                |                        |   |   |                      |
| Commercial and industrial                                   | \$ 26,490                      | \$ 12,237              | \$ 13,450   | \$ 43   |                      |
| Agriculture production financing and other loans to farmers | 767                            | 319                    | 424   |   |                      |
| Real Estate Loans:  |                                |                        |   |   |                      |
| Construction  | 15,390                         | 10,421                 | 11,706  | 11  |                      |
| Commercial and farm land                                    | 65,106                         | 43,166                 | 45,266  | 206   |                      |
| Residential   | 9,981                          | 7,115                  | 7,395   | 22  |                      |
| Home equity   | 4,882                          | 1,706                  | 1,811   | 7   |                      |
| Other loans   | 98                             | 13                     | 13  |   |                      |
| Total   | \$ 122,714                     | \$ 74,977              | \$ 80,065   | \$ 289  |                      |
| Impaired loans with an allowance recorded:                  |                                |                        |   |   |                      |
| Commercial and industrial                                   | \$ 16,133                      | \$ 16,035              | \$ 15,709   | \$ 162  | \$ 7,576             |
| Agriculture production financing and other loans to farmers |                                |                        |   |   |                      |
| Real Estate Loans:  |                                |                        |   |   |                      |
| Construction  | 6,290                          | 4,761                  | 4,767   |   | 1,197                |
| Commercial and farm land                                    | 19,218                         | 18,351                 | 18,413  | 80  | 5,958                |
| Residential   | 2,137                          | 2,056                  | 2,076   |   | 489                  |
| Home equity   | 88                             | 30                     | 30  |   | 18                   |
| Other loans   | 616                            | 611                    | 611   | 1   | 611                  |
| Total   | \$ 44,482                      | \$ 41,844              | \$ 41,606   | \$ 243  | \$ 15,849            |
| Total Impaired Loans  | \$ 167,196                     | \$ 116,821             | \$ 121,671  | \$ 532  | \$ 15,849            |

<sup>1</sup> Cash basis interest income recognized as of March 31, 2011 was \$500,000.

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## NOTE 3. Loans and Allowance continued

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

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

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
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NOTE 3. Loans and Allowance continued

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

- Pass – Loans that are considered to be of acceptable credit quality.
- Special Mention – Loans which possess some credit deficiency or potential weakness, which deserves close attention. A special mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Corporation’s credit position at some future date. Special mention assets are not adversely classified and do not expose the Corporation to sufficient risk to warrant adverse classification. Such loans pose an unwarranted financial risk that, if not corrected, could weaken the loan adversely impacting the future repayment ability of the borrower. The key distinctions of this category’s classification are that it is indicative of an unwarranted level of risk; and weaknesses are considered “potential”, not “defined”, impairments to the primary source of repayment. Examples include businesses that may be suffering from inadequate management, loss of key personnel or significant customer or litigation.
- Substandard – A substandard loan is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness that jeopardizes the liquidation of the debt. They are characterized by the distinct possibility that the Corporation will sustain some loss if the deficiencies are not corrected. Other characteristics may include:
  - o the likelihood that a loan will be paid from the primary source of repayment is uncertain or financial deterioration is underway and very close attention is warranted to ensure that the loan is collected without loss,
  - o the primary source of repayment is gone, and the Corporation is forced to rely on a secondary source of repayment, such as collateral liquidation or guarantees,
    - o loans have a distinct possibility that the Corporation will sustain some loss if deficiencies are not corrected,
    - o unusual courses of action are needed to maintain a high probability of repayment,
  - o the borrower is not generating enough cash flow to repay loan principal; however, it continues to make interest payments,
    - o the Corporation is forced into a subordinated or unsecured position due to flaws in documentation,
  - o loans have been restructured so that payment schedules, terms and collateral represent concessions to the borrower when compared to the normal loan terms,
  - o the Corporation is seriously contemplating foreclosure or legal action due to the apparent deterioration of the loan, and
    - o there is significant deterioration in market conditions to which the borrower is highly vulnerable.
- Doubtful – Loans that have all of the weaknesses of those classified as Substandard. However, based on currently existing facts, conditions and values, these weaknesses make full collection of principal highly questionable and improbable. Other credit characteristics may include the primary source of repayment is gone or there is considerable doubt as to the quality of the secondary sources of repayment. The possibility of loss is high, but because of certain important pending factors that may strengthen the loan, loss classification is deferred until the exact status of repayment is known.
  - Loss – Loans that are considered uncollectible and of such little value that continuing to carry them as an asset is not warranted. Loans will be classified as Loss when it is neither practical not desirable to defer

writing off or reserving all or a portion of a basically worthless asset, even though partial recovery may be possible at some time in the future.

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(Table dollars in thousands)

(Unaudited)

NOTE 3. Loans and Allowance continued

The following table summarizes the credit quality of the Corporation's loan portfolio, by loan class for the periods indicated. Consumer Non-Performing loans include accruing consumer loans 90 plus days delinquent and consumer non-accrual loans.

|   | March 31, 2011     |                                  |                           |                        |                    |                        |                            | Total Loans  |
|---|--------------------|----------------------------------|---------------------------|------------------------|--------------------|------------------------|----------------------------|--------------|
|   | Commercial<br>Pass | Commercial<br>Special<br>Mention | Commercial<br>Substandard | Commercial<br>Doubtful | Commercial<br>Loss | Consumer<br>Performing | Consumer<br>Non-Performing |              |
| Commercial and industrial                                       | \$ 457,661         | \$ 18,473                        | \$ 51,162                 | \$ 1,794               | \$ 20              |                        |                            | \$ 529,110   |
| Agriculture production financing and other loans                | 86,276             | 1,930                            | 826                       |                        |                    |                        |                            | 89,032       |
| Real Estate Loans:  |                    |                                  |                           |                        |                    |                        |                            |              |
| Construction  | 61,506             | 13,380                           | 22,717                    | 6,192                  |                    |                        | \$ 161                     | 103,956      |
| Commercial and farm land  | 1,011,903          | 43,872                           | 137,425                   | 5,878                  |                    |                        |                            | 1,199,078    |
| Residential   | 137,360            | 10,845                           | 18,640                    | 709                    |                    | \$ 329,163             | 7,820                      | 504,537      |
| Home equity   | 16,864             | 25                               | 3,060                     | 30                     | 59                 | 173,842                | 1,355                      | 195,235      |
| Individuals loans for household and other personal expenditures |                    |                                  |                           |                        |                    | 104,633                | 69                         | 104,702      |
| Lease financing receivables, net of unearned income             | 220                |                                  | 9                         |                        |                    | 4,477                  |                            | 4,706        |
| Other loans   | 31,701             | 1,356                            | 104                       | 611                    |                    |                        |                            | 33,772       |
| Total   | \$ 1,803,491       | \$ 89,881                        | \$ 233,943                | \$ 15,214              | \$ 79              | \$ 612,115             | \$ 9,405                   | \$ 2,764,128 |

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

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

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
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## NOTE 3. Loans and Allowance continued

