

GERMAN AMERICAN BANCORP, INC.  
Form 10-Q  
November 12, 2013

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period  
Ended September 30, 2013

Commission File Number 001-15877

German American Bancorp, Inc.  
(Exact name of registrant as specified in its charter)

Indiana  
(State or other jurisdiction of  
incorporation or organization)

35-1547518  
(I.R.S. Employer  
Identification No.)

711 Main Street, Jasper, Indiana 47546  
(Address of Principal Executive Offices and Zip Code)

Registrant's telephone number, including area code: (812) 482-1314

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

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

YES  NO

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

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Class  
Common Shares, no par value

Outstanding at November 1, 2013  
13,169,396

CAUTION REGARDING FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS

Information included in or incorporated by reference in this Quarterly Report on Form 10-Q, our other filings with the Securities and Exchange Commission (the “SEC”) and our press releases or other public statements, contains or may contain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Please refer to the discussions of our forward-looking statements and associated risks in our annual report on Form 10-K for the year ended December 31, 2012, in Item 1, “Business Forward-Looking Statements and Associated Risks” and our discussion of risk factors in Item 1A, “Risk Factors” of that annual report on Form 10-K, as updated from time to time in our subsequent SEC filings, including by Item 2 of Part I of this Report (“Management’s Discussion and Analysis of Financial Condition and Results of Operations”) at the conclusion of that Item 2 under the heading “Forward-Looking Statements and Associated Risks.”

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**PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****GERMAN AMERICAN BANCORP, INC.****CONSOLIDATED BALANCE SHEETS****(unaudited, dollars in thousands except share and per share data)**

|   | September 30,<br>2013 | December 31,<br>2012 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Cash and Due from Banks   | \$ 46,657             | \$ 41,624            |
| Federal Funds Sold and Other Short-term Investments   | 18,014                | 7,463                |
| Cash and Cash Equivalents   | 64,671                | 49,087               |
| Interest-bearing Time Deposits with Banks   |                       | 2,707                |
| Securities Available-for-Sale, at Fair Value  | 608,653               | 587,602              |
| Securities Held-to-Maturity, at Cost (Fair value of \$271 and \$351<br>on September 30, 2013 and December 31, 2012, respectively) | 268                   | 346                  |
| Loans Held-for-Sale, at Fair Value  | 9,054                 | 16,641               |
| Loans   | 1,284,290             | 1,207,901            |
| Less: Unearned Income   | (2,848)               | (3,035)              |
| Allowance for Loan Losses   | (14,464)              | (15,520)             |
| Loans, Net  | 1,266,978             | 1,189,346            |
| Stock in FHLB of Indianapolis and Other Restricted Stock, at Cost   | 8,340                 | 8,340                |
| Premises, Furniture and Equipment, Net  | 36,679                | 36,554               |
| Other Real Estate   | 584                   | 1,645                |
| Goodwill  | 18,865                | 18,865               |
| Intangible Assets   | 1,647                 | 2,692                |
| Company Owned Life Insurance  | 30,932                | 30,223               |
| Accrued Interest Receivable and Other Assets  | 13,451                | 62,252               |
| <b>TOTAL ASSETS</b>   | <b>\$ 2,060,122</b>   | <b>\$ 2,006,300</b>  |
| <b>LIABILITIES</b>  |                       |                      |
| Non-interest-bearing Demand Deposits  | \$ 364,110            | \$ 349,174           |
| Interest-bearing Demand, Savings, and Money Market Accounts   | 974,748               | 962,574              |
| Time Deposits   | 332,181               | 329,183              |
| Total Deposits  | 1,671,039             | 1,640,931            |
| FHLB Advances and Other Borrowings  | 191,554               | 161,006              |
| Accrued Interest Payable and Other Liabilities  | 12,386                | 19,337               |
| <b>TOTAL LIABILITIES</b>  | <b>1,874,979</b>      | <b>1,821,274</b>     |
| <b>SHAREHOLDERS' EQUITY</b>   |                       |                      |
| Preferred Stock, no par value; 500,000<br>shares authorized, no shares issued   |                       |                      |
| Common Stock, no par value, \$1 stated value;<br>30,000,000 shares authorized   | 12,667                | 12,637               |
| Additional Paid-in Capital  | 95,838                | 95,617               |

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|   |              |              |
|---|--------------|--------------|
| Retained Earnings                             | 79,550       | 66,421       |
| Accumulated Other Comprehensive Income (Loss) | (2,912)      | 10,351       |
| TOTAL SHAREHOLDERS' EQUITY                    | 185,143      | 185,026      |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY    | \$ 2,060,122 | \$ 2,006,300 |
| End of period shares issued and outstanding   | 12,666,836   | 12,636,656   |

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(unaudited, dollars in thousands except per share data)

|   | Three Months Ended<br>September 30, |               |
|---|-------------------------------------|---------------|
|   | 2013                                | 2012          |
| <b>INTEREST INCOME</b>  |                                     |               |
| Interest and Fees on Loans                                      | \$ 15,307                           | \$ 15,082     |
| Interest on Federal Funds Sold and Other Short-term Investments | 2                                   | 11            |
| Interest and Dividends on Securities:                           |                                     |               |
| Taxable   | 2,768                               | 3,235         |
| Non-taxable   | 735                                 | 625           |
| <b>TOTAL INTEREST INCOME</b>                                    | <b>18,812</b>                       | <b>18,953</b> |
| <b>INTEREST EXPENSE</b>   |                                     |               |
| Interest on Deposits  | 1,145                               | 1,622         |
| Interest on FHLB Advances and Other Borrowings                  | 475                                 | 938           |
| <b>TOTAL INTEREST EXPENSE</b>                                   | <b>1,620</b>                        | <b>2,560</b>  |
| <b>NET INTEREST INCOME</b>                                      | <b>17,192</b>                       | <b>16,393</b> |
| Provision for Loan Losses                                       | (400)                               | 640           |
| <b>NET INTEREST INCOME AFTER PROVISION<br/>FOR LOAN LOSSES</b>  | <b>17,592</b>                       | <b>15,753</b> |
| <b>NON-INTEREST INCOME</b>                                      |                                     |               |
| Trust and Investment Product Fees                               | 802                                 | 659           |
| Service Charges on Deposit Accounts                             | 1,029                               | 1,049         |
| Insurance Revenues  | 1,495                               | 1,469         |
| Company Owned Life Insurance                                    | 233                                 | 213           |
| Interchange Fee Income  | 449                                 | 418           |
| Other Operating Income  | 395                                 | 811           |
| Net Gains on Sales of Loans                                     | 613                                 | 941           |
| Net Gains on Securities   | 428                                 | 598           |
| <b>TOTAL NON-INTEREST INCOME</b>                                | <b>5,444</b>                        | <b>6,158</b>  |
| <b>NON-INTEREST EXPENSE</b>                                     |                                     |               |
| Salaries and Employee Benefits                                  | 7,515                               | 7,261         |
| Occupancy Expense   | 1,155                               | 1,066         |
| Furniture and Equipment Expense                                 | 736                                 | 650           |
| FDIC Premiums   | 261                                 | 271           |
| Data Processing Fees  | 383                                 | 311           |
| Professional Fees   | 970                                 | 585           |
| Advertising and Promotion                                       | 447                                 | 439           |
| Intangible Amortization   | 329                                 | 405           |
| Other Operating Expenses  | 1,788                               | 1,740         |
| <b>TOTAL NON-INTEREST EXPENSE</b>                               | <b>13,584</b>                       | <b>12,728</b> |
| Income before Income Taxes                                      | 9,452                               | 9,183         |
| Income Tax Expense  | 2,969                               | 2,891         |

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|                            |    |       |    |       |
|----------------------------|----|-------|----|-------|
| NET INCOME                 | \$ | 6,483 | \$ | 6,292 |
| Basic Earnings Per Share   | \$ | 0.51  | \$ | 0.50  |
| Diluted Earnings Per Share | \$ | 0.51  | \$ | 0.50  |
| Dividends Per Share        | \$ | 0.15  | \$ | 0.14  |

See accompanying notes to consolidated financial statements.



**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(unaudited, dollars in thousands except per share data)

|   | Nine Months Ended<br>September 30, |               |
|---|------------------------------------|---------------|
|   | 2013                               | 2012          |
| <b>INTEREST INCOME</b>  |                                    |               |
| Interest and Fees on Loans                                      | \$ 45,227                          | \$ 46,380     |
| Interest on Federal Funds Sold and Other Short-term Investments | 25                                 | 84            |
| Interest and Dividends on Securities:                           |                                    |               |
| Taxable   | 8,380                              | 9,982         |
| Non-taxable   | 2,008                              | 1,797         |
| <b>TOTAL INTEREST INCOME</b>                                    | <b>55,640</b>                      | <b>58,243</b> |
| <b>INTEREST EXPENSE</b>   |                                    |               |
| Interest on Deposits  | 3,533                              | 5,523         |
| Interest on FHLB Advances and Other Borrowings                  | 1,978                              | 3,066         |
| <b>TOTAL INTEREST EXPENSE</b>                                   | <b>5,511</b>                       | <b>8,589</b>  |
| <b>NET INTEREST INCOME</b>                                      | <b>50,129</b>                      | <b>49,654</b> |
| Provision for Loan Losses                                       | (250)                              | 1,721         |
| <b>NET INTEREST INCOME AFTER PROVISION<br/>FOR LOAN LOSSES</b>  | <b>50,379</b>                      | <b>47,933</b> |
| <b>NON-INTEREST INCOME</b>                                      |                                    |               |
| Trust and Investment Product Fees                               | 2,433                              | 2,019         |
| Service Charges on Deposit Accounts                             | 3,034                              | 3,001         |
| Insurance Revenues  | 4,658                              | 4,218         |
| Company Owned Life Insurance                                    | 716                                | 723           |
| Interchange Fee Income  | 1,392                              | 1,309         |
| Other Operating Income  | 1,547                              | 1,500         |
| Net Gains on Sales of Loans                                     | 2,176                              | 2,330         |
| Net Gains on Securities   | 1,508                              | 692           |
| <b>TOTAL NON-INTEREST INCOME</b>                                | <b>17,464</b>                      | <b>15,792</b> |
| <b>NON-INTEREST EXPENSE</b>                                     |                                    |               |
| Salaries and Employee Benefits                                  | 22,926                             | 21,409        |
| Occupancy Expense   | 3,359                              | 3,219         |
| Furniture and Equipment Expense                                 | 2,229                              | 2,054         |
| FDIC Premiums   | 776                                | 851           |
| Data Processing Fees  | 1,085                              | 746           |
| Professional Fees   | 2,156                              | 1,777         |
| Advertising and Promotion                                       | 1,453                              | 1,208         |
| Intangible Amortization   | 1,044                              | 1,269         |
| Other Operating Expenses  | 5,279                              | 5,211         |
| <b>TOTAL NON-INTEREST EXPENSE</b>                               | <b>40,307</b>                      | <b>37,744</b> |
| Income before Income Taxes                                      | 27,536                             | 25,981        |
| Income Tax Expense  | 8,712                              | 8,120         |

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|                            |    |        |    |        |
|----------------------------|----|--------|----|--------|
| NET INCOME                 | \$ | 18,824 | \$ | 17,861 |
| Basic Earnings Per Share   | \$ | 1.49   | \$ | 1.42   |
| Diluted Earnings Per Share | \$ | 1.48   | \$ | 1.41   |
| Dividends Per Share        | \$ | 0.45   | \$ | 0.42   |

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**(unaudited, dollars in thousands)**

|   | Three Months Ended<br>September 30, |          |
|---|-------------------------------------|----------|
|   | 2013                                | 2012     |
| NET INCOME  | \$ 6,483                            | \$ 6,292 |
| Other Comprehensive Income (Loss):                                    |                                     |          |
| Unrealized Gains (Losses) on Securities                               |                                     |          |
| Unrealized Holding Gain (Loss) Arising During the Period              | (1,860)                             | 2,190    |
| Reclassification Adjustment for Losses (Gains) Included in Net Income | (428)                               | (598)    |
| Tax Effect  | 915                                 | (406)    |
| Net of Tax  | (1,373)                             | 1,186    |
| Total Other Comprehensive Income (Loss)                               | (1,373)                             | 1,186    |
| COMPREHENSIVE INCOME  | \$ 5,110                            | \$ 7,478 |

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**  
**(unaudited, dollars in thousands)**

|   | Nine Months Ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2013                               | 2012      |
| NET INCOME  | \$ 18,824                          | \$ 17,861 |
| Other Comprehensive Income (Loss):                                    |                                    |           |
| Unrealized Gains (Losses) on Securities                               |                                    |           |
| Unrealized Holding Gain (Loss) Arising During the Period              | (19,613)                           | 4,075     |
| Reclassification Adjustment for Losses (Gains) Included in Net Income | (1,508)                            | (692)     |
| Tax Effect  | 7,858                              | (1,018)   |
| Net of Tax  | (13,263)                           | 2,365     |
| Total Other Comprehensive Income (Loss)                               | (13,263)                           | 2,365     |
| COMPREHENSIVE INCOME  | \$ 5,561                           | \$ 20,226 |

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(unaudited, dollars in thousands)**

|   | Nine Months Ended<br>September 30,<br>2013 | 2012      |
|---|--|-----------|
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>                                   |  |           |
| Net Income  | \$ 18,824                                  | \$ 17,861 |
| Adjustments to Reconcile Net Income to Net Cash from Operating Activities:    |  |           |
| Net Amortization on Securities  | 2,338                                      | 3,419     |
| Depreciation and Amortization   | 3,308                                      | 3,584     |
| Loans Originated for Sale   | (132,471)                                  | (125,770) |
| Proceeds from Sales of Loans Held-for-Sale                                    | 142,433                                    | 130,375   |
| Provision for Loan Losses   | (250)                                      | 1,721     |
| Gain on Sale of Loans, net  | (2,176)                                    | (2,330)   |
| Gain on Securities, net   | (1,508)                                    | (692)     |
| Loss (Gain) on Sales of Other Real Estate and Repossessed Assets              | 258  | (232)     |
| Gain on Disposition and Impairment of Premises and Equipment                  | (70)                                       | (1)       |
| Increase in Cash Surrender Value of Company Owned Life Insurance              | (709)                                      | (712)     |
| Equity Based Compensation   | 247  | 463       |
| Change in Assets and Liabilities:   |  |           |
| Interest Receivable and Other Assets  | 2,799                                      | 3,716     |
| Interest Payable and Other Liabilities  | 278  | (1,048)   |
| Net Cash from Operating Activities  | 33,301                                     | 30,354    |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>                                   |  |           |
| Proceeds from Maturity of Other Short-term Investments                        | 2,690                                      | 3,236     |
| Proceeds from Maturities, Calls, Redemptions of Securities Available-for-Sale | 114,563                                    | 100,964   |
| Proceeds from Sales of Securities Available-for-Sale                          | 119,952                                    | 92,344    |
| Purchase of Securities Available-for-Sale                                     | (231,085)                                  | (244,755) |
| Proceeds from Maturities of Securities Held-to-Maturity                       | 78   | 344       |
| Purchase of Loans   | (744)                                      |           |
| Proceeds from Sales of Loans  | 3,250                                      | 7,560     |
| Loans Made to Customers, net of Payments Received                             | (80,564)                                   | (55,676)  |
| Proceeds from Sales of Other Real Estate                                      | 1,479                                      | 3,827     |
| Property and Equipment Expenditures   | (2,296)                                    | (3,091)   |
| Proceeds from Sales of Property and Equipment                                 | 88   | 1         |
| Net Cash from Investing Activities  | (72,589)                                   | (95,246)  |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>                                   |  |           |
| Change in Deposits  | 30,120                                     | 62,876    |
| Change in Short-term Borrowings   | 31,258                                     | 30,090    |
| Advances in Long-term Debt  | 50,000                                     |           |
| Repayments of Long-term Debt  | (50,815)                                   | (20,059)  |
| Issuance of Common Stock  | 13   | 35        |
| Employee Stock Purchase Plan  | (9)  | (66)      |
| Dividends Paid  | (5,695)                                    | (5,299)   |

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|  |           |           |
|--|-----------|-----------|
| Net Cash from Financing Activities             | 54,872    | 67,577    |
| Net Change in Cash and Cash Equivalents        | 15,584    | 2,685     |
| Cash and Cash Equivalents at Beginning of Year | 49,087    | 61,103    |
| Cash and Cash Equivalents at End of Period     | \$ 64,671 | \$ 63,788 |
| Cash Paid During the Period for                |           |           |
| Interest                                       | \$ 6,096  | \$ 9,411  |
| Income Taxes                                   | 8,732     | 6,484     |
| Supplemental Non Cash Disclosures              |           |           |
| Loans Transferred to Other Real Estate         | \$ 676    | \$ 2,862  |
| Accounts Receivable Transferred to Securities  | (45,803)  | (43,167)  |

See accompanying notes to consolidated financial statements.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2013**  
**(unaudited, dollars in thousands except share and per share data)**

**Note 1 Basis of Presentation**

German American Bancorp, Inc. operates primarily in the banking industry. The accounting and reporting policies of German American Bancorp, Inc. and its subsidiaries conform to U.S. generally accepted accounting principles. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. All adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the periods reported have been included in the accompanying unaudited consolidated financial statements, and all such adjustments are of a normal recurring nature. It is suggested that these consolidated financial statements and notes be read in conjunction with the financial statements and notes thereto in the German American Bancorp, Inc. December 31, 2012 Annual Report on Form 10-K.

**Note 2 Per Share Data**

The computations of Basic Earnings per Share and Diluted Earnings per Share are as follows:

|   | Three Months Ended<br>September 30,<br>2013 | 2012       |
|---|---|------------|
| Basic Earnings per Share:                   |   |            |
| Net Income                                  | \$ 6,483                                    | \$ 6,292   |
| Weighted Average Shares Outstanding         | 12,666,780                                  | 12,628,335 |
| Basic Earnings per Share                    | \$ 0.51                                     | \$ 0.50    |
| Diluted Earnings per Share:                 |   |            |
| Net Income                                  | \$ 6,483                                    | \$ 6,292   |
| Weighted Average Shares Outstanding         | 12,666,780                                  | 12,628,335 |
| Potentially Dilutive Shares, Net            | 24,384                                      | 20,589     |
| Diluted Weighted Average Shares Outstanding | 12,691,164                                  | 12,648,924 |
| Diluted Earnings per Share                  | \$ 0.51                                     | \$ 0.50    |

For the three months ended September 30, 2013 and 2012, there were no anti-dilutive shares.

The computations of Basic Earnings per Share and Diluted Earnings per Share are as follows:

|                                     | Nine Months Ended<br>September 30,<br>2013 | 2012       |
|-------------------------------------|--|------------|
| Basic Earnings per Share:           |  |            |
| Net Income                          | \$ 18,824                                  | \$ 17,861  |
| Weighted Average Shares Outstanding | 12,658,403                                 | 12,618,863 |
| Basic Earnings per Share            | \$ 1.49                                    | \$ 1.42    |
| Diluted Earnings per Share:         |  |            |

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|   |    |            |    |            |
|---|----|------------|----|------------|
| Net Income                                  | \$ | 18,824     | \$ | 17,861     |
| Weighted Average Shares Outstanding         |    | 12,658,403 |    | 12,618,863 |
| Potentially Dilutive Shares, Net            |    | 19,950     |    | 15,009     |
| Diluted Weighted Average Shares Outstanding |    | 12,678,353 |    | 12,633,872 |
| Diluted Earnings per Share                  | \$ | 1.48       | \$ | 1.41       |

For the nine months ended September 30, 2013 and 2012, there were no anti-dilutive shares.

