

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 or 15(d) of the  
Securities Exchange Act of 1934

For the fiscal year ended December 31, 2014

Commission file number 0-11487

**LAKELAND FINANCIAL CORPORATION**

**Indiana**  
(State of incorporation)

**35-1559596**  
(I.R.S. Employer Identification No.)

**202 East Center Street, P.O. Box 1387, Warsaw, Indiana 46581-1387**  
(Address of principal executive offices)

Telephone: (574) 267-6144

Securities registered pursuant to Section 12(b) of the Act:

**Common Stock, no par value**  
(Title of class)

**NASDAQ Global Select Market**  
(Name of each exchange on which registered)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes \_\_\_ No X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.  
Yes \_\_\_ No X

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 twelve months (or for such other 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 X 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 X No \_\_\_

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of the registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ]

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer [ ] Accelerated filer [X] 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 Act) Yes \_\_\_ No X

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based on the last sales price quoted on the Nasdaq Global Select Market on June 30, 2014, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$595,912,322.

Number of shares of common stock outstanding at February 25, 2015: 16,604,568

DOCUMENTS INCORPORATED BY REFERENCE

Part III - Portions of the Proxy Statement for the Annual Meeting of Stockholders to be held on April 14, 2015 are incorporated by reference into Part III hereof.

**LAKELAND FINANCIAL CORPORATION**  
**Annual Report on Form 10-K**  
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## PART I

### ITEM 1. BUSINESS

#### The Company

Lakeland Financial Corporation (“Lakeland Financial”), an Indiana corporation incorporated in 1983, is a bank holding company headquartered in Warsaw, Indiana that provides, through its wholly-owned subsidiary Lake City Bank (the “Bank” and together with Lakeland Financial, the “Company”), a broad array of products and services throughout its Northern and Central Indiana markets. The Company offers commercial and consumer banking services, as well as trust and wealth management, brokerage, and treasury management commercial services. The Company serves a wide variety of industries including, among others, manufacturing, agriculture, construction, retail, services, health care and transportation. The Company’s customer base is similarly diverse. The Company is not dependent upon any single industry or customer. At December 31, 2014, Lakeland Financial had consolidated total assets of \$3.4 billion and was the fourth largest independent bank holding company headquartered in the State of Indiana.

**Company’s Business.** The Company is a bank holding company as defined in the Bank Holding Company Act of 1956, as amended. The Company owns all of the outstanding stock of the Bank, a full-service commercial bank organized under Indiana law. The Company conducts no business except that incident to its ownership of the outstanding stock of the Bank and the operation of the Bank. Although Lakeland Financial is a corporate entity, legally separate and distinct from its affiliates, bank holding companies such as Lakeland Financial are required to act as a source of financial strength for their subsidiary banks. The principal source of Lakeland Financial’s income is dividends from the Bank. There are certain regulatory restrictions on the extent to which subsidiary banks can pay dividends or otherwise supply funds to their holding companies. See the section captioned “Supervision and Regulation” below for further discussion of these matters. Lakeland Financial’s executive offices are located at 202 East Center Street, Warsaw, Indiana 46580, and its telephone number is (574) 267-6144.

**Bank’s Business.** The Bank was originally organized in 1872 and has continuously operated under the laws of the State of Indiana since its organization. As of December 31, 2014, the Bank had 46 offices in fourteen counties throughout Northern and Central Indiana. The Bank’s deposits are insured by the Federal Deposit Insurance Corporation (the “FDIC”). The Bank’s activities cover all phases of commercial banking, including deposit products, commercial and consumer lending, retail and merchant credit card services, corporate treasury management services, and wealth advisory, trust and brokerage services.

The Bank’s business strategy is focused on building long-term relationships with its customers based on top quality service, high ethical standards and safe and sound lending. The Bank operates as a community-based financial services organization augmented by experienced, centralized support in select critical areas. The Bank’s local market orientation is reflected in its regional management, which divides the Bank’s market area into five distinct geographic regions each headed by a retail and commercial regional manager. This arrangement allows decision making to be as close to the customer as possible and enhances responsiveness to local banking needs. Despite this local market, community-based focus, the Bank offers many of the products and services available at much larger regional and national competitors. While our strategy encompasses all phases of traditional community banking, including consumer lending and wealth advisory and trust services, we focus on building expansive commercial relationships and developing retail and commercial deposit gathering strategies through relationship-based client services. Substantially all of the Bank’s assets and income are located in and derived from the United States. At December 31, 2014, the Company had 496 full-time equivalent employees. The Company is not a party to any collective bargaining agreements, and employee relations are considered good.

**Operating Segments.** The Company’s chief decision-makers monitor and evaluate financial performance on a Company-wide basis. All of the Company’s financial service operations are similar and considered by management to be aggregated into one reportable operating segment. While the Company has assigned certain management responsibilities by region and business-line, the Company’s chief decision-makers monitor and evaluate financial performance on a Company-wide basis. The majority of the Company’s revenue is from the business of banking and the Company’s assigned regions have similar economic characteristics, products, services and customers. Accordingly, all of the Company’s operations are considered by management to be aggregated in one reportable operating segment.

**Expansion Strategy.** Since 1990, the Company has expanded from 17 offices in four Indiana counties to 46 branches in fourteen Indiana counties primarily through de novo branching. During this period, the Company has grown its assets from \$286 million to \$3.4 billion, an increase of 1,104%. Mergers and acquisitions have not played a role in this growth as the Company’s expansion strategy has been driven by organic growth. The Company has opened four de novo branches in the past five years.

Over the past fifteen years, the Company has primarily targeted growth in the larger cities located in Northern Indiana and the Indianapolis market in Central Indiana. The Company believes these areas offer above average growth potential with attractive demographics and potential for commercial lending opportunities. The Company considers expanding into a market when the Company believes that market would be receptive to its strategic plan to deliver broad-based financial services with a commitment to

local communities. When entering new markets, the Company believes it is critical to attract experienced local management and staff with a similar philosophy in order to provide a basis for success. The Company previously announced plans to build a fourth de novo office in Indianapolis, as well as to lease office space in downtown Fort Wayne upon completion of a major construction project currently underway. The Company does not currently have any definitive understandings or agreements for any acquisitions.

**Competition.** The financial services industry is highly competitive. Competition is based on a number of factors including, among others, customer service, quality and range of products and services offered, price, reputation, interest rates on loans and deposits, lending limits and customer convenience. Our competitors include banks, thrifts, credit unions, farm credit services, finance companies, personal loan companies, brokerage firms, investment companies, insurance companies, mortgage banking companies, credit card issuers, mutual fund companies and e-commerce and other internet-based companies offering financial services. Many of these competitors enjoy fewer regulatory constraints and some may have lower cost structures.

### **Forward-looking Statements**

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

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

- the effects of future economic, business and market conditions and changes, both domestic and foreign, including seasonality;
- governmental monetary and fiscal policies;
- legislative and regulatory changes, including changes in banking, securities and tax laws and regulations and their application by our regulators;
- changes in the scope and cost of FDIC insurance, the state of Indiana's Public Deposit Insurance Fund and other coverages;
- changes in accounting policies, rules and practices;
- the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities and other interest sensitive assets and liabilities;
- the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates;
- changes in borrowers' credit risks and payment behaviors;
- changes in the availability and cost of credit and capital in the financial markets;
- changes in the prices, values and sales volumes of residential and commercial real estate;
- the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;
- the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions;
- changes in technology or products that may be more difficult, costly or less effective than anticipated;
- the effects of war or other conflicts, acts of terrorism or other catastrophic events, including storms, droughts, tornados and flooding, that may affect general economic conditions, including agricultural production and demand and prices for agricultural goods and land used for agricultural purposes, generally and in our markets;

- the failure of assumptions and estimates used in our reviews of our loan portfolio and our analysis of our capital position;
- cyber-security risks and or cyber-security damage that could result from attacks on networks or data of the Company; and
- other factors and risks described under “Risk Factors” herein.

These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. For additional information regarding these and other risks, uncertainties and other factors, please review the disclosure in this annual report under “Risk Factors.”

### **Internet Website**

The Company maintains an internet site at [www.lakecitybank.com](http://www.lakecitybank.com). The Company makes available free of charge in the Investor Relations section on this site its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and other reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), as soon as reasonably practicable after it electronically files such material with, or furnishes it to, the Securities and Exchange Commission (the “SEC”). All such documents filed with the SEC are also available for free on the SEC’s website ([www.sec.gov](http://www.sec.gov)). The Company’s Articles of Incorporation, Bylaws, Code of Conduct and the charters of its various committees of the Board of Directors are also available on the website.

## **SUPERVISION AND REGULATION**

### **General**

Financial institutions, their holding companies and their affiliates are extensively regulated under federal and state law. As a result, the growth and earnings performance of the Company may be affected not only by management decisions and general economic conditions, but also by requirements of federal and state statutes and by the regulations and policies of various bank regulatory agencies, including the Indiana Department of Financial Institutions (the “DFI”), the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the FDIC and the Bureau of Consumer Financial Protection (the “CFPB”). Furthermore, taxation laws administered by the Internal Revenue Service and state taxing authorities, accounting rules developed by the Financial Accounting Standards Board, securities laws administered by the Securities and Exchange Commission (the “SEC”) and state securities authorities, and anti-money laundering laws enforced by the U.S. Department of the Treasury (the “Treasury”) have an impact on the business of the Company. The effect of these statutes, regulations, regulatory policies and accounting rules are significant to the operations and results of the Company and Bank, and the nature and extent of future legislative, regulatory or other changes affecting financial institutions are impossible to predict with any certainty.

Federal and state banking laws impose a comprehensive system of supervision, regulation and enforcement on the operations of financial institutions, their holding companies and affiliates that is intended primarily for the protection of the FDIC-insured deposits and depositors of banks, rather than shareholders. These federal and state laws, and the regulations of the bank regulatory agencies issued under them, affect, among other things, the scope of business, the kinds and amounts of investments banks may make, reserve requirements, capital levels relative to operations, the nature and amount of collateral for loans, the establishment of branches, the ability to merge, consolidate and acquire, dealings with insiders and affiliates and the payment of dividends.

This supervisory and regulatory framework subjects banks and bank holding companies to regular examination by their respective regulatory agencies, which results in examination reports and ratings that are not publicly available and that can impact the conduct and growth of their business. These examinations consider not only compliance with applicable laws and regulations, but also capital levels, asset quality and risk, management ability and performance, earnings, liquidity and various other factors. The regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of a regulated entity where the agencies determine, among other things, that such operations are unsafe or unsound, fail to comply with applicable laws or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

The following is a summary of the material elements of the supervisory and regulatory framework applicable to the Company and the Bank. It does not describe all of the statutes, regulations and regulatory policies that apply, nor does it restate all of the requirements of those that are described. The descriptions are qualified in their entirety by reference to the particular statutory and regulatory provision.

### **Financial Regulatory Reform**

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) into law. The Dodd-Frank Act represented a sweeping reform of the U.S. supervisory and regulatory framework applicable to financial institutions and capital markets in the wake of the global financial crisis, certain aspects of which are described

below in more detail. In particular, and among other things, the Dodd-Frank Act: created a Financial Stability Oversight Council as part of a regulatory structure for identifying emerging systemic risks and improving interagency cooperation; created the CFPB, which is authorized to regulate providers of consumer credit, savings, payment and other consumer financial products and services; narrowed the scope of federal preemption of state consumer laws enjoyed by national banks and federal savings associations and expanded the authority of state attorneys general to bring actions to enforce federal consumer protection legislation; imposed more stringent capital requirements on bank holding companies and subjected certain activities, including interstate mergers and acquisitions, to heightened capital conditions; with respect to mortgage lending, (i) significantly expanded requirements applicable to loans secured by 1-4 family residential real property, (ii) imposed strict rules on mortgage servicing, and (iii) required the originator of a securitized loan, or the sponsor of a securitization, to retain at least 5% of the credit risk of securitized exposures unless the underlying exposures are qualified residential mortgages or meet certain underwriting standards; repealed the prohibition on the payment of interest on business checking accounts; restricted the interchange fees payable on debit card transactions for issuers with \$10 billion in assets or greater; in the so-called “Volcker Rule,” subject to numerous exceptions, prohibited depository institutions and affiliates from certain investments in, and sponsorship of, hedge funds and private equity funds and from engaging in proprietary trading; provided for enhanced regulation of advisers to private funds and of the derivatives markets; enhanced oversight of credit rating agencies; and prohibited banking agency requirements tied to credit ratings. These statutory changes shifted the regulatory framework for financial institutions, impacted the way in which they do business and have the potential to constrain revenues.

Numerous provisions of the Dodd-Frank Act were required to be implemented through rulemaking by the appropriate federal regulatory agencies. Many of the required regulations have been issued and others have been released for public comment, but are not yet final. Although the reforms primarily targeted systemically important financial service providers, their influence is expected to filter down in varying degrees to smaller institutions over time. Management of the Company and the Bank will continue to evaluate the effect of the Dodd-Frank Act; however, in many respects, the ultimate impact of the Dodd-Frank Act will not be fully known for years, and no current assurance may be given that the Dodd-Frank Act, or any other new legislative changes, will not have a negative impact on the results of operations and financial condition of the Company and the Bank.