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

|   | March 31, 2011 |                           |                           |                                       |             |                                    |              |
|---|----------------|---------------------------|---------------------------|---------------------------------------|-------------|------------------------------------|--------------|
|   | Current        | 30-59<br>Days Past<br>Due | 60-89<br>Days<br>Past Due | Loans ><br>90 Days<br>And<br>Accruing | Non-Accrual | Total Past<br>Due &<br>Non-Accrual | Total Loans  |
| Commercial and industrial                                       | \$ 518,042     | \$ 2,124                  | \$ 57                     | \$ 145                                | \$ 8,742    | \$ 11,068                          | \$ 529,110   |
| Agriculture production financing and other loans                | 88,086         | 3                         |                           |                                       | 943         | 946                                | 89,032       |
| Real Estate Loans:  |                |                           |                           |                                       |             |                                    |              |
| Construction  | 84,915         | 3,658                     | 40                        |                                       | 15,343      | 19,041                             | 103,956      |
| Commercial and farm land  | 1,149,037      | 5,938                     | 13                        | 241                                   | 43,849      | 50,041                             | 1,199,078    |
| Residential   | 481,246        | 4,620                     | 2,369                     | 57                                    | 16,246      | 23,292                             | 504,538      |
| Home equity   | 190,857        | 1,161                     | 387                       | 278                                   | 2,552       | 4,378                              | 195,235      |
| Individuals loans for household and other personal expenditures | 103,301        | 1,220                     | 112                       | 31                                    | 37          | 1,400                              | 104,701      |
| Lease financing receivables, net of unearned income             | 4,706          |                           |                           |                                       |             |                                    | 4,706        |
| Other loans   | 33,772         |                           |                           |                                       |             |                                    | 33,772       |
| Total   | \$ 2,653,962   | \$ 18,724                 | \$ 2,978                  | \$ 752                                | \$ 87,712   | \$ 110,166                         | \$ 2,764,128 |

|                                      | December 31, 2010 |                           |                           |                                       |             |                                    |             |
|--------------------------------------|-------------------|---------------------------|---------------------------|---------------------------------------|-------------|------------------------------------|-------------|
|                                      | Current           | 30-59<br>Days Past<br>Due | 60-89<br>Days<br>Past Due | Loans ><br>90 Days<br>And<br>Accruing | Non-Accrual | Total Past<br>Due &<br>Non-Accrual | Total Loans |
| Commercial and industrial            | \$ 518,683        | \$ 1,477                  | \$ 211                    | \$ 139                                | \$ 9,812    | \$ 11,639                          | \$ 530,322  |
| Agriculture production financing and | 94,972            |                           |                           |                                       | 544         | 544                                | 95,516      |



|   |              |           |           |          |           |            |              |  |
|---|--------------|-----------|-----------|----------|-----------|------------|--------------|--|
| other loans   |              |           |           |          |           |            |              |  |
| Real Estate Loans:  |              |           |           |          |           |            |              |  |
| Construction  | 86,710       | 1,543     | 996       | 202      | 17,164    | 19,905     | 106,615      |  |
| Commercial and farm land  | 1,171,580    | 6,769     | 5,380     | -        | 45,308    | 57,457     | 1,229,037    |  |
| Residential   | 498,066      | 5,261     | 3,363     | 246      | 15,115    | 23,985     | 522,051      |  |
| Home equity   | 196,276      | 1,825     | 534       | 686      | 2,648     | 5,693      | 201,969      |  |
| Individuals loans for household and other personal expenditures | 112,760      | 1,989     | 489       | 57       |           | 2,535      | 115,295      |  |
| Lease financing receivables, net of unearned income             | 5,157        |           |           |          |           |            | 5,157        |  |
| Other loans   | 29,721       |           |           |          |           |            | 29,721       |  |
| Total   | \$ 2,713,925 | \$ 18,864 | \$ 10,973 | \$ 1,330 | \$ 90,591 | \$ 121,758 | \$ 2,835,683 |  |

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

#### Note 4. Goodwill

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

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

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Note 4. Goodwill continued

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

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

NOTE 5. Derivative Financial Instruments

Cash Flow Hedges of Interest Rate Risk

The Corporation's objectives in using interest rate derivatives are to add stability to interest expense and to manage its exposure to interest rate movements. To accomplish this objective, the Corporation primarily uses interest rate swaps and interest rate caps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the payment of fixed amounts to a counterparty in exchange for the Corporation receiving variable payments over the life of the agreements without exchange of the underlying notional amount. Interest rate caps designated as cash flow hedges involve the receipt of variable amounts from a counterparty if interest rates rise above the strike rate on the contract in exchange for an up front premium. As of March 31, 2011, the Corporation had one interest rate swap with a notional amount of \$13 million and one interest rate cap with a notional amount of \$13 million that were designated as cash flow hedges.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in accumulated other comprehensive income and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. During 2011, such derivatives were used to hedge the forecasted variable cash outflows (LIBOR-based) associated with existing trust preferred securities when the outflows convert from a fixed rate to variable rate in September 2012. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. During the three months ended March 31, 2011, the Corporation did not recognize any ineffectiveness.

Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are made on the Corporation's variable-rate liabilities. During the next twelve months, the Corporation does not expect to reclassify any amounts from accumulated other comprehensive income to interest expense as the current designated hedges do not become effective until September 2012.

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## NOTE 5. Derivative Financial Instruments continued

## Non-designated Hedges

The Corporation does not use derivatives for trading or speculative purposes. Derivatives not designated as hedges are not speculative and result from a service the Corporation provides to certain customers. The Corporation executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. Those interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Corporation executes with a third party, such that the Corporation minimizes its net risk exposure resulting from such transactions. As the interest rate swaps associated with this program do not meet the strict hedge accounting requirements, changes in the fair value of both the customer swaps and the offsetting swaps are recognized directly in earnings. As of March 31, 2011, the notional amount of customer-facing swaps was approximately \$75,543,000. This amount is offset with third party counterparties, as described above.

## Fair Values of Derivative Instruments on the Balance Sheet

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

|  | Asset Derivatives      |            |                        |            | Liability Derivatives  |            |                        |            |
|--|------------------------|------------|------------------------|------------|------------------------|------------|------------------------|------------|
|  | March 31, 2011         |            | December 31, 2010      |            | March 31, 2011         |            | December 31, 2010      |            |
|  | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments:     |                        |            |                        |            |                        |            |                        |            |
| Interest rate contracts                            | Other Assets           | \$ 1,527   | Other Assets           | \$ 1,393   |                        |            |                        |            |
| Derivatives not designated as hedging instruments: |                        |            |                        |            |                        |            |                        |            |
| Interest rate contracts                            | Other Assets           | \$ 3,244   | Other Assets           | \$ 3,718   | Other Liabilities      | \$ 3,379   | Other Liabilities      | \$ 3,876   |

## Effect of Derivative Instruments on the Income Statement

The tables below present the effect of the Corporation's derivative financial instruments on the Income Statement for the years ended March 31, 2011 and December 31, 2010.

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| Derivatives Not Designated as Hedging Instruments under ASC 815-10 | Location of Gain (Loss) Recognized Income on Derivative | Amount of Gain (Loss) Recognized  | Amount of Gain (Loss) Recognized  |
|--|---|-----------------------------------|-----------------------------------|
|  |   | Income on Derivative              | Income on Derivative              |
|  |   | Three Months Ended March 31, 2011 | Three Months Ended March 31, 2010 |
| Interest rate contracts  | Other income  | \$ 23                             | \$ (6)                            |

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

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NOTE 5. Derivative Financial Instruments continued

Credit-risk-related Contingent Features

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

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

As of March 31, 2011, the termination value of derivatives in a net liability position related to these agreements was \$3,434,000. As of March 31, 2011, the Corporation has minimum collateral posting thresholds with certain of its derivative counterparties and has posted collateral of \$2,800,000. If the Corporation had breached any of these provisions at March 31, 2011, it could have been required to settle its obligations under the agreements at their termination value.

