

FIRST MERCHANTS CORP  
Form 10-Q  
May 10, 2010

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

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

For the quarterly period ended March 31, 2010

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

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

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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 30, 2010, there were 25,522,494 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)

## CONSOLIDATED CONDENSED BALANCE SHEETS

|  | March 31,<br>2010  | December<br>31,<br>2009 |
|--|--------------------|-------------------------|
|  | (Unaudited)        |                         |
| <b>ASSETS</b>  |                    |                         |
| Cash and due from banks  | \$ 52,679          | \$ 76,801               |
| Federal funds sold   | 7,044              | 102,346                 |
| Cash and cash equivalents  | 59,723             | 179,147                 |
| Interest-bearing time deposits                                   | 157,735            | 74,025                  |
| Investment securities available for sale                         | 475,596            | 413,607                 |
| Investment securities held to maturity                           | 163,485            | 149,510                 |
| Mortgage loans held for sale                                     | 3,646              | 8,036                   |
| Loans, net of allowance for loan losses of \$88,568 and \$92,131 | 3,045,972          | 3,177,657               |
| Premises and equipment   | 54,431             | 55,804                  |
| Federal Reserve and Federal Home Loan Bank stock                 | 36,721             | 38,576                  |
| Interest receivable  | 19,532             | 20,818                  |
| Core deposit intangibles   | 16,175             | 17,383                  |
| Goodwill   | 141,357            | 141,357                 |
| Cash surrender value of life insurance                           | 95,146             | 94,636                  |
| Other real estate owned  | 18,268             | 14,879                  |
| Tax asset, deferred and receivable                               | 59,190             | 64,394                  |
| Other assets   | 28,889             | 31,123                  |
| <b>TOTAL ASSETS</b>  | <b>\$4,375,866</b> | <b>\$4,480,952</b>      |
| <b>LIABILITIES</b>   |                    |                         |
| Deposits:  |                    |                         |
| Noninterest-bearing  | \$ 520,551         | \$ 516,487              |
| Interest-bearing   | 2,877,235          | 3,020,049               |
| <b>Total Deposits</b>  | <b>3,397,786</b>   | <b>3,536,536</b>        |
| Borrowings:  |                    |                         |
| Securities sold under repurchase agreements                      | 112,826            | 125,687                 |
| Federal Home Loan Bank advances                                  | 123,261            | 129,749                 |
| Subordinated debentures, revolving credit lines and term loans   | 194,794            | 194,790                 |
| <b>Total Borrowings</b>  | <b>430,881</b>     | <b>450,226</b>          |
| Interest payable   | 4,812              | 5,711                   |
| Other liabilities  | 53,446             | 24,694                  |
| <b>Total Liabilities</b>   | <b>3,886,925</b>   | <b>4,017,167</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 - 116,000 shares                | 112,559            | 112,373                 |

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|   |                    |                    |
|---|--------------------|--------------------|
| 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 - 25,495,550 and 21,227,741 shares                 | 3,187              | 2,653              |
| Additional paid-in capital  | 230,764            | 206,600            |
| Retained earnings   | 150,595            | 150,860            |
| Accumulated other comprehensive loss                                      | (8,289 )           | (8,826 )           |
| Total Stockholders' Equity  | 488,941            | 463,785            |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>                         | <b>\$4,375,866</b> | <b>\$4,480,952</b> |

See notes to consolidated condensed financial statements.

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

## CONSOLIDATED CONDENSED STATEMENTS OF OPERATIONS

|   | Three Months Ended<br>March 31, |               |
|---|---------------------------------|---------------|
|   | 2010                            | 2009          |
| <b>INTEREST INCOME</b>  |                                 |               |
| Loans receivable:   |                                 |               |
| Taxable   | \$45,448                        | \$53,793      |
| Tax exempt  | 277                             | 215           |
| Investment securities:  |                                 |               |
| Taxable   | 2,891                           | 3,763         |
| Tax exempt  | 2,646                           | 1,769         |
| Federal funds sold  | 17                              | 12            |
| Deposits with financial institutions                                  | 60                              | 102           |
| Federal Reserve and Federal Home Loan Bank stock                      | 360                             | 473           |
| <b>Total Interest Income</b>  | <b>51,699</b>                   | <b>60,127</b> |
| <b>INTEREST EXPENSE</b>   |                                 |               |
| Deposits  | 11,495                          | 16,711        |
| Federal funds purchased   |                                 | 22            |
| Securities sold under repurchase agreements                           | 499                             | 467           |
| Federal Home Loan Bank advances                                       | 1,564                           | 2,949         |
| Subordinated debentures, revolving credit lines and term loans        | 1,926                           | 1,479         |
| <b>Total Interest Expense</b>   | <b>15,484</b>                   | <b>21,628</b> |
| <b>NET INTEREST INCOME</b>  | <b>36,215</b>                   | <b>38,499</b> |
| Provision for loan losses   | 13,869                          | 12,921        |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>            | <b>22,346</b>                   | <b>25,578</b> |
| <b>OTHER INCOME</b>   |                                 |               |
| Service charges on deposit accounts                                   | 3,262                           | 3,542         |
| Fiduciary activities  | 2,060                           | 2,059         |
| Other customer fees   | 2,498                           | 2,003         |
| Commission income   | 1,989                           | 2,059         |
| Earnings on cash surrender value of life insurance                    | 508                             | 323           |
| Net gains and fees on sales of loans                                  | 1,149                           | 1,430         |
| Net realized gains on sales of available for sale securities          | 1,842                           | 2,792         |
| Other-than-temporary impairment on available for sale securities      | (1,179)                         | (478)         |
| Portion of loss recognized in other comprehensive income before taxes | 691                             |               |
| Net impairment losses recognized in earnings                          | (488)                           | (478)         |
| Other income  | 144                             | 741           |
| <b>Total Other Income</b>   | <b>12,964</b>                   | <b>14,471</b> |
| <b>OTHER EXPENSES</b>   |                                 |               |
| Salaries and employee benefits  | 17,562                          | 20,015        |
| Net occupancy   | 2,851                           | 2,569         |
| Equipment   | 1,853                           | 1,876         |

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|   |        |          |
|---|--------|----------|
| Marketing   | 429    | 549      |
| Outside data processing fees                        | 1,280  | 1,933    |
| Printing and office supplies                        | 318    | 363      |
| Core deposit amortization                           | 1,207  | 1,277    |
| FDIC assessments                                    | 1,722  | 576      |
| Other expenses                                      | 7,418  | 5,556    |
| Total Other Expenses                                | 34,640 | 34,714   |
| INCOME BEFORE INCOME TAX                            | 670    | 5,335    |
| Income tax expense (benefit)                        | (916 ) | 1,218    |
| NET INCOME  | 1,586  | 4,117    |
| Preferred stock dividends and discount accretion    | 1,450  | 628      |
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS         | \$ 136 | \$ 3,489 |
| Per Share Data:                                     |        |          |
| Basic Net Income Available to Common Stockholders   | \$0.01 | \$0.17   |
| Diluted Net Income Available to Common Stockholders | \$0.01 | \$0.17   |
| Cash Dividends Paid                                 | \$0.01 | \$0.23   |
| Average Diluted Shares Outstanding (in thousands)   | 21,462 | 21,093   |

See notes to consolidated condensed financial statements.

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

|   | Three Months Ended<br>March 31, |          |
|---|---------------------------------|----------|
|   | 2010                            | 2009     |
| Net income  | \$1,586                         | \$4,117  |
| Other comprehensive income (losses) net of tax:   |                                 |          |
| Unrealized holding gain on securities available for sale arising during the period, net of income tax expense of \$(994) and \$(874)  | 1,846                           | 1,622    |
| 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 benefit of \$243 and \$0 | (452 )                          |          |
| Unrealized losses on cash flow hedges:  |                                 |          |
| Unrealized losses arising during the period, net of income tax benefit of \$0 and \$926   |                                 | (1,388 ) |
| Amortization of items previously recorded in accumulated other comprehensive income (losses), net of income tax (expense) benefit of \$(15) and \$469                         | 23                              | (704 )   |
| Reclassification adjustment for gains (losses) included in net income net of income tax (expense) benefit of \$474 and \$(98)   | (880 )                          | 147      |
|   | 537                             | (323 )   |
| Comprehensive income  | \$2,123                         | \$3,794  |

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

|  | March 31,<br>2010 | March 31,<br>2009 |
|--|-------------------|-------------------|
| Net unrealized gain (loss) on securities available for sale  | \$5,140           | \$(625 )          |
| Net unrealized loss on securities available for sale for which a portion of an other-than-temporary impairment has been recognized in income | (452 )            |                   |
| Net unrealized gain on cash flow hedges  |                   | 229               |
| Defined Benefit Plans  | (12,977 )         | (15,592 )         |
| Accumulated other comprehensive income   | \$(8,289 )        | \$(15,988 )       |



See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY  
(Dollars in thousands)  
(Unaudited)

## CONSOLIDATED CONDENSED STATEMENTS OF STOCKHOLDERS' EQUITY

|  | March 31, |           |
|--|-----------|-----------|
|  | 2010      | 2009      |
| Balances, January 1  | \$463,785 | \$395,903 |
| Net income   | 1,586     | 4,117     |
| Cash dividends on common stock                                   | (215 )    | (4,921 )  |
| Cash dividends on preferred stock                                | (1,450 )  |           |
| Other comprehensive income (loss), net of tax                    | 537       | (323 )    |
| Stock issued under employee benefit plan                         | 164       |           |
| Stock issued under dividend reinvestment and stock purchase plan | 16        | 228       |
| Tax benefit (expense) from stock compensation                    | (48 )     | 198       |
| Stock redeemed   | (69 )     | (190 )    |
| Common stock issued  | 24,150    |           |
| Adjustment to Issuance of stock related to acquisition           |           | (3,451 )  |
| Warrants issued under Capital Purchase Program                   |           | 4,169     |
| Cumulative preferred stock issued under Capital Purchase Program |           | 111,831   |
| Share-based compensation   | 485       | 544       |
| Balances, March 31   | \$488,941 | \$508,105 |

See notes to consolidated condensed financial statements.