### **The Increasing Regulatory Emphasis on Capital**

Regulatory capital represents the net assets of a financial institution available to absorb losses. Because of the risks attendant to their business, depository institutions are generally required to hold more capital than other businesses, which directly affects earnings capabilities. While capital has historically been one of the key measures of the financial health of both bank holding companies and banks, its role has become fundamentally more important in the wake of the global financial crisis, as the banking regulators recognized that the amount and quality of capital held by banks prior to the crisis was insufficient to absorb losses during periods of severe stress. Certain provisions of the Dodd-Frank Act and Basel III, discussed below, establish strengthened capital standards for banks and bank holding companies, require more capital to be held in the form of common stock and disallow certain funds from being included in capital determinations. Once fully implemented, these standards will represent regulatory capital requirements that are meaningfully more stringent than those in place previously.

**The Company and Bank Required Capital Levels.** Bank holding companies have had to comply with less stringent capital standards than their bank subsidiaries and have been able to raise capital with hybrid instruments such as trust preferred securities. The Dodd-Frank Act mandated the Federal Reserve to establish minimum capital levels for bank holding companies on a consolidated basis as stringent as those required for insured depository institutions. As a consequence, the components of holding company permanent capital known as “Tier 1 Capital” were restricted to those capital instruments that are considered to be Tier 1 Capital for insured depository institutions. A result of this change is that the proceeds of hybrid instruments, such as trust preferred securities, are being excluded from Tier 1 Capital over a phase-out period. However, if such securities were issued prior to May 19, 2010 by bank holding companies with less than \$15 billion of assets as of December 31, 2009, they may be retained as Tier I Capital subject to certain restrictions. Because the Company had assets of less than \$15 billion, it was able to meet the requirements and maintain its trust preferred proceeds as Tier 1 Capital but will have to comply with the revised capital mandates in other respects and will not be able to raise Tier 1 Capital in the future through the issuance of trust preferred securities.

The minimum capital standards effective for the year ended December 31, 2014 were:

- A leverage requirement, consisting of a minimum ratio of Tier 1 Capital to total adjusted book assets of 3% for the most highly-rated banks with a minimum requirement of at least 4% for all others, and
- A risk-based capital requirement, consisting of a minimum ratio of Total Capital to total risk-weighted assets of 8% and a minimum ratio of Tier 1 Capital to total risk-weighted assets of 4%.

For these purposes, “Tier 1 Capital” consisted primarily of common stock, noncumulative perpetual preferred stock and related surplus less intangible assets (other than certain loan servicing rights and purchased credit card relationships). “Total Capital” consisted primarily of Tier 1 Capital plus “Tier 2 Capital,” which included other non-permanent capital items, such as certain other debt and equity instruments that do not qualify as Tier 1 Capital, and a portion of the Bank’s allowance for loan and lease losses. Further, risk-weighted assets for the purpose of the risk-weighted ratio calculations were balance sheet assets and off-balance sheet exposures to which required risk weightings of 0% to 100% were applied.

The capital standards described above are **minimum** requirements and were increased beginning January 1, 2015 under Basel III, as discussed below. Bank regulatory agencies uniformly encourage banks and bank holding companies to be “well-capitalized” and, to that end, federal law and regulations provide various incentives for banking organizations to maintain regulatory capital at levels in excess of minimum regulatory requirements. For example, a banking organization that is “well-capitalized” may: (i) qualify for exemptions from prior notice or application requirements otherwise applicable to certain types of activities; (ii) qualify for expedited processing of other required notices or applications; and (iii) accept roll-over or renew brokered deposits. Under the capital regulations of the FDIC and Federal Reserve, in order to be “well-capitalized,” a banking organization, for the year ended December 31, 2014, must have maintained:

- A leverage ratio of Tier 1 Capital to total assets of 5% or greater,
- A ratio of Tier 1 Capital to total risk-weighted assets of 6% or greater, and
- A ratio of Total Capital to total risk-weighted assets of 10% or greater.

The FDIC and Federal Reserve guidelines also provide that banks and bank holding companies experiencing internal growth or making acquisitions would be expected to maintain capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Furthermore, the guidelines indicate that the agencies will continue to consider a “tangible Tier 1 leverage ratio” (deducting all intangibles) in evaluating proposals for expansion or to engage in new activities.

Higher capital levels could also be required if warranted by the particular circumstances or risk profile of individual banking organizations. For example, the Federal Reserve’s capital guidelines contemplate that additional capital may be required to take adequate account of, among other things, interest rate risk, or the risks posed by concentrations of credit, nontraditional activities or securities trading activities. Further, any banking organization experiencing or anticipating significant growth would be expected to maintain capital ratios, including tangible capital positions (*i.e.*, Tier 1 Capital less all intangible assets), well above the minimum levels.

**Prompt Corrective Action.** A banking organization’s capital plays an important role in connection with regulatory enforcement as well. Federal law provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators’ powers depends on whether the institution in question is “adequately capitalized,” “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized,” in each case as defined by regulation. Depending upon the capital category to which an institution is assigned, the regulators’ corrective powers include: (i) requiring the institution to submit a capital restoration plan; (ii) limiting the institution’s asset growth and restricting its activities; (iii) requiring the institution to issue additional capital stock (including additional voting stock) or to sell itself; (iv) restricting transactions between the institution and its affiliates; (v) restricting the interest rate that the institution may pay on deposits; (vi) ordering a new election of directors of the institution; (vii) requiring that senior executive officers or directors be dismissed; (viii) prohibiting the institution from accepting deposits from correspondent banks; (ix) requiring the institution to divest certain subsidiaries; (x) prohibiting the payment of principal or interest on subordinated debt; and (xi) ultimately, appointing a receiver for the institution.

As of December 31, 2014: (i) the Bank was not subject to a directive from its regulatory agencies to increase its capital and (ii) the Bank was “well-capitalized,” as defined by Federal Reserve regulations. As of December 31, 2014, the Company had regulatory capital in excess of the Federal Reserve’s requirements and met the Dodd-Frank Act requirements.

**The Basel International Capital Accords.** The risk-based capital guidelines described above are based upon the 1988 capital accord known as “Basel I” adopted by the international Basel Committee on Banking Supervision, a committee of central banks and bank supervisors, as implemented by the U.S. federal banking regulators on an interagency basis. In 2008, the banking agencies collaboratively began to phase-in capital standards based on a second capital accord, referred to as “Basel II,” for large or “core” international banks (generally defined for U.S. purposes as having total assets of \$250 billion or more, or consolidated foreign exposures of \$10 billion or more). Basel II emphasized internal assessment of credit, market and operational risk, as well as supervisory assessment and market discipline in determining minimum capital requirements.

On September 12, 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, announced agreement on a strengthened set of capital requirements for banking organizations around the world, known as Basel III, to address deficiencies recognized in connection with the global financial crisis. Basel III was intended to be effective globally on January 1, 2013, with phase-in of certain elements continuing until January 1, 2019, and it is currently effective in many countries.

**U.S. Implementation of Basel III.** In July of 2013, the U.S. federal banking agencies approved the implementation of the Basel III regulatory capital reforms in pertinent part, and, at the same time, promulgated rules effecting certain changes required by the Dodd-Frank Act (the “Basel III Rule”). In contrast to capital requirements previously, which were in the form of guidelines, Basel III was released in the form of regulations by each of the federal regulatory agencies. The Basel III Rule is applicable to all financial institutions that are subject to minimum capital requirements, including federal and state banks and savings and loan associations, as well as to bank and savings and loan holding companies other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than \$1 billion).

The Basel III Rule not only increased most of the required minimum capital ratios as of January 1, 2015, but it introduced the concept of “Common Equity Tier 1 Capital,” which consists primarily of common stock, related surplus (net of Treasury stock),

retained earnings, and Common Equity Tier 1 minority interests, subject to certain regulatory adjustments. The Basel III Rule also established more stringent criteria for instruments to be considered “Additional Tier 1 Capital” (Tier 1 Capital in addition to Common Equity) and Tier 2 Capital. A number of instruments that qualified as Tier 1 Capital will not qualify, or their qualifications will change. For example, cumulative preferred stock and certain hybrid capital instruments, including trust preferred securities, will no longer qualify as Tier 1 Capital of any kind, with the exception, subject to certain restrictions, of such instruments issued before May 10, 2010, by bank holding companies with total consolidated assets of less than \$15 billion as of December 31, 2009. For those institutions, trust preferred securities and other nonqualifying capital instruments currently included in consolidated Tier 1 Capital were permanently grandfathered under the Basel III Rule, subject to certain restrictions. Noncumulative perpetual preferred stock, which formerly qualified as simple Tier 1 Capital, will not qualify as Common Equity Tier 1 Capital, but will instead qualify as Additional Tier 1 Capital. The Basel III Rule also constrained the inclusion of minority interests, mortgage-servicing assets and deferred tax assets in capital and requires deductions from Common Equity Tier 1 Capital in the event that such assets exceed a certain percentage of a banking institution’s Common Equity Tier 1 Capital.

As of January 1, 2015, the Basel III Rule requires:

- A new minimum ratio of Common Equity Tier 1 Capital to risk-weighted assets of 4.5%;
- An increase in the minimum required amount of Tier 1 Capital to 6% of risk-weighted assets;
- A continuation of the current minimum required amount of Total Capital (Tier 1 plus Tier 2) at 8% of risk-weighted assets; and
- A minimum leverage ratio of Tier 1 Capital to total assets equal to 4% in all circumstances.

The Basel III Rule maintained the general structure of the prompt corrective action framework, while incorporating the increased requirements and adding the Common Equity Tier 1 Capital ratio. In order to be “well-capitalized” under the new regime, a depository institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; a Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more.

In addition, institutions that seek the freedom to make capital distributions (including for dividends and repurchases of stock) and pay discretionary bonuses to executive officers without restriction must also maintain 2.5% of risk-weighted assets in Common Equity Tier 1 attributable to a capital conservation buffer to be phased in over three years beginning in 2016. The purpose of the conservation buffer is to ensure that banking institutions maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. Factoring in the fully phased-in conservation buffer increases the minimum ratios depicted above to 7% for Common Equity Tier 1, 8.5% for Tier 1 Capital and 10.5% for Total Capital. The leverage ratio is not impacted by the conservation buffer, and a banking institution may be considered well-capitalized while remaining out of compliance with the capital conservation buffer.

As discussed above, most of the capital requirements are based on a ratio of specific types of capital to “risk-weighted assets.” Not only did Basel III change the components and requirements of capital, but, for nearly every class of financial assets, the Basel III Rule requires a more complex, detailed and calibrated assessment of credit risk and calculation of risk weightings. While Basel III would have changed the risk weighting for residential mortgage loans based on loan-to-value ratios and certain product and underwriting characteristics, there was concern in the United States that the proposed methodology for risk weighting residential mortgage exposures and the higher risk weightings for certain types of mortgage products would increase costs to consumers and reduce their access to mortgage credit. As a result, the Basel III Rule did not effect this change, and banking institutions will continue to apply a risk weight of 50% or 100% to their exposure from residential mortgages.

Furthermore, there was significant concern noted by the financial industry in connection with the Basel III rulemaking as to the proposed treatment of accumulated other comprehensive income (“AOCI”). Basel III requires unrealized gains and losses on available-for-sale securities to flow through to regulatory capital as opposed to the previous treatment, which neutralized such effects. Recognizing the problem for community banks, the U.S. bank regulatory agencies adopted the Basel III Rule with a one-time election for smaller institutions like the Company and the Bank to opt-out of including most elements of AOCI in regulatory capital. This opt-out, which must be made in the first quarter of 2015, would exclude from regulatory capital both unrealized gains and losses on available-for-sale debt securities and accumulated net gains and losses on cash-flow hedges and amounts attributable to defined benefit post-retirement plans. The Company and the Bank expect to make this election to avoid variations in the level of their capital depending on fluctuations in the fair value of their securities portfolio.

Banking institutions (except for large, internationally active financial institutions) became subject to the Basel III Rule on January 1, 2015, and both the Company and the Bank are currently in compliance with the new required ratios. There are separate phase-in/phase-out periods for: (i) the capital conservation buffer; (ii) regulatory capital adjustments and deductions; (iii) nonqualifying capital instruments; and (iv) changes to the prompt corrective action rules. The phase-in periods commence on January 1, 2016 and extend until 2019.

## **The Company**

**General.** The Company, as the sole shareholder of the Bank, is a bank holding company. As a bank holding company, the Company is registered with, and is subject to regulation by, the Federal Reserve under the Bank Holding Company Act of 1956, as amended (the “BHCA”). In accordance with Federal Reserve policy, and as now codified by the Dodd-Frank Act, the Company is



legally obligated to act as a source of financial strength to the Bank and to commit resources to support the Bank in circumstances where the Company might not otherwise do so. Under the BHCA, the Company is subject to periodic examination by the Federal Reserve. The Company is required to file with the Federal Reserve periodic reports of the Company's operations and such additional information regarding the Company and its subsidiaries as the Federal Reserve may require. The Company is also subject to regulation by the DFI under Indiana law.