Note 6. Disclosures About Fair Value of Assets and Liabilities

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

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

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

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

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



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

Investment securities

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

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

Pooled Trust Preferred Securities

Six of the pooled trust preferred securities in the portfolio amount to \$5.5 million in amortized cost, with a fair value of \$138,000; all are which are classified as Level 3 inputs in the fair value hierarchy. These securities were rated A or better at inception, but at March 31, 2011, Moody's ratings on these securities now range from Ca to C. The issuers in these securities are primarily banks, but some of the pools do include a limited number of insurance companies. On a quarterly basis, the Corporation uses an other-than-temporary impairment ("OTTI") evaluation process to compare the present value of expected cash flows to determine whether an adverse change in cash flows has occurred. The OTTI process considers the structure and term of the collateralized debt obligation ("CDO"), interest rates, principal balances of note classes and underlying issuers, the timing and amount of interest and principal payments of the underlying issuers, and the allocation of the payments to the note classes. The current estimate of expected cash flows is based on the most recent trustee reports and any other relevant market information including announcements of interest payment deferrals or defaults of underlying trust preferred securities. Assumptions used in the process include expected future default rates and prepayments as well as recovery assumptions on defaults and deferrals. In addition, the process is used to "stress" each CDO, or make assumptions more severe than expected activity, to determine the degree to which assumptions could deteriorate before the CDO could no longer fully support repayment of the Corporation's note class. Upon completion of the March 31, 2011 quarterly analysis, the conclusion was other-than-temporary impairment of \$400,000 on one of these securities. The Corporation recognized OTTI impairment for the three months ended March 31, 2010 of \$488,000.

Interest rate swap agreements



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

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

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

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

| March 31, 2011                              | Fair Value | Fair Value Measurements Using<br>Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs (Level<br>2) | Significant<br>Unobservable<br>Inputs (Level<br>3) |
|---|------------|---|---|--|
| Available for sale securities:              |            |   |   |  |
| U.S. Government-sponsored agency securities | \$ 111     |   | \$ 111  |  |
| State and municipal                         | 239,821    |   | 239,821   |  |
| Mortgage-backed securities                  | 332,180    |   | 332,180   |  |
| Corporate obligations                       | 169        |   |   | \$ 169   |
| Equity securities                           | 3,265      |   | 3,261   | 4  |
| Interest rate swap asset                    | 3,647      |   |   | 3,647  |
| Interest rate cap                           | 1,124      |   |   | 1,124  |
| Interest rate swap liability                | (3,379)    |   |   | (3,379)  |

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

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|                              |         |         |
|------------------------------|---------|---------|
| Interest rate swap asset     | 4,002   | 4,002   |
| Interest rate cap            | 1,109   | 1,109   |
| Interest rate swap liability | (3,876) | (3,876) |

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the Consolidated Condensed Balance Sheets using significant unobservable Level 3 inputs for the three months ended March 31, 2011 and 2010.

|   | Three Months Ended March 31, 2011   |                                |                      |                                    |
|---|-------------------------------------|--------------------------------|----------------------|------------------------------------|
|   | Available<br>for Sale<br>Securities | Interest<br>Rate Swap<br>Asset | Interest<br>Rate Cap | Interest<br>Rate Swap<br>Liability |
| Balance at beginning of the period              | \$ 186                              | \$ 4,002                       | \$ 1,109             | \$ (3,876)                         |
| Total realized and unrealized gains and losses: |                                     |                                |                      |                                    |
| Included in net income (loss)                   | (400)                               | (474)                          |                      | 497                                |
| Included in other comprehensive income          | 322                                 | \$ 119                         | \$ 15                |                                    |
| Purchases, issuances and settlements            |                                     |                                |                      |                                    |
| Transfers in/(out) of Level 3                   |                                     |                                |                      |                                    |
| Principal payments                              | 65                                  |                                |                      |                                    |
| Ending balance at March 31, 2011                | \$ 173                              | \$ 3,647                       | \$ 1,124             | \$ (3,379)                         |

|   | Three Months Ended March 31, 2010   |                                |                       |                                    |
|---|-------------------------------------|--------------------------------|-----------------------|------------------------------------|
|   | Available<br>for Sale<br>Securities | Interest<br>Rate Swap<br>Asset | Interest<br>Rate Swap | Interest<br>Rate Swap<br>Liability |
| Balance at beginning of the period              | \$ 2,483                            | \$ 2,624                       |                       | \$ (2,648)                         |
| Total realized and unrealized gains and losses: |                                     |                                |                       |                                    |
| Included in net income (loss)                   |                                     | (488)                          | 219                   | (225)                              |
| Included in other comprehensive income          |                                     | (669)                          |                       |                                    |
| Purchases, issuances and settlements            |                                     |                                |                       |                                    |
| Transfers in/(out) of Level 3                   |                                     |                                |                       |                                    |
| Principal payments                              |                                     | 68                             |                       |                                    |
| Ending balance at March 31, 2010                | \$ 1,394                            | \$ 2,843                       |                       | \$ (2,873)                         |

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

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

|  | Fair Value | Fair Value Measurements Using  |   |  |
|--|------------|--|---|--|
|  |            | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| March 31, 2011                                 |            |  |   |  |
| Impaired loans                                 | \$ 34,876  |  |   | \$ 34,876  |
| Other real estate owned (collateral dependent) | \$ 6,917   |  |   | \$ 6,917   |

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

## Impaired Loans (collateral dependent) and Other Real Estate Owned

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

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

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

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

|  | March 31, 2011     |              | December 31, 2010  |              |
|--|--------------------|--------------|--------------------|--------------|
|  | Carrying<br>Amount | Fair Value   | Carrying<br>Amount | Fair Value   |
| <b>Assets:</b>   |                    |              |                    |              |
| Cash and due from banks  | \$ 50,375          | \$ 50,375    | \$ 58,307          | \$ 58,307    |
| Interest-bearing time deposits                                 | 61,843             | 61,843       | 65,216             | 65,216       |
| Investment securities available for sale                       | 575,546            | 575,546      | 539,370            | 539,370      |
| Investment securities held to maturity                         | 310,483            | 310,987      | 287,427            | 286,270      |
| Mortgage loans held for sale                                   | 2,111              | 2,111        | 21,469             | 21,469       |
| Loans  | 2,683,192          | 2,649,087    | 2,752,706          | 2,715,924    |
| FRB and FHLB stock   | 33,801             | 33,801       | 33,884             | 33,884       |
| Interest Rate Swap Asset                                       | 4,771              | 4,771        | 5,111              | 5,111        |
| Interest receivable  | 17,583             | 17,583       | 18,674             | 18,674       |
| <b>Liabilities:</b>  |                    |              |                    |              |
| Deposits   | \$ 3,152,336       | \$ 3,155,720 | \$ 3,268,880       | \$ 3,280,489 |
| <b>Borrowings:</b>   |                    |              |                    |              |
| Securities sold under repurchase agreements                    | 115,684            | 116,238      | 109,871            | 110,494      |
| Federal Home Loan Bank advances                                | 104,697            | 108,711      | 82,684             | 87,463       |
| Subordinated debentures, revolving credit lines and term loans | 226,400            | 182,583      | 226,440            | 176,259      |
| Interest Rate Swap Liability                                   | 3,379              | 3,379        | 3,876              | 3,876        |
| Interest Payable   | 3,117              | 3,117        | 4,262              | 4,262        |

**Cash and Due from Banks:** The fair value of cash and cash equivalents approximates carrying value.

**Interest-Bearing Time Deposits:** The fair value of interest-bearing time deposits approximates carrying value.

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

**Mortgage Loans Held for Sale:** The fair value of mortgage loans held for sale approximates carrying value.

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

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

Interest Receivable and Interest Payable: The fair value of interest receivable/payable approximate carrying value.