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CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

(Dollars in thousands)

(Unaudited)

CONSOLIDATED CONDENSED STATEMENTS OF CASH FLOWS

|   | March 31,   |              |
|---|-------------|--------------|
|   | 2010        | 2009         |
| <b>Cash Flow From Operating Activities:</b>                                       |             |              |
| Net income  | \$1,586     | \$4,117      |
| Adjustments to reconcile net income to net cash provided by operating activities: |             |              |
| Provision for loan losses   | 13,869      | 12,921       |
| Depreciation and amortization   | 1,447       | 1,464        |
| Share-based compensation  | 485         | 544          |
| Tax expense (benefit) from stock compensation                                     | 48          | (198 )       |
| Mortgage loans originated for sale  | (37,492 )   | (59,335 )    |
| Proceeds from sales of mortgage loans   | 41,882      | 54,971       |
| Gains on sales of securities available for sale                                   | 1,842       | 2,791        |
| Recognized loss on other-than-temporary-impairment                                | (488 )      | (477 )       |
| Change in interest receivable   | 1,286       | 3,193        |
| Change in interest payable  | (899 )      | (566 )       |
| Other adjustments   | 7,294       | (24,211 )    |
| Net cash provided by (used in) operating activities                               | \$30,860    | \$(4,786 )   |
| <b>Cash Flows from Investing Activities:</b>                                      |             |              |
| Net change in interest-bearing deposits   | \$(83,710 ) | \$(119,472 ) |
| Purchases of:   |             |              |
| Securities available for sale   | (95,265 )   | (32,190 )    |
| Securities held to maturity   | (17,120 )   | (5,397 )     |
| Proceeds from sales of securities available for sale                              | 42,743      | 47,480       |
| Proceeds from maturities of:  |             |              |
| Securities available for sale   | 20,757      | 26,894       |
| Securities held to maturity   | 2,825       | 8,019        |
| Change in Federal Reserve and Federal Home Loan Bank stock                        | 1,855       | (101 )       |
| Net change in loans   | 107,709     | 59,347       |
| Proceeds from the sale of other real estate owned                                 | 5,543       | 796          |
| Other adjustments   | (74 )       | (771 )       |
| Net cash used in investing activities   | \$(14,737 ) | \$(15,395 )  |
| <b>Cash Flows from Financing Activities:</b>                                      |             |              |
| Net change in :   |             |              |
| Demand and savings deposits   | \$(41,836 ) | \$52,362     |
| Certificates of deposit and other time deposits                                   | (96,914 )   | (86,208 )    |
| Borrowings  | 4           | 78,953       |
| Repayment of borrowings   | (19,349 )   | (100,839 )   |
| Cash dividends on common stock  | (215 )      | (4,921 )     |
| Cash dividends on preferred stock   | (1,450 )    |              |
| Stock issued in private equity placement  | 24,150      |              |
| Stock issued under dividend reinvestment and stock purchase plans                 | 180         | 228          |
| Cumulative preferred stock issued   |             | 116,000      |
| Tax (expense) benefit from stock options exercised                                | (48 )       | 198          |

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|   |              |           |
|---|--------------|-----------|
| Stock redeemed  | (69 )        | (190 )    |
| Net cash provided by (used in) financing activities       | \$(135,547 ) | \$55,583  |
| Net Change in Cash and Cash Equivalents                   | (119,424 )   | 35,402    |
| Cash and Cash Equivalents, January 1                      | 179,147      | 150,486   |
| Cash and Cash Equivalents, March 31                       | \$59,723     | \$185,888 |
| Additional cash flow information:                         |              |           |
| Interest paid   | \$16,383     | \$22,194  |
| Income tax refunded                                       | \$(6,054 )   |           |
| Loans transferred to other real estate owned              | \$10,107     | \$4,569   |
| Non-cash investing activities using trade date accounting | \$28,308     | \$6,208   |

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 ("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, 2009 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, 2010 are not necessarily indicative of the results to be expected for the year.

NOTE 2. 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, 2010, there were 4,594 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.

Share-based compensation guidance requires the Corporation to record compensation expense related to unvested share-based awards 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, 2010 and 2009 were \$485,000 and \$544,000, respectively, and has been recognized as a component of salaries and benefits expense in the accompanying Consolidated Condensed Statements of Income.

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 2. Share-Based Compensation continued

The estimated fair value of the stock options granted during 2010 and in prior years was calculated using a Black Scholes option pricing model. The following summarizes the assumptions used in the 2010 Black Scholes model:

|  |            |
|--|------------|
| Risk-free interest rate                        | 2.38%      |
| Expected price volatility                      | 43.54%     |
| Dividend yield                                 | 4.02%      |
| Forfeiture rate                                | 5.00%      |
| Weighted-average expected life, until exercise | 6.68 years |

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 5 percent for the three months ended March 31, 2010, based on historical experience.

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

|  | Three Months Ended<br>March 31, |        |
|--|---------------------------------|--------|
|  | 2010                            | 2009   |
| <b>Stock and ESPP Options</b>                        |                                 |        |
| Pre-tax compensation expense                         | \$ 182                          | \$ 209 |
| Income tax benefit                                   | (17 )                           | (19 )  |
| Stock and ESPP option expense, net of income taxes   | \$ 165                          | \$ 190 |
| <b>Restricted Stock Awards</b>                       |                                 |        |
| Pre-tax compensation expense                         | \$ 302                          | \$ 335 |
| Income tax benefit                                   | (106 )                          | (121 ) |
| Restricted stock awards expense, net of income taxes | \$ 196                          | \$ 214 |
| <b>Total Share-Based Compensation:</b>               |                                 |        |
| Pre-tax compensation expense                         | \$ 485                          | \$ 544 |
| Income tax benefit                                   | (123 )                          | (140 ) |

|   |       |       |
|---|-------|-------|
| Total share-based compensation expense, net of income taxes | \$362 | \$404 |
|---|-------|-------|

As of March 31, 2010, unrecognized compensation expense related to stock options and RSAs totaling \$147,000 and \$302,000, respectively, is expected to be recognized over weighted-average periods of .98 and 2.11 years, respectively.



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

## NOTE 2. Share-Based Compensation continued

Stock option activity under the Corporation's stock option plans as of March 31, 2010 and changes during the three months ended March 31, 2010 were as follows:

|   | Number of<br>Shares | Weighted-Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term (in<br>Years) | Aggregate<br>Intrinsic<br>Value |
|---|---------------------|------------------------------------|---|---------------------------------|
| Outstanding at January 1, 2010                | 1,087,930           | \$ 23.51                           |   |                                 |
| Granted                                       | 35,000              | \$ 5.89                            |   |                                 |
| Exercised                                     |                     |                                    |   |                                 |
| Cancelled                                     | (12,063 )           | 26.02                              |   |                                 |
| Outstanding March 31, 2010                    | 1,110,867           | \$ 22.93                           | 5.31  | 1,750                           |
| Vested and Expected to Vest at March 31, 2010 | 1,110,867           | \$ 22.93                           | 5.31  | 1,750                           |
| Exercisable at March 31, 2010                 | 892,296             | \$ 24.70                           | 4.41  | 0                               |

The weighted-average grant date fair value was \$1.81 for stock options granted during the three months ended March 31, 2010.

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 2010 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, 2010. 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 2010.

The following table summarizes information on unvested RSAs outstanding as of March 31, 2010:

|                                  | Number of<br>Shares | Weighted-Average<br>Grant Date Fair<br>Value |
|----------------------------------|---------------------|--|
| Unvested RSAs at January 1, 2010 | 204,091             | \$ 19.95                                     |
| Granted                          | 107,866             | \$ 5.53                                      |
| Forfeited                        | (45,102 )           | \$ 26.24                                     |
| Vested                           | (1,668 )            | \$ 18.55                                     |
| Unvested RSAs at March 31, 2010  | 265,187             | \$ 12.76                                     |

The grant date fair value of ESPP options was estimated at the beginning of the January 1, 2010 quarterly offering period of approximately \$35,000. The ESPP options vested during the three month period ending March 31, 2010. At

March 31, 2010, there was no unrecognized compensation expense related to unvested ESPP options.

NOTE 3. Derivative Financial Instruments

The Corporation offers interest rate derivative products (e.g. interest rate swaps) to certain of its sophisticated commercial borrowers. This product allows customers to enter into an agreement with the Corporation to swap their variable rate loan to a fixed rate. These derivative products are designed to reduce, eliminate or modify the risk of changes in the borrower's interest rate or market price risk. The extension of credit incurred through the execution of these derivative products is subject to the same approvals and underwriting standards as the related traditional credit product. The Corporation limits its risk exposure to these products by entering into a mirror-image, offsetting swap agreement with a separate, well-capitalized and rated counterparty previously approved by the Corporation's Asset Liability Committee. By using these interest rate swap arrangements, the Corporation is also better insulated from the interest rate risk associated with underwriting fixed-rate loans. These derivative contracts are not designated against specific assets or liabilities and, therefore, do not qualify for hedge accounting. The derivatives are recorded on the balance sheet at fair value and changes in fair value of both the customer and the offsetting swap agreements are recorded (and essentially offset) in non-interest income. The fair value of the derivative instruments incorporates a consideration of credit risk (in accordance with fair value guidance), resulting in some insignificant volatility in earnings each period. The notional amounts of the interest rate swaps were \$60,351,000 at March 31, 2010.