**Acquisitions, Activities and Change in Control.** The primary purpose of a bank holding company is to control and manage banks. The BHCA generally requires the prior approval of the Federal Reserve for any merger involving a bank holding company or any acquisition by a bank holding company of another bank or bank holding company. Subject to certain conditions (including deposit concentration limits established by the BHCA and the Dodd-Frank Act), the Federal Reserve may allow a bank holding company to acquire banks located in any state of the United States. In approving interstate acquisitions, the Federal Reserve is required to give effect to applicable state law limitations on the aggregate amount of deposits that may be held by the acquiring bank holding company and its insured depository institution affiliates in the state in which the target bank is located (provided that those limits do not discriminate against out-of-state depository institutions or their holding companies) and state laws that require that the target bank have been in existence for a minimum period of time (not to exceed five years) before being acquired by an out-of-state bank holding company. Furthermore, in accordance with the Dodd-Frank Act, bank holding companies must be well-capitalized and well-managed in order to effect interstate mergers or acquisitions. For a discussion of the capital requirements, see "The Increasing Regulatory Emphasis on Capital" above.

The BHCA generally prohibits the Company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company that is not a bank and from engaging in any business other than that of banking, managing and controlling banks or furnishing services to banks and their subsidiaries. This general prohibition is subject to a number of exceptions. The principal exception allows bank holding companies to engage in, and to own shares of companies engaged in, certain businesses found by the Federal Reserve prior to November 11, 1999 to be "so closely related to banking ... as to be a proper incident thereto." This authority would permit the Company to engage in a variety of banking-related businesses, including the ownership and operation of a savings association, or any entity engaged in consumer finance, equipment leasing, the operation of a computer service bureau (including software development) and mortgage banking and brokerage. The BHCA generally does not place territorial restrictions on the domestic activities of nonbank subsidiaries of bank holding companies.

Additionally, bank holding companies that meet certain eligibility requirements prescribed by the BHCA and elect to operate as financial holding companies may engage in, or own shares in companies engaged in, a wider range of nonbanking activities, including securities and insurance underwriting and sales, merchant banking and any other activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines by regulation or order is financial in nature or incidental to any such financial activity or that the Federal Reserve determines by order to be complementary to any such financial activity and does not pose a substantial risk to the safety or soundness of depository institutions or the financial system generally. The Company elected to, and continues to operate as, a financial holding company. Maintaining financial holding company status requires that the Bank remain "well-capitalized" and "well-managed" as defined by regulation and maintain at least a "satisfactory" rating under the Community Reinvestment Act. In addition, under the Dodd-Frank Act, the Company must also remain well-capitalized and well-managed to maintain its financial holding company status. If the Company or the Bank fails to continue to meet these requirements, the Company could be subject to restrictions on new activities and acquisitions and/or be required to cease and possibly divest of operations that conduct existing activities that are not permissible for a bank holding company that is not a financial holding company.

Federal law also prohibits any person or company from acquiring "control" of an FDIC-insured depository institution or its holding company without prior notice to the appropriate federal bank regulator. "Control" is conclusively presumed to exist upon the acquisition of 25% or more of the outstanding voting securities of a bank or bank holding company, but may arise under certain circumstances between 10% and 24.99% ownership.

**Capital Requirements.** Bank holding companies are required to maintain capital in accordance with Federal Reserve capital adequacy requirements, as affected by the Dodd-Frank Act and Basel III. For a discussion of capital requirements, see "—The Increasing Regulatory Emphasis on Capital" above.

**Dividend Payments.** The Company's ability to pay dividends to its shareholders may be affected by both general corporate law considerations and policies of the Federal Reserve applicable to bank holding companies. As an Indiana corporation, the Company is subject to the limitations of the Indiana General Business Corporation Law, which prohibit the Company from paying dividends if the Company is, or by payment of the dividend would become, insolvent, or if the payment of dividends would render the Company unable to pay its debts as they become due in the usual course of business. In addition, under the Basel III Rule, institutions that seek the freedom to pay dividends will have to maintain 2.5% in Common Equity Tier 1 attributable to the capital conservation buffer to be phased in over three years beginning in 2016. See "—The Increasing Regulatory Emphasis on Capital" above.

As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should eliminate, defer or significantly reduce dividends to shareholders if: (i) the company's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends; (ii) the prospective rate of earnings retention is inconsistent with the company's capital needs and overall current and prospective financial condition; or (iii) the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios. The Federal Reserve

also possesses enforcement powers over bank holding companies and their non-bank subsidiaries to prevent or remedy actions that represent unsafe or unsound practices or violations of applicable statutes and regulations. Among these powers is the ability to proscribe the payment of dividends by banks and bank holding companies.

**Federal Securities Regulation.** The Company's common stock is registered with the SEC under the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Consequently, the Company is subject to the information, proxy solicitation, insider trading and other restrictions and requirements of the SEC under the Exchange Act.

**Corporate Governance.** The Dodd-Frank Act addresses many investor protection, corporate governance and executive compensation matters that will affect most U.S. publicly traded companies. The Dodd-Frank Act will increase stockholder influence over boards of directors by requiring companies to give stockholders a non-binding vote on executive compensation and so-called "golden parachute" payments, and authorizing the SEC to promulgate rules that would allow stockholders to nominate and solicit voters for their own candidates using a company's proxy materials. The legislation also directs the Federal Reserve to promulgate rules prohibiting excessive compensation paid to executives of bank holding companies, regardless of whether such companies are publicly traded.

## **The Bank**

**General.** The Bank is an Indiana-chartered bank, the deposit accounts of which are insured by the Deposit Insurance Fund ("the DIF") to the maximum extent provided under federal law and FDIC regulations. The Bank is also a member of the Federal Reserve System (a "member bank"). As an Indiana-chartered, FDIC-insured member bank, the Bank is presently subject to the examination, supervision, reporting and enforcement requirements of the DFI, the chartering authority for Indiana banks, the Federal Reserve, as the primary federal regulator of member banks, and the FDIC, as administrator of the DIF.

**Deposit Insurance.** As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. The FDIC has adopted a risk-based assessment system whereby FDIC-insured depository institutions pay insurance premiums at rates based on their risk classification. An institution's risk classification is assigned based on its capital levels and the level of supervisory concern the institution poses to the regulators. For deposit insurance assessment purposes, an insured depository institution is placed in one of four risk categories each quarter. An institution's assessment is determined by multiplying its assessment rate by its assessment base. The total base assessment rates range from 2.5 basis points to 45 basis points. While in the past an insured depository institution's assessment base was determined by its deposit base, amendments to the Federal Deposit Insurance Act revised the assessment base so that it is calculated using average consolidated total assets minus average tangible equity. This change shifted the burden of deposit insurance premiums toward those large depository institutions that rely on funding sources other than U.S. deposits.

The FDIC has authority to raise or lower assessment rates on insured deposits in order to achieve statutorily required reserve ratios in the DIF and to impose special additional assessments. In light of the significant increase in depository institution failures in 2008-2010 and the increase of deposit insurance limits, the DIF incurred substantial losses during recent years. To bolster reserves in the DIF, the Dodd-Frank Act increased the minimum reserve ratio of the DIF to 1.35% of insured deposits and deleted the statutory cap for the reserve ratio. In December 2010, the FDIC set the designated reserve ratio at 2%, 65 basis points above the statutory minimum. At least semi-annually, the FDIC will update its loss and income projections for the DIF and, if needed, will increase or decrease the assessment rates, following notice and comment on proposed rulemaking. As a result, the Bank's FDIC deposit insurance premiums could increase.

**FICO Assessments.** In addition to paying basic deposit insurance assessments, insured depository institutions must pay Financing Corporation ("FICO") assessments. FICO is a mixed-ownership governmental corporation chartered by the former Federal Home Loan Bank Board pursuant to the Competitive Equality Banking Act of 1987 to function as a financing vehicle for the recapitalization of the former Federal Savings and Loan Insurance Corporation. FICO issued 30-year noncallable bonds of approximately \$8.1 billion that mature in 2017 through 2019. FICO's authority to issue bonds ended on December 12, 1991. Since 1996, federal legislation has required that all FDIC-insured depository institutions pay assessments to cover interest payments on FICO's outstanding obligations. The FICO assessment rate is adjusted quarterly and for the fourth quarter of 2014 was approximately 0.620 basis points (62 cents per \$100 of assessable deposits).

**Supervisory Assessments.** All Indiana banks are required to pay supervisory assessments to the DFI to fund the operations of the DFI. The amount of the assessment is calculated on the basis of the bank's total assets. During the year ended December 31, 2014, the Bank paid supervisory assessments to the DFI totaling \$224,000.

**Capital Requirements.** Banks are generally required to maintain capital levels in excess of other businesses. For a discussion of capital requirements, see "—The Increasing Regulatory Emphasis on Capital" above.

**Liquidity Requirements.** Liquidity is a measure of the ability and ease with which bank assets may be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations. To remain viable, financial institutions must have enough liquid assets to meet their near-term obligations, such as withdrawals by depositors. Because the global financial crisis was in part a liquidity crisis, Basel III also included a liquidity framework that requires financial institutions to measure their liquidity against specific liquidity tests. One test, referred to as the Liquidity Coverage Ratio ("LCR"), is designed to ensure that

the banking entity has an adequate stock of unencumbered high-quality liquid assets that can be converted easily and immediately in private markets into cash to meet liquidity needs for a 30-calendar day liquidity stress scenario. The other test, known as the Net Stable Funding Ratio (“NSFR”), is designed to promote more medium- and long-term funding of the assets and activities of financial institutions over a one-year horizon. These tests provide an incentive for banks and holding companies to increase their holdings in Treasury securities and other sovereign debt as a component of assets, increase the use of long-term debt as a funding source and rely on stable funding like core deposits (in lieu of brokered deposits).

In addition to liquidity guidelines already in place, the U.S. bank regulatory agencies implemented the LCR in September 2014, which requires large financial firms to hold levels of liquid assets sufficient to protect against constraints on their funding during times of financial turmoil. While the LCR only applies to the largest banking organizations in the country, certain elements are expected to filter down to all insured depository institutions. The Company and the Bank are reviewing their liquidity risk management policies in light of the LCR and NSFR.

**Dividend Payments.** The primary source of funds for the Company is dividends from the Bank. Indiana law prohibits the Bank from paying dividends in an amount greater than its undivided profits. The Bank is required to obtain the approval of the DFI for the payment of any dividend if the total of all dividends declared by the Bank during the calendar year, including the proposed dividend, would exceed the sum of the Bank’s net income for the year-to-date combined with its retained net income for the previous two years. Indiana law defines “retained net income” to mean the net income of a specified period, calculated under the consolidated report of income instructions, less the total amount of all dividends declared for the specified period. The Federal Reserve Act also imposes limitations on the amount of dividends that may be paid by state member banks, such as the Bank. Without Federal Reserve approval, a state member bank may not pay dividends in any calendar year that, in the aggregate, exceed the bank’s calendar year-to-date net income plus the bank’s retained net income for the two preceding calendar years.

The payment of dividends by any financial institution is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and a financial institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, the Bank exceeded its minimum capital requirements under applicable guidelines as of December 31, 2014. As of December 31, 2014, approximately \$59.6 million was available to be paid as dividends by the Bank. Notwithstanding the availability of funds for dividends, however, the Federal Reserve may prohibit the payment of dividends by the Bank if it determines such payment would constitute an unsafe or unsound practice. In addition, under the Basel III Rule, institutions that seek the freedom to pay dividends will have to maintain 2.5% in Common Equity Tier 1 attributable to the capital conservation buffer to be phased in over three years beginning in 2016. See “—The Increasing Regulatory Emphasis on Capital” above.

**Insider Transactions.** The Bank is subject to certain restrictions imposed by federal law on “covered transactions” between the Bank and its “affiliates”. The Company is an affiliate of the Bank for purposes of these restrictions, and covered transactions subject to the restrictions include extensions of credit to the Company, investments in the stock or other securities of the Company and the acceptance of the stock or other securities of the Company as collateral for loans made by the Bank. The Dodd-Frank Act enhances the requirements for certain transactions with affiliates as of July 21, 2011, including an expansion of the definition of “covered transactions” and an increase in the amount of time for which collateral requirements regarding covered transactions must be maintained.

Certain limitations and reporting requirements are also placed on extensions of credit by the Bank to its directors and officers, to directors and officers of the Company and its subsidiaries, to principal shareholders of the Company and to “related interests” of such directors, officers and principal shareholders. In addition, federal law and regulations may affect the terms upon which any person who is a director or officer of the Company or the Bank, or a principal shareholder of the Company, may obtain credit from banks with which the Bank maintains a correspondent relationship.