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

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

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

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 7. Share-Based Compensation

Stock options and restricted stock awards ("RSAs") have been issued to directors, officers and other management employees under the Corporation's 1999 Long-term Equity Incentive Plan and the 2009 Long-term Equity Incentive Plan. The stock options, which have a ten-year life, become 100 percent vested ranging from three months to two years and are fully exercisable when vested. Option exercise prices equal the Corporation's common stock closing price on NASDAQ on the date of grant. RSAs provide for the issuance of shares of the Corporation's common stock at no cost to the holder and generally vest after three years. The RSAs vest only if the employee is actively employed by the Corporation on the vesting date and, therefore, any unvested shares are forfeited. Deferred stock units ("DSUs") have been credited to non-employee directors who have elected to defer payment of compensation under the Corporation's 2008 Equity Compensation Plan for Non-employee Directors. DSUs credited are equal to the restricted shares that the non-employee director would have received under the plan. As of March 31, 2011, there were 7,666 DSUs credited to the non-employee directors.

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

Compensation expense related to unvested share-based awards is recorded by recognizing the unamortized grant date fair value of these awards over the remaining service periods of those awards, with no change in historical reported fair values and earnings. Awards are valued at fair value in accordance with provisions of share-based compensation guidance and are recognized on a straight-line basis over the service periods of each award. To complete the exercise of vested stock options, RSA's and ESPP options, the Corporation generally issues new shares from its authorized but unissued share pool. Share-based compensation for the three months ended March 31, 2011, was \$368,000 compared to \$485,000 for the three months ended March 31, 2010. Share-based compensation has been recognized as a component of salaries and benefits expense in the accompanying Consolidated Condensed Statements of Operations.

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

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



Weighted-average  
expected life,  
until exercise

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

Share-based compensation expense recognized in the Consolidated Condensed Statements of Operations is based on awards ultimately expected to vest and is reduced for estimated forfeitures. Share-based compensation guidance requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods, if actual forfeitures differ from those estimates. Pre-vesting forfeitures were estimated to be approximately five percent for the three months ended March 31, 2011, based on historical experience.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 7. Share-Based Compensation continued

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

|   | Three Months Ended<br>March 31, |        |
|---|---------------------------------|--------|
|   | 2011                            | 2010   |
| <b>Stock and ESPP Options</b>                               |                                 |        |
| Pre-tax compensation expense                                | \$ 71                           | \$ 182 |
| Income tax benefit  | (1)                             | (17)   |
| Stock and ESPP option expense, net of income taxes          | \$ 70                           | \$ 165 |
| <b>Restricted Stock Awards</b>                              |                                 |        |
| Pre-tax compensation expense                                | \$ 297                          | \$ 303 |
| Income tax benefit  | (102)                           | (106)  |
| Restricted stock awards expense, net of income taxes        | \$ 195                          | \$ 197 |
| <b>Total Share-Based Compensation:</b>                      |                                 |        |
| Pre-tax compensation expense                                | \$ 368                          | \$ 485 |
| Income tax benefit  | (103)                           | (123)  |
| Total share-based compensation expense, net of income taxes | \$ 265                          | \$ 362 |

As of March 31, 2011, unrecognized compensation expense related to stock options and RSAs totaling \$122,000 and \$1,871,000, respectively, is expected to be recognized over weighted-average periods of 1.34 and 1.97 years, respectively.

Stock option activity under the Corporation's stock option plans as of March 31, 2011 and changes during the three months ended March 31, 2011, were as follows:

|   | Number of<br>Shares | Weighted-Average<br>Exercise Price | Weighted Average<br>Remaining<br>Contractual Term<br>(in Years) | Aggregate<br>Intrinsic<br>Value |
|---|---------------------|------------------------------------|---|---------------------------------|
| Outstanding at January 1, 2011                | 1,061,429           | \$ 23.01                           |   |                                 |
| Granted                                       | 35,800              | \$ 9.17                            |   |                                 |
| <b>Exercised</b>                              |                     |                                    |   |                                 |
| Cancelled                                     | (6,180)             | 26.13                              |   |                                 |
| Outstanding March 31, 2011                    | 1,091,049           | \$ 22.54                           | 4.79  | 82,950                          |
| Vested and Expected to Vest at March 31, 2011 | 1,091,049           | \$ 22.54                           | 4.79  | 82,950                          |
| Exercisable at March 31, 2011                 | 1,020,249           | \$ 23.58                           | 4.48  | 0                               |

The weighted-average grant date fair value was \$3.08 for stock options granted during the three months ended March 31, 2011.

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Corporation's closing stock price on the last trading day of the first three months of 2011 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their stock options on March 31, 2011. The amount of aggregate intrinsic value will change based on the fair market value of the Corporation's common stock. There were no stock options exercised during the first three months of 2011.

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(Table dollars in thousands)  
(Unaudited)

## NOTE 7. Share-Based Compensation continued

The following table summarizes information on unvested RSAs outstanding as of March 31, 2011:

|                                     | Number of<br>Shares | Weighted-Average<br>Grant Date Fair<br>Value |
|-------------------------------------|---------------------|--|
| Unvested RSAs at<br>January 1, 2011 | 272,737             | \$ 12.46                                     |
| Granted                             | 116,197             | \$ 9.06                                      |
| Forfeited                           | (1,735)             | \$ 8.11                                      |
| Vested                              | (51,615)            | \$ 27.88                                     |
| Unvested RSAs at<br>March 31, 2011  | 335,584             | \$ 8.94                                      |

The grant date fair value of ESPP options was estimated at the beginning of the January 1, 2011, quarterly offering period of approximately \$33,000. The ESPP options vested during the three months ending March 31, 2011, leaving no unrecognized compensation expense related to unvested ESPP options at March 31, 2011.

## NOTE 8. Net Income Per Share

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

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

|                                    | Three Months Ended March 31, |                                    |                     |               |                                    |                     |
|------------------------------------|------------------------------|------------------------------------|---------------------|---------------|------------------------------------|---------------------|
|                                    | Net<br>Income                | 2011<br>Weighted-Average<br>Shares | Per Share<br>Amount | Net<br>Income | 2010<br>Weighted-Average<br>Shares | Per Share<br>Amount |
| Basic net income per<br>share:     | \$ 5,461                     |                                    |                     | \$ 1,586      |                                    |                     |
| Less: Preferred stock<br>dividends | 988                          |                                    |                     | 1,450         |                                    |                     |
|                                    | 4,473                        | 25,605,571                         | \$ 0.17             | 136           | 21,373,405                         | \$ 0.01             |

|   |    |       |            |    |      |            |     |      |
|---|----|-------|------------|----|------|------------|-----|------|
| Net income available to common stockholders   |    |       |            |    |      |            |     |      |
| Effect of dilutive stock options and warrants |    |       |            |    |      |            |     |      |
|   |    |       | 157,807    |    |      | 88,770     |     |      |
| Diluted net income per share:                 |    |       |            |    |      |            |     |      |
| Net income available to common stockholders   |    |       |            |    |      |            |     |      |
|   | \$ | 4,473 | 25,763,378 | \$ | 0.17 | \$         | 136 |      |
|   |    |       |            |    |      | 21,462,175 | \$  | 0.01 |

Stock options to purchase 1,014,352 and 1,093,344 shares for the three months ended March 31, 2011 and 2010, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

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(Unaudited)

Note 9. Impact of Accounting Changes

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

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

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

FORWARD-LOOKING STATEMENTS

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

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

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

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

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

- adverse developments in our loan and investment portfolios;
- competitive factors in the banking industry, such as the trend towards consolidation in our market;

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

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

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

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

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



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

CRITICAL ACCOUNTING POLICIES

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

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

BUSINESS SUMMARY

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

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

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

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

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

REGULATORY DEVELOPMENTS

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

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

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

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

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

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported first quarter earnings of \$.17 per fully diluted common share and net income available to stockholders of \$4,473,000, compared to \$.01 per common share and net income available to stockholders of \$136,000 for the quarter ended March 31, 2010.