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## NOTE 3. Derivative Financial Instruments continued

This amount is offset with third-party counterparties, as described above, in the same amount.

The tables summarize the fair value of derivative financial instruments utilized by the Corporation as well as their classification on the Consolidated Condensed Balance Sheets as of March 31, 2010 and December 31, 2009:

|  |              | Asset Derivatives      |            |                        |            | Liability Derivatives  |            |                        |            |
|--|--------------|------------------------|------------|------------------------|------------|------------------------|------------|------------------------|------------|
|  |              | March 31, 2010         |            | December 31, 2009      |            | March 31, 2010         |            | December 31, 2009      |            |
|  |              | Balance sheet location |            | Balance sheet location |            | Balance sheet location |            | Balance sheet location |            |
|  |              | Fair Value             | Fair Value | Fair Value             | Fair Value | Fair Value             | Fair Value | Fair Value             | Fair Value |
| Derivatives not designated as hedging instruments under ASC 815-10 |              |                        |            |                        |            |                        |            |                        |            |
| Interest rate contracts  | Other assets | \$2,843                |            | Other assets           | \$2,624    | Other Liabilities      | \$(2,873)  | Other assets           | \$(2,648)  |
|  |              | \$2,843                |            |                        | \$2,624    |                        | \$(2,873)  |                        | \$(2,648)  |

The effect of derivative instruments on the Consolidated Condensed Statements of Operations for the three months ended March 31, 2010 and 2009 is as follows:

| Derivatives Not Designated as Hedging Instruments under ASC 815-10 |              | Location of Gain (Loss) Recognized Income on Derivative | Amount of Loss Recognized Income on Derivative Three Months Ended March 31, 2010 | Amount of Gain) Recognized Income on Derivative Three Months Ended March 31, 2009 |
|--|--------------|---|--|---|
| Interest rate contracts  | Other income |   | \$ (6 )  | \$ 29   |

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.

The Corporation's agreements with its counterparties have certain contingent features that allow for the termination of all outstanding derivative contracts, or for the full collateralization of such contracts in the event that the Corporation loses its status as a well, or adequately capitalized institution. These features may include a default indebtedness provision that declares any indebtedness default, including a default without an acceleration of repayment by obligator, a declaration of a default on the derivative obligation.

As of March 31, 2010, the termination value of derivatives in a net liability position related to these agreements was \$2,784,000. The Corporation has minimum collateral posting thresholds with one of its derivative counterparties and has posted collateral of \$1,979,000 as of March 31, 2010. If the Corporation had breached any of these provisions at March 31, 2010, it could have been required to settle its obligations under the agreements at termination value.

#### Note 4. 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.

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Note 4. Disclosures About Fair Value of Assets and Liabilities continued

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.

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 and include corporate obligations and equity securities. Level 3 fair value on 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 (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

Seven of the pooled trust preferred securities in the portfolio amount to \$6.6 million in amortized cost, with a fair value of \$1.4 million. These securities were rated A or better at inception, but at March 31, 2010, 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. 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”) and the financial condition of the underlying issuers. Specifically, the process details 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, 2010 analysis, the conclusion was other-than-temporary impairment of \$488,000 on one of these securities.

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NOTE 4. Disclosures About Fair Value of Assets and Liabilities continued

Interest rate swap agreements

See information regarding the Corporation's interest rate derivative products in Note 3. 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.

The following table presents the fair value measurements of assets and liabilities recognized in the Consolidated Condensed Balance Sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at March 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 Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) |
|---|------------|---|---|---|
| Available for sale securities:              |            |   |   |   |
| U.S. Government-sponsored agency securities | \$ 4,407   |   | \$ 4,407  |   |
| State and municipal                         | 239,719    |   | 239,719   |   |
| Mortgage-backed securities                  | 228,250    |   | 228,250   |   |
| Corporate obligations                       | 1,390      |   |   | \$ 1,390  |
| Equity securities                           | 1,830      |   | 1,826   | 4   |
| Interest rate swap asset                    | 2,843      |   |   | 2,843   |
| Interest rate swap liability                | (2,873 )   |   |   | (2,873 )  |

The following table presents the fair value measurements of assets and liabilities recognized in the accompanying balance sheet measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2009.

|  | Fair Value | Fair Value Measurements Using<br>Quoted<br>Prices in<br>Active<br>Markets for | Significant Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) |
|--|------------|---|---|---|
|--|------------|---|---|---|

Identical  
Assets  
(Level 1)

|   |          |          |          |
|---|----------|----------|----------|
| Available for sale securities:              |          |          |          |
| U.S. Government-sponsored agency securities | \$ 4,406 | \$ 4,406 |          |
| State and municipal                         | 246,231  | 246,231  |          |
| Mortgage-backed securities                  | 155,978  | 155,978  |          |
| Corporate obligations                       | 5,162    | 2,683    | \$ 2,479 |
| Equity securities                           | 1,830    | 1,826    | 4        |
| Interest rate swap asset                    | 2,624    |          | 2,624    |
| Interest rate swap liability                | (2,648 ) |          | (2,648 ) |



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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
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## NOTE 4. Disclosures About Fair Value of Assets and Liabilities continued

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, 2010 and 2009.

|   | Three Months Ended March 31, 2010 |                             |                                 |
|---|-----------------------------------|-----------------------------|---------------------------------|
|   | Available for<br>Sale Securities  | Interest Rate<br>Swap Asset | Interest Rate<br>Swap 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 )                     |

|   | Three Months Ended March 31, 2009 |                             |                                 |
|---|-----------------------------------|-----------------------------|---------------------------------|
|   | Available for<br>Sale Securities  | Interest Rate<br>Swap Asset | Interest Rate<br>Swap Liability |
| Balance at beginning of the period              | \$ 7,929                          | \$ 4,094                    | \$ (4,224 )                     |
| Total realized and unrealized gains and losses: |                                   |                             |                                 |
| Included in net income (loss)                   | (477 )                            | (222 )                      | 251                             |
| Included in other comprehensive income          | (2,528 )                          |                             |                                 |
| Purchases, issuances and settlements            |                                   |                             |                                 |
| Transfers in/(out) of Level 3                   | (3,460 )                          |                             |                                 |
| Principal payments                              | 86                                |                             |                                 |
| Ending balance at March 31, 2009                | \$ 1,550                          | \$ 3,872                    | \$ (3,973 )                     |

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

|                | Fair Value | Fair Value Measurements Using   |  |   |
|----------------|------------|---|--|---|
|                |            | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
| March 31, 2010 |            |   |  |   |

|                                       |    |        |    |        |
|---------------------------------------|----|--------|----|--------|
| Impaired loans (collateral dependent) | \$ | 40,178 | \$ | 40,178 |
| Other real estate owned               | \$ | 489    | \$ | 489    |

| December 31, 2009                     | Fair Value | Fair Value Measurements Using   |  |   |
|---------------------------------------|------------|---|--|---|
|                                       |            | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets (Level<br>1) | Significant<br>Other<br>Observable<br>Inputs (Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |
| Impaired loans (collateral dependent) | \$         | 75,802  | \$   | 75,802  |
| Other real estate owned               | \$         | 5,193   | \$   | 5,193   |

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS  
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## NOTE 4. Disclosures About Fair Value of Assets and Liabilities continued

## Impaired Loans 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 2010, 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/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.

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

|  | March 31, 2010     |             |
|--|--------------------|-------------|
|  | Carrying<br>Amount | Fair Value  |
| <b>Assets at March 31, 2010:</b>                               |                    |             |
| Cash and due from banks  | \$59,723           | \$59,723    |
| Interest-bearing time deposits                                 | 157,735            | 157,735     |
| Investment securities available for sale                       | 475,596            | 475,596     |
| Investment securities held to maturity                         | 163,485            | 163,350     |
| Mortgage loans held for sale                                   | 3,646              | 3,646       |
| Loans  | 3,045,972          | 3,004,778   |
| FRB and FHLB stock   | 36,721             | 36,721      |
| Interest receivable  | 19,532             | 19,532      |
| <b>Liabilities at March 31, 2010:</b>                          |                    |             |
| Deposits   | \$3,397,786        | \$3,415,297 |
| <b>Borrowings:</b>   |                    |             |
| Securities sold under repurchase agreements                    | 112,826            | 113,276     |
| Federal Home Loan Bank advances                                | 123,261            | 129,806     |
| Subordinated debentures, revolving credit lines and term loans | 194,794            | 151,438     |

|                  |       |       |
|------------------|-------|-------|
| Interest Payable | 4,812 | 4,812 |
|------------------|-------|-------|

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.

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NOTE 4. Disclosures About Fair Value of Assets and Liabilities continued

Available for Sale: The fair value of investment securities available for sale approximates carrying value.

Held to Maturity 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: For both short-term loans and variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair value for other 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.

Loan commitments and letters-of-credit generally have short-term, variable-rate features and contain clauses which limit the Corporation's exposure to changes in customer credit quality. Accordingly, their carrying values, which are immaterial at the respective balance sheet dates, are reasonable estimates of fair value.

Federal Reserve ("FRB") and Federal Home Loan Bank ("FHLB") 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 approximates carrying value.