**Safety and Soundness Standards/Risk Management.** The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each financial institution is responsible for establishing its own procedures to achieve those goals. If a financial institution fails to comply with any of the standards set forth in the guidelines, the financial institution’s primary federal regulator may require the financial institution to submit a plan for achieving and maintaining compliance. If a financial institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the financial institution to cure the deficiency. Until the deficiency cited in the regulator’s order is cured, the regulator may restrict the financial institution’s rate of growth, require the financial institution to increase its capital, restrict the rates the financial institution pays on deposits or require the financial institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal bank regulatory agencies, including cease and desist orders and civil money penalty assessments.

During the past decade, the bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the financial institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk. In particular, recent regulatory pronouncements have focused on operational risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. New products and services, third-party risk management and cyber-security are critical sources of operational risk that financial institutions are expected to address in the current environment. The Bank is expected to have active board and senior management oversight; adequate policies, procedures and limits; adequate risk measurement, monitoring and management information systems; and comprehensive internal controls.

**Branching Authority.** Indiana banks, such as the Bank, have the authority under Indiana law to establish branches anywhere in the State of Indiana, subject to receipt of all required regulatory approvals.

Federal law permits state and national banks to merge with banks in other states subject to: (i) regulatory approval; (ii) federal and state deposit concentration limits; and (iii) state law limitations requiring the merging bank to have been in existence for a minimum period of time (not to exceed five years) prior to the merger. The establishment of new interstate branches has historically been permitted only in those states the laws of which expressly authorize such expansion. The Dodd-Frank Act permits well-capitalized and well-managed banks to establish new interstate branches or the acquisition of individual branches of a bank in another state (rather than the acquisition of an out-of-state bank in its entirety) without impediments.

**State Bank Investments and Activities.** The Bank is permitted to make investments and engage in activities directly or through subsidiaries as authorized by Indiana law. However, under federal law, FDIC-insured state banks are prohibited, subject to certain exceptions, from making or retaining equity investments of a type, or in an amount, that are not permissible for a national bank. Federal law also prohibits FDIC-insured state banks and their subsidiaries, subject to certain exceptions, from engaging as principal in any activity that is not permitted for a national bank unless the bank meets, and continues to meet, its minimum regulatory capital requirements and the FDIC determines that the activity would not pose a significant risk to the DIF. These restrictions have not had, and are not currently expected to have, a material impact on the operations of the Bank.

**Transaction Account Reserves.** Federal Reserve regulations require insured depository institutions to maintain reserves against their transaction accounts (primarily NOW and regular checking accounts). For 2015: the first \$14.5 million of otherwise reservable balances are exempt from the reserve requirements; for transaction accounts aggregating more than \$14.5 million to \$103.6 million, the reserve requirement is 3% of total transaction accounts; and for net transaction accounts in excess of \$103.6 million, the reserve requirement is \$2,673,000 plus 10% of the aggregate amount of total transaction accounts in excess of \$103.6 million. These reserve requirements are subject to annual adjustment by the Federal Reserve.

**Federal Home Loan Bank System.** The Bank is a member of the Federal Home Loan Bank of Indianapolis (the "FHLB"), which serves as a central credit facility for its members. The FHLB is funded primarily from proceeds from the sale of obligations of the FHLB system. It makes loans to member banks in the form of FHLB advances. All advances from the FHLB are required to be fully collateralized as determined by the FHLB.

**Community Reinvestment Act Requirements.** The Community Reinvestment Act requires the Bank to have a continuing and affirmative obligation in a safe and sound manner to help meet the credit needs of its entire community, including low- and moderate-income neighborhoods. Federal regulators regularly assess the Bank's record of meeting the credit needs of its communities. Applications for additional acquisitions would be affected by the evaluation of the Bank's effectiveness in meeting its Community Reinvestment Act requirements.

**Anti-Money Laundering.** The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "Patriot Act") is designed to deny terrorists and criminals the ability to obtain access to the U.S. financial system and has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act mandates financial services companies to have policies and procedures with respect to measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between financial institutions and law enforcement authorities.

**Concentrations in Commercial Real Estate.** Concentration risk exists when financial institutions deploy too many assets to any one industry or segment. Concentration stemming from commercial real estate is one area of regulatory concern. The interagency Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices guidance ("CRE Guidance") provides supervisory criteria, including the following numerical indicators, to assist bank examiners in identifying banks with potentially significant commercial real estate loan concentrations that may warrant greater supervisory scrutiny: (i) commercial real estate loans exceeding 300% of capital and increasing 50% or more in the preceding three years; or (ii) construction and land development loans exceeding 100% of capital. The CRE Guidance does not limit banks' levels of commercial real estate lending activities, but rather guides institutions in developing risk management practices and levels of capital that are commensurate with the level and nature of their commercial real estate concentrations. Based on the Bank's loan portfolio, the Bank does not exceed these guidelines.

## Consumer Financial Services

The historical structure of federal consumer protection regulation applicable to all providers of consumer financial products and services changed significantly on July 21, 2011, when the CFPB commenced operations to supervise and enforce consumer protection laws. The CFPB has broad rulemaking authority for a wide range of consumer protection laws that apply to all providers of consumer products and services, including the Bank, as well as the authority to prohibit “unfair, deceptive or abusive” acts and practices. The CFPB has examination and enforcement authority over providers with more than \$10 billion in assets. Banks and savings institutions with \$10 billion or less in assets, like the Bank, will continue to be examined by their applicable bank regulators.

Because abuses in connection with residential mortgages were a significant factor contributing to the financial crisis, many new rules issued by the CFPB and required by the Dodd-Frank Act address mortgage and mortgage-related products, their underwriting, origination, servicing and sales. The Dodd-Frank Act significantly expanded underwriting requirements applicable to loans secured by 1-4 family residential real property and augmented federal law combating predatory lending practices. In addition to numerous disclosure requirements, the Dodd-Frank Act imposed new standards for mortgage loan originations on all lenders, including banks and savings associations, in an effort to strongly encourage lenders to verify a borrower’s ability to repay, while also establishing a presumption of compliance for certain “qualified mortgages”. In addition, the Dodd-Frank Act generally required lenders or securitizers to retain an economic interest in the credit risk relating to loans that the lender sells, and other asset-backed securities that the securitizer issues, if the loans do not comply with the ability-to-repay standards described below. The risk retention requirement generally is 5%, but could be increased or decreased by regulation. The Bank does not currently expect the CFPB’s rules to have a significant impact on its operations, except for higher compliance costs.

**Ability-to-Repay Requirement and Qualified Mortgage Rule.** On January 10, 2013, the CFPB issued a final rule implementing the Dodd-Frank Act’s ability-to-repay requirements. Under the final rule, lenders, in assessing a borrower’s ability to repay a mortgage-related obligation, must consider eight underwriting factors: (i) current or reasonably expected income or assets; (ii) current employment status; (iii) monthly payment on the subject transaction; (iv) monthly payment on any simultaneous loan; (v) monthly payment for all mortgage-related obligations; (vi) current debt obligations, alimony and child support; (vii) monthly debt-to-income ratio or residual income; and (viii) credit history. The final rule also includes guidance regarding the application of, and methodology for evaluating, these factors.

Further, the final rule clarified that qualified mortgages do not include “no-doc” loans and loans with negative amortization, interest-only payments, balloon payments, terms in excess of 30 years, or points and fees paid by the borrower that exceed 3% of the loan amount, subject to certain exceptions. In addition, for qualified mortgages, the rule mandated that the monthly payment be calculated on the highest payment that will occur in the first five years of the loan, and required that the borrower’s total debt-to-income ratio generally may not be more than 43%. The final rule also provided that certain mortgages that satisfy the general product feature requirements for qualified mortgages and that also satisfy the underwriting requirements of Fannie Mae and Freddie Mac (while they operate under federal conservatorship or receivership), or the U.S. Department of Housing and Urban Development, Department of Veterans Affairs, or Department of Agriculture or Rural Housing Service, are also considered to be qualified mortgages. This second category of qualified mortgages will phase out as the aforementioned federal agencies issue their own rules regarding qualified mortgages, the conservatorship of Fannie Mae and Freddie Mac ends, and, in any event, after seven years.

As set forth in the Dodd-Frank Act, subprime (or higher-priced) mortgage loans are subject to the ability-to-repay requirement, and the final rule provided for a rebuttable presumption of lender compliance for those loans. The final rule also applied the ability-to-repay requirement to prime loans, while also providing a conclusive presumption of compliance (*i.e.*, a safe harbor) for prime loans that are also qualified mortgages. Additionally, the final rule generally prohibited prepayment penalties (subject to certain exceptions) and set forth a 3-year record retention period with respect to documenting and demonstrating the ability-to-repay requirement and other provisions.

**Mortgage Loan Originator Compensation.** As a part of the overhaul of mortgage origination practices, mortgage loan originators’ compensation was limited such that they may no longer receive compensation based on a mortgage transaction’s terms or conditions other than the amount of credit extended under the mortgage loan. Further, the total points and fees that a bank and/or a broker may charge on conforming and jumbo loans was limited to 3.0% of the total loan amount. Mortgage loan originators may receive compensation from a consumer or from a lender, but not both. These rules contain requirements designed to prohibit mortgage loan originators from “steering” consumers to loans that provide mortgage loan originators with greater compensation. In addition, the rules contain other requirements concerning recordkeeping.

**Servicing.** The CFPB was also required to implement certain provisions of the Dodd-Frank Act relating to mortgage servicing through rulemaking. The servicing rules require servicers to meet certain benchmarks for loan servicing and customer service in general. Servicers must provide periodic billing statements and certain required notices and acknowledgments, promptly credit borrowers’ accounts for payments received and promptly investigate complaints by borrowers and are required to take additional steps before purchasing insurance to protect the lender’s interest in the property. The servicing rules also called for additional notice, review and timing requirements with respect to delinquent borrowers, including early intervention, ongoing access to servicer personnel and specific loss mitigation and foreclosure procedures. The rules provided for an exemption from most of these requirements for “small servicers”. A small servicer is defined as a loan servicer that services 5,000 or fewer mortgage loans and services only mortgage loans that they or an affiliate originated or own.

## **Additional Constraints on the Company and Bank**

**Monetary Policy.** The monetary policy of the Federal Reserve has a significant effect on the operating results of financial or bank holding companies and their subsidiaries. Among the tools available to the Federal Reserve to affect the money supply are open market transactions in U.S. government securities, changes in the discount rate on member bank borrowings and changes in reserve requirements against member bank deposits. These means are used in varying combinations to influence overall growth and distribution of bank loans, investments and deposits, and their use may affect interest rates charged on loans or paid on deposits.

**The Volcker Rule.** In addition to other implications of the Dodd-Frank Act discussed above, the Act amended the BHCA to require the federal regulatory agencies to adopt rules that prohibit banking entities and their affiliates from engaging in proprietary trading and investing in and sponsoring certain unregistered investment companies (defined as hedge funds and private equity funds). This statutory provision is commonly called the “Volcker Rule.” On December 10, 2013, the federal regulatory agencies issued final rules to implement the prohibitions required by the Volcker Rule. Thereafter, in reaction to industry concern over the adverse impact to community banks of the treatment of certain collateralized debt instruments in the final rule, the federal regulatory agencies approved an interim final rule to permit financial institutions to retain interests in collateralized debt obligations backed primarily by trust preferred securities (“TruPS CDOs”) from the investment prohibitions contained in the final rule. Under the interim final rule, the regulatory agencies permitted the retention of an interest in or sponsorship of covered funds by banking entities if the following qualifications were met: (i) the TruPS CDO was established, and the interest was issued, before May 19, 2010; (ii) the banking entity reasonably believes that the offering proceeds received by the TruPS CDO were invested primarily in qualifying TruPS collateral; and (iii) the banking entity's interest in the TruPS CDO was acquired on or before December 10, 2013.

Although the Volcker Rule has significant implications for many large financial institutions, the Company does not currently anticipate that it will have a material effect on the operations of the Company or the Bank, particularly as the Company does not own any TruPS CDOs. The Company may incur costs if it is required to adopt additional policies and systems to ensure compliance with certain provisions of the Volcker Rule, but any such costs are not expected to be material.

## **ITEM 1A. RISK FACTORS**

In addition to the other information in this Annual Report on Form 10-K, stockholders or prospective investors should carefully consider the following risk factors:

**A downturn in the general economic or business conditions, where our business is concentrated, could have an adverse effect on our business, results of operations and financial condition.**

We operate branch offices in five geographical markets concentrated in Northern Indiana and three full service offices in Central Indiana in the Indianapolis market. We have divided our Northern Indiana markets into four distinct regions, the North Region, the South Region, the East Region and the West Region. Our most mature market, the South Region, includes Kosciusko County and portions of contiguous counties. The Bank was founded in this market in 1872. Warsaw is this region's primary city. The Bank entered the North Region in 1990, which includes portions of Elkhart and St. Joseph counties. This region includes the cities of Elkhart and South Bend. The Central Region includes portions of Elkhart County and contiguous counties and is anchored by the city of Goshen. The North and Central regions represent relatively older markets for us with nearly 25 years of business activity. We entered the East Region in 1999, which includes Allen and DeKalb counties. Fort Wayne represents the primary city in this market. We have experienced rapid commercial loan growth in this market over the past 14 years. We entered the Indianapolis market in 2006 with the opening of a loan production office in Hamilton County and opened a full service retail and commercial branch in late 2011. We opened a second office in the Indianapolis market in January 2014 and a third in December 2014.