Net charge offs were \$7.6 million for the quarter, exceeding provision expense of \$5.6 million by \$2.0 million as certain charge offs were preceded by specific reserves. The specific reserves at March 31, 2011 were \$15.9 million compared to \$13.9 million at December 31, 2010. Non-performing assets plus 90 days delinquent loans improved to \$107.6 million or 2.6 percent of total assets at March 31, 2011 from \$120.0 million, or 2.9 percent of total assets at December 31, 2010. The Corporation's allowance for loan losses increased to 2.93 percent of total loans, an increase from 2.90 percent of loans at December 31, 2010.

Assets decreased by \$53.7 million during the first three months of 2011. Loans, including loans held for sale, decreased \$90.9 million during the first three months of 2011, or 3.2 percent, due to normal loan run-off coupled with a reduction in both consumer and commercial demand for borrowing. The combined cash and cash equivalents and interest bearing deposits declined by \$11.3 million. These declines have generated excess liquidity of \$102.2 million, of which \$59.2 million has been invested in the investment securities portfolio.

Deposits decreased \$116.5 million during the first three months of 2011, or 3.6 percent. Maturing brokered deposits and CDs over \$100,000 accounted for \$35.5 million of the decline. Another \$37.5 million were maturities of CDs below \$100,000. Demand and savings deposits, combined, decreased by \$43.6 million. Management continues to focus on maximizing deposit pricing in an effort to balance maintaining strong customer relationships, remaining competitive in the local markets while still allowing higher cost deposits to mature.

Net deferred and refundable taxes have declined by \$7.4 million in the first quarter of 2011. The decline is primarily a result of receiving \$3.5 million in net tax refunds during the quarter and utilization of \$2.9 million of deferred tax asset associated with net operating loss carryforwards.

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

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

Net Interest Income

Net interest income is the primary source of the Corporation's earnings. It is a function of net interest margin and the level of average earning assets. Net interest income and net interest margin are presented in the following table on a fully taxable equivalent basis, which adjusts tax-exempt or nontaxable interest income to an amount that would be comparable to interest subject to income taxes using the federal statutory tax rate of 35% in effect for all periods. Net interest margin increased 13 basis points from 3.82 percent in the first quarter of 2010 to 3.95 percent in the first quarter of 2011, while earning assets decreased by \$211 million. The table below presents the Corporation's asset yields, interest expense, and net interest income as a percent of average earning assets for the three months ended March 31, 2011 and 2010.

During the three months ended March 31, 2011, asset yields decreased 28 basis points on a fully taxable equivalent basis (FTE) and interest costs decreased 41 basis points, resulting in a 13 basis point (FTE) increase in net interest income as compared to the same period in 2010.

| (Dollars in thousands)   | Three Months Ended<br>March 31, |              |
|--|---------------------------------|--------------|
|  | 2011                            | 2010         |
| Annualized net interest income                                     | \$ 141,909                      | \$ 144,859   |
| Annualized FTE adjustment  | \$ 5,719                        | \$ 6,295     |
| Annualized net interest income on a fully taxable equivalent basis | \$ 147,628                      | \$ 151,154   |
| Average earning assets   | \$ 3,744,196                    | \$ 3,955,515 |
| Interest income (FTE) as a percent of average earning assets       | 5.11%                           | 5.39%        |
| Interest expense as a percent of average earning assets            | 1.16%                           | 1.57%        |
| Net interest income (FTE) as a percent of average earning assets   | 3.95%                           | 3.82%        |

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

Non-Interest Income

Non-interest income decreased by \$1,106,000 or 8.5% during the first quarter of 2011, compared to the first quarter of 2010. During the first quarter of 2011, other-than-temporary impairment costs on pooled trust preferred investments of \$400,000 offset gains recognized on the sale of investment securities, resulting in a net gain of approximately \$63,000. In comparison during the first quarter of 2010, other-than-temporary impairment costs on pooled trust preferred investments of \$488,000 offset gains recognized on the sale of investment securities, resulting in a net gain of approximately \$1,354,000 or \$1,291,000 higher than the current quarter. Additionally, income from service charges was \$483,000 lower in the first quarter of 2011 than first quarter of 2010. The decrease in revenue is primarily attributable to a decrease in fee income from customer overdrafts reflecting a lower volume of overdraft transactions. Gains on the sale of mortgages increased \$724,000 in the first quarter of 2011 compared to the first quarter of 2010, due to the high volume of mortgage originations, primarily refinances resulting from low rates that

had been strong throughout 2010 and have continued into the first quarter of 2011.

#### Non-Interest Expense

Non-interest expenses for the first quarter of 2011, compared with the same period in 2010, decreased by \$759,000 or 2.2%. Salaries and employee benefit costs decreased \$386,000 or 2.2% due to continued prudent management of staffing and pay increase levels. Other real estate owned and credit-related expenses declined by \$466,000 in the first quarter of 2011 compared to the first quarter of 2010. Credit-related expenses, which include legal expenses, are included in Other Expenses for the three months ended March 31, 2010.

#### Income Tax

The income tax expense for the three months ended March 31, 2011 was \$2,399,000 on pre-tax net income of \$7,860,000. For the same period in 2010, the income tax benefit was \$916,000 on pre-tax net income of \$670,000.

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

CAPITAL

Capital adequacy is an important indicator of financial stability and performance. The Corporation maintained a strong capital position as tangible common equity to tangible assets was 6.16% at March 31, 2011 and 5.86% at December 31, 2010.

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies and are assigned to a capital category. The assigned capital category is largely determined by three ratios that are calculated according to the regulations: total risk-based capital, Tier 1 capital, and Tier 1 leverage ratios. The ratios are intended to measure capital relative to assets and credit risk associated with those assets and off-balance sheet exposures of the entity. The capital category assigned to an entity can also be affected by qualitative judgments made by regulatory agencies about the risk inherent in the entity's activities that are not part of the calculated ratios. At March 31, 2011, the management of the Corporation believes that it meets all capital adequacy requirements to which it is subject. The most recent notifications from the regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action.