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, except for short-term and adjustable rate borrowing arrangements. At March 31, the fair value for these instruments approximates carrying value.

NOTE 5. 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, 2010 |                   |                              |                               |            |

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|   |           |          |            |         |
|---|-----------|----------|------------|---------|
| U.S. Government-sponsored agency securities | \$4,344   | \$63     |            | \$4,407 |
| State and municipal                         | 229,968   | 9,795    | \$(44 )    | 239,719 |
| Mortgage-backed securities                  | 225,589   | 2,847    | (186 )     | 228,250 |
| Corporate Obligations                       | 6,651     |          | (5,261 )   | 1,390   |
| Equity securities                           | 1,830     |          |            | 1,830   |
| Total available for sale                    | 468,382   | 12,705   | (5,491 )   | 475,596 |
| Held to maturity at March 31, 2010          |           |          |            |         |
| State and municipal                         | 17,495    | 382      |            | 17,877  |
| Mortgage-backed securities                  | 145,990   | 184      | (701 )     | 145,473 |
| Total held to maturity                      | 163,485   | 566      | (701 )     | 163,350 |
| Total Investment Securities                 | \$631,867 | \$13,271 | \$(6,192 ) | 638,946 |

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## NOTE 5. Investment Securities continued

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------|
| Available for sale at December 31, 2009     |                   |                              |                               |            |
| U.S. Government-sponsored agency securities | \$4,350           | \$56                         |                               | \$4,406    |
| State and municipal                         | 236,933           | 9,307                        | \$(9 )                        | 246,231    |
| Mortgage-backed securities                  | 154,488           | 2,321                        | (831 )                        | 155,978    |
| Corporate Obligations                       | 9,585             | 310                          | (4,733 )                      | 5,162      |
| Equity securities                           | 1,830             |                              |                               | 1,830      |
| Total available for sale                    | 407,186           | 11,994                       | (5,573 )                      | 413,607    |
| Held to maturity at December 31, 2009       |                   |                              |                               |            |
| State and municipal                         | 15,990            | 327                          | (13 )                         | 16,304     |
| Mortgage-backed securities                  | 133,520           |                              | (2,488 )                      | 131,032    |
| Total held to maturity                      | 149,510           | 327                          | (2,501 )                      | 147,336    |
| Total Investment Securities                 | \$556,696         | \$12,321                     | \$(8,074 )                    | 560,943    |

The amortized cost and fair value of available for sale securities and held to maturity securities at March 31, 2010, 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<br>Cost  | Fair Value | Amortized<br>Cost | Fair Value |
| Maturity Distribution at March 31, 2010: |                    |            |                   |            |
| Due in one year or less                  | \$13,084           | \$13,205   | \$9,147           | \$9,193    |
| Due after one through five years         | 36,100             | 37,677     | 535               | 568        |
| Due after five through ten years         | 35,454             | 37,356     | 3,643             | 3,716      |
| Due after ten years                      | 156,325            | 157,278    | 4,170             | 4,400      |
|  | \$240,963          | \$245,516  | \$17,495          | \$17,877   |
| Mortgage-backed securities               | 225,589            | 228,250    | 145,990           | 145,473    |
| Equity securities                        | 1,830              | 1,830      |                   |            |
| Total Investment Securities              | \$468,382          | \$475,596  | \$163,485         | \$163,350  |

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$251,801,000 at March 31, 2010.

The book value of securities sold under agreements to repurchase amounted to \$78 million at March 31, 2010.

Gross gains of \$1,842,000 resulting from sales and redemptions of available for sale securities were realized for the three months ended March 31, 2010. There were no gross losses resulting from sales and redemptions of available for sale securities realized for the three months ended March 31, 2010. The Corporation has recognized a credit loss of \$488,000 in the three months ended March 31, 2010, 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. Because the Corporation does not intend to sell the investment and it is not more likely than not the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity, it does not consider the remainder of the investment securities to be other-than-temporarily impaired at March 31, 2010.



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NOTE 5. Investment Securities continued

Gross gains of \$2,792,000 resulting from sales of available for sale securities were realized in the three months ended March 31, 2009. There were no losses recognized from the sales of available for sale securities in the three months ended March 31, 2009.

Certain investments in debt (and equity) securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments was \$163,212,000 and \$182,038,000, which is approximately 25.5 percent and 32.3 percent of the Corporation's available for sale and held to maturity investment portfolio at March 31, 2010 and December 31, 2009.

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 other-than-temporary impairment is identified.

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, 2010 and December 31, 2009:

|  | Fair Value<br>Less than 12 Months | Gross<br>Unrealized<br>Losses | Fair Value<br>12 Months or Longer | Gross<br>Unrealized<br>Losses | Fair Value<br>Total | Gross<br>Unrealized<br>Losses<br>Total |
|--|-----------------------------------|-------------------------------|-----------------------------------|-------------------------------|---------------------|--|
| <b>Temporarily Impaired Investment</b>           |                                   |                               |                                   |                               |                     |  |
| Securities at March 31, 2010                     |                                   |                               |                                   |                               |                     |  |
| State and municipal                              | \$8,649                           | \$(44 )                       |                                   |                               | \$8,649             | \$(44 )                                |
| Mortgage-backed securities                       | 152,246                           | (883 )                        | \$957                             | \$(4 )                        | 153,203             | (887 )                                 |
| Corporate obligations                            | 42                                | (773 )                        | 1,318                             | (4,488 )                      | 1,360               | (5,261 )                               |
| Total Temporarily Impaired Investment Securities | \$60,937                          | \$(1,700 )                    | \$2,275                           | \$(4,492 )                    | \$163,212           | \$(6,192 )                             |

|  | Fair Value<br>Less than 12 Months | Gross<br>Unrealized<br>Losses | Fair Value<br>12 Months or Longer | Gross<br>Unrealized<br>Losses | Fair Value<br>Total | Gross<br>Unrealized<br>Losses<br>Total |
|--|-----------------------------------|-------------------------------|-----------------------------------|-------------------------------|---------------------|--|
| <b>Temporarily Impaired Investment</b> |                                   |                               |                                   |                               |                     |  |
| Securities at December 31, 2009        |                                   |                               |                                   |                               |                     |  |
| State and municipal                    | \$7,813                           | \$(20 )                       | \$138                             | \$(2 )                        | \$7,951             | \$(22 )                                |

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|   |           |            |         |            |           |            |
|---|-----------|------------|---------|------------|-----------|------------|
| Mortgage-backed securities                          | 171,779   | (3,319 )   |         |            | 171,779   | (3,319 )   |
| Corporate obligations                               | 1,125     | (656 )     | 1,183   | (4,077 )   | 2,308     | (4,733 )   |
| Total Temporarily Impaired<br>Investment Securities | \$180,717 | \$(3,995 ) | \$1,321 | \$(4,079 ) | \$182,038 | \$(8,074 ) |

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

NOTE 5. Investment Securities continued

Mortgage-backed Securities

The unrealized losses on the Corporation's investment in mortgage-backed securities were a result of interest rate increases. The Corporation expects to recover the amortized cost basis over the term of the securities. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Corporation does not intend to sell the investments and it is not more likely than not the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Corporation does not consider those investments to be other-than-temporarily impaired at March 31, 2010. As noted in the table above, the mortgage-backed securities contain unrealized losses of \$186,000 on nine securities in the available for sale portfolio and \$701,000 on nineteen securities in the held to maturity portfolio. All but one of these securities is issued by a government sponsored entity. The unrealized loss on the single security not issued by a government sponsored entity, included in the table above, is \$14,000, on a book value of \$1,405,000.

State and Political Subdivisions

The unrealized losses on the Corporation's investments in securities of state and political subdivisions were caused by interest rate increases. 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. Because the Corporation does not intend to sell the investments and it is not more likely than not the Corporation will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Corporation does not consider those investments to be other-than-temporarily impaired at March 31, 2010.

Other Securities

The Corporation's unrealized losses on pooled trust preferred securities total \$5.2 million on a book value of \$6.6 million. 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. The Corporation 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 a credit loss of \$488,000 in the first quarter of 2010, 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. Because the Corporation does not intend to sell the investment and it is not more likely than not the Corporation will be required to sell the investment before recovery of its new, lower amortized cost basis, which may be maturity, it does not consider the remainder of the investment securities to be other-than-temporarily impaired at March 31, 2010.