Our success depends upon the business activity, population, income levels, deposits and real estate activity in these markets. Although our customers' business and financial interests may extend well beyond these market areas, adverse economic conditions that affect these market areas could reduce our growth rate, affect the ability of our customers to repay their loans to us and generally affect our financial condition and results of operations. A severe economic downturn began in late 2007 that had broad based impact throughout the United States on the national economy. During the downturn, certain areas of our geographical markets experienced notably worse economic conditions than those suffered by the country at-large. Weak economic conditions were characterized by, among other indicators, deflation, unemployment, fluctuations in debt and equity capital markets, increased delinquencies on mortgage, commercial and consumer loans, residential and commercial real estate price declines and lower home sales and commercial activity. All of those factors are generally detrimental to our business. While conditions have improved and there have been indications of economic growth both nationally and within our geographic area, the lingering impact of this downturn continues to represent a risk to our business.

As reported for December 2014, the 14 counties in which we operate had unemployment rates between 4.1% and 6.4%, which represent a considerable improvement from prior years. If the overall economic climate in the United States, generally, and our market areas, specifically, fails to continue to improve, our financial condition and the results of operations could be affected, including the volume of loan originations, increase the level of nonperforming assets, increase the rate of foreclosure losses on loans

and reduce the value of our loans and loan servicing portfolio. Additionally, we could experience a lack of demand for our products and services, an increase in loan delinquencies and defaults and high or increased levels of problem assets and foreclosures. Moreover, because of our geographic concentration, we are less able than other regional or national financial institutions to diversify our credit risks across multiple markets.

**If we do not effectively manage our credit risk, we may experience increased levels of nonperforming loans, charge-offs and delinquencies, which could require further increase in our provision for loan losses.**

There are risks inherent in making any loan, including risks inherent in dealing with individual borrowers, risks of nonpayment, risks resulting from uncertainties as to the future value of collateral and risks resulting from changes in economic and industry conditions. We attempt to minimize our credit risk through prudent loan application approval procedures, careful monitoring of the concentration of our loans within specific industries, a centralized credit administration department and periodic independent reviews of outstanding loans by our loan review department. However, we cannot make assurances that such approval and monitoring procedures will reduce these credit risks. If the overall economic climate in the United States, generally, and our market areas, specifically, does not continue to improve, or even if it does, our borrowers may experience difficulties in repaying their loans, and the level of nonperforming loans, charge-offs and delinquencies could rise and require increases in the provision for loan losses, which would cause our net income and return on equity to decrease.

**Commercial and industrial and agri-business loans make up a significant portion of our loan portfolio.**

Commercial and industrial and agri-business loans were \$1.309 billion, or approximately 47.4% of our total loan portfolio, as of December 31, 2014. Commercial loans are often larger and involve greater risks than other types of lending. Because payments on such loans are often dependent on the successful operation of the borrower involved, repayment of such loans is often more sensitive than other types of loans to adverse conditions in the general economy. Our commercial loans are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. Most often, this collateral is accounts receivable, inventory, machinery or real estate. Whenever possible, we require a personal guarantee on commercial loans. Credit support provided by the borrower for most of these loans and the probability of repayment is based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any exists. As a result, in the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. The collateral securing other loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. Due to the larger average size of each commercial loan as compared with other loans such as residential loans, as well as collateral that is generally less readily-marketable, losses incurred on a small number of commercial loans could adversely affect our business, results of operations and growth prospects.

**Our loan portfolio includes commercial real estate loans, which involve risks specific to real estate value.**

Commercial real estate loans were \$1.026 billion, or approximately 37.1% of our total loan portfolio, as of December 31, 2014. The market value of real estate can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Although a significant portion of such loans are secured by real estate as a secondary form of collateral, continued adverse developments affecting real estate values in one or more of our markets could increase the credit risk associated with our loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties.

If the loans that are collateralized by real estate become troubled and the value of the real estate has been significantly impaired, then we may not be able to recover the full contractual amount of principal and interest that we anticipated at the time of originating the loan, which could cause us to increase our provision for loan losses and adversely affect our operating results and financial condition.

**Our consumer loans generally have a higher degree of risk of default than our other loans.**

At December 31, 2014, consumer loans totaled \$49.5 million, or 1.8% of our total loan and lease portfolio. Consumer loans typically have shorter terms and lower balances with higher yields as compared to commercial loans, but generally carry higher risks of default. Consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on these loans.

**Our continued pace of growth may require us to raise additional capital in the future, but that capital may not be available when it is needed.**

We are required by federal and state regulatory authorities to maintain adequate levels of capital to support our operations. We may at some point need to raise additional capital to support our continued growth. Our ability to raise additional capital depends on conditions in the capital markets, economic conditions and a number of other factors, including investor perceptions regarding the banking industry, market conditions and governmental activities, and on our financial condition and performance. Accordingly, we cannot make assurances of our ability to raise additional capital, if needed, on terms acceptable to us. If we cannot raise additional capital when needed, our ability to further expand our operations through internal growth or acquisitions could be materially impaired.

**Interest rate shifts may reduce net interest income and otherwise negatively impact our financial condition and results of operations.**

Shifts in short-term interest rates may reduce net interest income, which is the principal component of our earnings. Net interest income is the difference between the amounts received by us on our interest-earning assets and the interest paid by us on our interest-bearing liabilities. When interest rates rise, the rate of interest we pay on our liabilities rises more quickly than the rate of interest that we receive on our interest-bearing assets, which may cause our profits to decrease. The impact on earnings is more adverse when the slope of the yield curve flattens, *i.e.* when short-term interest rates increase more than long-term interest rates or when long-term interest rates decrease more than short-term interest rates.

Interest rate increases often result in larger payment requirements for our borrowers, which increases the potential for default. At the same time, the marketability of the underlying property may be adversely affected by any reduced demand resulting from higher interest rates. In a declining interest rate environment, there may be an increase in prepayments on the loans underlying our participation interests as borrowers refinance their mortgages at lower rates.

Changes in interest rates also can affect the value of loans, securities and other assets. An increase in interest rates that adversely affects the ability of borrowers to pay the principal or interest on loans may lead to an increase in nonperforming assets and a reduction of income recognized, which could have a material adverse effect on our results of operations and cash flows. Thus, an increase in the amount of nonperforming assets would have an adverse impact on net interest income.

If short-term interest rates remain at their historically low levels for a prolonged period, and assuming long-term interest rates fall further, we could experience net interest margin compression as our interest-earning assets would continue to reprice downward while our interest bearing liability rates could fail to decline in tandem. This would have a material adverse effect on our net interest income and our results of operations.

**We must effectively manage credit risk and if we are unable to do so our allowance for loan losses may prove to be insufficient to absorb potential losses in our loan portfolio.**

We establish our allowance for loan losses and maintain it at a level considered adequate by management to absorb probable incurred loan losses that are inherent in the portfolio. The allowance contains provisions for probable incurred losses that have been identified relating to specific borrowing relationships, as well as probable losses inherent in the loan portfolio and credit undertakings that are not specifically identified. Additions to the allowance for loan losses, which are charged to earnings through the provision for loan losses, are determined based on a variety of factors, including an analysis of the loan portfolio, historical loss experience and an evaluation of current economic conditions in our market areas. The actual amount of loan losses is affected by changes in economic, operating and other conditions within our markets, which may be beyond our control, and such losses may exceed current estimates.

At December 31, 2014, our allowance for loan losses as a percentage of total loans was 1.67% and as a percentage of total nonperforming loans was 338%. Because of the nature of our loan portfolio and our concentration in commercial and industrial loans, which tend to be larger loans, the movement of a small number of loans to nonperforming status can have a significant impact on these ratios. Although management believes that the allowance for loan losses is adequate to absorb probable losses on any existing loans, we cannot predict loan losses with certainty and we cannot assure you that our allowance for loan losses will prove sufficient to cover actual loan losses in the future. Loan losses in excess of our reserves may adversely affect our business, results of operations and financial condition.

**Nonperforming assets take significant time to resolve and adversely affect our results of operations and financial condition and could result in further losses in the future.**

Our nonperforming assets adversely affect our net income in various ways. We do not record interest income on nonaccrual loans or other real estate owned, which adversely affects our net income and returns on assets and equity, increases our loan administration costs and adversely affects our efficiency ratio. When we take collateral in foreclosure and similar proceedings, we are required to mark the collateral to its then fair market value, which may result in a loss. These nonperforming loans and other real



estate owned also increase our risk profile and our regulatory capital requirements may increase in light of such risks. The resolution of nonperforming assets requires significant time commitments from management and can be detrimental to the performance of their other responsibilities. If we experience increases in nonperforming loans and nonperforming assets, our net interest income may be negatively impacted and our loan administration costs could increase, each of which could have an adverse effect on our net income and related ratios, such as return on assets and equity.

**Liquidity risks could affect operations and jeopardize our business, results of operations and financial condition.**

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the sale of loans and other sources could have a substantial, negative effect on our liquidity. Our primary sources of funds consist of cash from operations, investment maturities and sales and deposits. Additional liquidity is provided by brokered deposits, Certificate of Deposit Account Registry Service ("CDARS") deposits, repurchase agreements as well as our ability to borrow from the Federal Reserve and the FHLB. Our access to funding sources in amounts adequate to finance or capitalize our activities or on terms that are acceptable to us could be impaired by factors that affect us directly or the financial services industry or economy in general, such as disruptions in the financial markets or negative views and expectations about the prospects for the financial services industry.

During the recent recession, the financial services industry and the credit markets generally were materially and adversely affected by significant declines in asset values and historically depressed levels of liquidity. The liquidity issues were also particularly acute for regional and community banks, as many of the larger financial institutions curtailed their lending to regional and community banks to reduce their exposure to the risks of other banks. In addition, many of the larger correspondent lenders reduced or even eliminated federal funds lines for their correspondent customers. Furthermore, regional and community banks generally have less access to the capital markets than national and super-regional banks because of their smaller size and limited analyst coverage. Although availability has improved since the beginning of the recession, any decline in available funding, similar to the decline experienced during the recession, could adversely impact our ability to originate loans, invest in securities, meet our expenses, pay dividends to our stockholders, or fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could have a material adverse impact on our liquidity, business, results of operations and financial condition.

**Any action or steps to change coverages or eliminate Indiana's Public Deposit Insurance Fund could require us to find alternative, higher-cost funding sources to replace public fund deposits or to provide for collateralization of these deposits.**

Approximately 26% of our deposits are concentrated in public funds from a small number of municipalities and government agencies. A shift in funding away from public fund deposits would likely increase our cost of funds, as the alternate funding sources, such as brokered certificates of deposit, are higher-cost, less favorable deposits. The inability to maintain these public funds on deposit could result in a material adverse effect on the Bank's liquidity and could materially impact our ability to grow and remain profitable.

**Declines in asset values may result in impairment charges and adversely affect the value of our investments, financial performance and capital.**

We maintain an investment portfolio that includes, but is not limited to, mortgage-backed securities. The market value of investments may be affected by factors other than the underlying performance of the servicer of the securities or the mortgages underlying the securities, such as ratings downgrades, adverse changes in the business climate and a lack of liquidity in the secondary market for certain investment securities. On a monthly basis, we evaluate investments and other assets for impairment indicators. We may be required to record additional impairment charges if our investments suffer a decline in value that is considered other-than-temporary. If we determine that a significant impairment has occurred, we would be required to charge against earnings the credit-related portion of the other-than-temporary impairment, which could have a material adverse effect on our results of operations in the periods in which the write-offs occur.

**We may experience difficulties in managing our growth, and our growth strategy involves risks that may negatively impact our net income.**

In addition to our ongoing expansion in Indianapolis, we may expand into additional communities or attempt to strengthen our position in our current markets through opportunistic acquisitions of all or part of other financial institutions, including FDIC-assisted transactions, or by opening new branches. To the extent that we undertake acquisitions or new branch openings, we are likely to experience the effects of higher operating expenses relative to operating income from the new operations, which may have an adverse effect on our levels of reported net income, return on average equity and return on average assets. Other effects of engaging in such growth strategies may include potential diversion of our management's time and attention and general disruption to our business.

To the extent that we grow through acquisitions and branch openings, we cannot assure you that we will be able to adequately and profitably manage this growth. Acquiring other banks and businesses will involve similar risks to those commonly associated with branching but may also involve additional risks, including:

- potential exposure to unknown or contingent liabilities of banks and businesses we acquire;

- exposure to potential asset quality issues of the acquired bank or related business;
- difficulty and expense of integrating the operations and personnel of banks and businesses we acquire; and
- the possible loss of key employees and customers of the banks and businesses we acquire.