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

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

As of March 31, 2011, the Corporation, on a consolidated basis, as well as the Bank, exceeded the minimum capital levels of the well capitalized category.

| (Dollars in thousands)                   | March 31, 2011 |        | December 31, 2010 |        |
|--|----------------|--------|-------------------|--------|
|  | Amount         | Ratio  | Amount            | Ratio  |
| <b>Consolidated</b>                      |                |        |                   |        |
| Total capital (to risk-weighted assets)  | \$ 464,713     | 15.66% | \$ 476,490        | 15.74% |
| Tier 1 capital (to risk-weighted assets) | 387,086        | 13.05% | 388,090           | 12.82% |
| Tier 1 capital (to average assets)       | 387,086        | 9.80%  | 388,090           | 9.50%  |
| <b>First Merchants Bank</b>              |                |        |                   |        |
| Total capital (to risk-weighted assets)  | \$ 444,940     | 15.03% | \$ 450,629        | 14.89% |
| Tier 1 capital (to risk-weighted assets) | 407,393        | 13.77% | 412,654           | 13.64% |

|                                    |         |        |         |        |
|------------------------------------|---------|--------|---------|--------|
| Tier 1 capital (to average assets) | 407,393 | 10.35% | 412,654 | 10.14% |
|------------------------------------|---------|--------|---------|--------|

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

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

CAPITAL continued

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

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

| (Dollars in thousands, except per share amounts)                             | March 31,<br>2011 | December 31,<br>2010 |
|--|-------------------|----------------------|
| Average goodwill   | \$ 141,357        | \$ 141,357           |
| Average core deposit intangible (CDI)  | 12,149            | 15,026               |
| Average deferred tax on CDI  | (2,781)           | (3,385)              |
| Intangible adjustment  | \$ 150,725        | \$ 152,998           |
| Average stockholders' equity (GAAP capital)                                  | \$ 456,189        | \$ 470,379           |
| Average cumulative preferred stock issued under the Capital Purchase Program | (67,934)          | (89,847)             |
| Intangible adjustment  | (150,725)         | (152,998)            |
| Average tangible capital   | \$ 237,530        | \$ 227,534           |
| Average assets   | \$ 4,122,390      | \$ 4,271,715         |
| Intangible adjustment  | (150,725)         | (152,998)            |
| Average tangible assets  | \$ 3,971,665      | \$ 4,118,717         |
| Net income available to common stockholders                                  | \$ 4,473          | \$ 11,722            |
| CDI amortization, net of tax   | 663               | 2,852                |
| Tangible net income available to common stockholders                         | \$ 5,136          | \$ 14,574            |
| Diluted earnings per share   | \$ 0.17           | \$ 0.48              |
| Diluted tangible earnings per share  | \$ 0.20           | \$ 0.60              |
| Return on average GAAP capital   | 3.92%             | 2.49%                |
| Return on average tangible capital   | 8.65%             | 6.40%                |
| Return on average assets   | 0.43%             | 0.27%                |
| Return on average tangible assets  | 0.52%             | 0.35%                |





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

LOAN QUALITY/PROVISION FOR LOAN LOSSES

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

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

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

Non-accruals declined by \$2,879,000 in the three month period from \$90,591,000 at December 31, 2010 to the current March 31, 2011 balance of \$87,712,000. Decreases were also experienced in other real estate owned, which decreased \$3,871,000, and 90 plus day delinquents, which decreased \$578,000, during the first three months of 2011. For other real estate owned, current appraisals are obtained to determine value as management continues to aggressively market these real estate assets.

| (Dollars in thousands)                   | March 31,<br>2011 | December<br>31,<br>2010 |
|--|-------------------|-------------------------|
| <b>Non-Performing Assets:</b>            |                   |                         |
| Non-accrual loans                        | \$ 87,712         | \$ 90,591               |
| Renegotiated loans                       | 2,125             | 7,139                   |
| Non-performing loans (NPL)               | 89,837            | 97,730                  |
| Real estate owned and repossessed assets | 17,056            | 20,927                  |
| Non-performing assets (NPA)              | 106,893           | 118,657                 |
| 90+ days delinquent and still accruing   | 752               | 1,330                   |
| NPAs & 90+ days delinquent               | \$ 107,645        | \$ 119,987              |
| Impaired Loans                           | \$ 116,821        | \$ 116,204              |

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

| (Dollars in thousands)                                | March 31,<br>2011 | December<br>31,<br>2010 |
|---|-------------------|-------------------------|
| <b>Non Performing Assets and 90+ Days Delinquent:</b> |                   |                         |

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|  |    |         |    |         |
|--|----|---------|----|---------|
| Commercial and industrial loans                                  | \$ | 8,954   | \$ | 10,499  |
| Agricultural production financing and other loans to farmers     |    | 943     |    | 544     |
| Real estate loans:   |    |         |    |         |
| Construction   |    | 23,029  |    | 28,907  |
| Commercial and farm land   |    | 50,357  |    | 54,297  |
| Residential  |    | 24,222  |    | 25,339  |
| Individual's loans for household and other personal expenditures |    | 140     |    | 401     |
| Other loans  |    |         |    |         |
| Non performing assets plus 90+ days delinquent                   | \$ | 107,645 | \$ | 119,987 |

A loan is deemed impaired when, based on current information or events, it is probable that all amounts due of principal and interest according to the contractual terms of the loan agreement will not be collected substantially within the contractual terms of the note. At March 31, 2011, impaired loans totaled \$116,821,000, and were relatively flat to the \$116,204,000 at December 31, 2010. At March 31, 2011, an allowance for losses was not deemed necessary for impaired loans totaling \$74,977,000, as there was no identified loss on these credits. An allowance of \$15,849,000 was recorded for the remaining balance of impaired loans totaling \$41,844,000 and is included in the corporation's allowance for loan losses.

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

LOAN QUALITY/PROVISION FOR LOAN LOSSES continued

At March 31, 2011, the allowance for loan losses was \$80,936,000, a decrease of \$2,041,000 from year end 2010. As a percent of loans, the allowance was 2.93 percent at March 31, 2011 and 2.90 percent at December 31, 2010. The provision for loan losses for the three months of 2011 was \$5,594,000, a decrease of \$8,275,000 from \$13,869,000 for the same period in 2010. Specific reserves on impaired loans increased \$1,935,000 from \$13,914,000 at December 31, 2010 to \$15,849,000 at March 31, 2011.

Net charge offs for the first quarter of 2011 were \$7,635,000, a decrease of \$9,797,000 from the same period in 2010. Of this amount, \$4,412,000, or 57.8%, was made up of five customer charge offs of more than \$500,000. The two largest relationships that were charged off for the first quarter were \$1,334,000 and \$1,038,000. The distribution of the net charge offs for the three months ended March 31, 2011 and March 31, 2010 is reflected in the following table.

| (Dollars in thousands)   | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2011                            | 2010      |
| Net Charge Offs:   |                                 |           |
| Commercial and industrial loans                                  | \$ 508                          | \$ 12,153 |
| Agricultural production financing and other loans to farmers     |                                 |           |
| Real estate loans  |                                 |           |
| Construction   | 2,588                           | 63        |
| Commercial and farm land   | 3,439                           | 2,936     |
| Residential  | 879                             | 1,062     |
| Individual's loans for household and other personal expenditures | 309                             | 381       |
| Lease financing receivables, net of unearned income              | (1)                             | 54        |
| Other Loans  | (87)                            | 783       |
| Total Net Charge Offs  | \$ 7,635                        | \$ 17,432 |

The declines in the value of commercial and residential real estate in our market over the last couple of years has had a negative impact on the underlying collateral value in our commercial, residential, land development and construction loans. Management continually evaluates commercial borrowers by including consideration of specific borrower cash flow analysis and estimated collateral values, types and amounts on non-performing loans, past and anticipated loan loss experience, changes in the composition of the loan portfolio, and the current condition and amount of loans outstanding. The determination of the provision in any period is based on management's continuing review and evaluation of the loan portfolio, and its judgment as to the impact of current economic conditions on the portfolio.

LIQUIDITY

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

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

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. In addition, Federal Home Loan Bank ("FHLB") advances are utilized as funding sources. At March 31, 2011, total borrowings from the FHLB were \$104,697,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at March 31, 2011, was \$133,737,000.