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2013**  
**(unaudited, dollars in thousands except share and per share data)**

**Note 3 Securities**

The amortized cost, unrealized gross gains and losses recognized in accumulated other comprehensive income (loss), and fair value of Securities Available-for-Sale at September 30, 2013 and December 31, 2012, were as follows:

|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|------------------------------|-------------------------------|---------------|
| Securities Available-for-Sale:                  |                   |                              |                               |               |
| September 30, 2013                              |                   |                              |                               |               |
| U.S. Treasury and Agency Securities             | \$ 20,754         | \$ 2                         | \$ (969)                      | \$ 19,787     |
| Obligations of State and Political Subdivisions | 95,033            | 2,793                        | (555)                         | 97,271        |
| Mortgage-backed Securities - Residential        | 496,129           | 4,765                        | (10,325)                      | 490,569       |
| Equity Securities                               | 684               | 342                          |                               | 1,026         |
| Total   | \$ 612,600        | \$ 7,902                     | \$ (11,849)                   | \$ 608,653    |
| December 31, 2012                               |                   |                              |                               |               |
| U.S. Treasury and Agency Securities             | \$ 23,570         | \$ 40                        | \$ (138)                      | \$ 23,472     |
| Obligations of State and Political Subdivisions | 71,352            | 5,145                        | (12)                          | 76,485        |
| Mortgage-backed Securities - Residential        | 475,452           | 11,505                       | (45)                          | 486,912       |
| Equity Securities                               | 684               | 49                           |                               | 733           |
| Total   | \$ 571,058        | \$ 16,739                    | \$ (195)                      | \$ 587,602    |

Equity securities that do not have readily determinable fair values are included in the above totals, are carried at historical cost and are evaluated for impairment on a periodic basis. All mortgage-backed securities in the above table are residential mortgage-backed securities and guaranteed by government sponsored entities.

The carrying amount, unrecognized gains and losses and fair value of Securities Held-to-Maturity at September 30, 2013 and December 31, 2012, were as follows:

|   | Carrying<br>Amount | Gross<br>Unrecognized<br>Gains | Gross<br>Unrecognized<br>Losses | Fair<br>Value |
|---|--------------------|--------------------------------|---------------------------------|---------------|
| Securities Held-to-Maturity:                    |                    |                                |                                 |               |
| September 30, 2013                              |                    |                                |                                 |               |
| Obligations of State and Political Subdivisions | \$ 268             | \$ 3                           | \$                              | \$ 271        |
| December 31, 2012                               |                    |                                |                                 |               |
| Obligations of State and Political Subdivisions | \$ 346             | \$ 5                           | \$                              | \$ 351        |

The amortized cost and fair value of Securities at September 30, 2013 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because some issuers have the right to call or prepay certain obligations with or without call or prepayment penalties. Mortgage-backed and Equity Securities are



not due at a single maturity date and are shown separately.

|  | Amortized<br>Cost | Fair<br>Value |
|--|-------------------|---------------|
| Securities Available-for-Sale:           |                   |               |
| Due in one year or less                  | \$ 2,855          | \$ 2,878      |
| Due after one year through five years    | 11,966            | 12,237        |
| Due after five years through ten years   | 60,770            | 61,075        |
| Due after ten years                      | 40,196            | 40,868        |
| Mortgage-backed Securities - Residential | 496,129           | 490,569       |
| Equity Securities                        | 684               | 1,026         |
| Totals                                   | \$ 612,600        | \$ 608,653    |

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**Note 3 Securities (continued)**

|  | Carrying<br>Amount | Fair<br>Value |
|--|--------------------|---------------|
| Securities Held-to-Maturity:           |                    |               |
| Due in one year or less                | \$                 | \$            |
| Due after one year through five years  | 268                | 271           |
| Due after five years through ten years |                    |               |
| Due after ten years                    |                    |               |
| Totals                                 | \$ 268             | \$ 271        |

Proceeds from the sales of Available-for-Sale Securities are summarized below:

|                                | Three Months<br>Ended<br>September 30, 2013 | Three Months<br>Ended<br>September 30, 2012 |
|--------------------------------|---|---|
| Proceeds from Sales and Calls  | \$ 19,231                                   | \$ 40,949                                   |
| Gross Gains on Sales and Calls | 428   | 598   |
| Income Taxes on Gross Gains    | 150   | 209   |
|                                | Nine Months<br>Ended<br>September 30, 2013  | Nine Months<br>Ended<br>September 30, 2012  |
| Proceeds from Sales and Calls  | \$ 119,952                                  | \$ 92,344                                   |
| Gross Gains on Sales and Calls | 1,508                                       | 692   |
| Income Taxes on Gross Gains    | 528   | 242   |

Below is a summary of securities with unrealized losses as of September 30, 2013 and December 31, 2012, presented by length of time the securities have been in a continuous unrealized loss position:

|  | Less than 12 Months |                    | 12 Months or More |                    | Total         |                    |
|--|---------------------|--------------------|-------------------|--------------------|---------------|--------------------|
|  | Fair<br>Value       | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| September 30, 2013   |                     |                    |                   |                    |               |                    |
| U.S. Treasury and Agency Securities                        | \$ 19,031           | \$ (969)           | \$                | \$                 | \$ 19,031     | \$ (969)           |
| Obligations of State and Political Subdivisions            | 18,166              | (555)              |                   |                    | 18,166        | (555)              |
| Mortgage-backed Securities - Residential Equity Securities | 319,113             | (10,325)           |                   |                    | 319,113       | (10,325)           |
| Total  | \$ 356,310          | \$ (11,849)        | \$                | \$                 | \$ 356,310    | \$ (11,849)        |

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|  | Less than 12 Months |                 | 12 Months or More |                 | Total      |                 |
|--|---------------------|-----------------|-------------------|-----------------|------------|-----------------|
|  | Fair Value          | Unrealized Loss | Fair Value        | Unrealized Loss | Fair Value | Unrealized Loss |
| December 31, 2012  |                     |                 |                   |                 |            |                 |
| U.S. Treasury and Agency Securities                        | \$ 19,862           | \$ (138)        | \$                | \$              | \$ 19,862  | \$ (138)        |
| Obligations of State and Political Subdivisions            | 1,042               | (12)            |                   |                 | 1,042      | (12)            |
| Mortgage-backed Securities - Residential Equity Securities | 18,323              | (45)            |                   |                 | 18,323     | (45)            |
| Total  | \$ 39,227           | \$ (195)        | \$                | \$              | \$ 39,227  | \$ (195)        |

Securities are written down to fair value when a decline in fair value is not considered temporary. In estimating other-than-temporary losses, management considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the Company has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The Company doesn't intend to sell or expect to be required to sell these securities, and the decline in fair value is largely due to changes in market interest rates, therefore, the Company does not consider these securities to be other-than-temporarily impaired. All mortgage-backed securities in the Company's portfolio are guaranteed by government sponsored entities, are investment grade, and are performing as expected.

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**Note 4 Derivatives**

The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. The notional amounts of these interest rate swaps and the offsetting counterparty derivative instruments were \$18.0 million at September 30, 2013 and \$6.1 million at December 31, 2012. These interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions with approved, reputable, independent counterparties with substantially matching terms. The agreements are considered stand alone derivatives and changes in the fair value of derivatives are reported in earnings as non-interest income.

Credit risk arises from the possible inability of counterparties to meet the terms of their contracts. The Company's exposure is limited to the replacement value of the contracts rather than the notional, principal or contract amounts. There are provisions in the agreements with the counterparties that allow for certain unsecured credit exposure up to an agreed threshold. Exposures in excess of the agreed thresholds are collateralized. In addition, the Company minimizes credit risk through credit approvals, limits, and monitoring procedures.

The following table reflects the fair value hedges included in the Consolidated Balance Sheets as of:

|                                | September 30, 2013 |            | December 31, 2012  |            |
|--------------------------------|--------------------|------------|--------------------|------------|
|                                | Notional<br>Amount | Fair Value | Notional<br>Amount | Fair Value |
| Included in Other Assets:      |                    |            |                    |            |
| Interest Rate Swaps            | \$ 17,951          | \$ 511     | \$ 6,051           | \$ 187     |
| Included in Other Liabilities: |                    |            |                    |            |
| Interest Rate Swaps            | \$ 17,951          | \$ 392     | \$ 6,051           | \$ 178     |

The following tables present the effect of derivative instruments on the Consolidated Statements of Income for the periods presented:

|   | Three Months Ended<br>September 30 |      | Nine Months Ended<br>September 30 |      |
|---|------------------------------------|------|-----------------------------------|------|
|   | 2013                               | 2012 | 2013                              | 2012 |
| Interest Rate Swaps:                    |                                    |      |                                   |      |
| Included in Interest Income / (Expense) | \$                                 | \$   | \$                                | \$   |
| Included in Other Income / (Expense)    | (34)                               | 148  | 517                               | 148  |

**Note 5 Loans**

Loans were comprised of the following classifications at September 30, 2013 and December 31, 2012:

| September 30,<br>2013 | December 31,<br>2012 |
|-----------------------|----------------------|
|-----------------------|----------------------|

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|  |              |              |
|--|--------------|--------------|
| Commercial:                                |              |              |
| Commercial and Industrial Loans and Leases | \$ 338,770   | \$ 335,373   |
| Commercial Real Estate Loans               | 530,260      | 488,496      |
| Agricultural Loans                         | 185,868      | 179,906      |
| Retail:                                    |              |              |
| Home Equity Loans                          | 75,018       | 74,437       |
| Consumer Loans                             | 46,754       | 41,103       |
| Residential Mortgage Loans                 | 107,620      | 88,586       |
| Subtotal                                   | 1,284,290    | 1,207,901    |
| Less: Unearned Income                      | (2,848)      | (3,035)      |
| Allowance for Loan Losses                  | (14,464)     | (15,520)     |
| Loans, Net                                 | \$ 1,266,978 | \$ 1,189,346 |

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**NOTE 5 Loans (continued)**

The following table presents the activity in the allowance for loan losses by portfolio class for the three months ending September 30, 2013 and 2012:

|                           | Commercial<br>and<br>Industrial<br>Loans and<br>Leases | Commercial<br>Real Estate<br>Loans | Agricultural<br>Loans | Home<br>Equity<br>Loans | Consumer<br>Loans | Residential<br>Mortgage<br>Loans | Unallocated | Total     |
|---------------------------|--|------------------------------------|-----------------------|-------------------------|-------------------|----------------------------------|-------------|-----------|
| September 30, 2013        |  |                                    |                       |                         |                   |                                  |             |           |
| Beginning Balance         | \$ 4,258   | \$ 8,636                           | \$ 817                | \$ 313                  | \$ 199            | \$ 280                           | \$ 760      | \$ 15,263 |
| Provision for Loan Losses | (361)  | (214)                              | 53                    | 89                      | 64                | 36                               | (67)        | (400)     |
| Recoveries                | 108  | 7                                  |                       |                         | 33                | 2                                |             | 150       |
| Loans Charged-off         | (34)   | (212)                              |                       | (193)                   | (93)              | (17)                             |             | (549)     |
| Ending Balance            | \$ 3,971   | \$ 8,217                           | \$ 870                | \$ 209                  | \$ 203            | \$ 301                           | \$ 693      | \$ 14,464 |

|                           | Commercial<br>and<br>Industrial<br>Loans and<br>Leases | Commercial<br>Real Estate<br>Loans | Agricultural<br>Loans | Home<br>Equity<br>Loans | Consumer<br>Loans | Residential<br>Mortgage<br>Loans | Unallocated | Total     |
|---------------------------|--|------------------------------------|-----------------------|-------------------------|-------------------|----------------------------------|-------------|-----------|
| September 30, 2012        |  |                                    |                       |                         |                   |                                  |             |           |
| Beginning Balance         | \$ 4,707   | \$ 8,732                           | \$ 890                | \$ 181                  | \$ 227            | \$ 391                           | \$ 564      | \$ 15,692 |
| Provision for Loan Losses | 193  | 376                                | 21                    | 21                      | 12                | (12)                             | 29          | 640       |
| Recoveries                | 8  | 62                                 |                       |                         | 35                | 2                                |             | 107       |
| Loans Charged-off         | (54)   | (351)                              |                       | (7)                     | (63)              | (42)                             |             | (517)     |
| Ending Balance            | \$ 4,854   | \$ 8,819                           | \$ 911                | \$ 195                  | \$ 211            | \$ 339                           | \$ 593      | \$ 15,922 |

The following table presents the activity in the allowance for loan losses by portfolio class for the nine months ending September 30, 2013 and 2012:

|                           | Commercial<br>and<br>Industrial<br>Loans and<br>Leases | Commercial<br>Real Estate<br>Loans | Agricultural<br>Loans | Home<br>Equity<br>Loans | Consumer<br>Loans | Residential<br>Mortgage<br>Loans | Unallocated | Total     |
|---------------------------|--|------------------------------------|-----------------------|-------------------------|-------------------|----------------------------------|-------------|-----------|
| September 30, 2013        |  |                                    |                       |                         |                   |                                  |             |           |
| Beginning Balance         | \$ 4,555   | \$ 8,931                           | \$ 989                | \$ 141                  | \$ 214            | \$ 186                           | \$ 504      | \$ 15,520 |
| Provision for Loan Losses | (618)  | (261)                              | (119)                 | 326                     | 100               | 133                              | 189         | (250)     |
| Recoveries                | 121  | 85                                 |                       |                         | 104               | 5                                |             | 315       |
| Loans Charged-off         | (87)   | (538)                              |                       | (258)                   | (215)             | (23)                             |             | (1,121)   |

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| Ending Balance            | \$ 3,971                                   | \$ 8,217           | \$ 870            | \$ 209         | \$ 203                     | \$ 301      | \$ 693 | \$ 14,464 |
|---------------------------|--|--------------------|-------------------|----------------|----------------------------|-------------|--------|-----------|
|                           | Commercial and Industrial Loans and Leases |                    |                   |                |                            |             |        |           |
|                           | Commercial Real Estate Loans               | Agricultural Loans | Home Equity Loans | Consumer Loans | Residential Mortgage Loans | Unallocated | Total  |           |
| September 30, 2012        |  |                    |                   |                |                            |             |        |           |
| Beginning Balance         | \$ 3,493                                   | \$ 9,297           | \$ 926            | \$ 258         | \$ 190                     | \$ 402      | \$ 746 | \$ 15,312 |
| Provision for Loan Losses | 1,466                                      | 232                | (15)              | (9)            | 141                        | 59          | (153)  | 1,721     |
| Recoveries                | 57   | 88                 |                   | 1              | 99                         | 11          |        | 256       |
| Loans Charged-off         | (162)                                      | (798)              |                   | (55)           | (219)                      | (133)       |        | (1,367)   |
| Ending Balance            | \$ 4,854                                   | \$ 8,819           | \$ 911            | \$ 195         | \$ 211                     | \$ 339      | \$ 593 | \$ 15,922 |

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**NOTE 5 Loans (continued)**

In determining the adequacy of the allowance for loan loss, general allocations are made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a three-year historical average for loan losses for these portfolios, judgmentally adjusted for current economic factors and portfolio trends. For 2012, the Company utilized a 4 quarter rolling historical loan loss average. Beginning in 2013, management deemed a rolling 12 quarter historical loan loss average to be more indicative of the inherent losses in the Company's loan portfolio in the current economic environment than the 4 quarter average. This change in methodology resulted in an increase to the required loan loss allowance of approximately \$280 in the first quarter of 2013.

Loan impairment is reported when full repayment under the terms of the loan is not expected. This methodology is used for all loans, including loans acquired with deteriorated credit quality. For purchased loans, the assessment is made at the time of acquisition as well as over the life of loan. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate, or at the fair value of collateral if repayment is expected solely from the collateral. Commercial and industrial loans, commercial real estate loans, and agricultural loans are evaluated individually for impairment. Smaller balance homogeneous loans are evaluated for impairment in total. Such loans include real estate loans secured by one-to-four family residences and loans to individuals for household, family and other personal expenditures. Individually evaluated loans on non-accrual are generally considered impaired. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio class and based on impairment method as of September 30, 2013 and December 31, 2012:

|   | Total    | Commercial<br>and<br>Industrial<br>Loans and<br>Leases | Commercial<br>Real Estate<br>Loans | Agricultural<br>Loans | Home<br>Equity<br>Loans | Consumer<br>Loans | Residential<br>Mortgage<br>Loans | Unallocated |
|---|----------|--|------------------------------------|-----------------------|-------------------------|-------------------|----------------------------------|-------------|
| September 30, 2013                          |          |  |                                    |                       |                         |                   |                                  |             |
| Allowance for Loan<br>Losses:               |          |  |                                    |                       |                         |                   |                                  |             |
| Ending Allowance<br>Balance                 |          |  |                                    |                       |                         |                   |                                  |             |
| Attributable to<br>Loans:                   |          |  |                                    |                       |                         |                   |                                  |             |
| Individually<br>Evaluated<br>for Impairment | \$ 3,681 | \$ 461   | \$ 3,220                           | \$                    | \$                      | \$                | \$                               | \$          |
| Collectively<br>Evaluated<br>for Impairment | 10,774   | 3,510  | 4,988                              | 870                   | 209                     | 203               | 301                              | 693         |
|   | 9        |  | 9                                  |                       |                         |                   |                                  |             |



|   |              |            |            |            |           |           |            |        |
|---|--------------|------------|------------|------------|-----------|-----------|------------|--------|
| Acquired with<br>Deteriorated<br>Credit Quality<br>Total Ending<br>Allowance Balance                  | \$ 14,464    | \$ 3,971   | \$ 8,217   | \$ 870     | \$ 209    | \$ 203    | \$ 301     | \$ 693 |
| Loans:  |              |            |            |            |           |           |            |        |
| Loans Individually<br>Evaluated for<br>Impairment   | \$ 9,577     | \$ 2,622   | \$ 6,267   | \$ 688     | \$        | \$        | \$         | \$     |
| Loans Collectively<br>Evaluated for<br>Impairment   | 1,271,221    | 334,789    | 518,842    | 187,787    | 75,278    | 46,741    | 107,784    |        |
| Loans Acquired with<br>Deteriorated<br>Credit Quality<br>Total Ending Loans<br>Balance <sup>(1)</sup> | 8,909        | 2,186      | 6,438      |            |           | 138       | 147        |        |
|   | \$ 1,289,707 | \$ 339,597 | \$ 531,547 | \$ 188,475 | \$ 75,278 | \$ 46,879 | \$ 107,931 | \$     |

<sup>(1)</sup> Total recorded investment in loans includes \$5,417 in accrued interest.