**Attractive acquisition opportunities may not be available to us in the future.**

We expect that other banking and financial service companies, many of which have significantly greater resources than us, will compete with us in acquiring other financial institutions if we pursue such acquisitions. This competition could increase prices for potential acquisitions that we believe are attractive. Also, acquisitions are subject to various regulatory approvals. If we fail to receive the appropriate regulatory approvals, we will not be able to consummate an acquisition that we believe is in our best interests. Among other things, our regulators consider our capital, liquidity, profitability, regulatory compliance and levels of goodwill and intangibles when considering acquisition and expansion proposals. Any acquisition could be dilutive to our earnings and stockholders' equity per share of our common stock.

**Our accounting policies and methods are the basis for how we report our financial condition and results of operations, and they may require management to make estimates about matters that are inherently uncertain.**

Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. Our management must exercise judgment in selecting and applying many of these accounting policies and methods in order to ensure they comply with GAAP and reflect management's judgment as to the most appropriate manner in which to record and report our financial condition and results of operations. In some cases, management must select the accounting policy or method to apply from two or more alternatives, any of which might be reasonable under the circumstances. The application of that chosen accounting policy or method might result in the Company reporting different amounts than would have been reported under a different alternative. If management's estimates or assumptions are incorrect, the Company may experience material losses.

Management has identified two accounting policies as being "critical" to the presentation of the Company's financial condition and results of operations because they require management to make particularly subject and complex judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These critical accounting policies relate to: (1) determining the fair value and possible other than temporary impairment of investment securities available for sale and (2) the allowance for loan losses. Because of the inherent uncertainty of these estimates, no assurance can be given that the application of alternative policies or methods might not result in the reporting of different amounts of the fair value of securities available for sale, or the allowance for loan losses and, accordingly, net income.

From time to time, the FASB and the SEC change the financial accounting and reporting standards or the interpretation of those standards that govern the preparation of our external financial statements. These changes are beyond our control, can be difficult to predict and could materially impact how we report our financial condition and results of operations. Changes in these standards are continuously occurring, and given the current economic environment, more drastic changes may occur. The implementation of such changes could have a material adverse effect on our financial condition and results of operations.

**We face intense competition in all phases of our business from other banks and financial institutions.**

The banking and financial services business in our market is highly competitive. Our competitors include large national and regional banks, local community banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market mutual funds, credit unions, farm credit services and other nonbank financial service providers. Many of these competitors are not subject to the same regulatory restrictions as we are and are able to provide customers with a feasible alternative to traditional banking services.

Increased competition in our market may also result in a decrease in the amounts of our loans and deposits, reduced spreads between loan rates and deposit rates or loan terms that are more favorable to the borrower. Any of these results could have a material adverse effect on our ability to grow and remain profitable. If increased competition causes us to significantly discount the interest rates we offer on loans or increase the amount we pay on deposits, our net interest income could be adversely impacted. If increased competition causes us to relax our underwriting standards, we could be exposed to higher losses from lending activities. Moreover, we rely on deposits to be a low cost source of funding, and a loss in our deposit base could cause us to incur higher funding costs. Additionally, many of our competitors are much larger in total assets and capitalization, have greater access to capital markets, possess larger lending limits and offer a broader range of financial services than we can offer.

**The repeal of federal prohibitions on payment of interest on business demand deposits could increase our interest expense and have a material adverse effect on us.**

All federal prohibitions on the ability of financial institutions to pay interest on business demand deposit accounts were repealed as part of the Dodd-Frank Act. As a result, some financial institutions have commenced offering interest on these demand deposits to compete for customers. If competitive pressures require us to pay interest on these demand deposits to attract and retain business customers, our interest expense would increase and our net interest margin would decrease. This could have a material adverse effect on us. Further, the effect of the repeal of the prohibition could be more significant in a higher interest rate environment as business customers would have a greater incentive to seek interest on demand deposits.

**We are required to maintain capital to meet regulatory requirements, and, if we fail to maintain sufficient capital, whether due to losses, an inability to raise additional capital or otherwise, our financial condition, liquidity and results of operations, as well as our ability to maintain regulatory compliance, would be adversely affected.**

The Company, on a consolidated basis, and the Bank, on a stand-alone basis, must meet certain regulatory capital requirements and maintain sufficient liquidity. We face significant capital and other regulatory requirements as a financial institution, which were heightened with the implementation of the Basel III rule on January 1, 2015. Our ability to raise additional capital depends on conditions in the capital markets, economic conditions and a number of other factors, including investor perceptions regarding the banking industry, market conditions and governmental activities and on our financial condition and performance. Accordingly, we cannot assure you that we will be able to raise additional capital if needed or on terms acceptable to us. If we fail to maintain capital to meet regulatory requirements, our financial condition, liquidity and results of operations would be materially and adversely affected.

**Monetary policies and regulations of the Federal Reserve could adversely affect our business, financial condition and results of operations.**

In addition to being affected by general economic conditions, our earnings and growth are affected by the policies of the Federal Reserve. An important function of the Federal Reserve is to regulate the money supply and credit conditions. Among the instruments used by the Federal Reserve to implement these objectives are open market operations in U.S. government securities, adjustments of the discount rate and changes in reserve requirements against bank deposits. These instruments are used in varying combinations to influence overall economic growth and the distribution of credit, bank loans, investments and deposits. Their use also affects interest rates charged on loans or paid on deposits.

The monetary policies and regulations of the Federal Reserve have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future. The effects of such policies upon our business, financial condition and results of operations cannot be predicted.

**We may be materially and adversely affected by the highly regulated environment in which we operate.**

We are subject to extensive federal and state regulation, supervision and examination. A more detailed description of the primary federal and state banking laws and regulations that affect us is contained in the section of this Form 10-K captioned "Supervision and Regulation." Banking regulations are primarily intended to protect depositors' funds, FDIC funds, customers and the banking system as a whole, rather than our shareholders. These regulations affect our lending practices, capital structure, investment practices, dividend policy and growth, among other things.

As a bank holding company, we are subject to extensive regulation and supervision and undergo periodic examinations by our regulators, who have extensive discretion and authority to prevent or remedy unsafe or unsound practices or violations of law by banks and bank holding companies. Failure to comply with applicable laws, regulations or policies could result in sanctions by regulatory agencies, civil monetary penalties and/or damage to our reputation, which could have a material adverse effect on us. Although we have policies and procedures designed to mitigate the risk of any such violations, there can be no assurance that such violations will not occur.

The laws, regulations, rules, standards, policies and interpretations governing us are constantly evolving and may change significantly over time. For example, on July 21, 2010, the Dodd-Frank Act was signed into law, which significantly changed the regulation of financial institutions and the financial services industry. The Dodd-Frank Act, together with the regulations to be developed thereunder, includes provisions affecting large and small financial institutions alike, including several provisions that affect how community banks, thrifts and small bank and thrift holding companies will be regulated. In addition, the Federal Reserve, in recent years, has adopted numerous new regulations addressing banks' overdraft and mortgage lending practices. Further, the CFPB was recently established, with broad powers to supervise and enforce consumer protection laws, and additional consumer protection legislation and regulatory activity is anticipated in the near future.

In addition, in July 2013, the U.S. federal banking authorities approved the implementation of the Basel III Rules. The Basel III Rules are applicable to all U.S. banks that are subject to minimum capital requirements as well as to bank and saving and loan holding companies, other than “small bank holding companies” (generally bank holding companies with consolidated assets of less than \$1 billion).

The Basel III Rules became effective on January 1, 2015, with a phase in period through 2019 for many of the changes. The Basel III Rules not only increase most of the required minimum regulatory capital ratios, they introduce a new Common Equity Tier 1 Capital ratio and the concept of a capital conservation buffer. The Basel III Rules also expand the current definition of capital by establishing additional criteria that capital instruments must meet to be considered Additional Tier 1 Capital (i.e., Tier 1 Capital in addition to Common Equity) and Tier 2 Capital. A number of instruments that formerly qualified as Tier 1 Capital will not qualify or their qualifications will change when the Basel III Rules are fully implemented. However, the Basel III Rules permit banking organizations with less than \$15 billion in assets to retain, through a one-time election, the existing treatment for accumulated other comprehensive income, which currently does not affect regulatory capital. The Basel III Rules have maintained the general structure of the current prompt corrective action thresholds while incorporating the increased requirements, including the Common Equity Tier 1 Capital ratio. In order to be a “well-capitalized” depository institution under the new regime, an institution must maintain a Common Equity Tier 1 Capital ratio of 6.5% or more; a Tier 1 Capital ratio of 8% or more; a Total Capital ratio of 10% or more; and a leverage ratio of 5% or more. Institutions must also maintain a capital conservation buffer consisting of Common Equity Tier 1 Capital.

These provisions, as well as any other aspects of current or proposed regulatory or legislative changes to laws applicable to the financial industry, may impact the profitability of our business activities and may change certain of our business practices, including our ability to offer new products, obtain financing, attract deposits, make loans and achieve satisfactory interest spreads and could expose us to additional costs, including increased compliance costs. Although we are currently compliant with the Basel III Rules, these changes also may require us to invest significant management attention and resources to make any necessary changes to operations in order to comply and could therefore also materially and adversely affect our business, financial condition and results of operations.

**Our ability to attract and retain management and key personnel and any damage to our reputation may affect future growth and earnings.**

Much of our success and growth has been influenced strongly by our ability to attract and retain management experienced in banking and financial services and familiar with the communities in our market areas. Our ability to retain the executive officers, management teams, branch managers and loan officers at the Bank will continue to be important to the successful implementation of our strategy. It is also critical, as we grow, to be able to attract and retain qualified additional management and loan officers with the appropriate level of experience and knowledge about our market areas to implement our community-based operating strategy. The unexpected loss of services of any key management personnel, or the inability to recruit and retain qualified personnel in the future, could have an adverse effect on our business, results of operations and financial condition.

In addition, our business depends on earning and maintaining the trust of our customers and communities. Harm to our reputation could arise from numerous sources, including employee misconduct, compliance failures, litigation or our failure to deliver appropriate levels of service. If any events or circumstances occur which could undermine our reputation, there can be no assurance that the additional costs and expenses we may incur as a result would not have an adverse impact on our business.

**We have a continuing need for technological change and we may not have the resources to effectively implement new technology.**

The financial services industry is constantly undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to better serving customers, the effective use of technology increases efficiency and enables financial institutions to reduce costs. Our future success will depend in part upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience as well as to create additional efficiencies in our operations as we continue to grow and expand our market areas. Many of our larger competitors have substantially greater resources to invest in technological improvements. As a result, they may be able to offer additional or superior products to those that we will be able to offer, which would put us at a competitive disadvantage. Accordingly, we cannot provide assurances that we will be able to effectively implement new technology-driven products and services or be successful in marketing such products and services to our customers.

**The Company’s information systems may experience an interruption or breach in security and cyber-attacks, all of which could have a material adverse effect on the Company’s business.**

The Company relies heavily on internal and outsourced technologies, communications, and information systems to conduct its business. Additionally, in the normal course of business, the Company collects, processes and retains sensitive and confidential information regarding our customers. As the Company’s reliance on technology has increased, so have the potential risks of a

technology-related operation interruption (such as disruptions in the Company's customer relationship management, general ledger, deposit, loan, or other systems) or the occurrence of a cyber-attacks (such as unauthorized access to the Company's systems). These risks have increased for all financial institutions as new technologies, the use of the Internet and telecommunications technologies (including mobile devices) to conduct financial and other business transactions and the increased sophistication and activities of organized crime, perpetrators of fraud, hackers, terrorists and others. In addition to cyber-attacks or other security breaches involving the theft of sensitive and confidential information, hackers recently have engaged in attacks against large financial institutions, particularly denial of service attacks, that are designed to disrupt key business services, such as customer-facing web sites. The Company is not able to anticipate or implement effective preventive measures against all security breaches of these types, especially because the techniques used change frequently and because attacks can originate from a wide variety of sources. However, applying guidance from FFIEC, the Company has analyzed and will continue to analyze security related to device specific considerations, user access topics, transaction-processing and network integrity.

The Company also faces risks related to cyber-attacks and other security breaches in connection with credit card and debit card transactions that typically involve the transmission of sensitive information regarding the Company's customers through various third parties, including merchant acquiring banks, payment processors, payment card networks and its processors. Some of these parties have in the past been the target of security breaches and cyber-attacks, and because the transactions involve third parties and environments such as the point of sale that the Company does not control or secure, future security breaches or cyber-attacks affecting any of these third parties could impact the Company through no fault of its own, and in some cases it may have exposure and suffer losses for breaches or attacks relating to them. Further cyber-attacks or other breaches in the future, whether affecting the Company or others, could intensify consumer concern and regulatory focus and result in reduced use of payment cards and increased costs, all of which could have a material adverse effect on the Company's business. To the extent we are involved in any future cyber-attacks or other breaches, the Company's reputation could be affected, would could also have a material adverse effect on the Company's business, financial condition or results of operations.