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

LIQUIDITY continued

The Bank currently has \$79,000,000 of Senior Notes (the "Notes") that are guaranteed by the FDIC under its Temporary Liquidity Guarantee Program ("TLGP") and are backed by the full faith and credit of the United States. The Notes mature on March 30, 2012. The Notes are issued by the Bank and are not obligations of, or guaranteed by, the Corporation. In connection with the FDIC's TLGP, the Bank entered into a Master Agreement with the FDIC that contains, among other things, certain terms and conditions that must be included in the governing documents for any senior debt securities issued by the Bank that are guaranteed pursuant to the FDIC's TLGP.

The principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$575,546,000 at March 31, 2011, an increase of \$36,176,000, or 6.71 percent, from December 31, 2010. Securities classified as held to maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held to maturity that are maturing in one year or less, totaled \$3,704,000 at March 31, 2011. In addition, other types of assets such as cash and due from banks, federal funds sold, and securities purchased under agreements to resell, loans and interest-bearing deposits with other banks maturing within one year are sources of liquidity.

The Corporation currently has a \$55 million credit facility with Bank of America, N.A., comprised of (a) a term loan in the principal amount of \$5.0 million (the "Term Loan") and (b) a subordinated debenture in the principal amount of \$50.0 million (the "Subordinated Debt"). Pursuant to the terms of the underlying Loan Agreement (the "Loan Agreement"), the Term Loan and the Subordinated Debt each mature on February 15, 2015. The Term Loan is secured by a pledge of all of the issued and outstanding shares of the Bank.

The Loan Agreement contains certain customary representations and warranties and financial and negative covenants. A breach of any of these covenants could result in a default under the Loan Agreement. As of March 31, 2011, the Corporation failed to meet the minimum return on average total assets covenant of at least 0.75%.

The Loan Agreement provides that upon an event of default as the result of the Corporation's failure to comply with a financial covenant, Bank of America may (a) declare the \$5 million outstanding principal amount of the Term Loan immediately due and payable, (b) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral if payment of the Term Loan is not made in full, and (c) add a default rate of 3% per annum to the Term Loan. Because the Subordinated Debt is treated as Tier 2 capital for regulatory capital purposes, the Loan Agreement does not provide Bank of America with any right of acceleration or other remedies with regard to the Subordinated Debt upon an event of default caused by the Corporation's breach of a financial covenant. To date, Bank of America has chosen to apply the default rate, but not to accelerate the Term Loan based on the Corporation's failure to meet these financial covenants.

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

The Bank provides customers with off-balance sheet credit support through loan commitments and standby letters of credit. Summarized credit-related financial instruments at March 31, 2011 are as follows:

|                                      | March 31,<br>2011 |
|--------------------------------------|-------------------|
| (Dollars in thousands)               |                   |
| Amounts of<br>commitments:           |                   |
| Loan commitments to<br>extend credit | \$ 551,561        |
| Standby letters of<br>credit         | 28,138            |
|                                      | \$ 579,699        |

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

LIQUIDITY continued

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

In addition to owned banking facilities, the Corporation has entered into a number of long-term leasing arrangements to support ongoing activities. The required payments under such commitments and borrowings at March 31, 2011 are as follows:

| (Dollars in thousands)   | 2011<br>Remaining | 2012              | 2013            | 2014             | 2015             | 2016            | 2017 and<br>after | Total             |
|--|-------------------|-------------------|-----------------|------------------|------------------|-----------------|-------------------|-------------------|
| Operating leases   | \$ 1,738          | \$ 1,964          | \$ 1,198        | \$ 1,029         | \$ 854           | \$ 473          | \$                | \$ 7,256          |
| Securities sold under repurchase agreements                    | 91,434            | 14,250            |                 | 10,000           |                  |                 |                   | 115,684           |
| Federal Home Loan Bank advances                                | 41,000            | 50,041            | 225             | 1,270            | 2,000            | 4,095           | 6,066             | 104,697           |
| Subordinated debentures, revolving credit lines and term loans | 81                | 78,984            |                 |                  | 55,000           |                 | 92,335            | 226,400           |
| <b>Total</b>   | <b>\$ 134,253</b> | <b>\$ 145,239</b> | <b>\$ 1,423</b> | <b>\$ 12,299</b> | <b>\$ 57,854</b> | <b>\$ 4,568</b> | <b>\$ 98,401</b>  | <b>\$ 454,037</b> |

INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK

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

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

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



volatility interest rate movements may introduce into the earnings of the Corporation.

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

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INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK continued

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of March 31, 2011, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In the current rate environment, many driver rates are at or near historical lows, thus total rate movements (beginning point minus ending point) to each of the various driver rates utilized by management have the following results:

| Driver Rates      | At March 31, 2011               |                                  |
|-------------------|---------------------------------|----------------------------------|
|                   | RISING<br>(200<br>Basis Points) | FALLING<br>(100 Basis<br>Points) |
| Prime             | 200                             | 0                                |
| Federal Funds     | 200                             | 0                                |
| One-Year<br>CMT   | 200                             | (6)                              |
| Three-Year<br>CMT | 200                             | (89)                             |
| Five-Year<br>CMT  | 200                             | (100)                            |
| CD's              | 200                             | (58)                             |
| FHLB<br>Advances  | 200                             | (63)                             |

Results for the base, rising 200 basis points, and falling 100 basis points interest rate scenarios are listed below based upon the Corporation's rate sensitive assets and liabilities at March 31, 2011. The net interest income shown represents cumulative net interest income over a 12-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

| Driver Rates                   | Base       | At March 31, 2011               |                                  |
|--------------------------------|------------|---------------------------------|----------------------------------|
|                                |            | RISING<br>(200 Basis<br>Points) | FALLING<br>(100 Basis<br>Points) |
| Net Interest Income            | \$ 147,088 | \$ 148,369                      | \$ 141,848                       |
| Variance from Base             |            | \$ 1,281                        | \$ (5,240)                       |
| Percent of change from<br>base |            | 0.87%                           | -3.56%                           |
| Policy Limit                   |            | -5.00%                          | -2.00%                           |

The comparative rising 200 basis points and falling 100 basis points scenarios below, as of December 31, 2010, assume further interest rate changes in addition to the base simulation discussed above. These changes are immediate and parallel changes to the base case scenario. In addition, total rate movements (beginning point minus ending point)

to each of the various driver rates utilized by management in the base simulation are as follows:

| At December 31,<br>2010 |                                 |                                  |
|-------------------------|---------------------------------|----------------------------------|
|                         | RISING<br>(200<br>Basis Points) | FALLING<br>(100 Basis<br>Points) |
| Driver Rates            |                                 |                                  |
| Prime                   | 200                             | 0                                |
| Federal Funds           | 200                             | 0                                |
| One-Year<br>CMT         | 200                             | (3)                              |
| Three-Year<br>CMT       | 200                             | (37)                             |
| Five-Year<br>CMT        | 200                             | (77)                             |
| CD's                    | 200                             | (59)                             |
| FHLB<br>Advances        | 200                             | (47)                             |

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

| At December 31, 2010           |            |                                 |                                  |
|--------------------------------|------------|---------------------------------|----------------------------------|
|                                | Base       | RISING<br>(200 Basis<br>Points) | FALLING<br>(100 Basis<br>Points) |
| Driver Rates                   |            |                                 |                                  |
| Net Interest Income            | \$ 144,603 | \$ 147,478                      | \$ 140,811                       |
| Variance from Base             |            | \$ 2,875                        | \$ (3,792)                       |
| Percent of change from<br>base |            | 1.99%                           | -2.62%                           |
| Policy Limit                   |            | -5.00%                          | -2.00%                           |