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**NOTE 5 Loans (continued)**

|   | Total        | Commercial<br>and<br>Industrial<br>Loans and<br>Leases | Commercial<br>Real Estate<br>Loans | Agricultural<br>Loans | Home<br>Equity<br>Loans | Consumer<br>Loans | Residential<br>Mortgage<br>Loans | Unallocated |
|---|--------------|--|------------------------------------|-----------------------|-------------------------|-------------------|----------------------------------|-------------|
| December 31, 2012                                     |              |  |                                    |                       |                         |                   |                                  |             |
| Allowance for Loan<br>Losses:                         |              |  |                                    |                       |                         |                   |                                  |             |
| Ending Allowance<br>Balance                           |              |  |                                    |                       |                         |                   |                                  |             |
| Attributable to<br>Loans:                             |              |  |                                    |                       |                         |                   |                                  |             |
| Individually<br>Evaluated<br>for Impairment           | \$ 5,323     | \$ 1,279   | \$ 3,894                           | \$ 150                | \$                      | \$                | \$                               | \$          |
| Collectively<br>Evaluated<br>for Impairment           | 10,109       | 3,208  | 5,017                              | 839                   | 141                     | 214               | 186                              | 504         |
| Acquired with<br>Deteriorated<br>Credit Quality       | 88           | 68   | 20                                 |                       |                         |                   |                                  |             |
| Total Ending<br>Allowance Balance                     | \$ 15,520    | \$ 4,555   | \$ 8,931                           | \$ 989                | \$ 141                  | \$ 214            | \$ 186                           | \$ 504      |
| Loans:  |              |  |                                    |                       |                         |                   |                                  |             |
| Loans Individually<br>Evaluated for<br>Impairment     | \$ 12,520    | \$ 2,547   | \$ 7,550                           | \$ 2,423              | \$                      | \$                | \$                               | \$          |
| Loans Collectively<br>Evaluated for<br>Impairment     | 1,189,729    | 331,920  | 473,209                            | 180,152               | 74,699                  | 41,083            | 88,666                           |             |
| Loans Acquired with<br>Deteriorated<br>Credit Quality | 11,174       | 1,840  | 9,037                              |                       |                         | 148               | 149                              |             |
| Total Ending Loans<br>Balance <sup>(1)</sup>          | \$ 1,213,423 | \$ 336,307   | \$ 489,796                         | \$ 182,575            | \$ 74,699               | \$ 41,231         | \$ 88,815                        | \$          |

<sup>(1)</sup> Total recorded investment in loans includes \$5,522 in accrued interest.

The following table presents loans individually evaluated for impairment by class of loans as of September 30, 2013 and December 31, 2012:

Unpaid Allowance for

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|  | Principal<br>Balance <sup>(1)</sup> | Recorded<br>Investment | Loan Losses<br>Allocated |
|--|-------------------------------------|------------------------|--------------------------|
| September 30, 2013   |                                     |                        |                          |
| With No Related Allowance Recorded:  |                                     |                        |                          |
| Commercial and Industrial Loans and Leases                                   | \$ 2,143                            | \$ 2,161               | \$                       |
| Commercial Real Estate Loans   | 3,694                               | 1,907                  |                          |
| Agricultural Loans   | 675                                 | 688                    |                          |
| Subtotal   | 6,512                               | 4,756                  |                          |
| With An Allowance Recorded:  |                                     |                        |                          |
| Commercial and Industrial Loans and Leases                                   | 511                                 | 461                    | 461                      |
| Commercial Real Estate Loans   | 4,608                               | 4,488                  | 3,229                    |
| Agricultural Loans   |                                     |                        |                          |
| Subtotal   | 5,119                               | 4,949                  | 3,690                    |
| Total  | \$ 11,631                           | \$ 9,705               | \$ 3,690                 |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance    |                                     |                        |                          |
| Recorded (Included in the Total Above)                                       | \$ 125                              | \$ 119                 | \$                       |
| Loans Acquired With Deteriorated Credit Quality With An Additional Allowance |                                     |                        |                          |
| Recorded (Included in the Total Above)                                       | \$ 34                               | \$ 9                   | \$ 9                     |

<sup>(1)</sup> Unpaid Principal Balance is the remaining contractual payments inclusive of partial charge-offs.

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**NOTE 5 Loans (continued)**

|   | Unpaid<br>Principal<br>Balance <sup>(1)</sup> | Recorded<br>Investment | Allowance for<br>Loan Losses<br>Allocated |
|---|---|------------------------|---|
| December 31, 2012   |   |                        |   |
| With No Related Allowance Recorded:   |   |                        |   |
| Commercial and Industrial Loans and Leases  | \$ 108  | \$ 87                  | \$  |
| Commercial Real Estate Loans  | 4,312   | 2,154                  |   |
| Agricultural Loans  | 2,126   | 2,137                  |   |
| Subtotal  | 6,546   | 4,378                  |   |
| With An Allowance Recorded:   |   |                        |   |
| Commercial and Industrial Loans and Leases  | 2,642   | 2,581                  | 1,347                                     |
| Commercial Real Estate Loans  | 5,579   | 5,418                  | 3,914                                     |
| Agricultural Loans  | 285   | 286                    | 150                                       |
| Subtotal  | 8,506   | 8,285                  | 5,411                                     |
| Total   | \$ 15,052                                     | \$ 12,663              | \$ 5,411                                  |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above)    | \$ 45   | \$ 25                  | \$  |
| Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above) | \$ 155  | \$ 118                 | \$ 88                                     |

<sup>(1)</sup> Unpaid Principal Balance is the remaining contractual payments inclusive of partial charge-offs.

The following table presents loans individually evaluated for impairment by class of loans for the three month period ended September 30, 2013 and 2012:

|  | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Cash<br>Basis<br>Recognized |
|--|-----------------------------------|----------------------------------|-----------------------------|
| September 30, 2013                         |                                   |                                  |                             |
| With No Related Allowance Recorded:        |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases | \$ 2,223                          | \$ 33                            | \$ 32                       |
| Commercial Real Estate Loans               | 1,956                             | 1                                | 2                           |
| Agricultural Loans                         | 751                               | 21                               | 16                          |
| Subtotal                                   | 4,930                             | 55                               | 50                          |
| With An Allowance Recorded:                |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases | 464                               | 1                                | 1                           |
| Commercial Real Estate Loans               | 5,415                             | 5                                | 4                           |
| Agricultural Loans                         |                                   |                                  |                             |
| Subtotal                                   | 5,879                             | 6                                | 5                           |
| Total                                      | \$ 10,809                         | \$ 61                            | \$ 55                       |

|   |        |      |      |
|---|--------|------|------|
| Loans Acquired With Deteriorated Credit Quality With No<br>Related Allowance Recorded (Included in the Total Above)       | \$ 119 | \$   | \$   |
| Loans Acquired With Deteriorated Credit Quality With An<br>Additional Allowance Recorded (Included in the Total<br>Above) | \$ 214 | \$ 1 | \$ 1 |

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**NOTE 5 Loans (continued)**

|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Cash<br>Basis<br>Recognized |
|---|-----------------------------------|----------------------------------|-----------------------------|
| September 30, 2012  |                                   |                                  |                             |
| With No Related Allowance Recorded:   |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases  | \$ 139                            | \$ 1                             | \$ 1                        |
| Commercial Real Estate Loans  | 3,353                             | 12                               | 12                          |
| Agricultural Loans  |                                   |                                  |                             |
| Subtotal  | 3,492                             | 13                               | 13                          |
| With An Allowance Recorded:   |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases  | 2,749                             | 4                                | 3                           |
| Commercial Real Estate Loans  | 7,179                             | 6                                | 5                           |
| Agricultural Loans  |                                   |                                  |                             |
| Subtotal  | 9,928                             | 10                               | 8                           |
| Total   | \$ 13,420                         | \$ 23                            | \$ 21                       |
| Loans Acquired With Deteriorated Credit Quality With No<br>Related Allowance Recorded (Included in the Total Above)       | \$ 471                            | \$ 1                             | \$ 1                        |
| Loans Acquired With Deteriorated Credit Quality With An<br>Additional Allowance Recorded (Included in the Total<br>Above) | \$ 134                            | \$ 3                             | \$ 3                        |

The following table presents loans individually evaluated for impairment by class of loans for the nine month period ended September 30, 2013 and 2012:

|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Cash<br>Basis<br>Recognized |
|---|-----------------------------------|----------------------------------|-----------------------------|
| September 30, 2013  |                                   |                                  |                             |
| With No Related Allowance Recorded:   |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases  | \$ 818                            | \$ 33                            | \$ 33                       |
| Commercial Real Estate Loans  | 2,196                             | 1                                | 2                           |
| Agricultural Loans  | 1,738                             | 196                              | 200                         |
| Subtotal  | 4,752                             | 230                              | 235                         |
| With An Allowance Recorded:   |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases  | 1,797                             | 3                                | 3                           |
| Commercial Real Estate Loans  | 5,745                             | 17                               | 13                          |
| Agricultural Loans  |                                   |                                  |                             |
| Subtotal  | 7,542                             | 20                               | 16                          |
| Total   | \$ 12,294                         | \$ 250                           | \$ 251                      |
| Loans Acquired With Deteriorated Credit Quality With No<br>Related Allowance Recorded (Included in the Total Above) | \$ 39                             | \$                               | \$                          |

|   |        |      |      |
|---|--------|------|------|
| Loans Acquired With Deteriorated Credit Quality With An<br>Additional Allowance Recorded (Included in the Total<br>Above) | \$ 182 | \$ 2 | \$ 2 |
|---|--------|------|------|

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**NOTE 5 Loans (continued)**

|   | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Cash<br>Basis<br>Recognized |
|---|-----------------------------------|----------------------------------|-----------------------------|
| September 30, 2012  |                                   |                                  |                             |
| With No Related Allowance Recorded:   |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases  | \$ 298                            | \$ 3                             | \$ 3                        |
| Commercial Real Estate Loans  | 5,023                             | 17                               | 17                          |
| Agricultural Loans  | 49                                | 2                                | 2                           |
| Subtotal  | 5,370                             | 22                               | 22                          |
| With An Allowance Recorded:   |                                   |                                  |                             |
| Commercial and Industrial Loans and Leases  | 2,795                             | 7                                | 6                           |
| Commercial Real Estate Loans  | 7,003                             | 17                               | 14                          |
| Agricultural Loans  |                                   |                                  |                             |
| Subtotal  | 9,798                             | 24                               | 20                          |
| Total   | \$ 15,168                         | \$ 46                            | \$ 42                       |
| Loans Acquired With Deteriorated Credit Quality With No<br>Related Allowance Recorded (Included in the Total Above)       | \$ 169                            | \$ 1                             | \$ 1                        |
| Loans Acquired With Deteriorated Credit Quality With An<br>Additional Allowance Recorded (Included in the Total<br>Above) | \$ 93                             | \$ 3                             | \$ 3                        |

All classes of loans, including loans acquired with deteriorated credit quality, are generally placed on non-accrual status when scheduled principal or interest payments are past due for 90 days or more or when the borrower's ability to repay becomes doubtful. For purchased loans, the determination is made at the time of acquisition as well as over the life of the loan. Uncollected accrued interest for each class of loans is reversed against income at the time a loan is placed on non-accrual. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. All classes of loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Loans are typically charged-off at 180 days past due, or earlier if deemed uncollectible. Exceptions to the non-accrual and charge-off policies are made when the loan is well secured and in the process of collection.

The following table presents the recorded investment in non-accrual loans and loans past due 90 days or more still on accrual by class of loans as of September 30, 2013 and December 31, 2012:

|  | Non-Accrual |          | Loans Past Due<br>90 Days or More<br>& Still Accruing |      |
|--|-------------|----------|---|------|
|  | 2013        | 2012     | 2013  | 2012 |
| Commercial and Industrial Loans and Leases | \$ 434      | \$ 2,480 | \$  | \$   |
| Commercial Real Estate Loans               | 6,017       | 7,275    |   |      |
| Agricultural Loans                         |             |          | 94  |      |



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|   |          |           |       |    |
|---|----------|-----------|-------|----|
| Home Equity Loans   | 149      | 178       |       |    |
| Consumer Loans  | 189      | 167       |       |    |
| Residential Mortgage Loans  | 68       | 257       |       |    |
| Total   | \$ 6,857 | \$ 10,357 | \$ 94 | \$ |
| Loans Acquired With Deteriorated Credit<br>Quality<br>(Included in the Total Above) | \$ 256   | \$ 148    | \$    | \$ |

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**NOTE 5 Loans (continued)**

The following table presents the aging of the recorded investment in past due loans by class of loans as of September 30, 2013 and December 31, 2012:

|  | Total        | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due |
|--|--------------|------------------------|------------------------|--------------------------------|-------------------|-----------------------|
| September 30, 2013   |              |                        |                        |                                |                   |                       |
| Commercial and Industrial<br>Loans and Leases  | \$ 339,597   | \$ 251                 | \$ 19                  | \$ 413                         | \$ 683            | \$ 338,914            |
| Commercial Real Estate<br>Loans  | 531,547      | 561                    | 216                    | 1,805                          | 2,582             | 528,965               |
| Agricultural Loans   | 188,475      | 1,021                  |                        | 94                             | 1,115             | 187,360               |
| Home Equity Loans  | 75,278       | 194                    | 145                    | 149                            | 488               | 74,790                |
| Consumer Loans   | 46,879       | 127                    | 26                     | 50                             | 203               | 46,676                |
| Residential Mortgage Loans   | 107,931      | 1,599                  | 163                    | 68                             | 1,830             | 106,101               |
| Total <sup>(1)</sup>   | \$ 1,289,707 | \$ 3,753               | \$ 569                 | \$ 2,579                       | \$ 6,901          | \$ 1,282,806          |
| Loans Acquired With<br>Deteriorated<br>Credit Quality (Included in<br>the Total Above) | \$ 8,909     | \$ 245                 | \$                     | \$                             | \$ 245            | \$ 8,664              |

<sup>(1)</sup> Total recorded investment in loans includes \$5,417 in accrued interest.

|  | Total        | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days<br>or More<br>Past Due | Total<br>Past Due | Loans Not<br>Past Due |
|--|--------------|------------------------|------------------------|--------------------------------|-------------------|-----------------------|
| December 31, 2012  |              |                        |                        |                                |                   |                       |
| Commercial and Industrial<br>Loans and Leases  | \$ 336,307   | \$ 436                 | \$ 133                 | \$ 448                         | \$ 1,017          | \$ 335,290            |
| Commercial Real Estate<br>Loans  | 489,796      | 1,352                  |                        | 2,063                          | 3,415             | 486,381               |
| Agricultural Loans   | 182,575      | 42                     | 14                     |                                | 56                | 182,519               |
| Home Equity Loans  | 74,699       | 177                    | 48                     | 178                            | 403               | 74,296                |
| Consumer Loans   | 41,231       | 431                    | 23                     | 18                             | 472               | 40,759                |
| Residential Mortgage Loans   | 88,815       | 2,070                  | 495                    | 257                            | 2,822             | 85,993                |
| Total <sup>(1)</sup>   | \$ 1,213,423 | \$ 4,508               | \$ 713                 | \$ 2,964                       | \$ 8,185          | \$ 1,205,238          |
| Loans Acquired With<br>Deteriorated<br>Credit Quality (Included in<br>the Total Above) | \$ 11,174    | \$                     | \$ 120                 | \$                             | \$ 120            | \$ 11,054             |

<sup>(1)</sup> Total recorded investment in loans includes \$5,522 in accrued interest.

**Troubled Debt Restructurings:**

In certain instances, the Company may choose to restructure the contractual terms of loans. A troubled debt restructuring occurs when the Bank grants a concession to the borrower that it would not otherwise consider due to a borrower's financial difficulty. In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without modification. This evaluation is performed under the Company's internal underwriting policy. The Company uses the same methodology for loans acquired with deteriorated credit quality as for all other loans when determining whether the loan is a troubled debt restructuring.

During the nine months ended September 30, 2013 and the year ended December 31, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included one or a combination of the following: a reduction of the stated interest rate of the loan; an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk; or a permanent reduction of the recorded investment in the loan. There were no troubled debt restructurings for the nine months ended September 30, 2013 and the year ended December 31, 2012 for loans acquired with deteriorated credit quality at the time of acquisition.

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**NOTE 5 Loans (continued)**

The following table presents the recorded investment of troubled debt restructurings by class of loans as of September 30, 2013 and December 31, 2012:

|  | Total    | Performing | Non-Accrual <sup>(1)</sup> |
|--|----------|------------|----------------------------|
| September 30, 2013                         |          |            |                            |
| Commercial and Industrial Loans and Leases | \$ 2,609 | \$ 2,188   | \$ 421                     |
| Commercial Real Estate Loans               | 4,417    | 381        | 4,036                      |
| Total                                      | \$ 7,026 | \$ 2,569   | \$ 4,457                   |
| December 31, 2012                          |          |            |                            |
| Commercial and Industrial Loans and Leases | \$ 2,461 | \$ 66      | \$ 2,395                   |
| Commercial Real Estate Loans               | 6,031    | 304        | 5,727                      |
| Total                                      | \$ 8,492 | \$ 370     | \$ 8,122                   |

<sup>(1)</sup> The non-accrual troubled debt restructurings are included in the Non-Accrual Loan table presented on previous page.

The Company has committed to lending an additional amount of \$40 as of September 30, 2013 to customers with outstanding loans that are classified as troubled debt restructurings. The Company had not committed to lending any additional amounts as of December 31, 2012 to customers with outstanding loans that are classified as troubled debt restructurings.

The following table presents loans by class modified as troubled debt restructurings that occurred during the three months ending September 30, 2013 and 2012:

|  | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--|--------------------|--|---|
| September 30, 2013                         |                    |  |   |
| Commercial and Industrial Loans and Leases | 1                  | \$ 224   | \$ 230  |
| Commercial Real Estate Loans               |                    |  |   |
| Total                                      | 1                  | \$ 224   | \$ 230  |

The troubled debt restructurings described above increased the allowance for loan losses by \$0 and resulted in charge-offs of \$0 during the three months ending September 30, 2013.

|  | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--|--------------------|--|---|
| September 30, 2012                         |                    |  |   |
| Commercial and Industrial Loans and Leases | 2                  | \$ 9   | \$ 9  |
| Commercial Real Estate Loans               |                    |  |   |

|       |   |    |   |    |   |
|-------|---|----|---|----|---|
| Total | 2 | \$ | 9 | \$ | 9 |
|-------|---|----|---|----|---|

The troubled debt restructurings described above increased the allowance for loan losses by \$0 and resulted in charge-offs of \$0 during the three months ending September 30, 2012.

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**NOTE 5 Loans (continued)**

The following table presents loans by class modified as troubled debt restructurings that occurred during the nine months ending September 30, 2013 and 2012:

|  | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--|--------------------|--|---|
| September 30, 2013                         |                    |  |   |
| Commercial and Industrial Loans and Leases | 1                  | \$ 224   | \$ 230  |
| Commercial Real Estate Loans               | 1                  | 81   | 118   |
| Total                                      | 2                  | \$ 305   | \$ 348  |

The troubled debt restructurings described above decreased the allowance for loan losses by \$210 and resulted in charge-offs of \$0 during the nine months ending September 30, 2013.

|  | Number of<br>Loans | Pre-Modification<br>Outstanding Recorded<br>Investment | Post-Modification<br>Outstanding Recorded<br>Investment |
|--|--------------------|--|---|
| September 30, 2012                         |                    |  |   |
| Commercial and Industrial Loans and Leases | 2                  | \$ 9   | \$ 9  |
| Commercial Real Estate Loans               |                    |  |   |
| Total                                      | 2                  | \$ 9   | \$ 9  |

The troubled debt restructurings described above increased the allowance for loan losses by \$0 and resulted in charge-offs of \$0 during the nine months ending September 30, 2012.