**We are subject to certain operational risks, including, but not limited to, customer or employee fraud and data processing system failures and errors.**

Employee errors and misconduct could subject us to financial losses or regulatory sanctions and seriously harm our reputation. Misconduct by our employees could include hiding their own unauthorized activities from us, improper or unauthorized activities on behalf of our customers or improper use of confidential information. It is not always possible to prevent employee errors and misconduct, and the precautions we take to prevent and detect this activity may not be effective in all cases. Employee errors could also subject us to financial claims for negligence, among others.

We maintain a system of internal controls and insurance coverage to mitigate operational risks, including data processing system failures and errors and customer or employee fraud. Should our internal controls fail to prevent or detect an occurrence, or if any resulting loss is not insured or exceeds applicable insurance limits, it could have a material adverse effect on our business, results of operations and financial condition.

**The preparation of our consolidated financial statements requires us to make estimates and judgments, which are subject to an inherent degree of uncertainty and which may differ from actual results.**

Our consolidated financial statements are prepared in accordance with GAAP and general reporting practices within the financial services industry, which require us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. Some accounting policies, such as those pertaining to our allowance for loan losses and deferred tax asset and the necessity of any related valuation allowance, require the application of significant judgment by management in selecting the appropriate assumptions for calculating financial estimates. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty and actual results may differ from these estimates and judgments under different assumptions or conditions, which may have a material adverse effect on our financial condition or results of operations in subsequent periods.

**We may be subject to a higher consolidated effective tax rate if there is a change in tax laws relating to LCB Investments II, Inc. or if LCB Funding, Inc. fails to qualify as a real estate investment trust.**

The Bank holds certain investment securities in its wholly-owned subsidiary LCB Investments II, Inc., which is incorporated in Nevada. Pursuant to the State of Indiana's current tax laws and regulations, we are not subject to Indiana income tax for income earned through that subsidiary. If there are changes in Indiana's tax laws or interpretations thereof requiring us to pay state taxes for income generated by LCB Investments II, Inc., the resulting tax consequences could increase our effective tax rate or cause us to have a tax liability for prior years.

The Bank also holds certain commercial real estate loans, residential real estate loans and other loans in a real estate investment trust through LCB Investments II, Inc. Qualification as a real estate investment trust involves application of specific provisions of the Internal Revenue Code relating to various asset tests. If LCB Funding, Inc. fails to meet any of the required provisions for real estate investment trusts, it could no longer qualify as a real estate investment trust and the resulting tax consequences would increase our effective tax rate or cause us to have a tax liability for prior years.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

We have no unresolved SEC staff comments.

## ITEM 2. PROPERTIES

The Company is headquartered in the main office building of the Bank at 202 E. Center Street, Warsaw, Indiana. The Company operates in 53 locations, 48 of which are owned by the Bank and five of which are leased from third parties. In addition, the Company leases the real estate for its four freestanding ATMs.

None of the Company's assets are the subject of any material encumbrances.

## ITEM 3. LEGAL PROCEEDINGS

There are no material pending legal proceedings other than ordinary routine litigation incidental to the business to which the Company and the Bank are a party or of which any of their property is subject.

## ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

## PART II

## ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The quarterly high and low closing prices for the Company's common stock and the cash dividends declared and paid on that common stock are set forth in the table below.

	2014			2013		
	High*	Low*	Cash Dividend	High*	Low*	Cash Dividend
Fourth quarter	\$ 44.15	\$ 36.98	\$ 0.21	\$ 39.32	\$ 31.72	\$ 0.19
Third quarter	\$ 39.93	\$ 35.50	\$ 0.21	\$ 34.69	\$ 27.74	\$ 0.19
Second quarter	\$ 41.26	\$ 34.96	\$ 0.21	\$ 28.50	\$ 25.26	\$ 0.19
First quarter	\$ 41.46	\$ 35.31	\$ 0.19	\$ 27.02	\$ 23.92	\$ 0.00 <sup>(1)</sup>

(1) The Company declared and paid the fourth quarter 2012 dividend in the fourth quarter of 2012 instead of the first quarter of 2013 because of possible tax increases on dividends to individuals.

\* The trading ranges are the high and low prices as obtained from The Nasdaq Stock Market.

The common stock of the Company was first quoted on The Nasdaq Stock Market under the symbol LKFN in August 1997. Currently, the Company's common stock is listed for trading on the Nasdaq Global Select Market under the symbol "LKFN". On December 31, 2014, the Company had approximately 351 stockholders of record and estimates that it has approximately 2,100 stockholders in total.

The Company paid dividends on its common stock as set forth in the table above. The Company's ability to pay dividends to stockholders is largely dependent upon the dividends it receives from the Bank, and the Bank is subject to regulatory limitations on the amount of cash dividends it may pay.

## Equity Compensation Plan Information

The table below sets forth the following information as of December 31, 2014 for (i) all compensation plans previously approved by the Company's stockholders and (ii) all compensation plans not previously approved by the Company's stockholders:

- (a) the number of securities to be issued upon the exercise of outstanding options, warrants and rights;
- (b) the weighted-average exercise price of such outstanding options, warrants and rights; and
- (c) other than securities to be issued upon the exercise of such outstanding options, warrants and rights, the number of securities remaining available for future issuance under the plans.

### EQUITY COMPENSATION PLAN INFORMATION

Plan category	Number of securities to be issued upon exercise of outstanding options	Weighted-average exercise price of outstanding options	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by security holders <sup>(1)(2)(3)</sup>	57,918	\$22.95	215,275
Equity compensation plans not approved by security holders	0	0.00	0
Total	<u>57,918</u>	<u>\$22.95</u>	<u>215,275</u>

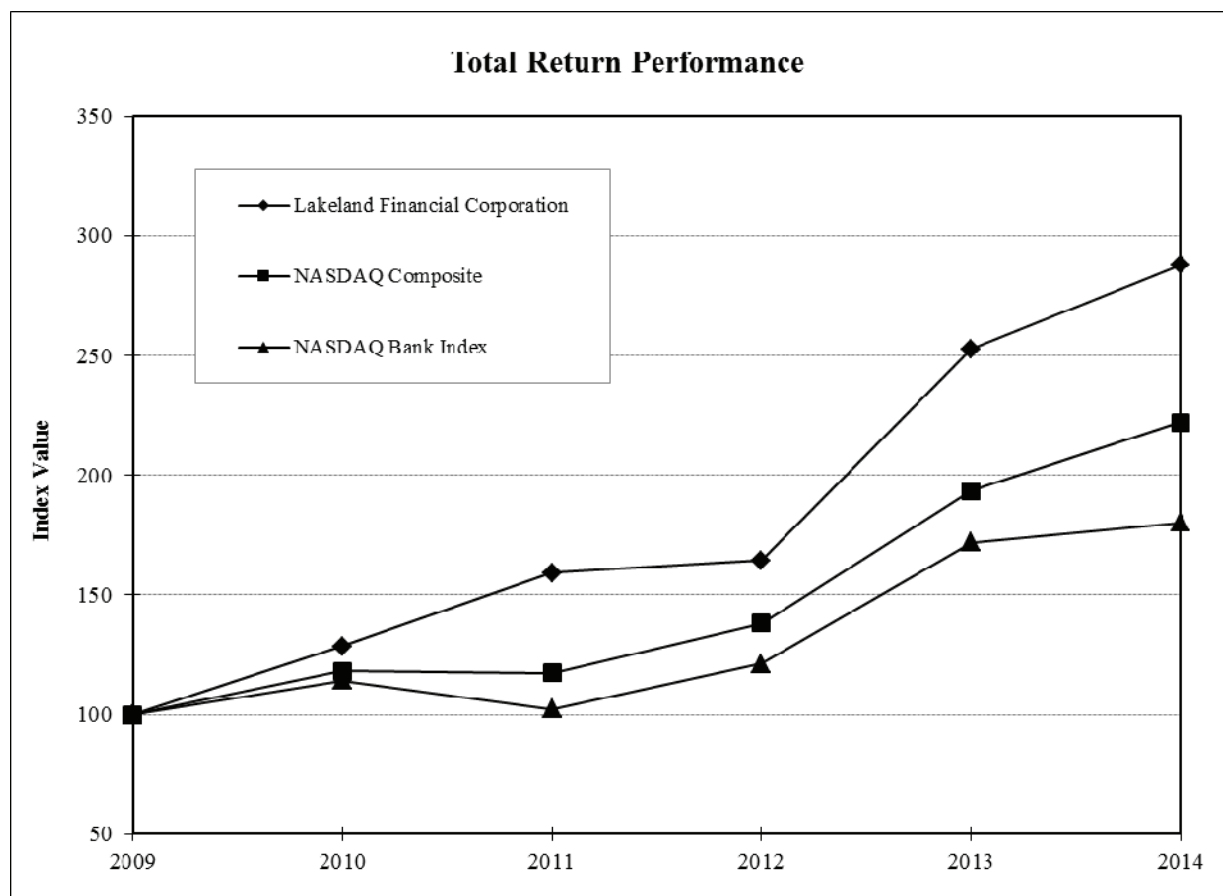
(1) Lakeland Financial Corporation 1997 Share Incentive Plan adopted on April 14, 1998 by the Board of Directors.

(2) Lakeland Financial Corporation 2008 Equity Incentive Plan adopted on May 14, 2008 by the Board of Directors.

(3) Lakeland Financial Corporation 2013 Equity Incentive Plan adopted on April 9, 2013 by the Board of Directors.

## STOCK PRICE PERFORMANCE GRAPH

The graph below compares the cumulative total return of the Company, the Nasdaq Market Index, and the NASDAQ Bank Index.



INDEX	2009	2010	2011	2012	2013	2014
Lakeland Financial Corporation	\$100.00	\$128.54	\$159.24	\$164.30	\$252.70	\$287.91
NASDAQ Composite	100.00	118.15	117.22	138.02	193.47	222.16
NASDAQ Bank Index	100.00	114.16	102.17	121.26	171.86	180.31

The above returns assume \$100 invested on December 31, 2009 and dividends were reinvested.

The following table provides information about purchases by the Company and its affiliates during the quarter ended December 31, 2014 of equity securities that are registered by the Company pursuant to Section 12 of the Exchange Act:

### ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Appropriate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
10/01/14-10/31/14	0	\$ 0.00	0	\$ 0.00
11/01/14-11/30/14	425	41.45	0	0.00
12/01/14-12/31/14	0	0.00	0	0.00
<b>Total</b>	<b>425</b>	<b>\$ 41.45</b>	<b>0</b>	<b>\$ 0.00</b>

The shares purchased during the quarter were credited to the deferred share accounts of eight nonemployee directors under the Company's directors' deferred compensation plan.



## ITEM 6. SELECTED FINANCIAL DATA

(in thousands except share and per share data)

	2014	2013	2012	2011	2010
<b>Ending period balances</b>					
Assets	\$ 3,443,284	\$ 3,175,764	\$3,064,144	\$2,889,688	\$2,681,926
Deposits	2,873,120	2,546,068	2,581,756	2,412,696	2,201,025
Loans	2,762,320	2,535,098	2,257,520	2,233,709	2,089,959
Allowance for loan losses	46,262	48,797	51,445	53,400	45,007
Total equity	361,385	321,964	297,828	273,289	247,086
<b>Average balances</b>					
Total assets	\$ 3,318,271	\$ 3,009,738	\$2,976,239	\$2,792,770	\$2,652,624
Earning assets	3,137,082	2,833,505	2,720,783	2,642,158	2,522,360
Investments	475,068	474,711	477,010	447,620	430,615
Loans	2,650,678	2,343,422	2,216,131	2,148,046	2,049,209
Total deposits	2,797,929	2,505,341	2,505,195	2,325,964	2,132,608
Interest bearing deposits	2,299,578	2,087,870	2,151,094	2,015,440	1,866,184
Interest bearing liabilities	2,461,352	2,265,303	2,316,375	2,206,714	2,107,351
Total equity	343,135	310,627	287,866	260,335	262,861
<b>Income statement data</b>					
Net interest income	\$ 102,303	\$ 90,439	\$ 87,671	\$ 92,080	\$ 92,653
Net interest income-fully tax equivalent	104,232	92,235	89,277	93,664	94,028
Provision for loan loss	0	0	2,549	13,800	23,947
Non-interest income	30,053	30,737	25,196	22,205	21,509
Non-interest expense	66,166	62,778	57,742	55,105	53,435
Net income	43,805	38,839	35,394	30,662	24,543
Net income available to shareholders	43,805	38,839	35,394	30,662	21,356
<b>Per share data</b>					
Basic net income per common share	\$ 2.65	\$ 2.36	\$ 2.17	\$ 1.89	\$ 1.32
Diluted net income per common share	2.61	2.33	2.15	1.88	1.32
Cash dividends declared per common share	0.82	0.57	0.84	0.62	0.62
Dividend payout	31.42%	24.46%	38.84%	32.98%	46.97%
Book value per common share	21.83	19.54	18.18	16.85	15.28
Basic weighted average common shares outstanding	16,535,530	16,436,131	16,323,870	16,204,952	16,120,606
Diluted weighted average common shares outstanding	16,781,455	16,634,338	16,482,937	16,324,644	16,213,747
<b>Key ratios</b>					
Return on average assets	1.32%	1.29%	1.19%	1.10%	0.93%
Return on average total equity	12.77%	12.50%	12.30%	11.78%	9.34%
Equity to average assets	10.34%	10.32%	9.67%	9.32%	9.91%
Net interest margin	3.32%	3.26%	3.28%	3.54%	3.73%
Efficiency	49.99%	51.81%	51.16%	48.22%	46.81%
<b>Asset Quality</b>					
Net charge offs to average loans	0.10%	0.11%	0.20%	0.25%	0.54%
Loan loss reserve to total loans	1.67%	1.92%	2.28%	2.39%	2.15%
Loan loss reserve to nonperforming loans	337.51%	203.79%	166.60%	135.27%	121.90%
Nonperforming assets to total loans	0.51%	0.96%	1.40%	1.86%	1.95%
<b>Other Data</b>					
Full-time equivalent employees	496	497	493	482	467
Offices	46	45	45	44	43

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

### **OVERVIEW**

Net income in 2014 was \$43.8 million, up 13% from \$38.8 million in 2013 and up from \$35.4 million in 2012. Diluted net income per common share was \$2.61 in 2014, \$2.33 in 2013 and \$2.15 in 2012. Return on average total assets was 1.32% in 2014 compared to 1.29% in 2013 and 1.19% in 2012. Return on average common shareholders' equity was 12.77% in 2014 versus 12.50% in 2013, and 12.30% in 2012. The dividend payout ratio with respect to diluted earnings per share was 31.42% in 2014, 24.46% in 2013 and 38.84% in 2012. The equity to average assets ratio was 10.34% in 2014 compared to 10.32% in 2013 and 9.67% in 2012.