Credit Losses Recognized on Investments

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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 Losses in<br>2010 | Accumulated<br>Credit Losses in<br>2009 |
|--|---|---|
| Credit losses on debt securities held:                                     |   |   |
| Balance, January 1   | \$ 9,411                                | \$ 2,682                                |
| Additions related to other-than-temporary losses not previously recognized | 488                                     | 477                                     |
| Balance, March 31  | \$ 9,899                                | \$ 3,159                                |

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

## NOTE 6. Loans and Allowance

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

|  | March 31,<br>2010  | December<br>31,<br>2009 |
|--|--------------------|-------------------------|
| <b>Loans:</b>  |                    |                         |
| Commercial and industrial loans                                  | \$621,591          | \$675,860               |
| Agricultural production financing and other loans to farmers     | 109,457            | 121,031                 |
| Real estate loans  |                    |                         |
| Construction   | 131,548            | 158,725                 |
| Commercial and farm land   | 1,259,588          | 1,254,115               |
| Residential  | 821,014            | 841,584                 |
| Individual's loans for household and other personal expenditures | 142,108            | 154,132                 |
| Tax-exempt loans   | 23,047             | 22,049                  |
| Lease financing receivables, net of unearned income              | 6,396              | 7,135                   |
| Other loans  | 19,791             | 35,157                  |
|  | 3,134,540          | 3,269,788               |
| Allowance for loan losses  | (88,568 )          | (92,131 )               |
| <b>Total Loans</b>   | <b>\$3,045,972</b> | <b>\$3,177,657</b>      |

The following table summarizes changes in the allowance for loan losses for the periods indicated:

|                                   | Three Months Ended<br>March 31, |                 |
|-----------------------------------|---------------------------------|-----------------|
|                                   | 2010                            | 2009            |
| <b>Allowance for loan losses:</b> |                                 |                 |
| Balances, January 1               | \$92,131                        | \$49,543        |
| Provision for losses              | 13,869                          | 12,921          |
| Adjustment related to acquisition |                                 | 2,040           |
| Recoveries on loans               | 832                             | 688             |
| Loans charged off                 | (18,264 )                       | (6,690 )        |
| <b>Balances, March 31</b>         | <b>\$88,568</b>                 | <b>\$58,502</b> |

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

|                               | March 31,<br>2010 | December<br>31,<br>2009 |
|-------------------------------|-------------------|-------------------------|
| <b>Non-Performing Assets:</b> |                   |                         |

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|  |           |           |
|--|-----------|-----------|
| Non-accrual loans                        | \$122,891 | \$118,409 |
| Renegotiated loans                       | 859       | 8,833     |
| Non-performing loans (NPL)               | 123,750   | 127,242   |
| Real estate owned and repossessed assets | 18,268    | 14,879    |
| Non-performing assets (NPA)              | 142,018   | 142,121   |
| 90+ days delinquent and still accruing   | 2,600     | 3,967     |
| NPAS & 90+ days delinquent               | \$144,618 | \$146,088 |
| Impaired Loans                           | \$157,391 | \$178,754 |

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NOTES TO CONSOLIDATED CONDENSED FINANCIAL STATEMENTS

(Table dollars in thousands)

(Unaudited)

NOTE 6. Loans and Allowance continued

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 7. 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, |                            |                     |               |                            |                     |
|---|------------------------------|----------------------------|---------------------|---------------|----------------------------|---------------------|
|   | 2010                         |                            |                     | 2009          |                            |                     |
|   | Net<br>Income                | Weighted-Average<br>Shares | Per Share<br>Amount | Net<br>Income | Weighted-Average<br>Shares | Per Share<br>Amount |
| Basic net income per share:   | \$ 1,586                     |                            |                     | \$4,117       |                            |                     |
| Less: Preferred stock dividends                                     | 1,450                        |                            |                     | 628           |                            |                     |
| Net income available to common stockholders                         | 136                          | 21,373,405                 | \$0.01              | 3,489         | 21,022,505                 | \$0.17              |
| Effect of dilutive stock options and warrants                       |                              | 88,770                     |                     |               | 70,862                     |                     |
| Diluted net income per share:                                       |                              |                            |                     |               |                            |                     |
| Net income available to common stockholders and assumed conversions | \$ 136                       | 21,462,175                 | \$0.01              | \$3,489       | 21,093,367                 | \$0.17              |

Stock options to purchase 1,093,344 and 1,085,848 shares for the three months ended March 31, 2010 and 2009, respectively, were not included in the earnings per share calculation because the exercise price exceeded the average market price.

Note 8. Goodwill

Goodwill is reviewed for impairment at least annually. Due to the declining stock price and the economic environment during 2009, the Corporation engaged a third party to perform the evaluation several times in 2009. The evaluation included a weighted average of three approaches. The asset approach values each asset and liability separately, which are then summed to produce an indication of the equity value of the business. The market approach compares the subject to similar businesses that have been sold. The income approach determines the value of a business using a discounted cash flow based on expectations of future earnings or cash flows. The most recent review was completed in the fourth quarter of 2009 and the results of the evaluation showed that the carrying value of First Merchants Corporation, as of November 30, 2009, did not exceed its fair value, and therefore management concluded that goodwill was 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), 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.



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

Note 8. Goodwill continued

At March 31, 2010, management reviewed the discounted cash flow approach used by the third party with updated information and reviewed the future earnings assumptions in the most recent third party analysis. Management determined that the carrying value of First Merchants Corporation does not exceed the fair value and therefore, management concluded that goodwill was not impaired.

Note 9. Impact of Accounting Changes

FASB ASC Topic 860-10, Accounting for Transfers of Financial Assets, and No. 167, Amendments to FASB ASC 810-10. In June 2009, the Financial Accounting Standards Board (“FASB”) issued FASB ASC Topic 860-10 and FASB ASC 810-10, which change the way entities account for securitizations and special-purpose entities, and will have a material effect on how banking organizations account for off-balance sheet vehicles. The new standards amend Statement of FASB ASC 860-10, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, and FASB ASC 810-10, Consolidation of Variable Interest Entities. Both FASB ASC Topic 860-10 and FASB ASC Topic 810-10 were effective January 1, 2010 and neither have a significant impact on the Corporation’s financial statements.

On January 21, 2010, the Board of Governors of the Federal Reserve System issued final risk-based capital rules related to the adoption of these accounting standards by financial institutions. ASC 860-10 and ASC 810-10 make substantive changes to how banking organizations account for many items, including securitized assets, that had been previously excluded from their balance sheets. Banking organizations affected by ASC 860-10 and ASC 810-10 generally will be subject to higher risk-based regulatory capital requirements intended to better align risk-based capital requirements with the actual risks of certain exposures.

The Corporation has adopted these standards, and takes into account in our internal capital planning processes the impact of these standards. Management continues to assess whether additional capital may be necessary to support the risks associated with off-balance-sheet vehicles affected by the new accounting standards.

FASB ASU 2010-09, Subsequent Event – Amendments to Certain Recognition and Disclosure Requirements. On February 24, 2010, FASB issued Accounting Standards Update (ASU) 2010-09, Subsequent Event – Amendments to Certain Recognition and Disclosure Requirements. The ASU establishes separate subsequent event recognition criteria and disclosure requirements for U.S. Securities and Exchange Commission (“SEC”) filers. Effective with the release date, the financial statements of SEC filers will no longer disclose either the date through which subsequent events were reviewed or that subsequent events were evaluated through the date financial statements were issued. The requirement to evaluate subsequent events through the date of issuance is still in place. Only the disclosure is affected.

The ASU also removes the requirement to make those disclosures in financial statements revised for either a correction of an error or a retrospective application of an accounting change. SEC filers are defined in the update as entities required to file or to furnish their financial statements with either the SEC or another appropriate agency (such as the Federal Deposit Insurance Corporation or Office of Thrift Supervision) under Section 12(i) of the Securities and Exchange Act of 1934, as amended.



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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, 2009. 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, 2010 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, 2009.

BUSINESS SUMMARY

The Corporation is a diversified financial holding company headquartered in Muncie, Indiana. Since its organization in 1982, the Corporation has grown to include 80 banking center locations in 24 Indiana and 3 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 Corporation's business activities are currently limited to one significant business segment, which is community banking. The Corporation's financial service affiliates included one nationally chartered bank: First Merchants Bank, National Association ("First Merchants"). First Merchants provides commercial and retail banking services. In addition, the Corporation's trust company and multi-line insurance company provide trust asset management services and retail and commercial insurance agency services, respectively.

RESULTS OF OPERATIONS

Executive Summary

First Merchants Corporation reported a first quarter return to profitability with net income available to shareholders of \$136,000 or \$.01 per common share, for the quarter ended March 31, 2010, compared to net income of \$3.5 million, or \$.17 per common share, for the quarter ended March 31, 2009.

Net charge-offs were \$17.4 million for the quarter, exceeding provision expense of \$13.9 million by \$3.5 million. Commercial and industrial loans represented the largest portion of net charge-offs at \$12.2 million for the quarter. Non-performing assets plus 90 days delinquent loans were \$145 million, or 3.3 percent of total assets at March 31, 2010. The Corporation's allowance for loan losses increased to 2.82 percent of total loans, a \$3.6 million decrease from December 31, 2009, but a \$30 million increase over March 31, 2009.

Assets decreased by \$105 million during the quarter. Loans, including loans held for sale, decreased \$139.6 million during the first quarter of 2010, or 4.3 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 \$35.7 million. Cash and cash equivalent balances were moved into interest bearing accounts as available. These declines have generated excess liquidity of \$175.3 million, of which \$76.0 million has been invested in the investment securities portfolio, and \$19.3 million was used to reduce higher cost borrowings and brokered CD balances.

Deposits decreased \$138.8 million during the first quarter of 2010, or 3.9 percent. Maturing brokered deposits and CDs over \$100,000 accounted for \$66.4 million of the decline. Another \$30.5 million were maturities of CDs below \$100,000. Management continues to focus on maximizing deposit pricing in an effort to retain customer relationships, remain competitive in the local markets and allow higher cost deposits to mature.

The Corporation's loan to deposit ratio is now 92.25 percent and its loan to asset ratio totals 71.63 percent.

The Corporation was able 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 14 basis points from 3.68 percent in the first quarter of 2009 to 3.82 percent in the first quarter of 2010 while earning assets decreased by \$343 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, 2010 and 2009.