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three months ending September 30, 2013 and 2012:

| Troubled Debt Restructurings That Subsequently Defaulted: | Number of Loans | Recorded Investment |
|---|-----------------|---------------------|
| September 30, 2013  |                 |                     |
| Commercial and Industrial Loans and Leases                |                 | \$                  |
| Commercial Real Estate Loans                              |                 |                     |
| Total   |                 | \$                  |

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and no charge-offs during the three months ending September 30, 2013.

| Troubled Debt Restructurings That Subsequently Defaulted: | Number of Loans | Recorded Investment |
|---|-----------------|---------------------|
| September 30, 2012  |                 |                     |
| Commercial and Industrial Loans and Leases                |                 | \$                  |
| Commercial Real Estate Loans                              | 1               | 834                 |
| Total   | 1               | \$ 834              |

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and no charge-offs during the three months ending September 30, 2012.

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

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**NOTE 5 Loans (continued)**

The following table presents loans by class modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the nine months ending September 30, 2013 and 2012:

| Troubled Debt Restructurings That Subsequently Defaulted:<br>September 30, 2013 | Number of Loans | Recorded Investment |
|---|-----------------|---------------------|
| Commercial and Industrial Loans and Leases                                      |                 | \$                  |
| Commercial Real Estate Loans  |                 |                     |
| Total   |                 | \$                  |

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and no charge-offs during the nine months ending September 30, 2013.

| Troubled Debt Restructurings That Subsequently Defaulted:<br>September 30, 2012 | Number of Loans | Recorded Investment |
|---|-----------------|---------------------|
| Commercial and Industrial Loans and Leases                                      | 1               | \$ 565              |
| Commercial Real Estate Loans  | 2               | 1,126               |
| Total   | 3               | \$ 1,691            |

The troubled debt restructurings that subsequently defaulted described above resulted in no change to the allowance for loan losses and charge-offs of \$108 during the nine months ending September 30, 2012.

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

**Credit Quality Indicators:**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company classifies loans as to credit risk by individually analyzing loans. This analysis includes commercial and industrial loans, commercial real estate loans, and agricultural loans with an outstanding balance greater than \$100. This analysis is typically performed on at least an annual basis. The Company uses the following definitions for risk ratings:

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

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



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

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**NOTE 5 Loans (continued)**

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. Based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

|  | Pass       | Special<br>Mention | Substandard | Doubtful | Total        |
|--|------------|--------------------|-------------|----------|--------------|
| September 30, 2013   |            |                    |             |          |              |
| Commercial and Industrial Loans and Leases                                       | \$ 314,037 | \$ 13,936          | \$ 11,624   | \$       | \$ 339,597   |
| Commercial Real Estate Loans   | 497,670    | 17,380             | 16,497      |          | 531,547      |
| Agricultural Loans   | 184,974    | 2,606              | 895         |          | 188,475      |
| Total  | \$ 996,681 | \$ 33,922          | \$ 29,016   | \$       | \$ 1,059,619 |
| Loans Acquired With Deteriorated Credit Quality<br>(Included in the Total Above) | \$ 3,180   | \$ 816             | \$ 4,628    | \$       | \$ 8,624     |
| December 31, 2012  |            |                    |             |          |              |
| Commercial and Industrial Loans and Leases                                       | \$ 307,997 | \$ 14,441          | \$ 13,869   | \$       | \$ 336,307   |
| Commercial Real Estate Loans   | 446,639    | 21,338             | 21,819      |          | 489,796      |
| Agricultural Loans   | 176,730    | 2,855              | 2,990       |          | 182,575      |
| Total  | \$ 931,366 | \$ 38,634          | \$ 38,678   | \$       | \$ 1,008,678 |
| Loans Acquired With Deteriorated Credit Quality<br>(Included in the Total Above) | \$ 319     | \$ 3,220           | \$ 7,338    | \$       | \$ 10,877    |

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For home equity, consumer and residential mortgage loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in home equity, consumer and residential mortgage loans based on payment activity as of September 30, 2013 and December 31, 2012:

|  | Home Equity<br>Loans | Consumer<br>Loans | Residential<br>Mortgage Loans |
|--|----------------------|-------------------|-------------------------------|
| September 30, 2013   |                      |                   |                               |
| Performing   | \$ 75,129            | \$ 46,690         | \$ 107,863                    |
| Nonperforming  | 149                  | 189               | 68                            |
| Total  | \$ 75,278            | \$ 46,879         | \$ 107,931                    |
| Loans Acquired With Deteriorated Credit Quality<br>(Included in the Total Above) | \$                   | \$ 138            | \$ 147                        |

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|  | Home Equity<br>Loans | Consumer<br>Loans | Residential<br>Mortgage Loans |
|--|----------------------|-------------------|-------------------------------|
| December 31, 2012  |                      |                   |                               |
| Performing   | \$ 74,521            | \$ 41,064         | \$ 88,558                     |
| Nonperforming  | 178                  | 167               | 257                           |
| Total  | \$ 74,699            | \$ 41,231         | \$ 88,815                     |
| Loans Acquired With Deteriorated Credit Quality<br>(Included in the Total Above) | \$                   | \$ 148            | \$ 149                        |

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**NOTE 5 Loans (continued)**

The Company has purchased loans, for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The recorded investment of those loans is as follows:

|                                   | September 30, 2013 |
|-----------------------------------|--------------------|
| Commercial and Industrial Loans   | \$ 2,186           |
| Commercial Real Estate Loans      | 6,438              |
| Home Equity Loans                 |                    |
| Consumer Loans                    | 138                |
| Residential Mortgage Loans        | 147                |
| Total                             | \$ 8,909           |
| Carrying amount, Net of Allowance | \$ 8,900           |
|                                   | December 31, 2012  |
| Commercial and Industrial Loans   | \$ 1,840           |
| Commercial Real Estate Loans      | 9,037              |
| Home Equity Loans                 |                    |
| Consumer Loans                    | 148                |
| Residential Mortgage Loans        | 149                |
| Total                             | \$ 11,174          |
| Carrying amount, Net of Allowance | \$ 11,086          |

Accretable yield, or income expected to be collected, is as follows:

|  | September 30, 2013 | September 30, 2012 |
|--|--------------------|--------------------|
| Balance at July 1                                | \$ 182             | \$ 389             |
| New Loans Purchased                              |                    |                    |
| Accretion of Income                              | (443)              | (223)              |
| Reclassifications from Non-accretable Difference | 444                | 262                |
| Charge-off of Accretable Yield                   |                    |                    |
| Balance at September 30                          | \$ 183             | \$ 428             |

Accretable yield, or income expected to be collected, is as follows:

|  | September 30, 2013 | September 30, 2012 |
|--|--------------------|--------------------|
| Balance at January 1                             | \$ 170             | \$ 967             |
| New Loans Purchased                              |                    |                    |
| Accretion of Income                              | (889)              | (1,007)            |
| Reclassifications from Non-accretable Difference | 902                | 468                |
| Charge-off of Accretable Yield                   |                    |                    |
| Balance at September 30                          | \$ 183             | \$ 428             |

For those purchased loans disclosed above, the Company decreased the allowance for loan losses by \$141 during the three months ended September 30, 2013. For those purchased loans disclosed above, the Company decreased the allowance for loan losses by \$80 during the nine months ended September 30, 2013. For those purchased loans disclosed above, the Company increased the allowance for loan losses by \$20 during the three and nine months ended September 30, 2012. No allowances for loan losses were reversed during the same periods.

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**Note 6 Segment Information**

The Company's operations include three primary segments: core banking, trust and investment advisory services, and insurance operations. The core banking segment involves attracting deposits from the general public and using such funds to originate consumer, commercial and agricultural, commercial and agricultural real estate, and residential mortgage loans, primarily in the Company's local markets. The core banking segment also involves the sale of residential mortgage loans in the secondary market. The trust and investment advisory services segment involves providing trust, investment advisory, and brokerage services to customers. The insurance segment offers a full range of personal and corporate property and casualty insurance products, primarily in the Company's banking subsidiary's local markets.

The core banking segment is comprised by the Company's banking subsidiary, German American Bancorp, which operated through 37 banking offices at September 30, 2013. Net interest income from loans and investments funded by deposits and borrowings is the primary revenue for the core-banking segment. The trust and investment advisory services segment's revenues are comprised primarily of fees generated by German American Financial Advisors & Trust Company. These fees are derived by providing trust, investment advisory, and brokerage services to its customers. The insurance segment primarily consists of German American Insurance, Inc., which provides a full line of personal and corporate insurance products. Commissions derived from the sale of insurance products are the primary source of revenue for the insurance segment.

The following segment financial information has been derived from the internal financial statements of German American Bancorp, Inc., which are used by management to monitor and manage the financial performance of the Company. The accounting policies of the three segments are the same as those of the Company. The evaluation process for segments does not include holding company income and expense. Holding company amounts are the primary differences between segment amounts and consolidated totals, and are reflected in the column labeled "Other" below, along with amounts to eliminate transactions between segments.

|  | Core<br>Banking | Trust and<br>Investment<br>Advisory<br>Services | Insurance | Other    | Consolidated<br>Totals |
|--|-----------------|---|-----------|----------|------------------------|
| Three Months Ended<br>September 30, 2013 |                 |   |           |          |                        |
| Net Interest Income                      | \$ 17,334       | \$ 5  | \$ 4      | \$ (151) | \$ 17,192              |
| Net Gains on Sales of Loans              | 613             |   |           |          | 613                    |
| Net Gains on Securities                  | 415             |   |           | 13       | 428                    |
| Trust and Investment Product Fees        | 1               | 802   |           | (1)      | 802                    |
| Insurance Revenues                       | 10              | 7   | 1,478     |          | 1,495                  |
| Noncash Items:                           |                 |   |           |          |                        |
| Provision for Loan Losses                | (400)           |   |           |          | (400)                  |
| Depreciation and Amortization            | 941             | 6   | 99        | 38       | 1,084                  |
| Income Tax Expense (Benefit)             | 3,218           | (24)  | 67        | (292)    | 2,969                  |
| Segment Profit (Loss)                    | 6,581           | (41)  | 96        | (153)    | 6,483                  |
| Segment Assets at September 30,<br>2013  | 2,068,392       | 11,641  | 8,149     | (28,060) | 2,060,122              |



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**NOTE 6 Segment Information (continued)**

|  | Core<br>Banking | Trust and<br>Investment<br>Advisory<br>Services | Insurance | Other    | Consolidated<br>Totals |
|--|-----------------|---|-----------|----------|------------------------|
| Three Months Ended<br>September 30, 2012 |                 |   |           |          |                        |
| Net Interest Income                      | \$ 16,909       | \$ 6  | \$ 9      | \$ (531) | \$ 16,393              |
| Net Gains on Sales of Loans              | 941             |   |           |          | 941                    |
| Net Gains on Securities                  | 598             |   |           |          | 598                    |
| Trust and Investment Product Fees        |                 | 659   |           |          | 659                    |
| Insurance Revenues                       | 3               | 5   | 1,461     |          | 1,469                  |
| Noncash Items:                           |                 |   |           |          |                        |
| Provision for Loan Losses                | 640             |   |           |          | 640                    |
| Depreciation and Amortization            | 941             | 6   | 101       | 37       | 1,085                  |
| Income Tax Expense (Benefit)             | 3,186           | (45)  | 70        | (320)    | 2,891                  |
| Segment Profit (Loss)                    | 6,578           | (71)  | 100       | (315)    | 6,292                  |
| Segment Assets at December 31,<br>2012   | 2,006,992       | 11,551  | 8,333     | (20,576) | 2,006,300              |

|   | Core<br>Banking | Trust and<br>Investment<br>Advisory<br>Services | Insurance | Other      | Consolidated<br>Totals |
|---|-----------------|---|-----------|------------|------------------------|
| Nine Months Ended<br>September 30, 2013 |                 |   |           |            |                        |
| Net Interest Income                     | \$ 51,102       | \$ 16   | \$ 16     | \$ (1,005) | \$ 50,129              |
| Net Gains on Sales of Loans             | 2,176           |   |           |            | 2,176                  |
| Net Gains on Securities                 | 1,495           |   |           | 13         | 1,508                  |
| Trust and Investment Product Fees       | 5               | 2,430   |           | (2)        | 2,433                  |
| Insurance Revenues                      | 25              | 26  | 4,607     |            | 4,658                  |
| Noncash Items:                          |                 |   |           |            |                        |
| Provision for Loan Losses               | (250)           |   |           |            | (250)                  |
| Depreciation and Amortization           | 2,864           | 21  | 310       | 113        | 3,308                  |
| Income Tax Expense (Benefit)            | 9,588           | (50)  | 254       | (1,080)    | 8,712                  |
| Segment Profit (Loss)                   | 19,262          | (90)  | 334       | (682)      | 18,824                 |
| Segment Assets at September 30,<br>2013 | 2,068,392       | 11,641  | 8,149     | (28,060)   | 2,060,122              |

|   | Core<br>Banking | Trust and<br>Investment<br>Advisory<br>Services | Insurance | Other | Consolidated<br>Totals |
|---|-----------------|---|-----------|-------|------------------------|
| Nine Months Ended<br>September 30, 2012 |                 |   |           |       |                        |



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|  |           |        |       |            |           |
|--|-----------|--------|-------|------------|-----------|
| Net Interest Income                    | \$ 51,213 | \$ 16  | \$ 26 | \$ (1,601) | \$ 49,654 |
| Net Gains on Sales of Loans            | 2,330     |        |       |            | 2,330     |
| Net Gains on Securities                | 692       |        |       |            | 692       |
| Trust and Investment Product Fees      | 3         | 2,018  |       | (2)        | 2,019     |
| Insurance Revenues                     | 19        | 32     | 4,167 |            | 4,218     |
| Noncash Items:                         |           |        |       |            |           |
| Provision for Loan Losses              | 1,721     |        |       |            | 1,721     |
| Depreciation and Amortization          | 3,145     | 16     | 311   | 112        | 3,584     |
| Income Tax Expense (Benefit)           | 9,041     | (103)  | 176   | (994)      | 8,120     |
| Segment Profit (Loss)                  | 18,737    | (168)  | 245   | (953)      | 17,861    |
| Segment Assets at December 31,<br>2012 | 2,006,992 | 11,551 | 8,333 | (20,576)   | 2,006,300 |

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**Note 7 Stock Repurchase Plan**

On April 26, 2001 the Company announced that its Board of Directors approved a stock repurchase program for up to 607,754 of the outstanding Common Shares of the Company. Shares may be purchased from time to time in the open market and in large block privately negotiated transactions. The Company is not obligated to purchase any shares under the program, and the program may be discontinued at any time before the maximum number of shares specified by the program is purchased. The Board of Directors established no expiration date for this program. As of September 30, 2013, the Company had purchased 334,965 shares under the program. No shares were purchased under the program during the three and nine months ended September 30, 2013 and 2012.

**Note 8 Equity Plans and Equity Based Compensation**

The Company maintains three equity incentive plans under which stock options, restricted stock, and other equity incentive awards can be granted. At September 30, 2013, the Company has reserved 481,791 shares of Common Stock (as adjusted for subsequent stock dividends and subject to further customary anti-dilution adjustments) for the purpose of issuance pursuant to outstanding and future grants of options, restricted stock, and other equity awards to officers, directors and other employees of the Company.

For the three and nine months ended September 30, 2013 and 2012, the Company granted no options, and accordingly, recorded no stock option expense related to option grants during the three and nine months ended September 30, 2013 and 2012. The Company recorded no other stock compensation expense applicable to options during the three and nine months ended September 30, 2013 and 2012 because all outstanding options were fully vested prior to 2007. In addition, there was no unrecognized option expense as all outstanding options were fully vested prior to September 30, 2013 and 2012.

During the periods presented, awards of long-term incentives were granted in the form of restricted stock. Awards that were granted to management under a management incentive plan were granted in tandem with cash credit entitlements (typically in the form of 50% restricted stock grants and 50% cash credit entitlements). The management restricted stock grants and tandem cash credit entitlements awarded in 2013 will vest in three equal installments of 33.3% with the first annual vesting on December 5<sup>th</sup> of the year of the grant and on December 5<sup>th</sup> of the next two succeeding years. The management restricted stock grants and tandem cash credit entitlements awarded in 2012 were subject to forfeiture in the event that the recipient of the grant did not continue employment with the Company through December 5<sup>th</sup> of the year of grant, at which time they generally vest 100 percent. Awards that were granted to directors as additional retainer for their services in December 2012 do not include any cash credit entitlement. These director restricted stock grants are subject to forfeiture in the event that the recipient of the grant does not continue in service as a director of the Company through December 5<sup>th</sup> of the year after grant or do not satisfy certain meeting attendance requirements, at which time they generally vest 100 percent. For measuring compensation costs, restricted stock awards are valued based upon the market value of the common shares on the date of grant. During the three months ended September 30, 2013, the Company granted no shares of restricted stock. During the three months ended September 30, 2012, the Company granted awards of 118 shares of restricted stock. During the nine months ended September 30, 2013 and 2012, the Company granted awards of 29,170 and 30,137 shares of restricted stock, respectively.



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**Note 8 Equity Plans and Equity Based Compensation (continued)**

The following table presents expense recorded for restricted stock and cash entitlements as well as the related tax effect for the periods presented:

|                          | Three Months Ended<br>September 30, |        |
|--------------------------|-------------------------------------|--------|
|                          | 2013                                | 2012   |
| Restricted Stock Expense | \$ 77                               | \$ 155 |
| Cash Entitlement Expense | 54                                  | 147    |
| Tax Effect               | (53)                                | (122)  |
| Net of Tax               | \$ 78                               | \$ 180 |

  

|                          | Nine Months Ended<br>September 30, |        |
|--------------------------|------------------------------------|--------|
|                          | 2013                               | 2012   |
| Restricted Stock Expense | \$ 247                             | \$ 463 |
| Cash Entitlement Expense | 162                                | 440    |
| Tax Effect               | (166)                              | (365)  |
| Net of Tax               | \$ 243                             | \$ 538 |

Unrecognized expense associated with the restricted stock grants and cash entitlements totaled \$971 and \$304 as of September 30, 2013 and 2012, respectively.

The Company maintains an Employee Stock Purchase Plan whereby eligible employees have the option to purchase the Company's common stock at a discount. The purchase price of the shares under this Plan has been set at 95% of the fair market value of the Company's common stock as of the last day of the plan year. The plan provides for the purchase of up to 500,000 shares of common stock, which the Company may obtain by purchases on the open market or from private sources, or by issuing authorized but unissued common shares. Funding for the purchase of common stock is from employee and Company contributions.

The Employee Stock Purchase Plan is not considered compensatory. There was no expense recorded for the employee stock purchase plan during the three and nine months ended September 30, 2013 and 2012, nor was there any unrecognized compensation expense as of September 30, 2013 and 2012 for the Employee Stock Purchase Plan.