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

EARNING ASSETS

The following table presents the earning asset mix as of March 31, 2011, and December 31, 2010. Earning assets decreased by \$36,508,000 in the three months ended March 31, 2011. Federal funds sold decreased \$1,371,000, and interest-bearing time deposits decreased \$3,373,000. Investments increased by approximately \$59,232,000, while loans and loans held for sale decreased by \$90,913,000. Excess liquidity mainly created by the decline in the loan portfolio was used to increase the investment securities portfolio. The three largest loan segments that decreased were commercial and farmland, residential real estate and individual loans.

| (Dollars in thousands)                           | March 31,<br>2011 | December<br>31,<br>2010 |
|--|-------------------|-------------------------|
| Federal funds sold                               | \$ 6,092          | \$ 7,463                |
| Interest-bearing time deposits                   | 61,843            | 65,216                  |
| Investment securities available for sale         | 575,546           | 539,370                 |
| Investment securities held to maturity           | 310,483           | 287,427                 |
| Mortgage loans held for sale                     | 2,111             | 21,469                  |
| Loans  | 2,764,128         | 2,835,683               |
| Federal Reserve and Federal Home Loan Bank stock | 33,801            | 33,884                  |
| Total  | \$ 3,754,004      | \$ 3,790,512            |

OTHER

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

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

ITEM 4. CONTROLS AND PROCEDURES

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

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

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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 1.A. RISK FACTORS

There have been no material changes to the risk factors previously disclosed in the Corporation's December 31, 2010 Annual Report on Form 10-K.

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

a. None

b. None

c. None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. [RESERVED]

ITEM 5. OTHER INFORMATION

a. None

b. None

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ITEM 6. EXHIBITS.

Exhibit No: Description of Exhibits:

- 3.1 First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-K/A filed on March 31, 2009)
- 3.2 Bylaws of First Merchants Corporation dated October 28, 2009 (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2009)
- 4.1 First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.2 Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.3 Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.4 Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.5 Form of Certificate for the First Merchants Corporation Fixed Rate Cumulative Perpetual Preferred Stock, Series A dated February 20, 2009 (Incorporated by reference to registrant's Form 8-K filed on February 23, 2009)
- 4.6 Warrant to Purchase Common Stock of First Merchants Corporation dated February 20, 2009 (Incorporated by reference to registrant's Form 8-K filed on February 23, 2009)
- 4.7 First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009)
- 4.8 Amended and Restated Declaration of Trust, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.9 Indenture, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.10 First Supplemental Indenture, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.11 Guarantee Agreement, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.12 Form of Capital Securities Certificate of First Merchants Capital Trust III (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)

- 31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
- 31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002 (1)
- 32 Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)

(1) Filed herewith.



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SIGNATURES

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

First Merchants Corporation

(Registrant)

Date: May 10, 2011  
Michael C. Rechin  
President and Chief Executive Officer  
(Principal Executive Officer)

by /s/ Michael C. Rechin

Date: May 10, 2011  
Mark K. Hardwick  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

by /s/ Mark K. Hardwick

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FORM 10Q

INDEX TO EXHIBITS

Exhibit No: Description of Exhibits:

- 3.1 First Merchants Corporation Articles of Incorporation, as amended (Incorporated by reference to registrant's Form 10-K/A filed on March 31, 2009)
- 3.2 Bylaws of First Merchants Corporation dated October 28, 2009 (Incorporated by reference to registrant's Form 10-Q filed on November 9, 2009)
- 4.1 First Merchants Corporation Amended and Restated Declaration of Trust of First Merchants Capital Trust II dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.2 Indenture dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.3 Guarantee Agreement dated as of July 2, 2007 (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.4 Form of Capital Securities Certification of First Merchants Capital Trust II (Incorporated by reference to registrant's Form 8-K filed on July 3, 2007)
- 4.5 Form of Certificate for the First Merchants Corporation Fixed Rate Cumulative Perpetual Preferred Stock, Series A dated February 20, 2009 (Incorporated by reference to registrant's Form 8-K filed on February 23, 2009)
- 4.6 Warrant to Purchase Common Stock of First Merchants Corporation dated February 20, 2009 (Incorporated by reference to registrant's Form 8-K filed on February 23, 2009)
- 4.7 First Merchants Corporation Dividend Reinvestment and Stock Purchase Plan (Incorporated by reference to registrant's Post-Effective Amendment No. 1 to Form S-3 filed on August 21, 2009)
- 4.8 Amended and Restated Declaration of Trust, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.9 Indenture, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.10 First Supplemental Indenture, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.11 Guarantee Agreement, dated as of June 30, 2010 (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 4.12 Form of Capital Securities Certificate of First Merchants Capital Trust III (Incorporated by reference to registrant's Form 8-K filed on July 2, 2010)
- 31.1

Certification of Chief Executive Officer Pursuant to Section  
302 of the Sarbanes - Oxley Act of 2002 (1)

31.2 Certification of Chief Financial Officer Pursuant to Section  
302 of the Sarbanes - Oxley Act of 2002 (1)

32 Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted  
Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (1)

(1) Filed herewith.

FIRST MERCHANTS CORPORATION  
FORM 10Q

EXHIBIT-31.1

CERTIFICATIONS PURSUANT TO  
SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION

I, Michael C. Rechin, President and Chief Executive Officer of First Merchants Corporation, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Merchants Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 10, 2011  
Michael C. Rechin  
President and Chief Executive Officer  
(Principal Executive Officer)

by /s/ Michael C. Rechin

FIRST MERCHANTS CORPORATION  
FORM 10Q

EXHIBIT-31.2

CERTIFICATIONS PURSUANT TO  
SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002

CERTIFICATION

I, Mark K. Hardwick, Executive Vice President and Chief Financial Officer of First Merchants Corporation, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of First Merchants Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in the Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report, based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or

persons performing the equivalent functions):

- a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: May 10, 2011  
Mark K. Hardwick  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

by: /s/ Mark K. Hardwick

FIRST MERCHANTS CORPORATION  
FORM 10Q

EXHIBIT-32

CERTIFICATIONS PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the quarterly report of First Merchants Corporation (the "Corporation") on Form 10-Q for the period ending March 31, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Michael C. Rechin, President and Chief Executive Officer of the Corporation, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o (d)); and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

Date: May 10, 2011  
Michael C. Rechin  
President and  
Chief Executive Officer  
(Principal Executive Officer)

by /s/ Michael C. Rechin

A signed copy of this written statement required by Section 906 has been provided to First Merchants Corporation and will be retained by First Merchants Corporation and furnished to the Securities and Exchange Commission or its staff upon request.

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In connection with the quarterly report of First Merchants Corporation (the "Corporation") on Form 10-Q for the period ending March 31, 2011 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Mark K. Hardwick, Executive Vice President and Chief Financial Officer of the Corporation, do hereby certify, in accordance with 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o (d)); and



(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Corporation.

Date: May 10, 2011

by /s/ Mark K. Hardwick

Mark K. Hardwick

Executive Vice President and

Chief Financial Officer

(Principal Financial and Accounting Officer)

A signed copy of this written statement required by Section 906 has been provided to First Merchants Corporation and will be retained by First Merchants Corporation and furnished to the Securities and Exchange Commission or its staff upon request.