During the three months ended March 31, 2010, asset yields decreased 30 basis points on a fully taxable equivalent basis (FTE) and interest costs decreased 44 basis points, resulting in a 14 basis point (FTE) increase in net interest income as compared to the same period in 2009.

| (Dollars in Thousands)   | Three Months Ended |              |      |   |
|--|--------------------|--------------|------|---|
|  | March 31,          |              |      |   |
|  | 2010               | 2009         |      |   |
| Annualized net interest income                                     | \$ 144,859         | \$ 153,999   |      |   |
| Annualized FTE adjustment  | \$ 6,295           | \$ 4,274     |      |   |
| Annualized net interest income on a fully taxable equivalent basis | \$ 151,154         | \$ 158,273   |      |   |
| Average earning assets   | \$ 3,955,515       | \$ 4,298,621 |      |   |
| Interest income (FTE) as a percent of average earning assets       | 5.39               | %            | 5.69 | % |
| Interest expense as a percent of average earning assets            | 1.57               | %            | 2.01 | % |
| Net interest income (FTE) as a percent of average earning assets   | 3.82               | %            | 3.68 | % |

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 \$1,507,000 or 10.4% during the first quarter of 2010, compared to the first quarter of 2009. Other-than-temporary impairment losses 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 during the first quarter of 2010, \$960,000 lower than the same period in 2009. Gains on interest rate floors were fully realized in 2009, causing the first quarter of 2010 to be lower than the same period in 2009 by \$481,000. Additionally, income from the loan level hedge agreements and the related fair value adjustments was \$61,000 lower than the first quarter in 2009.

Non-Interest Expense

First quarter non-interest expenses in 2010, compared with the same period in 2009, decreased by \$74,000 or 0.21%. Salaries and employee benefit costs fell \$2,453,000 or 12.26% due to cost savings realized after the Lincoln Bank acquisition and other staff reductions. Similarly, processing expenses decreased \$653,000 due to one-time expenses incurred in the first quarter of 2009 related to the consolidation of core systems after the Lincoln acquisition. However, FDIC expenses were up this quarter compared with the first quarter of 2009 by \$1,146,000 due to rate increases throughout 2009. OREO and credit related expenses increased \$2,151,000 due to increased write-downs of OREO properties and other impaired loan expenses.



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

RESULTS OF OPERATIONS continued

Income Tax Expense (Benefit)

The income tax benefit for the three months ended March 31, 2010 was \$916,000 with an effective tax rate of (136.7) percent. For the same period in 2009, the income tax expense was \$1,218,000 with an effective tax rate of 22.8 percent. The main factor for the decrease in the effective tax rate is that tax-exempt interest income comprised a higher percentage of pre-tax earnings in the first quarter of 2010 than in the first quarter of 2009.

CAPITAL

To be categorized as well capitalized, the Bank must maintain a minimum total capital to risk-weighted assets, Tier I capital to risk-weighted assets and Tier I capital to average assets of 10 percent, 6 percent and 5 percent, respectively. The Corporation's regulatory capital exceeded the regulatory "well capitalized" standard at March 31, 2010.

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. The Corporation's Tier I capital to average assets ratio was 9.13 percent at March 31, 2010 and 8.20 percent at December 31, 2009.

At March 31, 2010, the Corporation had a Tier I risk-based capital ratio of 11.65 percent and total risk-based capital ratio of 14.44 percent, compared to 10.32 percent and 13.04 percent respectively at December 31, 2009. Regulatory capital guidelines require a Tier I risk-based capital ratio of at least 4.0 percent and a total risk-based capital ratio of at least 8.0 percent.

Management is currently evaluating various methods for repayment of the \$116.0 million of preferred stock, which was issued to the Treasury Department in connection with the Troubled Assets Relief Program's Capital Purchase Program (CPP) during 2009, the most immediate being earnings growth and capital retention as evidenced by a reduction in the dividend paid to common shareholders. On January 29, 2010 the Corporate Board of Directors declared a reduced dividend of \$0.01 per share, payable on March 19, 2010. In addition to other legal and regulatory restrictions on the Corporation's ability to pay dividends, the terms of the CPP also prevent the Corporation from declaring a quarterly dividend on its common stock in excess of \$0.23 per share without the prior consent of the Treasury Department.

On March 25, 2010, the Corporation received a response from the Treasury Department expressing its willingness to consent to management's proposed exchange (a) of up to 58,000 shares of the Corporation's Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "Designated Preferred Stock"), having a liquidation amount of \$1,000 per share currently held by the Treasury, for (b) approximately \$58.0 million in aggregate principal amount of Trust Preferred Securities. The Treasury Department's willingness to consent to the partial exchange of Designated Preferred Stock for Trust Preferred Securities was subject to, in part, the Corporation's raising capital through a registered direct private placement of between 2.1 million and 4.2 million common shares. Subject to appropriate regulatory approval, completion of the exchange of Designated Preferred Stock for Trust Preferred Securities is expected in the second quarter of 2010.

On March 30, 2010, the Corporation completed the registered direct private placement of common equity totaling 4.2 million shares of its common stock in exchange for gross proceeds of approximately \$24.15 million.

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

CAPITAL continued

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>2010 | December<br>31,<br>2009 |        |   |
|--|-------------------|-------------------------|--------|---|
| Average goodwill   | \$ 141,357        | \$ 141,238              |        |   |
| Average core deposit intangible (CDI)  | 16,818            | 19,878                  |        |   |
| Average deferred tax on CDI  | (3,730 )          | (2,494 )                |        |   |
| Intangible adjustment  | \$ 154,445        | \$ 158,622              |        |   |
| Average stockholders' equity (GAAP capital)                                  | \$ 466,994        | \$ 477,148              |        |   |
| Average cumulative preferred stock issued under the Capital Purchase Program | (112,455 )        | (96,518 )               |        |   |
| Intangible adjustment  | (154,445 )        | (158,622 )              |        |   |
| Average tangible capital   | \$ 200,094        | \$ 222,008              |        |   |
| Average assets   | \$ 4,363,768      | \$ 4,674,590            |        |   |
| Intangible adjustment  | (154,445 )        | (158,622 )              |        |   |
| Average tangible assets  | \$ 4,209,323      | \$ 4,515,968            |        |   |
| Net income (loss) available to common stockholders                           | \$ 136            | \$(45,742 )             |        |   |
| CDI amortization, net of tax   | 730               | 3,097                   |        |   |
| Tangible net income (loss) available to common stockholders                  | \$ 866            | \$(42,645 )             |        |   |
| Diluted earnings per share   | \$ 0.01           | \$(2.17 )               |        |   |
| Diluted tangible earnings per share  | \$ 0.04           | \$(2.02 )               |        |   |
| Return on average GAAP capital   | 0.12              | %                       | -9.59  | % |
| Return on average tangible capital   | 1.73              | %                       | -19.21 | % |
| Return on average assets   | 0.01              | %                       | -0.98  | % |
| Return on average tangible assets  | 0.08              | %                       | -0.94  | % |

LOAN QUALITY/PROVISION FOR LOAN LOSSES

Our primary business focus is middle market commercial and residential real estate, auto and small consumer lending, which results in portfolio diversification. We ensure that appropriate methods to understand and underwrite risk are utilized. 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.

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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

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.

At March 31, 2010, non-performing assets, which includes non-accrual loans, restructured loans, and other real estate owned, plus loans 90-days delinquent, totaled \$144,618,000, a decrease of \$1,470,000 from December 31, 2009 as noted in the table below. Other real estate owned increased \$3,389,000 from December 31, 2009. Current appraisals are obtained to determine value as management continues to aggressively market these real estate assets. Loans 90-days delinquent decreased \$1,367,000 from December 31, 2009.

| (Dollars in Thousands)                   | March 31,<br>2010 | December<br>31,<br>2009 |
|--|-------------------|-------------------------|
| <b>Non-Performing Assets:</b>            |                   |                         |
| Non-accrual loans                        | \$122,891         | \$118,409               |
| Renegotiated loans                       | 859               | 8,833                   |
| Non-performing loans (NPL)               | 123,750           | 127,242                 |
| Real estate owned and repossessed assets | 18,268            | 14,879                  |
| Non-performing assets (NPA)              | 142,018           | 142,121                 |
| 90+ days delinquent and still accruing   | 2,600             | 3,967                   |
| NPAS & 90+ days delinquent               | \$144,618         | \$146,088               |
| Impaired Loans                           | \$157,391         | \$178,754               |

The composition of the non-accrual loans is reflected in the following table.

| (Dollars in<br>Thousands)                          | Commercial<br>& Commercial<br>Industrial | Commercial<br>Mortgage | Land<br>and<br>Lot | Agriculture | Total<br>Commercial | Residential<br>Mortgage | Home<br>Equity | Other<br>Consumer | Total<br>Consumer | Total<br>&<br>Consumer<br>Commercial |
|--|--|------------------------|--------------------|-------------|---------------------|-------------------------|----------------|-------------------|-------------------|--------------------------------------|
| <b>Loan Balances including Loans Held for Sale</b> | \$642.3                                  | \$1,132.1              | \$131.5            | \$260.0     | \$2,165.9           | \$604.6                 | \$220.0        | \$147.6           | \$972.3           | \$3,138.2                            |
| <b>% of Total</b>                                  | 20.5 %                                   | 36.1 %                 | 4.1 %              | 8.3 %       | 69.0 %              | 19.3 %                  | 7.0 %          | 4.7 %             | 31.0 %            |                                      |
| <b>Non-Accrual Loans</b>                           | \$23.7                                   | \$54.4                 | \$13.5             | \$6.2       | \$97.7              | \$23.4                  | \$1.7          | \$0.1             | \$25.2            | \$122.9                              |
| <b>Non-accrual ratio</b>                           | 3.68 %                                   | 4.80 %                 | 10.25 %            | 2.38 %      | 4.51 %              | 3.86 %                  | 0.79 %         | 0.06 %            | 2.59 %            | 3.92 %                               |

Prior to December 31, 2009, the Corporation globally included all classified loans, including substandard, doubtful and loss credits in impaired loans. At December 31, 2009, management refined its internal definition of impaired loans to be more specific and include all non-accrual loans, renegotiated loans, as well as substandard, doubtful and loss grade loans that were deemed impaired according to the applicable guidance. 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, 2010, impaired loans totaled \$157,391,000, a decrease of \$21,363,000 from December 31, 2009. At March 31, 2010, an allowance for losses was not deemed necessary for impaired loans totaling \$91,507,000, as there was no identified loss on these credits. An allowance of \$21,815,000 was recorded for the remaining balance of impaired loans of \$65,884,000 and is included in our allowance for loan losses.