**Note 9 Fair Value**

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

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

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

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

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

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**Note 9 Fair Value (continued)**

**Investment Securities:** The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Level 3 pricing is obtained from a third-party based upon similar trades that are not traded frequently without adjustment by the Company. At September 30, 2013, the Company held \$11.4 million in Level 3 securities which consist of \$11.0 million of non-rated Obligations of State and Political Subdivisions and \$353 thousand of equity securities that are not actively traded. Absent the credit rating, significant assumptions must be made such that the credit risk input becomes an unobservable input and thus these securities are reported by the Company in a Level 3 classification.

**Derivatives:** The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2).

**Impaired Loans:** Fair values for impaired collateral dependent loans are generally based on appraisals obtained from licensed real estate appraisers and in certain circumstances consideration of offers obtained to purchase properties prior to foreclosure. Appraisals for commercial real estate generally use three methods to derive value: cost, sales or market comparison and income approach. The cost method bases value in the cost to replace the current property. Value of market comparison approach evaluates the sales price of similar properties in the same market area. The income approach considers net operating income generated by the property and an investors required return. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Comparable sales adjustments are based on known sales prices of similar type and similar use properties and duration of time that the property has been on the market to sell. Such adjustments made in the appraisal process are typically significant and result in a Level 3 classification of the inputs for determining fair value.

Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Company. Once received, a member of the Company's Risk Management Area reviews the assumptions and approaches utilized in the appraisal. In determining the value of impaired collateral dependent loans and other real estate owned, significant unobservable inputs may be used which include: physical condition of comparable properties sold, net operating income generated by the property and investor rates of return.

**Other Real Estate:** Nonrecurring adjustments to certain commercial and residential real estate properties classified as other real estate (ORE) are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are generally based on third party appraisals of the property utilizing similar techniques as discussed above for Impaired Loans, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, impairment loss is recognized.

**Loans Held-for-Sale:** The fair values of loans held for sale are determined by using quoted prices for similar assets, adjusted for specific attributes of that loan resulting in a Level 2 classification.



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**Note 9 Fair Value (continued)**Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis, including financial assets and liabilities for which the Company has elected the fair value option, are summarized below:

|  | Fair Value Measurements at September 30, 2013 Using                     |   |  |            |
|--|---|---|--|------------|
|  | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Observable Inputs<br>(Level 2) | Other<br>Significant<br>Unobservable Inputs<br>(Level 3) | Total      |
| Assets:  |   |   |  |            |
| U.S. Treasury and Agency Securities                | \$  | \$ 19,787                                     | \$   | \$ 19,787  |
| Corporate Securities                               |   |   |  |            |
| Obligations of State and<br>Political Subdivisions |   | 86,269  | 11,002   | 97,271     |
| Mortgage-backed Securities-Residential             |   | 490,569                                       |  | 490,569    |
| Equity Securities                                  | 673   |   | 353  | 1,026      |
| Total Securities                                   | \$ 673  | \$ 596,625                                    | \$ 11,355  | \$ 608,653 |
| Loans Held-for-Sale                                | \$  | \$ 9,054                                      | \$   | \$ 9,054   |
| Derivatives  | \$  | \$ 511  | \$   | \$ 511     |
| Financial Liabilities Derivatives                  | \$  | \$ 392  | \$   | \$ 392     |
|  |   |   |  |            |
|  | Fair Value Measurements at December 31, 2012 Using                      |   |  |            |
|  | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Observable Inputs<br>(Level 2) | Other<br>Significant<br>Unobservable Inputs<br>(Level 3) | Total      |
| Assets:  |   |   |  |            |
| U.S. Treasury and Agency Securities                | \$  | \$ 23,472                                     | \$   | \$ 23,472  |
| Corporate Securities                               |   |   |  |            |
| Obligations of State and<br>Political Subdivisions |   | 64,316  | 12,169   | 76,485     |
| Mortgage-backed Securities-Residential             |   | 486,912                                       |  | 486,912    |
| Equity Securities                                  | 380   |   | 353  | 733        |
| Total Securities                                   | \$ 380  | \$ 574,700                                    | \$ 12,522  | \$ 587,602 |
| Loans Held-for-Sale                                | \$  | \$ 16,641                                     | \$   | \$ 16,641  |
| Derivatives  | \$  | \$ 187  | \$   | \$ 187     |



|                                   |    |        |    |        |
|-----------------------------------|----|--------|----|--------|
| Financial Liabilities Derivatives | \$ | \$ 178 | \$ | \$ 178 |
|-----------------------------------|----|--------|----|--------|

There were no transfers between Level 1 and Level 2 for the periods ended September 30, 2013 and December 31, 2012.

At September 30, 2013, the aggregate fair value of the Loans Held-for-Sale was \$9,054, aggregate contractual principal balance was \$8,937 with a difference of \$117. At December 31, 2012, the aggregate fair value of the Loans Held-for-Sale was \$16,641, aggregate contractual principle balance was \$16,413 with a difference of \$228.

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**Note 9 Fair Value (continued)**

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2013 and 2012:

|  | Obligations of State<br>and Political<br>Subdivisions |           | Equity Securities |        | Corporate Securities |          |
|--|---|-----------|-------------------|--------|----------------------|----------|
|  | 2013  | 2012      | 2013              | 2012   | 2013                 | 2012     |
| Balance of Recurring Level 3 Assets<br>at June 30      | \$ 11,439   | \$ 11,791 | \$ 353            | \$ 353 | \$                   | \$       |
| Total Gains or Losses<br>(realized/unrealized)         |   |           |                   |        |                      |          |
| Included in Earnings                                   | (12)  | 9         |                   |        |                      |          |
| Maturities / Calls                                     | (425)   |           |                   |        |                      |          |
| Purchases  |   |           |                   |        |                      |          |
| Balance of Recurring Level 3 Assets<br>at September 30 | \$ 11,002   | \$ 11,800 | \$ 353            | \$ 353 | \$                   | \$       |
|  |   |           |                   |        |                      |          |
|  | Obligations of State<br>and Political<br>Subdivisions |           | Equity Securities |        | Corporate Securities |          |
|  | 2013  | 2012      | 2013              | 2012   | 2013                 | 2012     |
| Balance of Recurring Level 3<br>Assets at December 31  | \$ 12,169   | \$ 4,772  | \$ 353            | \$ 353 | \$                   | \$ 1,005 |
| Total Gains or Losses<br>(realized/unrealized)         |   |           |                   |        |                      |          |
| Included in Earnings                                   | (162)   | 60        |                   |        |                      |          |
| Maturities / Calls                                     | (1,005)   | (697)     |                   |        |                      | (1,005)  |
| Purchases  |   | 7,665     |                   |        |                      |          |
| Balance of Recurring Level 3<br>Assets at September 30 | \$ 11,002   | \$ 11,800 | \$ 353            | \$ 353 | \$                   | \$       |

Of the total gain/loss included in earnings for the three and nine months ended September 30, 2013, \$12 and \$162 was attributable to other changes in fair value, respectively. The three and nine months ended September 30, 2013 included no gain/loss attributable to interest income on securities. Of the total gain/loss included in earnings for the three and nine months ended September 30, 2012, \$9 and \$60 was attributable to other changes in fair value, respectively. The three and nine months ended September 30, 2012 included no gain/loss attributable to interest income on securities.



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**Note 9 Fair Value (continued)**Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

|   | Fair Value Measurements at September 30, 2013 Using                     |   |   | Total |
|---|---|---|---|-------|
|   | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |       |
| Assets:                                     |   |   |   |       |
| Impaired Loans with Specific<br>Allocations |   |   |   |       |
| Commercial and Industrial Loans             | \$  | \$  | \$  | \$    |
| Commercial Real Estate Loans                |   |   | 1,257   | 1,257 |
| Agricultural Loans                          |   |   |   |       |
| Other Real Estate                           |   |   |   |       |
| Commercial Real Estate                      |   |   | 290   | 290   |

|   | Fair Value Measurements at December 31, 2012 Using                      |   |   | Total    |
|---|---|---|---|----------|
|   | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable Inputs<br>(Level 3) |          |
| Assets:                                     |   |   |   |          |
| Impaired Loans with Specific<br>Allocations |   |   |   |          |
| Commercial and Industrial Loans             | \$  | \$  | \$ 1,231  | \$ 1,231 |
| Commercial Real Estate Loans                |   |   | 1,497   | 1,497    |
| Agricultural Loans                          |   |   | 135   | 135      |
| Other Real Estate                           |   |   |   |          |
| Commercial Real Estate                      |   |   | 150   | 150      |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$4,947 with a valuation allowance of \$3,690, resulting in an additional provision for loan losses of \$229 and \$608 for the three and nine months ended September 30, 2013. Impaired loans resulted in an additional provision for loan losses of \$393 for the three months ended September 30, 2012 and an additional provision for loan losses of \$1,023 for the nine months ended September 30, 2012. Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of \$8,274 with a valuation allowance of \$5,411, resulting in an additional provision for loan losses of \$2,320 for the year ended December 31, 2012.

Other Real Estate which is measured at the lower of carrying or fair value less costs to sell had a carrying value of \$290 at September 30, 2013. No charge to earnings was included in the three months ended September 30, 2013. A

charge to earnings through Other Operating Income of \$301 was included in the nine months ended September 30, 2013. A charge to earnings through Other Operating Income of \$100 was included in the three and nine months ended September 30, 2012. Other Real Estate which is measured at the lower of carrying or fair value less costs to sell had a carrying value of \$150 at December 31, 2012.

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**Note 9 Fair Value (continued)**

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2013:

|  | Fair Value | Valuation<br>Technique(s)  | Unobservable Input(s)  | Range<br>(Weighted<br>Average) |
|--|------------|--|--|--------------------------------|
| Impaired Loans - Commercial<br>Real Estate Loans       | \$ 1,257   | Sales comparison<br>approach<br>Income approach<br>Cost approach | Adjustment for physical<br>condition of comparable<br>properties sold<br>Adjustment for net operating<br>income generated by the<br>property<br>Adjustment for investor rates<br>of return | 12%-80%<br>(52)%               |
| Other Real Estate -<br>Commercial<br>Real Estate Loans | \$ 290     | Sales comparison<br>approach<br>Income approach<br>Cost approach | Adjustment for physical<br>condition of comparable<br>properties sold<br>Adjustment for net operating<br>income generated by the<br>property<br>Adjustment for investor rates<br>of return | 50%<br>(50)%                   |

The carrying amounts and estimated fair values of the Company's financial instruments not previously presented are provided in the table below for the periods ending September 30, 2013 and December 31, 2012. Not all of the Company's assets and liabilities are considered financial instruments, and therefore are not included in the table. Because no active market exists for a significant portion of the Company's financial instruments, fair value estimates were based on subjective judgments, and therefore cannot be determined with precision.

|   | Carrying Value | Fair Value Measurements at<br>September 30, 2013 Using |           |           | Total       |
|---|----------------|--|-----------|-----------|-------------|
|   |                | Level 1  | Level 2   | Level 3   |             |
| <b>Financial Assets:</b>                      |                |  |           |           |             |
| Cash and Short-term Investments               | \$ 64,671      | \$ 46,657  | \$ 18,014 | \$        | \$ 64,671   |
| Securities Held-to-Maturity                   | 268            |  | 271       |           | 271         |
| FHLB Stock and Other<br>Restricted Stock      | 8,340          | N/A  | N/A       | N/A       | N/A         |
| Loans, Net                                    | 1,265,721      |  |           | 1,270,263 | 1,270,263   |
| Accrued Interest Receivable                   | 7,402          |  | 1,906     | 5,496     | 7,402       |
| <b>Financial Liabilities:</b>                 |                |  |           |           |             |
| Demand, Savings, and Money<br>Market Deposits | (1,338,858)    | (1,338,858)  |           |           | (1,338,858) |
| Time Deposits                                 | (332,181)      |  | (335,093) |           | (335,093)   |

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|  |           |           |         |           |
|--|-----------|-----------|---------|-----------|
| Short-term Borrowings                  | (102,792) | (102,792) |         | (102,792) |
| Long-term Debt                         | (88,762)  | (85,026)  | (5,287) | (90,313)  |
| Accrued Interest Payable               | (690)     | (647)     | (43)    | (690)     |
| Unrecognized Financial<br>Instruments: |           |           |         |           |
| Commitments to Extend Credit           |           |           |         |           |
| Standby Letters of Credit              |           |           |         |           |
| Commitments to Sell Loans              |           |           |         |           |

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**Note 9 Fair Value (continued)**

|  | Carrying Value | Fair Value Measurements at<br>December 31, 2012 Using |           |           | Total       |
|--|----------------|---|-----------|-----------|-------------|
|  |                | Level 1   | Level 2   | Level 3   |             |
| <b>Financial Assets:</b>   |                |   |           |           |             |
| Cash and Short-term Investments  | \$ 51,794      | \$ 41,624   | \$ 10,170 | \$        | \$ 51,794   |
| Securities Held-to-Maturity  | 346            |   | 351       |           | 351         |
| FHLB Stock and Other<br>Restricted Stock   | 8,340          | N/A   | N/A       | N/A       | N/A         |
| Loans, Net   | 1,186,483      |   |           | 1,199,566 | 1,199,566   |
| Accrued Interest Receivable  | 7,419          |   | 1,893     | 5,526     | 7,419       |
| <b>Financial Liabilities:</b>  |                |   |           |           |             |
| Demand, Savings, and Money<br>Market Deposits  | (1,311,748)    | (1,311,748)   |           |           | (1,311,748) |
| Time Deposits  | (329,183)      |   | (333,170) |           | (333,170)   |
| Short-term Borrowings  | (71,534)       |   | (71,534)  |           | (71,534)    |
| Long-term Debt   | (89,472)       |   | (66,892)  | (28,872)  | (95,764)    |
| Accrued Interest Payable   | (1,275)        |   | (829)     | (446)     | (1,275)     |
| <b>Unrecognized Financial<br/>Instruments:</b>   |                |   |           |           |             |
| Commitments to Extend Credit<br>Standby Letters of Credit<br>Commitments to Sell Loans |                |   |           |           |             |

Cash and Short-term Investments:

The carrying amount of cash and short-term investments approximate fair values and are classified as Level 1 or Level 2.

Securities Held-to-Maturity:

The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2).

FHLB Stock and Other Restricted Stock:

It is not practical to determine the fair values of FHLB stock and other restricted stock due to restrictions placed on their transferability.

Loans:

Fair values of loans, excluding loans held for sale and collateral dependent impaired loans having a specific allowance allocation, are estimated as follows: For variable rate loans that repriced frequently and with no significant change in credit risk, fair values are based on carrying values resulting in a Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in a Level 3 classification. Impaired loans are valued as described previously. The methods utilized to estimate fair value of loans do not necessarily represent an exit price.

Accrued Interest Receivable:



The carrying amount of accrued interest approximates fair value resulting in a Level 2 or Level 3 classification consistent with the asset they are associated with.

Deposits:

The fair values disclosed for demand deposits (e.g., interest and non-interest checking, savings and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. Fair values for fixed rate time deposits are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Short-term Borrowings:

The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings, generally maturing within ninety days, approximate their fair values resulting in a Level 2 classification.

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**(unaudited, dollars in thousands except share and per share data)**

**Note 9 Fair Value (continued)**Long-term Debt:

The fair values of the Company's long-term borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

The fair values of the Company's subordinated debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Accrued Interest Payable:

The carrying amount of accrued interest approximates fair value resulting in a Level 2 or Level 3 classification consistent with the liability they are associated with.

Off-balance Sheet Instruments:

Commitments to extend credit and standby letters of credit are generally short-term or variable rate with minimal fees charged. These instruments have no carrying value, and the fair value is not material. The fair value of commitments to sell loans is the cost or benefit of settling the commitments with the counter-party at the reporting date. At September 30, 2013 and December 31, 2012, none of the Company's commitments to sell loans were mandatory, and there is no cost or benefit to settle these commitments.

**NOTE 10 Other Comprehensive Income (Loss)**

The table below summarizes the changes in accumulated other comprehensive income (loss) by component for the three months ended September 30, 2013, net of tax:

|  | Unrealized<br>Gains and<br>Losses on<br>Available-for-<br>Sale Securities | Defined<br>Benefit<br>Pension<br>Items | Postretirement<br>Benefit Items | Total      |
|--|---|--|---------------------------------|------------|
| Beginning Balance  | \$ (1,247)  | \$ (231)                               | \$ (61)                         | \$ (1,539) |
| Other Comprehensive Income (Loss) Before<br>Reclassification               | (1,118)   |  |                                 | (1,118)    |
| Amounts Reclassified from Accumulated<br>Other Comprehensive Income (Loss) | (255)   |  |                                 | (255)      |
| Net Current Period Other<br>Comprehensive Income (Loss)                    | (1,373)   |  |                                 | (1,373)    |
| Ending Balance   | \$ (2,620)  | \$ (231)                               | \$ (61)                         | \$ (2,912) |

The table below summarizes the changes in accumulated other comprehensive income (loss) by component for the nine months ended September 30, 2013, net of tax:

| Unrealized<br>Gains and<br>Losses on<br>Available-for- | Defined<br>Benefit<br>Pension | Postretirement |
|--|-------------------------------|----------------|
|--|-------------------------------|----------------|

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|  | Sale Securities | Items    | Benefit Items | Total      |
|--|-----------------|----------|---------------|------------|
| Beginning Balance  | \$ 10,643       | \$ (231) | \$ (61)       | \$ 10,351  |
| Other Comprehensive Income (Loss) Before<br>Reclassification               | (12,366)        |          |               | (12,366)   |
| Amounts Reclassified from Accumulated<br>Other Comprehensive Income (Loss) | (897)           |          |               | (897)      |
| Net Current Period Other<br>Comprehensive Income (Loss)                    | (13,263)        |          |               | (13,263)   |
| Ending Balance   | \$ (2,620)      | \$ (231) | \$ (61)       | \$ (2,912) |

**GERMAN AMERICAN BANCORP, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**September 30, 2013**  
**(unaudited, dollars in thousands except share and per share data)**

**NOTE 10 Other Comprehensive Income (Loss) (continued)**

The table below summarizes the classifications out of accumulated other comprehensive income (loss) by component for the three months ended September 30, 2013:

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified From Accumulated Other Comprehensive Income (Loss) | Affected Line Item in the Statement Where Net Income is Presented |
|--|--|---|
| Unrealized Gains and Losses on Available-for-Sale Securities           | \$ (428)   | Net (Gain) Loss on Securities                                     |
|  | 173  | Income Tax Expense  |
|  | (255)  | Net of Tax  |
| Total Reclassifications for the Period                                 | \$ (255)   |   |

The table below summarizes the classifications out of accumulated other comprehensive income (loss) by component for the nine months ended September 30, 2013:

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified From Accumulated Other Comprehensive Income (Loss) | Affected Line Item in the Statement Where Net Income is Presented |
|--|--|---|
| Unrealized Gains and Losses on Available-for-Sale Securities           | \$ (1,508)   | Net (Gain) Loss on Securities                                     |
|  | 611  | Income Tax Expense  |
|  | (897)  | Net of Tax  |
| Total Reclassifications for the Period                                 | \$ (897)   |   |

**Note 11 Subsequent Event**

German American Bancorp, Inc. completed its previously announced merger transaction with United Commerce Bancorp, the parent company of United Commerce Bank, of Bloomington, Indiana, effective October 1, 2013. United Commerce Bancorp merged into German American Bancorp, Inc. effective prior to the opening of business on October 1, 2013, followed immediately by the merger of United Commerce Bank with and into German American Bancorp, Inc.'s banking subsidiary. United Commerce Bank operated two banking offices in Bloomington, Indiana. United Commerce had consolidated total assets of approximately \$120.2 million, total loans of approximately \$83.5 million, total deposits of approximately \$106.5 million, and total shareholder's equity of approximately \$13.6 million as of September 30, 2013. The acquired assets and liabilities will be recorded at fair value at the date of acquisition and will be reflected in the December 31, 2013 financial statements as such; however, at the time of these financial statements, the appraisals and valuations are incomplete. The Company expects to record goodwill and a core deposit intangible in regards to this transaction based on earlier estimates, but the amount is not known as the initial fair value accounting is incomplete. The goodwill will not be deductible for tax purposes.

Under the terms of the merger, United Commerce shareholders received a combination of approximately \$12.7 million in GABC stock (502,560 shares) and \$1.4 million in cash consideration representing a total transaction value of approximately \$14.1 million. The basic transaction value excludes the indicated value of the approximately 4.6% interest that German American owned in United Commerce's outstanding stock prior to the completion of the merger and the approximately \$640 thousand in cash payments made in cancellation of dilutive stock options that had been issued by United Commerce.

Each United Commerce common shareholder of record at the effective time of the merger became entitled to receive (a) 0.5456 shares of German American common stock plus (b) a cash payment of \$1.51 for each of their former shares of United Commerce common stock and a cash settlement for any fractional shares of German American otherwise issuable to them.

This acquisition was consistent with the Company's strategy to build a regional presence in Southern Indiana. The acquisition offers the Company the opportunity to increase profitability by introducing existing products and services to the acquired customer base as well as add new customers in the expanded region.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

### **GERMAN AMERICAN BANCORP, INC. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

German American Bancorp, Inc. is a financial services holding company based in Jasper, Indiana. The Company's Common Stock is traded on NASDAQ's Global Select Market, under the symbol GABC. The principal subsidiary of German American Bancorp, Inc. is its banking subsidiary, German American Bancorp, which operates through 37 banking offices in 13 southern Indiana counties. German American Bancorp owns a trust, brokerage, and financial planning subsidiary, which operates from its banking offices, and a full line property and casualty insurance agency with eight insurance agency offices throughout its market area.

Throughout this Management's Discussion and Analysis, as elsewhere in this report, when we use the term "Company," we will usually be referring to the business and affairs (financial and otherwise) of the Company and its subsidiaries and affiliates as a whole. Occasionally, we will refer to the term "parent company" or "holding company" when we mean to refer to only German American Bancorp, Inc.

This section presents an analysis of the consolidated financial condition of the Company as of September 30, 2013 and December 31, 2012 and the consolidated results of operations for the three and nine months ended September 30, 2013 and 2012. This discussion should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein and with the financial statements and other financial data, as well as the Management's Discussion and Analysis of Financial Condition and Results of Operations, included in the Company's December 31, 2012 Annual Report on Form 10-K.

#### **MANAGEMENT OVERVIEW**

This updated discussion should be read in conjunction with the Management Overview that was included in our Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's December 31, 2012 Annual Report on Form 10-K and in the Company's Quarterly Reports on Form 10-Q for the quarter ended March 31, 2013 and the quarter ended June 30, 2013.

The Company's third quarter net income totaled \$6,483,000, or \$0.51 per diluted share, representing an increase of approximately 2% on a per share basis, from the \$6,292,000, or \$0.50 per diluted share, recorded during the same quarter last year. On a year-to-date basis, 2013 earnings improved to \$18,824,000 or \$1.48 per diluted share, as compared to \$17,861,000, or \$1.41 per diluted share for the first nine months of 2012 representing an increase of approximately 5% on a per share basis.

The Company's third quarter and first nine months of 2013 earnings were positively impacted by lower levels of provision for loan losses as compared with the same periods of 2012. The lower level of provision for loan losses were attributable to improved asset quality for the Company including lower levels of net-charge-offs, decreased non-performing loans, and lower adversely classified assets. The Company's third quarter and first nine months of 2013 earnings were also positively impacted by a \$799,000, or 5%, and \$475,000, or 1%, increase in the level of net interest income as compared to the same periods of 2012.

Partially mitigating the improvement in net income during the third quarter of 2013 compared with 2012 was a decline in non-interest income of \$714,000, or 12%. Non-interest income had a positive impact on year-to-date 2013 earnings compared with 2012. During the nine months ending September 30, 2013, non-interest income increased \$1,672,000, or 11%, compared with the same period of 2012.

Partially mitigating the improvement in earnings was an increased level of operating expenses during the three and nine months ended September 30, 2013 compared with the same periods of 2012. Operating expenses for the third quarter of 2013 increased \$856,000, or 7%, and for the first nine months of 2013 increased \$2,563,000, or 7%, as compared to the same periods of 2012.

Effective October 1, 2013, the Company completed the acquisition of United Commerce Bancorp (“United Commerce”) of Bloomington, Indiana. Upon completion of the transaction, the Company merged United Commerce’s subsidiary bank, United Commerce Bank, into the Company’s subsidiary bank, German American Bancorp. United Commerce Bank operated two branch locations in the Bloomington, Indiana market. Management believes this in-market transaction enhances its presence in the Bloomington, Indiana market.

## **CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

The financial condition and results of operations for German American Bancorp, Inc. presented in the Consolidated Financial Statements, accompanying Notes to the Consolidated Financial Statements, and selected financial data appearing elsewhere within this Report, are, to a large degree, dependent upon the Company's accounting policies. The selection of and application of these policies involve estimates, judgments, and uncertainties that are subject to change. The critical accounting policies and estimates that the Company has determined to be the most susceptible to change in the near term relate to the determination of the allowance for loan losses, the valuation of securities available for sale, and the valuation allowance on deferred tax assets.

### **Allowance for Loan Losses**

The Company maintains an allowance for loan losses to cover probable incurred credit losses at the balance sheet date. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off. A provision for loan losses is charged to operations based on management's periodic evaluation of the necessary allowance balance. Evaluations are conducted at least quarterly and more often if deemed necessary. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The Company has an established process to determine the adequacy of the allowance for loan losses. The determination of the allowance is inherently subjective, as it requires significant estimates, including the amounts and timing of expected future cash flows on impaired loans, estimated losses on other classified loans and pools of homogeneous loans, and consideration of past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors, all of which may be susceptible to significant change. The allowance consists of two components of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover losses inherent in the loan portfolio.

Commercial and agricultural loans are subject to a standardized grading process administered by an internal loan review function. The need for specific reserves is considered for credits when graded substandard or when: (a) the customer's cash flow or net worth appears insufficient to repay the loan; (b) the loan has been criticized in a regulatory examination; (c) the loan is on non-accrual; or, (d) other reasons where the ultimate collectibility of the loan is in question, or the loan characteristics require special monitoring. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that we believe indicates the loan is impaired. Specific allocations on impaired loans are determined by comparing the loan balance to the present value of expected cash flows or expected collateral proceeds. Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be greater than historical averages, including those graded substandard and non-performing consumer or residential real estate loans. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values.

General allocations are made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on a three-year historical average for loan losses for these portfolios, judgmentally adjusted for economic factors and portfolio trends. For 2012, the Company utilized a 4 quarter rolling historical loan loss average. Beginning in 2013, management deemed a rolling 12 quarter historical loan loss average to be more indicative of the inherent losses in the Company's loan portfolio in the current economic environment than the 4 quarter average. This change in methodology resulted in an increase to the required loan loss allowance of approximately \$280 in the first quarter of 2013.



Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes a minor unallocated component. The unallocated component of the allowance for loan losses incorporates the Company's judgmental determination of inherent losses that may not be fully reflected in other allocations, including factors such as economic uncertainties, lending staff quality, industry trends impacting specific portfolio segments, and broad portfolio quality trends. Therefore, the ratio of allocated to unallocated components within the total allowance may fluctuate from period to period.

### **Securities Valuation**

Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported separately in accumulated other comprehensive income (loss), net of tax. The Company obtains market values from a third party on a monthly basis in order to adjust the securities to fair value. Equity securities that do not have readily determinable fair values are carried at cost. Additionally, when securities are deemed to be other than temporarily impaired, a charge will be recorded through earnings; therefore, future changes in the fair value of securities could have a significant impact on the Company's operating results. In determining whether a market value decline is other than temporary, management considers the reason for the decline, the extent of the decline, the duration of the decline and whether the Company intends to sell or believes it will be required to sell the securities prior to recovery. As of September 30, 2013, gross unrealized losses on the securities available-for-sale portfolio totaled approximately \$11,849,000 and gross unrealized gains totaled approximately \$7,902,000. As of September 30, 2013, held-to-maturity securities had a gross unrecognized gain of approximately \$3,000.

## **Income Tax Expense**

Income tax expense involves estimates related to the valuation allowance on deferred tax assets and loss contingencies related to exposure from tax examinations.

A valuation allowance reduces deferred tax assets to the amount management believes is more likely than not to be realized. In evaluating the realization of deferred tax assets, management considers the likelihood that sufficient taxable income of appropriate character will be generated within carryback and carryforward periods, including consideration of available tax planning strategies. Tax related loss contingencies, including assessments arising from tax examinations and tax strategies, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. In considering the likelihood of loss, management considers the nature of the contingency, the progress of any examination or related protest or appeal, the views of legal counsel and other advisors, experience of the Company or other enterprises in similar matters, if any, and management's intended response to any assessment.

## **RESULTS OF OPERATIONS**

### **Net Income:**

Net income for the quarter ended September 30, 2013 totaled \$6,483,000, or \$0.51 per diluted share, an increase of \$191,000 or 3% from the quarter ended September 30, 2012 net income of \$6,292,000, or \$0.50 per diluted share. Net income for the nine months ended September 30, 2013 totaled \$18,824,000, or \$1.48 per diluted share, an increase of \$963,000 or 5% from the nine months ended September 30, 2012 net income of \$17,861,000, or \$1.41 per diluted share.

### **Net Interest Income:**

Net interest income is the Company's single largest source of earnings, and represents the difference between interest and fees realized on earning assets, less interest paid on deposits and borrowed funds. Several factors contribute to the determination of net interest income and net interest margin, including the volume and mix of earning assets, interest rates, and income taxes. Many factors affecting net interest income are subject to control by management policies and actions. Factors beyond the control of management include the general level of credit and deposit demand, Federal Reserve Board monetary policy, and changes in tax laws.

The following table summarizes net interest income (on a tax-equivalent basis). For tax-equivalent adjustments an effective tax rate of 35% was used for all periods presented <sup>(1)</sup>.

|  | Average Balance Sheet<br>(Tax-equivalent basis / dollars in thousands) |                     |                 |   |  |                     |                 |   |
|--|--|---------------------|-----------------|---|--|---------------------|-----------------|---|
|  | Three Months Ended<br>September 30, 2013                               |                     |                 |   | Three Months Ended<br>September 30, 2012 |                     |                 |   |
|  | Principal<br>Balance   | Income /<br>Expense | Yield /<br>Rate |   | Principal<br>Balance                     | Income /<br>Expense | Yield /<br>Rate |   |
| <b>Assets</b>  |  |                     |                 |   |  |                     |                 |   |
| Federal Funds Sold and Other                                     |  |                     |                 |   |  |                     |                 |   |
| Short-term Investments   | \$ 11,868  | \$ 2                | 0.08            | % | \$ 31,575                                | \$ 11               | 0.14            | % |
| Securities:  |  |                     |                 |   |  |                     |                 |   |
| Taxable  | 530,933  | 2,768               | 2.08            | % | 558,942                                  | 3,235               | 2.32            | % |
| Non-taxable  | 86,542   | 1,130               | 5.23            | % | 75,663                                   | 962                 | 5.09            | % |
| Total Loans and Leases <sup>(2)</sup>                            | 1,269,222  | 15,368              | 4.81            | % | 1,161,325                                | 15,148              | 5.19            | % |
| Total Interest Earning Assets                                    | 1,898,565  | 19,268              | 4.04            | % | 1,827,505                                | 19,356              | 4.22            | % |
| Other Assets   | 133,308  |                     |                 |   | 134,646                                  |                     |                 |   |
| Less: Allowance for Loan<br>Losses                               | (15,497)   |                     |                 |   | (16,298)                                 |                     |                 |   |
| Total Assets   | \$ 2,016,376   |                     |                 |   | \$ 1,945,853                             |                     |                 |   |
| <b>Liabilities and Shareholders' Equity</b>                      |  |                     |                 |   |  |                     |                 |   |
| Interest-bearing Demand,<br>Savings<br>and Money Market Deposits | \$ 979,049   | \$ 387              | 0.16            | % | \$ 943,035                               | \$ 387              | 0.16            | % |
| Time Deposits  | 333,000  | 758                 | 0.90            | % | 358,477                                  | 1,235               | 1.37            | % |
| FHLB Advances and Other<br>Borrowings                            | 161,092  | 475                 | 1.17            | % | 121,340                                  | 938                 | 3.08            | % |
| Total Interest-bearing<br>Liabilities                            | 1,473,141  | 1,620               | 0.44            | % | 1,422,852                                | 2,560               | 0.72            | % |
| Demand Deposit Accounts  | 349,323  |                     |                 |   | 322,003                                  |                     |                 |   |
| Other Liabilities  | 11,952   |                     |                 |   | 20,817                                   |                     |                 |   |
| Total Liabilities  | 1,834,416  |                     |                 |   | 1,765,672                                |                     |                 |   |
| Shareholders' Equity   | 181,960  |                     |                 |   | 180,181                                  |                     |                 |   |
| Total Liabilities and<br>Shareholders' Equity                    | \$ 2,016,376   |                     |                 |   | \$ 1,945,853                             |                     |                 |   |
| Cost of Funds  |  |                     | 0.34            | % |  |                     | 0.56            | % |
| Net Interest Income  |  | \$ 17,648           |                 |   |  | \$ 16,796           |                 |   |
| Net Interest Margin  |  |                     | 3.70            | % |  |                     | 3.66            | % |

(1) Effective tax rates were determined as though interest earned on the Company's investments in municipal bonds and loans was fully taxable.

(2) Loans held-for-sale and non-accruing loans have been included in average loans.

Net interest income increased \$799,000 or 5% (an increase of \$852,000 or 5% on a tax-equivalent basis) for the quarter ended September 30, 2013 compared with the same quarter of 2012. The increased level of net interest income during the third quarter of 2013 compared with the third quarter of 2012 was largely driven by a higher level of earning assets and a higher net interest margin (expressed as a percentage of average earning assets).

The net interest margin represents tax-equivalent net interest income expressed as a percentage of average earning assets. The tax equivalent net interest margin was 3.70% for the third quarter of 2013 compared to 3.66% during the third quarter of 2012. The yield on earning assets totaled 4.04% during the quarter ended September 30, 2013 compared to 4.22% in the same period of 2012 while the cost of funds (expressed as a percentage of average earning assets) totaled 0.34% during the quarter ended September 30, 2013 compared to 0.56% in the same period of 2012.

The increase in the net interest margin and net interest income during the third quarter of 2013 compared with the third quarter of 2012 was largely attributable to the growth of the loan portfolio, an increase in the accretion of loan discounts on acquired loans and the decline in the Company's cost of funds. Accretion of loan discounts on acquired loans contributed approximately 10 basis points on an annualized basis to the net interest margin in the third quarter of 2013 compared to 6 basis points in the third quarter of 2012.

| Average Balance Sheet<br>(Tax-equivalent basis / dollars in thousands) |                      |                     |                 |   |   |                     |                 |   |
|--|----------------------|---------------------|-----------------|---|---|---------------------|-----------------|---|
| Nine Months Ended<br>September 30, 2013                                |                      |                     |                 |   | Nine Months Ended<br>September 30, 2012 |                     |                 |   |
|  | Principal<br>Balance | Income /<br>Expense | Yield /<br>Rate |   | Principal<br>Balance                    | Income /<br>Expense | Yield /<br>Rate |   |
| <b>Assets</b>  |                      |                     |                 |   |   |                     |                 |   |
| Federal Funds Sold and Other   |                      |                     |                 |   |   |                     |                 |   |
| Short-term Investments   | \$ 14,483            | \$ 25               | 0.23            | % | \$ 52,415                               | \$ 84               | 0.21            | % |
| Securities:  |                      |                     |                 |   |   |                     |                 |   |
| Taxable  | 548,144              | 8,380               | 2.04            | % | 545,464                                 | 9,982               | 2.44            | % |
| Non-taxable  | 80,480               | 3,089               | 5.12            | % | 70,126                                  | 2,765               | 5.26            | % |
| Total Loans and Leases <sup>(2)</sup>                                  | 1,238,243            | 45,392              | 4.90            | % | 1,132,352                               | 46,574              | 5.49            | % |
| Total Interest Earning Assets  | 1,881,350            | 56,886              | 4.04            | % | 1,800,357                               | 59,405              | 4.40            | % |
| Other Assets   | 134,983              |                     |                 |   | 137,012                                 |                     |                 |   |
| Less: Allowance for Loan<br>Losses                                     | (15,736)             |                     |                 |   | (16,188)                                |                     |                 |   |
| Total Assets   | \$ 2,000,597         |                     |                 |   | \$ 1,921,181                            |                     |                 |   |
| <b>Liabilities and Shareholders' Equity</b>                            |                      |                     |                 |   |   |                     |                 |   |
| Interest-bearing Demand,<br>Savings<br>and Money Market Deposits       | \$ 982,227           | \$ 1,167            | 0.16            | % | \$ 941,179                              | \$ 1,370            | 0.19            | % |
| Time Deposits  | 334,024              | 2,366               | 0.95            | % | 362,459                                 | 4,153               | 1.53            | % |
| FHLB Advances and Other<br>Borrowings                                  | 140,210              | 1,978               | 1.89            | % | 118,428                                 | 3,066               | 3.46            | % |
| Total Interest-bearing<br>Liabilities                                  | 1,456,461            | 5,511               | 0.51            | % | 1,422,066                               | 8,589               | 0.81            | % |
| Demand Deposit Accounts  | 342,235              |                     |                 |   | 304,214                                 |                     |                 |   |
| Other Liabilities  | 16,247               |                     |                 |   | 19,922                                  |                     |                 |   |
| Total Liabilities  | 1,814,943            |                     |                 |   | 1,746,202                               |                     |                 |   |
| Shareholders' Equity   | 185,654              |                     |                 |   | 174,979                                 |                     |                 |   |
| Total Liabilities and<br>Shareholders' Equity                          | \$ 2,000,597         |                     |                 |   | \$ 1,921,181                            |                     |                 |   |
| Cost of Funds  |                      |                     | 0.39            | % |   |                     | 0.63            | % |
| Net Interest Income  |                      | \$ 51,375           |                 |   |   | \$ 50,816           |                 |   |
| Net Interest Margin  |                      |                     | 3.65            | % |   |                     | 3.77            | % |

(1) Effective tax rates were determined as though interest earned on the Company's investments in municipal bonds and loans was fully taxable.

(2) Loans held-for-sale and non-accruing loans have been included in average loans.