At March 31, 2010, the allowance for loan losses was \$88,568,000, a decrease of \$3,563,000 from year end 2009. As a percent of loans, the allowance was 2.82 percent at March 31, 2010 and 2.81 percent at December 31, 2009. The provision for loan losses for the first three months of 2010 was \$13,869,000, an increase of \$948,000 from \$12,921,000 for the same period in 2009. Specific reserves on impaired loans decreased \$4,464,000 from 26,279,000 at December 31, 2009 to \$21,815,000 at March 31, 2010

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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

Net charge offs for the first quarter of 2010 were \$17,432,000. Of this amount, the 5 largest customer charge offs totaled \$14,658,000, with \$10,928,000 being the largest, followed by \$2,383,000 as the next largest charge off. The distribution of the net charge offs for the first three months of 2010 is reflected in the following table.

|   | Commercial & Commercial Industrial Mortgage |           | Land and Lot Agriculture |         | Total Commercial | Residential Mortgage | Home Equity | Other Consumer | Total Consumer | Total Consumer & Commercial |
|---|---|-----------|--------------------------|---------|------------------|----------------------|-------------|----------------|----------------|-----------------------------|
| Loan Balances including Loans Held for Sale | \$642.3                                     | \$1,132.1 | \$131.5                  | \$260.0 | \$2,165.9        | \$604.6              | \$220.0     | \$147.6        | \$972.3        | \$3,138.2                   |
| % of Total                                  | 20.5 %                                      | 36.1 %    | 4.1 %                    | 8.3 %   | 69.0 %           | 19.3 %               | 7.0 %       | 4.7 %          | 31.0 %         |                             |
| YTD Net Charge-offs                         | \$12.2                                      | \$2.8     | \$0.1                    | \$0.9   | \$16.0           | \$0.8                | \$0.2       | \$0.4          | \$1.4          | \$17.4                      |
| Net Charge-off ratio*                       | 7.60 %                                      | 1.00 %    | 0.19 %                   | 1.38 %  | 2.95 %           | 0.55 %               | 0.43 %      | 1.03 %         | 0.59 %         | 2.22 %                      |
| *Annualized based on ending balances        |   |           |                          |         |                  |                      |             |                |                |                             |

The decline in the value of commercial and residential real estate in our market has negatively impacted the underlying collateral value in our commercial, residential, land development and construction loans. This downturn in the real estate market is expected to continue and management is proactive in evaluating loans collateralized by real estate. Management continues to evaluate 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.

Our 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 principal source of asset-funded liquidity is investment securities classified as available for sale, the market values of which totaled \$475,596,000 at March 31, 2010, an increase of \$61,989,000, or 15.0 percent above December 31, 2009. Securities classified as held to maturity that are maturing within a short period of time can also be a source of liquidity. Securities classified as held to maturity and that are maturing in one year or less totaled \$9,147,000 at March 31, 2010. In addition, other types of assets such as cash and due from banks, federal funds sold and securities purchased under agreements to resell, and loans and interest-bearing deposits with other banks maturing within one year are sources of liquidity.

The most stable source of liability-funded liquidity for both the long-term and short-term is deposit growth and retention in the core deposit base. In addition, Federal Home Loan Bank (“FHLB”) advances are utilized as funding sources. At March 31, 2010, total borrowings from the FHLB were \$123,261,000. The Bank has pledged certain mortgage loans and investments to the FHLB. The total available remaining borrowing capacity from the FHLB at March 31, 2010 was \$137,828,000.

The Bank 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.



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

LIQUIDITY continued

The Corporation currently has a \$55 million credit facility with Bank of America, N.A., as successor to LaSalle Bank National Association, 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, 2010, the Corporation failed to meet the minimum return on average total assets covenant of at least 0.50% and a second financial covenant in the Loan Agreement requiring the Corporation to maintain a certain asset quality ratio less than 25%.

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, 2010 are as follows:

| (Dollars in Thousands)            | March 31,<br>2010 |
|-----------------------------------|-------------------|
| <b>Amounts of commitments:</b>    |                   |
| Loan commitments to extend credit | \$ 498,544        |
| Standby letters of credit         | 42,465            |
|                                   | \$ 541,009        |

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.

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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, 2010 are as follows:

| (Dollars in<br>Thousands)  | 2010<br>Remaining | 2011            | 2012             | 2013           | 2014            | 2015 and<br>after | Total            |
|--|-------------------|-----------------|------------------|----------------|-----------------|-------------------|------------------|
| Operating leases   | \$1,659           | \$2,038         | \$1,647          | \$895          | \$820           | \$1,061           | \$8,120          |
| Securities sold<br>under repurchase<br>agreements                          | 88,576            |                 | 14,250           |                | 10,000          |                   | 112,826          |
| Federal Home<br>Loan Bank<br>advances                                      | 39,492            | 18,934          | 50,587           | 414            | 1,331           | 12,503            | 123,261          |
| Subordinated<br>debentures,<br>revolving credit<br>lines and term<br>loans |                   |                 | 78,968           |                |                 | 115,826           | 194,794          |
| <b>Total</b>   | <b>\$129,727</b>  | <b>\$20,972</b> | <b>\$145,452</b> | <b>\$1,309</b> | <b>\$12,151</b> | <b>\$129,390</b>  | <b>\$439,001</b> |

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

INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK

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

It is our objective to monitor and manage risk exposure to net interest income caused by changes in interest rates. It is the goal of our ALM function to provide optimum and stable net interest income. To accomplish this, we use two ALM tools. GAP/Interest Rate Sensitivity Reports and Net Interest Income Simulation Modeling are constructed, presented, and monitored quarterly.

Management believes that our liquidity and interest sensitivity position at March 31, 2010, remained adequate to meet our primary goal of achieving optimum interest margins while avoiding undue interest rate risk.

Net interest income simulation modeling, or earnings-at-risk, measures the sensitivity of net interest income to various interest rate movements. Our 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 on the following page. The interest rate scenarios are used for analytical purposes and do not necessarily represent our view of future market movements. Rather, these are intended to provide a measure of the degree of volatility interest rate movements may introduce into our earnings.

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 our 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 loans and investments, 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, e.g., savings, money market, NOW and demand deposits, reflect our best estimate of expected future behavior.

The comparative rising and falling scenarios below 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 us in the base simulation are as follows:

|        | At March 31, 2010 |            |
|--------|-------------------|------------|
|        | RISING            | FALLING    |
|        | (200              |            |
| Driver | Basis             | (100 Basis |
| Rates  | Points)           | Points)    |

|            |     |       |
|------------|-----|-------|
| Prime      | 200 | 0     |
| Federal    |     |       |
| Funds      | 200 | 0     |
| One-Year   |     |       |
| CMT        | 200 | (7)   |
| Three-Year |     |       |
| CMT        | 200 | (72)  |
| Five-Year  |     |       |
| CMT        | 200 | (100) |
| CD's       | 200 | (74)  |
| FHLB       |     |       |
| Advances   | 200 | (31)  |

Results for the base, rising and falling interest rate scenarios are listed below, based upon our rate sensitive assets and liabilities at March 31, 2010. 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. All results are within the Corporation's policy limits.

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

INTEREST SENSITIVITY AND DISCLOSURE ABOUT MARKET RISK continued

| Driver Rates                | Base       | At March 31, 2010               |  |                                  |   |
|-----------------------------|------------|---------------------------------|--|----------------------------------|---|
|                             |            | RISING<br>(200 Basis<br>Points) |  | FALLING<br>(100 Basis<br>Points) |   |
| Net Interest Income         | \$ 150,549 | \$ 154,358                      |  | \$ 148,517                       |   |
| Variance from Base          |            | \$ 3,809                        |  | \$ (2,032)                       | ) |
| Percent of change from base | 0.00 %     | 2.53 %                          |  | -1.35 %                          | % |
| Policy Limit                |            | -5.00 %                         |  | -2.00 %                          | % |

The comparative rising and falling scenarios below as of December 31, 2009, 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 us in the base simulation are as follows:

| Driver Rates   | At December 31,<br>2009            |                                  |
|----------------|------------------------------------|----------------------------------|
|                | RISING<br>(200<br>Basis<br>Points) | FALLING<br>(100 Basis<br>Points) |
| Prime          | 200                                | 0                                |
| Federal Funds  | 200                                | 0                                |
| One-Year CMT   | 200                                | (7)                              |
| Three-Year CMT | 200                                | (61)                             |
| Five-Year CMT  | 200                                | (100)                            |
| CD's           | 200                                | (79)                             |
| FHLB Advances  | 200                                | (37)                             |

Results for the base, rising and falling interest rate scenarios are listed below, based upon our rate sensitive assets and liabilities at December 31, 2009. 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 December 31, 2009 |         |
|--------------|------|----------------------|---------|
|              |      | RISING               | FALLING |