Net interest income increased \$475,000 or 1% (an increase of \$559,000 or 1% on a tax-equivalent basis) for the nine months ended September 30, 2013 compared with the first nine months of 2012. The increased level of net interest income during the first nine months of 2013 compared with the first half of 2012 was largely driven by an increased level of earning assets partially mitigated by a decline in the accretion of loan discounts on acquired loans and a lower net interest margin (expressed as a percentage of average earning assets).

The tax equivalent net interest margin was 3.65% for the first nine months of 2013 compared to 3.77% during the first nine months of 2012. The yield on earning assets totaled 4.04% during the nine months ended September 30, 2013 compared to 4.40% in the same period of 2012 while the cost of funds (expressed as a percentage of average earning assets) totaled 0.39% during the first nine months of 2013 compared to 0.63% in the same period of 2012.

The decline in the net interest margin in the first nine months of 2013 compared with the first nine months of 2012 was largely attributable to the continued downward pressure on earning asset yields being driven by a historically low market interest rate environment and a competitive marketplace for lending opportunities. Also contributing to the lower net interest margin was a decline in the accretion of loan discounts on certain acquired loans. Accretion contributed approximately 8 basis points on an annualized basis to the net interest margin in the nine months ended September 30, 2013 compared to approximately 14 basis points during the first nine months of 2012. The decline in the Company's cost of funds by approximately 24 basis points during the first nine months of 2013 compared to the first nine months of 2012 was largely driven by a continued decline in deposit rates and also attributable to the repayment of \$19.3 million of subordinated debentures with an interest rate of 8% that occurred in the second quarter of 2013.

Average earning assets increased by approximately \$81.0 million for the nine months ended September 30, 2013 compared with the same period of 2012. Average loans outstanding increased \$105.9 million during the nine months ended September 30, 2013 compared with the first nine months of 2012. Average federal funds sold and other short-term investments decreased by \$37.9 million during the first nine months of 2013 compared with the same period of 2012. The average securities portfolio increased approximately \$13.0 million in the nine months ended September 30, 2013 compared with the first nine months of 2012.

**Provision for Loan Losses:**

The Company provides for loan losses through regular provisions to the allowance for loan losses. The provision is affected by net charge-offs on loans and changes in specific and general allocations of the allowance. During the quarter ended September 30, 2013, the Company recognized a negative \$400,000 provision for loan loss which represented a decrease of \$1,040,000 from the third quarter of 2012 provision of \$640,000. The Company recognized a negative provision for loan losses of \$250,000 for the nine months ended September 30, 2013, a decrease of \$1,971,000 compared to the provision of \$1,721,000 during the nine months ended September 30, 2012. The decline in the provision for loan losses in the three and nine month periods ended September 30, 2013 compared with the same periods of 2012 was attributable to a reduced level of net charge-offs, lower levels of non-performing loans, and a lower level of adversely classified loans.

Net charge-offs totaled \$399,000 or 0.13% on an annualized basis of average loans outstanding during the three months ended September 30, 2013, compared with \$410,000 or 0.14% on an annualized basis of average loans outstanding during the same period of 2012. Net charge-offs totaled \$806,000 or 0.09% on an annualized basis of average loans outstanding during the nine months ended September 30, 2013, compared with \$1,111,000 or 0.13% on an annualized basis of average loans outstanding during the same period of 2012.

The provision for loan losses made during the three and nine months ended September 30, 2013 was made at a level deemed necessary by management to absorb estimated, probable incurred losses in the loan portfolio. A detailed evaluation of the adequacy of the allowance for loan losses is completed quarterly by management, the results of which are used to determine provision for loan losses. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors.

**Non-interest Income:**

During the quarter ended September 30, 2013, non-interest income totaled \$5,444,000, a decline of \$714,000, or 12%, compared with the third quarter of 2012.

| Non-interest Income<br>(dollars in thousands) | Three Months<br>Ended September 30, |          | Change from<br>Prior Period<br>Amount | Percent<br>Change |   |
|---|-------------------------------------|----------|---------------------------------------|-------------------|---|
|   | 2013                                | 2012     | Change                                | Change            |   |
| Trust and Investment Product Fees             | \$ 802                              | \$ 659   | \$ 143                                | 22                | % |
| Service Charges on Deposit Accounts           | 1,029                               | 1,049    | (20)                                  | (2)               |   |
| Insurance Revenues                            | 1,495                               | 1,469    | 26                                    | 2                 |   |
| Company Owned Life Insurance                  | 233                                 | 213      | 20                                    | 9                 |   |
| Interchange Fee Income                        | 449                                 | 418      | 31                                    | 7                 |   |
| Other Operating Income                        | 395                                 | 811      | (416)                                 | (51)              |   |
| Subtotal                                      | 4,403                               | 4,619    | (216)                                 | (5)               |   |
| Net Gains on Sales of Loans                   | 613                                 | 941      | (328)                                 | (35)              |   |
| Net Gains on Securities                       | 428                                 | 598      | (170)                                 | (28)              |   |
| Total Non-interest Income                     | \$ 5,444                            | \$ 6,158 | \$ (714)                              | (12)              |   |

During the third quarter of 2013, trust and investment product fees increased \$143,000, or 22%, compared with third quarter of 2012. The increase was due to an increase in trust revenues as well as brokerage revenues.

Other operating income decreased \$416,000 or 51% during the quarter ended September 30, 2013 compared with the third quarter of 2012. The decline was largely related to fees and fair value adjustments associated with interest rate

swap transactions with loan customers which declined by \$182,000 and with other real estate sales activity which declined by \$306,000.

Net gains on sales of loans totaled \$613,000 during the quarter ended September 30, 2013, a decline of \$328,000, or 35%, compared with the third quarter of 2012. Loan sales totaled \$40.3 million during the third quarter of 2013, compared with \$37.8 million during the third quarter of 2012.

During the third quarter of 2013, the Company realized a net gain on the sale of securities of \$428,000 related to the sale of \$18.8 million of securities, compared with a net gain on the sale of securities of \$598,000 related to the sale of approximately \$40.4 million of securities in the third quarter of 2012.



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During the nine months ended September 30, 2013, non-interest income totaled \$17,464,000, an increase of \$1,672,000, or 11%, compared with the first nine months of 2012.

| Non-interest Income<br>(dollars in thousands) | Nine Months<br>Ended September 30, |           | Change from<br>Prior Period<br>Amount<br>Change | Percent<br>Change |   |
|---|------------------------------------|-----------|---|-------------------|---|
|   | 2013                               | 2012      |   |                   | % |
| Trust and Investment Product Fees             | \$ 2,433                           | \$ 2,019  | \$ 414  | 21                | % |
| Service Charges on Deposit Accounts           | 3,034                              | 3,001     | 33  | 1                 |   |
| Insurance Revenues                            | 4,658                              | 4,218     | 440   | 10                |   |
| Company Owned Life Insurance                  | 716                                | 723       | (7)   | (1)               |   |
| Interchange Fee Income                        | 1,392                              | 1,309     | 83  | 6                 |   |
| Other Operating Income                        | 1,547                              | 1,500     | 47  | 3                 |   |
| Subtotal                                      | 13,780                             | 12,770    | 1,010   | 8                 |   |
| Net Gains on Sales of Loans                   | 2,176                              | 2,330     | (154)   | (7)               |   |
| Net Gains on Securities                       | 1,508                              | 692       | 816   | 118               |   |
| Total Non-interest Income                     | \$ 17,464                          | \$ 15,792 | \$ 1,672  | 11                |   |

During the nine months ended September 30, 2013, trust and investment product fees increased \$414,000, or 21%, compared with the first nine months of 2012. The increase was due primarily to an increase in trust revenues.

Insurance revenues increased \$440,000, or 10%, during the nine months ended September 30, 2013, compared with the first nine months of 2012. The increase during 2013 compared with first nine months of 2012 was due to increased contingency revenue and increased commercial insurance revenue. Contingency revenue during the first nine months of 2013 totaled \$246,000 compared with \$88,000 during the same period of 2012. The fluctuation in contingency revenue during 2013 and 2012 is a normal course of business type of variance and is reflective of claims and loss experience with insurance carriers that the Company represents through its property and casualty insurance agency.

Net gains on sales of loans totaled \$2,176,000 during the nine months ended September 30, 2013, a decline of \$154,000, or 7%, compared with the same period of 2012. Loan sales totaled \$139.9 million during the first nine months of 2013, compared with \$128.2 million during the first nine months of 2012.

During the nine months ended September 30, 2013, the Company realized a net gain on the sale of securities of \$1,508,000 related to the sale of \$74.1 million of securities, compared with a net gain on the sale of securities of \$692,000 in the first nine months of 2012.

**Non-interest Expense:**

During the quarter ended September 30, 2013, non-interest expense totaled \$13,584,000, an increase of \$856,000, or 7%, compared with the third quarter of 2012.

| Non-interest Expense<br>(dollars in thousands) | Three Months<br>Ended September 30, |          | Change from<br>Prior Period<br>Amount<br>Change | Percent<br>Change |   |
|--|-------------------------------------|----------|---|-------------------|---|
|  | 2013                                | 2012     |   |                   | % |
| Salaries and Employee Benefits                 | \$ 7,515                            | \$ 7,261 | \$ 254  | 3                 | % |
| Occupancy, Furniture and Equipment<br>Expense  | 1,891                               | 1,716    | 175   | 10                |   |
| FDIC Premiums                                  | 261                                 | 271      | (10)  | (4)               |   |
| Data Processing Fees                           | 383                                 | 311      | 72  | 23                |   |

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|                            |           |           |        |      |
|----------------------------|-----------|-----------|--------|------|
| Professional Fees          | 970       | 585       | 385    | 66   |
| Advertising and Promotion  | 447       | 439       | 8      | 2    |
| Intangible Amortization    | 329       | 405       | (76)   | (19) |
| Other Operating Expenses   | 1,788     | 1,740     | 48     | 3    |
| Total Non-interest Expense | \$ 13,584 | \$ 12,728 | \$ 856 | 7    |

Salaries and benefits increased \$254,000, or 3%, during the quarter ended September 30, 2013 compared with the third quarter of 2012. The increase in salaries and benefits during the third quarter of 2013 compared with the third quarter of 2012 was primarily the result of an increased number of full-time equivalent employees.

Occupancy, furniture and equipment expense increased \$175,000, or 10%, during the quarter ended September 30, 2013 compared with the third quarter 2012. The increase was largely related to a larger number of banking offices and other technology related expenditures.

Professional fees increased \$385,000, or 66%, during the quarter ended September 30, 2013 compared with the third quarter of 2012. The increase was largely related to professional fees associated with the recently completed acquisition of United Commerce Bancorp and related to fees associated with the Company's review of its overall operating effectiveness and efficiency.

During the nine months ended September 30, 2013, non-interest expense totaled \$40,307,000, an increase of \$2,563,000, or 7%, compared with the first nine months of 2012.

| Non-interest Expense<br>(dollars in thousands) | Nine Months<br>Ended September 30, |           | Change from<br>Prior Period<br>Amount | Percent<br>Change |   |
|--|------------------------------------|-----------|---------------------------------------|-------------------|---|
|  | 2013                               | 2012      | Change                                |                   | % |
| Salaries and Employee Benefits                 | \$ 22,926                          | \$ 21,409 | \$ 1,517                              | 7                 |   |
| Occupancy, Furniture and Equipment<br>Expense  | 5,588                              | 5,273     | 315                                   | 6                 |   |
| FDIC Premiums                                  | 776                                | 851       | (75)                                  | (9)               |   |
| Data Processing Fees                           | 1,085                              | 746       | 339                                   | 45                |   |
| Professional Fees                              | 2,156                              | 1,777     | 379                                   | 21                |   |
| Advertising and Promotion                      | 1,453                              | 1,208     | 245                                   | 20                |   |
| Intangible Amortization                        | 1,044                              | 1,269     | (225)                                 | (18)              |   |
| Other Operating Expenses                       | 5,279                              | 5,211     | 68                                    | 1                 |   |
| Total Non-interest Expense                     | \$ 40,307                          | \$ 37,744 | \$ 2,563                              | 7                 |   |

Salaries and benefits increased \$1,517,000, or 7%, during the nine months ended September 30, 2013 compared with the first nine months of 2012. The increase in salaries and benefits during the first nine months of 2013 compared with the first nine months of 2012 was primarily the result of an increased number of full-time equivalent employees due in part to an increased number of banking locations, increased costs related to the Company's health insurance plan, and the pending termination of a frozen defined benefit pension plan.

Occupancy, furniture and equipment expense increased \$315,000, or 6%, during the nine months ended September 30, 2013 compared with the same period of 2012. The increase was largely related to a larger number of banking offices and other technology related expenditures.

Professional fees increased \$379,000, or 21%, during the nine months ended September 30, 2013 compared with the same period of 2012. The increase was largely related to professional fees associated with the recently completed acquisition of United Commerce Bancorp and related to fees associated with the Company's review of its overall operating effectiveness and efficiency.

Data processing fees increased \$339,000, or 45%, during the nine months ended September 30, 2013 compared with the first nine months of 2012. The increase was largely related to the resolution of a contractual dispute during 2012 related to the acquisition of American Community Bancorp. An expense for the cancellation of a data processing contract was recorded in the first half of 2011, and upon resolution of the contractual dispute, a portion of that accrued expense was reversed during 2012.

Advertising and promotion expense increased \$245,000, or 20%, during the nine months ended September 30, 2013 compared with the first nine months of 2012. The increase was largely related to an increased level of community

contributions made in the Company's primary market areas.

Intangible amortization decreased \$225,000, or 18%, during the nine months ended September 30, 2013 compared with the first nine months of 2012. The decline was attributable to a reduced level of core deposit intangible associated with previous bank and bank branch acquisitions.

**Income Taxes:**

The Company's effective income tax rate was 31.4% during the three months ended September 30, 2013 and 2012. The Company's effective income tax rate approximated 31.6% and 31.3% during the nine months ended September 30, 2013 and 2012, respectively. The effective tax rate in all periods presented was lower than the blended statutory rate of 40.5% resulting primarily from the Company's tax-exempt investment income on securities, loans and company owned life insurance, income tax credits generated from investments in a new markets tax credit project and affordable housing projects, and income generated by subsidiaries domiciled in a state with no state or local income tax.

**FINANCIAL CONDITION**

Total assets at September 30, 2013 increased \$53.8 million to \$2.060 billion compared with \$2.006 billion in total assets at December 31, 2012. Securities available-for-sale increased \$21.1 million to \$608.7 million at September 30, 2013 compared with \$587.6 million at year-end 2012.

September 30, 2013 loans outstanding increased by \$76.4 million, or approximately 8% on an annualized basis, compared with year-end 2012. The increase in loans was broad based including commercial and industrial loans, commercial real estate loans, agricultural loans, consumer loans, and residential mortgage loans and occurred throughout the Company's market area.

| End of Period Loan Balances:<br>(dollars in thousands) | September 30,<br>2013 | December 31,<br>2012 | Current<br>Period<br>Change |
|--|-----------------------|----------------------|-----------------------------|
| Commercial & Industrial Loans                          | \$ 338,770            | \$ 335,373           | \$ 3,397                    |
| Commercial Real Estate Loans                           | 530,260               | 488,496              | 41,764                      |
| Agricultural Loans                                     | 185,868               | 179,906              | 5,962                       |
| Home Equity & Consumer Loans                           | 121,772               | 115,540              | 6,232                       |
| Residential Mortgage Loans                             | 107,620               | 88,586               | 19,034                      |
| Total Loans  | \$ 1,284,290          | \$ 1,207,901         | \$ 76,389                   |

The Company's allowance for loan losses totaled \$14.5 million at September 30, 2013 representing a decrease of \$1,056,000, or 9% on an annualized basis, from December 31, 2012. The allowance for loan losses represented 1.13% of period-end loans at September 30, 2013 compared with 1.29% of period-end loans at December 31, 2012. Under acquisition accounting treatment, loans acquired are recorded at fair value which includes a credit risk component, and therefore the allowance on loans acquired is not carried over from the seller. The Company held a discount on acquired loans of \$2.1 million as of September 30, 2013 and \$3.5 million at year-end 2012.

Total deposits increased \$30.1 million, or 2% on an annualized basis, as of September 30, 2013 compared with December 31, 2012 total deposits.

| End of Period Deposit Balances:<br>(dollars in thousands)    | September 30,<br>2013 | December 31,<br>2012 | Current<br>Period<br>Change |
|--|-----------------------|----------------------|-----------------------------|
| Non-interest-bearing Demand Deposits                         | \$ 364,110            | \$ 349,174           | \$ 14,936                   |
| Interest-bearing Demand, Savings,<br>& Money Market Accounts | 974,748               | 962,574              | 12,174                      |
| Time Deposits < \$100,000                                    | 215,082               | 233,422              | (18,340)                    |
| Time Deposits of \$100,000 or more                           | 117,099               | 95,761               | 21,338                      |
| Total Deposits   | \$ 1,671,039          | \$ 1,640,931         | \$ 30,108                   |

The following is an analysis of the Company's non-performing assets at September 30, 2013 and December 31, 2012:

Non-performing Assets:  
(dollars in thousands)

|   | September 30,<br>2013 |   | December 31,<br>2012 |   |
|---|-----------------------|---|----------------------|---|
| Non-accrual Loans                                   | \$ 6,857              |   | \$ 10,357            |   |
| Past Due Loans (90 days or more and still accruing) | 91                    |   |                      |   |
| Total Non-performing Loans                          | 6,948                 |   | 10,357               |   |
| Other Real Estate                                   | 584                   |   | 1,645                |   |
| Total Non-performing Assets                         | \$ 7,532              |   | \$ 12,002            |   |
| Restructured Loans                                  | \$ 2,536              |   | \$ 362               |   |
| Non-performing Loans to Total Loans                 | 0.54                  | % | 0.86                 | % |
| Allowance for Loan Loss to Non-performing Loans     | 208.18                | % | 149.85               | % |

Non-performing assets totaled \$7.5 million or 0.37% of total assets at September 30, 2013 compared to \$12.0 million or 0.60% of total assets at December 31, 2012. Non-performing loans totaled \$6.9 million or 0.54% of total loans at September 30, 2013 representing a \$3.4 million, or 33%, decline in non-performing loans compared to the \$10.4 million of non-performing loans at December 31, 2012. The decline in non-performing loans was largely the result of the placement of a commercial and industrial loan to a mechanical contractor back into accrual status based on the performance of the loan and company over an extended period of time. This loan was restructured and placed into non-accrual status in a prior period. After upgrading, because the loan was previously restructured, the Company continues to carry this credit as a restructured loan at September 30, 2013. This resulted in the increase in restructured loans to \$2.5 million at September 30, 2013 compared to \$0.4 million at December 31, 2012.

Non-accrual commercial real estate loans totaled \$6.0 million at September 30, 2013 representing a decline of \$1.3 million, or 17%, from the \$7.3 million of non-accrual commercial real estate loans at year-end 2012. Non-accrual commercial real estate loans represented 88% of the total non-performing loans at September 30, 2013 compared to 70% of total non-performing loans at year-end 2012. Non-accrual commercial and industrial loans totaled \$0.4 million at September 30, 2013 representing a decrease of \$2.1 million, or 83%, from the \$2.5 million of non-accrual commercial and industrial loans at December 31, 2012. Non-accrual commercial and industrial loans represented 6% of the total non-performing loans at September 30, 2013 compared with 24% of total non-performing loans at year-end 2012.