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|                             |    |         | (200 Basis<br>Points) |         | (100 Basis<br>Points) |          |
|-----------------------------|----|---------|-----------------------|---------|-----------------------|----------|
| Net Interest Income         | \$ | 148,713 | \$                    | 158,850 | \$                    | 146,071  |
| Variance from Base          |    |         | \$                    | 10,137  | \$                    | (2,642 ) |
| Percent of change from base |    | 0.00    | %                     | 6.82    | %                     | -1.78    |
| 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, 2010, and December 31, 2009. Earning assets decreased by \$77,121,000 in the three months ended March 31, 2010. Federal funds sold decreased \$95,302,000, whereas, interest-bearing time deposits increased by \$83,710,000, a majority of which related to the change in investing excess funds at the Federal Reserve Bank. Investments increased by approximately \$75,964,000, while loans and loans held for sale decreased by \$139,638,000. Excess liquidity 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 industrial, construction real estate, and residential real estate. The only loan segment that increased was commercial and farmland.

| (Dollars in Thousands)                           | March 31,<br>2010 | December<br>31,<br>2009 |
|--|-------------------|-------------------------|
| Federal funds sold                               | \$7,044           | \$102,346               |
| Interest-bearing time deposits                   | 157,735           | 74,025                  |
| Investment securities available for sale         | 475,596           | 413,607                 |
| Investment securities held to maturity           | 163,485           | 149,510                 |
| Mortgage loans held for sale                     | 3,646             | 8,036                   |
| Loans  | 3,134,540         | 3,269,788               |
| Federal Reserve and Federal Home Loan Bank stock | 36,721            | 38,576                  |
| Total  | \$3,978,767       | \$4,055,888             |

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.



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PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

None

ITEM 1.A. RISK FACTORS

There have been no material changes from to the risk factors previously disclosed in the Corporation's December 31, 2009 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

FIRST MERCHANTS CORPORATION  
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## ITEM 6. EXHIBITS

| Exhibit No.: | Description of Exhibit   | Form 10-Q No.: |
|--------------|--|----------------|
| 10.1         | First Merchants Corporation Senior Management Incentive Compensation Plan dated February 25, 2010 and amended on March 31, 2010  | 38             |
| 10.2         | Form of Securities Purchase Agreement between First Merchants Corporation and six groups of institutional investors, dated March 30, 2010 (incorporated by reference to registrant's Form 8K filed on March 30, 2010 |                |
| 31.1         | Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002   | 41             |
| 31.2         | Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002   | 42             |
| 32           | Certifications Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes - Oxley Act of 2002  | 43             |

FIRST MERCHANTS CORPORATION  
FORM 10Q

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, 2010

by /s/ Michael C. Rechin  
Michael C. Rechin  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: May 10, 2010

by /s/ Mark K. Hardwick  
Mark K. Hardwick  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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FORM 10Q

## INDEX TO EXHIBITS

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FIRST MERCHANTS CORPORATION  
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EXHIBIT-10.1

First Merchants Corporation  
Senior Management Incentive  
Compensation Program  
Approved February 25, 2010  
(as amended on March 31, 2010)

I. Purpose

The Board of Directors of First Merchants Corporation (FMC) has established an executive compensation program, which is designed to closely align the interests of executives with those of our shareholders by rewarding senior managers for achieving short-term and long-term strategic management and earnings goals, with the ultimate objective of obtaining a superior return on the shareholders' investment.

II. Administration

This plan will be administered solely by the Compensation and Human Resources Committee (Committee) of FMC, with supporting documentation and recommendations provided by the Chief Executive Officer (CEO) of FMC. The Committee will annually review the targets for applicability and competitiveness.

The Committee will have the authority to: (a) modify the formal plan document; (b) make the final award determinations; (c) set conditions for eligibility and awards; (d) define extraordinary accounting events in calculating earnings; (e) establish future payout schedules; (f) determine circumstances/causes for which payouts can be withheld; and (g) abolish the plan.

III. Covered Individuals by Officer Level/Role

- A. President and Chief Executive Officer of FMC;
- B. Executive Vice Presidents of FMC;
- C. Executive Officers, Non-Bank Presidents and Regional Presidents;
- D. Selected Senior Leadership
- E. Department Heads, Division Heads and Other Management Leadership; and
- F. Mortgage Sales Managers.

In order to receive an award, a participant must be employed at the time of the award except for conditions of death, disability or retirement.

Participants will be disqualified if their individual overall performance is rated "improvement needed" or "unacceptable." Additional disqualifiers will be added based on the position, role and level of influence on results.

Participant lists will be reviewed annually by the Committee.



FIRST MERCHANTS CORPORATION  
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EXHIBIT-10.1 Senior Management Incentive Compensation Program continued

IV. Implementation Parameters

A. The FMC CEO and EVP earnings component payouts will be determined by changes in FMC EPS calculated on a diluted GAAP basis.

Payouts to affiliate participants on their respective company earnings component will be determined by changes in “operating earnings” (net income plus or minus non-operating items including goodwill amortization and corporate administrative charges.)

B. When utilized, balanced scorecards will be tailored to each unit incorporating a specific weighting on various operating initiatives as set by the CEO, EVP’s and SVP of HR.

V. Plan Structure

All payouts will be determined from the schedules of percentage change in EPS (Section VI.B.). Participants will be notified in writing at the beginning of the plan year.

|               | A       | B       | C   | D                             | E   | F                             |
|---------------|---------|---------|---|-------------------------------|---|-------------------------------|
| Target %:     | 45%     | 40%     | 25% - 30%   | 15% - 20%                     | 10%- 15%  | 5 bps                         |
| Participants: | FMC CEO | FMC EVP | ·Executive Officers<br>·Non-Bank Presidents<br>·Regional Presidents | Selected Senior<br>Leadership | ·Department<br>Heads<br>·Division Heads<br>·Other<br>Management<br>Leadership | Mortgage<br>Sales<br>Managers |

| Incentive Components: | Operating EPS at 100% (calculated on GAAP basis) | Operating EPS at 100% (calculated on GAAP basis) | FMC participants: Change in EPS at 80%; Consolidated Efficiency Ratio at 20%<br>Bank Participants: Balanced Scorecard FMIS & FMTC: Change in Agency/Trust Operating Revenue at 50%;<br>Change in EPS at 30%<br>Change in Consolidated Efficiency Ratio at 20% | FMC participants: Change in EPS at 80%; Consolidated Efficiency Ratio at 20%<br>Bank Participants: Balanced Scorecard FMIS & FMTC: Change in Agency/Trust Operating Revenue at 50%;<br>Change in EPS at 30%<br>Change in Consolidated Efficiency Ratio at 20% | FMC participants: 5 bps of subordinate mortgage volume<br>Change in EPS at 80%; Consolidated Efficiency Ratio at 20%<br>Bank Participants: Balanced Scorecard FMIS & FMTC: Change in Agency/Trust Operating Revenue at 50%;<br>Change in EPS at 30%<br>Change in Consolidated Efficiency Ratio at 20% |
|-----------------------|--|--|---|---|---|
|                       |  |  |   |   |   |

VI. Supporting Parameters

A. Where individual components are applicable, they must be measurable with both beginning points and standard targets cited.



FIRST MERCHANTS CORPORATION  
FORM 10Q

EXHIBIT-10.1 Senior Management Incentive Compensation Program continued

B. Schedule Determining EPS on a diluted GAAP basis\* payouts

|        | \$       | Payout |
|--------|----------|--------|
|        | Actual   | %      |
|        | < \$0.05 | 0%     |
|        | 0.05     | 30%    |
|        | 0.10     | 40%    |
|        | 0.15     | 50%    |
|        | 0.20     | 60%    |
|        | 0.25     | 70%    |
|        | 0.30     | 80%    |
|        | 0.35     | 90%    |
| Target | 0.40     | 100%   |
|        | 0.45     | 110%   |
|        | 0.50     | 120%   |
|        | 0.55     | 130%   |
|        | 0.60     | 140%   |
|        | 0.65     | 150%   |

\* Earnings Per Share adjusted for any unplanned extraordinary income or expenses, all as determined by the Committee.

C. Schedule Determining Operating Earnings Payouts for FMTC and FMIS

|        | Operating<br>Earnings %<br>Change* | Payout % |
|--------|------------------------------------|----------|
|        | <10%                               | 0%       |
|        | 10%                                | 40%      |
|        | 12.5%                              | 50%      |
|        | 15%                                | 60%      |
|        | 17.5%                              | 70%      |
|        | 20%                                | 80%      |
|        | 22.5%                              | 90%      |
| Target | 25%                                | 100%     |
|        | 27.5%                              | 110%     |
|        | 30%                                | 120%     |
|        | 32.5%                              | 130%     |
|        | 35.0%                              | 140%     |
|        | 37.5%                              | 150%     |
|        | 40%                                | 160%     |
|        | 42.5%                              | 170%     |
|        | 45%                                | 180%     |
|        | 47.5%                              | 190%     |

=>50% 200%

\* Operating earnings adds back charges for amortization of goodwill and other non-operating expenses and excludes unplanned extraordinary income or expenses, all as determined by the Committee. Operating earnings will also be normalized for subsidiary acquisitions.

Senior Management Incentive Compensation Program - Revised 03/31/2010

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, 2010

by /s/ Michael C. Rechin

Michael C. Rechin  
President and Chief Executive Officer  
(Principal Executive Officer)

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, 2010

by: /s/ Mark K. Hardwick

Mark K. Hardwick  
Executive Vice President and  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

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, 2010 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, 2010

by /s/ Michael C. Rechin

Michael C. Rechin  
President and  
Chief Executive Officer  
(Principal Executive 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.

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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, 2010 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, 2010

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.