At September 30, 2013, two commercial loan relationships represented approximately 58% of the total non-performing loans of the Company. The first relationship was a \$2.1 million commercial real estate loan secured by various commercial real estate properties. This loan was in non-performing status as of December 31, 2012. The borrower has made all contractual payments due during 2013 and the principal balance of the loan was reduced by approximately \$0.5 million during the first nine months of 2013. The second relationship was a \$1.9 million commercial real estate loan secured by a commercial warehouse facility. This loan was in non-performing status as of year-end 2012. The borrower has made all contractual payments due during 2013 and the principal balance of this relationship was reduced by \$0.05 million during the first nine months of 2013. These two relationships represent the only loan relationships greater than \$1.0 million included in non-performing loans.

The Company purchases individual loans and groups of loans. Purchased loans that show evidence of credit deterioration since origination are recorded at the amount paid (or allocated fair value in a purchase business combination), such that there is no carryover of the seller's allowance for loan losses. After acquisition, incurred losses are recognized by an increase in the allowance for loan losses.

Purchased loans that indicated evidence of credit deterioration since origination at the time of acquisition by the Company did not have a material adverse impact on the Company's key credit metrics during 2012 or during the first nine months of 2013. The key credit metrics the Company measures generally include non-performing loans, past due loans, and adversely classified loans.

Non-performing purchased loans with evidence of credit deterioration since origination totaled \$256,000 at September 30, 2013 compared with \$148,000 at December 31, 2012. The non-performing purchased loans with evidence of credit deterioration since origination represented approximately 4% of total non-performing loans at September 30, 2013 compared with approximately 1% of total non-performing loans at December 31, 2012.

Past due purchased loans with evidence of credit deterioration since origination totaled \$245,000 at September 30, 2013 and \$118,000 at year-end 2012. Past due purchased loans with evidence of credit deterioration since origination represented approximately 4% of total past due loans at September 30, 2013 and approximately 1% of total past due loans at year-end 2012.

Adversely classified purchased loans with evidence of credit deterioration since origination totaled \$4.6 million at September 30, 2013 compared with \$7.3 million at December 31, 2012 a decline of approximately 37%. Adversely classified purchased loans with evidence of credit deterioration since origination represented approximately 16% of total adversely classified loans at September 30, 2013 compared with approximately 19% of total adversely classified loans at year-end 2012.

Loan impairment is reported when full repayment under the terms of the loan is not expected. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported net, at the present value of estimated future cash flows using the loan's existing rate, or at the fair value of collateral if repayment is expected solely from the collateral. Commercial and industrial loans, commercial real estate loans, and agricultural loans are evaluated individually for impairment. Smaller balance homogeneous loans are evaluated for impairment in total. Such loans include real estate loans secured by one-to-four family residences and loans to individuals for household, family and other personal expenditures. Individually evaluated loans on non-accrual are generally considered impaired. Impaired loans, or portions thereof, are charged off when deemed uncollectible. The amount of loans individually evaluated for impairment including purchase credit impaired loans totaled \$9.7 million at September 30, 2013.

### Capital Resources:

Federal banking regulations provide guidelines for determining the capital adequacy of bank holding companies and banks. These guidelines provide for a more narrow definition of core capital and assign a measure of risk to the various categories of assets. The Company is required to maintain minimum levels of capital in proportion to total risk-weighted assets and off-balance sheet exposures such as loan commitments and standby letters of credit.

Tier 1, or core capital, consists of shareholders' equity plus certain amounts of instruments commonly referred to as trust preferred securities, less goodwill, core deposit intangibles, other identifiable intangibles and certain deferred tax assets defined by bank regulations. Tier 2 capital currently consists of the amount of the allowance for loan losses which does not exceed a defined maximum allowance limit of 1.25 percent of gross risk adjusted assets and certain amounts of subordinated debenture obligations. Total capital is the sum of Tier 1 and Tier 2 capital.

The minimum requirements under these standards are generally at least a 4.0 percent leverage ratio, which is Tier 1 capital divided by defined "total assets"; 4.0 percent Tier 1 capital to risk-adjusted assets; and, an 8.0 percent total capital to risk-adjusted assets ratios. Under these guidelines, the Company, on a consolidated basis, and its subsidiary bank, have capital ratios that exceed the regulatory minimums.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires federal regulatory agencies to define capital tiers. These are: well-capitalized, adequately-capitalized, under-capitalized, significantly under-capitalized, and critically under-capitalized. Under these regulations, a "well-capitalized" entity must achieve a Tier 1 risk-based capital ratio of at least 6.0 percent; a total capital ratio of at least 10.0 percent; and, a leverage ratio of at least 5.0 percent, and not be under a capital directive. The Company's subsidiary bank was categorized as well-capitalized as of September 30, 2013.

At September 30, 2013, management was not under such a capital directive, nor was it aware of any current recommendations by banking regulatory authorities which, if they were to be implemented, would have or are reasonably likely to have, a material effect on the Company's liquidity, capital resources or operations.

The table below presents the Company's consolidated capital ratios under regulatory guidelines:

| Minimum for<br>Capital<br>Adequacy | At<br>September 30, | At<br>December 31, |
|------------------------------------|---------------------|--------------------|
|------------------------------------|---------------------|--------------------|



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|  | Purposes | 2013    | 2012    |   |
|--|----------|---------|---------|---|
| Leverage Ratio                         | 4.00     | % 8.63  | % 8.18  | % |
| Tier 1 Capital to Risk-adjusted Assets | 4.00     | % 11.92 | % 11.12 | % |
| Total Capital to Risk-adjusted Assets  | 8.00     | % 12.93 | % 13.70 | % |

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In July 2013, the two federal banking regulatory agencies that have authority to regulate the Company's capital resources and capital structure (the Board of Governors of the Federal Reserve System (FRB) and Federal Deposit Insurance Corporation (FDIC)) took action to finalize the application to the United States banking industry of new regulatory capital requirements that are established by the international banking framework commonly referred to as "Basel III" and to implement certain other changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. As anticipated by management of the Company (see the related discussion included in Item 1 of the Company's annual report on Form 10-K for the year 2012 filed in March 2013), these rules make significant changes to the U.S. bank regulatory capital framework, and generally increase capital requirements for banking organizations. However, in response to concerns expressed by community banks such as the Company, the final rules addressed previous concerns of community banks about the proposed rules' regulatory capital treatment of trust preferred securities, unrealized gains and losses on available-for-sale securities in accumulated other comprehensive income ("AOCI") and mortgage risk weights. The Company has not yet fully analyzed the final rules in detail in order to determine their likely impact upon the Company, and although management does continue to believe that such requirements will in general increase the amount of capital that the Company and the Bank may be required to maintain under these new standards, the Company now believes that its prior concerns regarding volatility and trust preferred securities have been favorably addressed by the final rules. The Company does not presently expect that any materially burdensome compliance efforts with these final capital rules will be required of us prior to January 1, 2015.

As of September 30, 2013, shareholders' equity remained stable at \$185.1 million compared with \$185.0 million at year-end 2012. During the first nine months of 2013 shareholders' equity was impacted by a decline of \$13.3 million in accumulated other comprehensive income related to a decrease in the fair value of the Company's available-for-sale securities portfolio largely offset by an increase of \$13.1 million in retained earnings. Shareholders' equity represented 9.0% of total assets at September 30, 2013 and 9.2% of total assets at December 31, 2012. Shareholders' equity included \$20.5 million of goodwill and other intangible assets at September 30, 2013 compared to \$21.6 million of goodwill and other intangible assets at December 31, 2012.

On April 1, 2013, the Company redeemed all \$19.3 million of its 8% subordinated debentures that were scheduled to mature in 2019 at a redemption price of 100% of principal, plus accrued but unpaid interest through the redemption date. The redemption of these subordinated debentures was funded through existing cash balances on hand at the parent company as of the redemption date. The entire principal amount was includable in the parent company's consolidated Tier 2 regulatory capital under banking agency regulatory standards prior to the redemption date.

### **Liquidity:**

The Consolidated Statement of Cash Flows details the elements of changes in the Company's consolidated cash and cash equivalents. Total cash and cash equivalents increased \$15.6 million during the nine months ended September 30, 2013 ending at \$64.7 million. During the nine months ended September 30, 2013, operating activities resulted in net cash inflows of \$33.3 million. Investing activities resulted in net cash outflows of \$72.6 million during the nine months ended September 30, 2013. Financing activities resulted in net cash inflows for the nine months ended September 30, 2013 of \$54.9 million.

The parent company is a corporation separate and distinct from its bank and other subsidiaries. The Company uses funds at the parent company level to pay dividends to its shareholders, to acquire or make other investments in other businesses or their securities or assets, to repurchase its stock from time to time, and for other general corporate purposes including debt service. The parent company does not have access at the parent-company level to the deposits and certain other sources of funds that are available to its bank subsidiary to support its operations. Instead, the parent company has historically derived most of its revenues from dividends paid to the parent company by its bank subsidiary. The Company's banking subsidiary is subject to statutory restrictions on its ability to pay dividends to the parent company. The parent company has in recent years supplemented the dividends received from its subsidiaries with borrowings. As of September 30, 2013, the parent company had approximately \$9.2 million of cash and cash

equivalents available to meet its cash flow needs.

## **FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS**

The Company from time to time in its oral and written communications makes statements relating to its expectations regarding the future. These types of statements are considered “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. The Company may include forward-looking statements in filings with the Securities and Exchange Commission (“SEC”), 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. Such forward looking statements can include statements about the Company’s net interest income or net interest margin; its adequacy of allowance for loan losses, levels of provisions for loan losses, and the quality of the Company’s loans and other assets; simulations of changes in interest rates; expected results from mergers with or acquisitions of other businesses; litigation results; tax estimates and recognition; dividend policy; parent company cash resources and cash requirements, and parent company capital resources; estimated cost savings, plans and objectives for future operations; and expectations about the Company’s financial and business performance and other business matters as well as economic and market conditions and trends. They often can be identified by the use of words like “expect,” “may,” “will,” “would,” “could,” “should,” “intend,” “project,” “estimate,” “believe” or “anticipate,” or similar expressions.

Forward-looking statements speak only as of the date they are made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the forward-looking statement is made.

Readers are cautioned that, by their nature, all forward-looking statements are based on assumptions and are subject to risks, uncertainties, and other factors. Actual results may differ materially and adversely from the expectations of the Company that are expressed or implied by any forward-looking statement. The discussions in this Item 2 list some of the factors that could cause the Company's actual results to vary materially from those expressed or implied by any forward-looking statements. Other risks, uncertainties, and factors that could cause the Company's actual results to vary materially from those expressed or implied by any forward-looking statement include the unknown future direction of interest rates and the timing and magnitude of any changes in interest rates; changes in competitive conditions; the introduction, withdrawal, success and timing of asset/liability management strategies or of mergers and acquisitions and other business initiatives and strategies; changes in customer borrowing, repayment, investment and deposit practices; changes in fiscal, monetary and tax policies; changes in financial and capital markets; deterioration in general economic conditions, either nationally or locally, resulting in, among other things, credit quality deterioration; capital management activities, including possible future sales of new securities, or possible repurchases or redemptions by the Company of outstanding debt or equity securities; risks of expansion through acquisitions and mergers, such as unexpected credit quality problems of the acquired loans or other assets, unexpected attrition of the customer base of the acquired institution or branches, and difficulties in integration of the acquired operations; factors driving impairment charges on investments; the impact, extent and timing of technological changes; litigation liabilities, including related costs, expenses, settlements and judgments, or the outcome of matters before regulatory agencies, whether pending or commencing in the future; actions of the Federal Reserve Board; changes in accounting principles and interpretations; potential increases of federal deposit insurance premium expense, and possible future special assessments of FDIC premiums, either industry wide or specific to the Company's banking subsidiary; actions of the regulatory authorities under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the Federal Deposit Insurance Act and other possible legislative and regulatory actions and reforms; and the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends. Such statements reflect our views with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to the operations, results of operations, growth strategy and liquidity of the Company. Readers are cautioned not to place undue reliance on these forward-looking statements.

Investors should consider these risks, uncertainties, and other factors, in addition to those mentioned by the Company in its Annual Report on Form 10-K for its fiscal year ended December 31, 2012, and other SEC filings from time to time, when considering any forward-looking statement.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The Company's exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee and Boards of Directors of the parent company and its subsidiary bank. Primary market risks which impact the Company's operations are liquidity risk and interest rate risk.

The liquidity of the parent company is dependent upon the receipt of dividends from its subsidiary bank, which is subject to certain regulatory limitations. The Bank's source of funding is predominately core deposits, maturities of securities, repayments of loan principal and interest, federal funds purchased, securities sold under agreements to repurchase and borrowings from the Federal Home Loan Bank.

The Company monitors interest rate risk by the use of computer simulation modeling to estimate the potential impact on its net interest income under various interest rate scenarios, and by estimating its static interest rate sensitivity position. Another method by which the Company's interest rate risk position can be estimated is by computing estimated changes in its net portfolio value ("NPV"). This method estimates interest rate risk exposure from movements in interest rates by using interest rate sensitivity analysis to determine the change in the NPV of discounted cash flows from assets and liabilities.

NPV represents the market value of portfolio equity and is equal to the estimated market value of assets minus the estimated market value of liabilities. Computations are based on a number of assumptions, including the relative levels of market interest rates and prepayments in mortgage loans and certain types of investments. These computations do not contemplate any actions management may undertake in response to changes in interest rates, and should not be relied upon as indicative of actual results. In addition, certain shortcomings are inherent in the method of computing NPV. Should interest rates remain or decrease below current levels, the proportion of adjustable rate loans could decrease in future periods due to refinancing activity. In the event of an interest rate change, prepayment levels would likely be different from those assumed in the table. Lastly, the ability of many borrowers to repay their adjustable rate debt may decline during a rising interest rate environment.

The Company from time to time utilizes derivatives to manage interest rate risk. Management continuously evaluates the merits of such interest rate risk products but does not anticipate the use of such products to become a major part of the Company's risk management strategy.

The table below provides an assessment of the risk to NPV in the event of a sudden and sustained 2% increase and decrease in prevailing interest rates (dollars in thousands).

### Interest Rate Sensitivity as of September 30, 2013

| Changes<br>in Rates | Net Portfolio<br>Value<br>Amount | % Change | Net Portfolio Value<br>as a % of Present Value<br>of Assets |   | Change |      |
|---------------------|----------------------------------|----------|---|---|--------|------|
|                     |                                  |          | NPV Ratio   |   |        |      |
| +2%                 | \$ 171,257                       | (19.24)  | % 8.70  | % | (156)  | b.p. |
| Base                | 212,062                          |          | 10.26   | % |        |      |
| -2%                 | 191,600                          | (9.65)   | % 9.08  | % | (118)  | b.p. |

This Item 3 includes forward-looking statements. See “Forward-looking Statements” included in Part I, Item 2 of this Report for a discussion of certain factors that could cause the Company’s actual exposure to market risk to vary materially from that expressed or implied above. These factors include possible changes in economic conditions; interest rate fluctuations, competitive product and pricing pressures within the Company’s markets; and equity and fixed income market fluctuations. Actual experience may also vary materially to the extent that the Company’s assumptions described above prove to be inaccurate.

#### Item 4. Controls and Procedures

As of September 30, 2013, the Company carried out an evaluation, under the supervision and with the participation of its principal executive officer and principal financial officer, of the effectiveness of the design and operation of its disclosure controls and procedures. Based on this evaluation, the Company’s principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures were as of that date effective in timely alerting them to material information required to be included in the Company’s periodic reports filed with the Securities and Exchange Commission. There are inherent limitations to the effectiveness of systems of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective systems of disclosure controls and procedures can provide only reasonable assurances of achieving their control objectives.

There was no change in the Company’s internal control over financial reporting that occurred during the Company’s third fiscal quarter of 2013 that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

**PART II. OTHER INFORMATION****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

(e) The following table sets forth information regarding the Company's purchases of its common shares during each of the three months ended September 30, 2013.

| Period         | Total<br>Number<br>of Shares<br>(or Units)<br>Purchased | Average Price<br>Paid Per Share<br>(or Unit) | Total Number of Shares<br>(or Units) Purchased as Part<br>of Publicly Announced Plans<br>or Programs | Maximum Number<br>(or Approximate Dollar<br>Value) of Shares (or Units)<br>that May Yet Be Purchased<br>under the Plans or Programs <sup>(1)</sup> |
|----------------|---|--|--|--|
| 7/1/13 7/31/13 |   |  |  | 272,789  |
| 8/1/13 8/31/13 |   |  |  | 272,789  |
| 9/1/13 9/30/13 |   |  |  | 272,789  |

<sup>(1)</sup> On April 26, 2001, the Company announced that its Board of Directors had approved a stock repurchase program for up to 607,754 of its outstanding common shares, of which the Company had purchased 334,965 common shares through September 30, 2013 (both such numbers adjusted for subsequent stock dividends). The Board of Directors established no expiration date for this program. The Company purchased no shares under this program during the three months ended September 30, 2013.

**Item 6. Exhibits**

The exhibits described by the Exhibit Index immediately following the Signature Page of this Report are incorporated herein by reference.

**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.

GERMAN AMERICAN BANCORP, INC.

Date: November 8, 2013

By/s/Mark A. Schroeder  
Mark A. Schroeder  
Chairman of the Board and Chief Executive Officer

Date: November 8, 2013

By/s/Bradley M. Rust  
Bradley M. Rust  
Executive Vice President and Chief Financial Officer



**INDEX OF EXHIBITS**

**Exhibit**

| <b>No.</b> | <b>Description</b>   |
|------------|--|
| 2.1        | Agreement and Plan of Reorganization among German American Bancorp, Inc., United Commerce Bancorp, German American Bancorp, and United Commerce Bank, dated July 23, 2013. The copy of this exhibit filed as Exhibit 2.1 to Registrant's Current Report on Form 8-K filed July 24, 2013 is incorporated herein by reference. Schedules identified in the list of Schedules to this Agreement are not filed as part of this Exhibit, but the Registrant agrees to furnish to the Commission supplementally any omitted schedule upon request. |
| 31.1**     | Sarbanes-Oxley Act of 2002, Section 302 Certification for Chairman of the Board and Chief Executive Officer.   |
| 31.2**     | Sarbanes-Oxley Act of 2002, Section 302 Certification for Executive Vice President and Chief Financial Officer.  |
| 32.1**     | Sarbanes-Oxley Act of 2002, Section 906 Certification for Chairman of the Board and Chief Executive Officer.   |
| 32.2**     | Sarbanes-Oxley Act of 2002, Section 906 Certification for Executive Vice President and Chief Financial Officer.  |
| 101**+     | The following materials from German American Bancorp, Inc.'s Form 10-Q Report for the quarterly period ended September 30, 2013, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows, and (v) the Notes to Consolidated Financial Statements.  |

\*\*Exhibits that are furnished or filed with this Report (other than through incorporation by reference to other disclosures or exhibits) are indicated by a double asterisk.

+Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are furnished and not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 and 12 of the Securities Act of 1933, as amended, and are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.