Net income in 2014 was positively impacted by an \$11.9 million increase in net interest income. Offsetting this positive impact was a \$3.4 million increase in noninterest expense and a \$684,000 decrease in noninterest income. Net income in 2013, as compared to 2012, was positively impacted by a \$5.5 million increase in noninterest income, a \$2.8 million increase in net interest income and a \$2.5 million decrease in the provision for loan losses. Offsetting these positive impacts in 2013 was a \$5.0 million increase in noninterest expense.

Total assets were \$3.443 billion as of December 31, 2014 versus \$3.176 billion as of December 31, 2013, an increase of \$267.5 million or 8.4%. This increase was primarily due to a \$227.2 million increase in total loans.

### **CRITICAL ACCOUNTING POLICIES**

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

#### **Allowance for Loan Losses**

The Company maintains an allowance for loan losses to provide for probable incurred credit losses. Loan losses are charged against the allowance when management believes that the principal is uncollectable. Subsequent recoveries, if any, are credited to the allowance. Allocations of the allowance are made for specific loans and for pools of similar types of loans, although the entire allowance is available for any loan that, in management's judgment, should be charged against the allowance. A provision for loan losses is taken based on management's ongoing evaluation of the appropriate allowance balance. A formal evaluation of the adequacy of the loan loss allowance is conducted monthly. The ultimate recovery of all loans is susceptible to future market factors beyond the Company's control.

The level of loan loss provision is influenced by growth in the overall loan portfolio, emerging market risk, emerging concentration risk, commercial loan focus and large credit concentration, new industry lending activity, general economic conditions and historical loss analysis. In addition, management gives consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Furthermore, management's overall view on credit quality is a factor in the determination of the provision.

The determination of the appropriate allowance is inherently subjective, as it requires significant estimates by management. The Company has an established process to determine the adequacy of the allowance for loan losses that generally includes consideration of the following factors: changes in the nature and volume of the loan portfolio, overall portfolio quality and current economic conditions that may affect the borrowers' ability to repay. Consideration is not limited to these factors although they represent the most commonly cited factors. With respect to specific allocation levels for individual credits, management considers the amounts and timing of expected future cash flows and the current valuation of collateral as the primary measures. Management also considers trends in adversely classified loans based upon an ongoing review of those credits. With respect to pools of similar loans, allocations are assigned based upon historical experience unless the rate of loss is expected to be greater than historical losses as noted below. A detailed analysis is performed on loans that are classified but determined not to be impaired which incorporates probability of default with a loss given default scenario to develop non-specific allocations for the loan pool. These allocations may be adjusted based on the other factors cited above. An appropriate level of general allowance for pooled loans is determined after considering the following: application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentration, new industry lending activity and general economic conditions. It is also possible that the following could affect the overall process: social, political, economic and terrorist events or activities. All of these factors are susceptible to change, which may be significant. As a

result of this detailed process, the allowance results in two forms of allocations, specific and general. These two components represent the total allowance for loan losses deemed adequate to cover probable losses inherent in the loan portfolio.

Commercial loans are subject to a dual standardized grading process administered by the credit administration function. These grade assignments are performed independent of each other and a loan may or may not be graded the same. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that indicate the loan is impaired. Considerations with respect to specific allocations for these individual credits include, but are not limited to, the following: (a) does the customer's cash flow or net worth appear insufficient to repay the loan; (b) is there adequate collateral to repay the loan; (c) has the loan been criticized in a regulatory examination; (d) is the loan impaired; (e) are there other reasons where the ultimate collectability of the loan is in question; or (f) are there unique loan characteristics that require special monitoring.

Allocations are also applied to categories of loans considered not to be individually impaired, but for which the rate of loss is expected to be consistent with or greater than historical averages. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values. In addition, general allocations are made for other pools of loans, including non-classified loans. These general pooled loan allocations are performed for portfolio segments of commercial and industrial, commercial real estate and multi-family, agri-business and agricultural, other commercial, consumer 1-4 family mortgage and other consumer 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, subjectively adjusted for economic factors and portfolio trends.

Due to the imprecise nature of estimating the allowance for loan losses, the Company's allowance for loan losses includes an 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 the level of classified credits, economic uncertainties, industry trends impacting specific portfolio segments, broad portfolio quality trends and trends in the composition of the Company's large commercial loan portfolio and related large dollar exposures to individual borrowers.

### **Valuation and Other-Than-Temporary Impairment of Investment Securities**

The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges or pricing models, which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Different judgments and assumptions used in pricing could result in different estimates of value. The fair value of certain securities is determined using unobservable inputs, primarily observable inputs of similar securities.

At the end of each reporting period, securities held in the investment portfolio are evaluated on an individual security level for other-than-temporary impairment in accordance with current accounting guidance. Impairment is other-than-temporary if the decline in the fair value of the security is below its amortized cost and it is probable that all amounts due according to the contractual terms of a debt security will not be received.

Significant judgments are required in determining impairment, which includes making assumptions regarding the estimated prepayments, loss assumptions and the change in interest rates.

We consider the following factors when determining other-than-temporary impairment for a security or investment:

- the length of time and the extent to which the market value has been less than amortized cost;
- the financial condition and near-term prospects of the issuer;
- the underlying fundamentals of the relevant market and the outlook for such market for the near future; and
- our intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in market value.

If, in management's judgment, other-than-temporary impairment exists, the cost basis of the security will be written down to the computed net present value, and the unrealized loss will be transferred from accumulated other comprehensive loss as an immediate reduction of current earnings (as if the loss had been realized in the period of other-than-temporary impairment). In addition, discount accretion will be discontinued on any bond that meets one or both of the following: (1) the rating by S&P, Moody's or Fitch decreases to below "A" and/or (2) the cash flow analysis on a security indicates under any scenario modeled by the third party there is a potential to not receive the full amount invested in the security.

## RESULTS OF OPERATIONS

### Overview

Selected income statement information for the years ended December 31, 2014, 2013 and 2012 is presented in the following table.

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
<b>Income Statement Summary:</b>			
Net interest income	\$ 102,303	\$ 90,439	\$ 85,122
Provision for loan losses	0	0	2,549
Noninterest income	30,053	30,737	25,196
Noninterest expense	66,166	62,778	57,742
<b>Other Data:</b>			
Efficiency ratio	49.99%	51.81%	51.16%
Dilutive EPS	\$ 2.61	\$ 2.33	\$ 2.15
Tangible capital ratio	10.41%	10.05%	9.63%
Net charge-offs to average loans	0.10%	0.11%	0.20%
Net interest margin	3.32%	3.26%	3.28%
Noninterest income to total revenue	22.71%	25.37%	22.32%

### Net Income

Net income was \$43.8 million in 2014, an increase of \$5.0 million, or 12.8%, versus net income of \$38.8 million in 2013. Net interest income increased \$11.9 million, or 13.1%, to \$102.3 million versus \$90.4 million in 2013. Net interest income increased primarily due to a 10.7% increase in average earning assets, driven by an increase of 14.8% in the commercial loan portfolio, which reflects our continuing strategic focus on commercial lending. The net interest margin increased to 3.32% in 2014 versus 3.26% in 2013. The higher margin resulted from a general decline in funding costs as well as higher levels of earning assets.

Net income was \$38.8 million in 2013, an increase of \$3.4 million, or 9.7%, versus net income of \$35.4 million in 2012. Net interest income increased \$2.8 million, or 3.2%, to \$90.4 million versus \$87.7 million in 2012. Net interest income increased primarily due to a 4.1% increase in average earning assets. Significantly affecting average earning assets during 2013 was an increase of 7.4% in the commercial loan portfolio, combined with a decrease in noninterest earning cash and due from banks. In addition, noninterest bearing demand deposits increased while interest bearing liabilities decreased. The net interest margin was 3.26% in 2013 versus 3.28% in 2012. The stable margin reflected a decline in funding costs offset by lower yields on earning assets.

## Net Interest Income

The following table presents a three-year average balance sheet and, for each major asset and liability category, its related interest income and yield or its expense and rate for the years ended December 31.

### THREE YEAR AVERAGE BALANCE SHEET AND NET INTEREST ANALYSIS

(fully tax equivalent basis, dollars in thousands)	2014			2013			2012		
	Average Balance	Interest Income	Yield (1)/Rate	Average Balance	Interest Income	Yield (1)/Rate	Average Balance	Interest Income	Yield (1)/Rate
<b>Earning Assets</b>									
Loans:									
Taxable (2)(3)	\$ 2,638,507	\$ 105,317	3.99 %	\$ 2,334,857	\$ 98,757	4.23 %	\$ 2,206,600	\$ 102,749	4.66 %
Tax exempt (1)	12,171	705	5.79	8,565	609	7.11	9,531	660	6.93
Investments: (1)									
Available for sale	475,068	13,151	2.77	474,711	10,111	2.13	477,010	12,498	2.62
Short-term investments	5,253	11	0.21	6,515	5	0.08	25,299	24	0.09
Interest bearing deposits	6,083	33	0.54	8,857	50	0.56	2,343	44	1.88
Total earning assets	\$ 3,137,082	\$ 119,217	3.80 %	\$ 2,833,505	\$ 109,532	3.87 %	\$ 2,720,783	\$ 115,975	4.26 %
Less: Allowance for loan losses	(46,831)			(50,651)			(52,795)		
<b>Nonearning Assets</b>									
Cash and due from banks	75,158			79,014			178,322		
Premises and equipment	40,241			36,544			34,945		
Other nonearning assets	112,621			111,326			94,984		
Total assets	\$ 3,318,271			\$ 3,009,738			\$ 2,976,239		
<b>Interest Bearing Liabilities</b>									
Savings deposits	\$ 233,657	\$ 507	0.22 %	\$ 229,440	\$ 634	0.28 %	\$ 195,666	\$ 697	0.36 %
Interest bearing checking accounts	1,169,338	4,660	0.40	1,028,224	5,287	0.51	1,002,418	9,012	0.90
Time deposits:									
In denominations under \$100,000	280,819	3,205	1.14	327,736	4,574	1.40	389,894	6,885	1.77
In denominations over \$100,000	615,764	5,196	0.84	502,470	5,250	1.04	563,116	8,073	1.43
Miscellaneous short-term borrowings	130,811	388	0.30	145,030	490	0.34	119,314	441	0.37
Long-term borrowings and subordinated debentures (4)	30,963	1,029	3.32	32,403	1,062	3.28	45,967	1,590	3.46
Total interest bearing liabilities	\$ 2,461,352	\$ 14,985	0.61 %	\$ 2,265,303	\$ 17,297	0.76 %	\$ 2,316,375	\$ 26,698	1.15 %
<b>Noninterest Bearing Liabilities</b>									
Demand deposits	498,351			417,471			354,101		
Other liabilities	15,433			16,337			17,897		
<b>Stockholders' Equity</b>	343,135			310,627			287,866		
Total liabilities and stockholders' equity	\$ 3,318,271			\$ 3,009,738			\$ 2,976,239		
<b>Interest Margin Recap</b>									
Interest income/average earning assets		119,217	3.80		109,532	3.87		115,975	4.26
Interest expense/average earning assets		14,985	0.48		17,297	0.61		26,698	0.98
Net interest income and margin		\$ 104,232	3.32 %		\$ 92,235	3.26 %		\$ 89,277	3.28 %

- (1) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2014, 2013 and 2012. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") adjustment applicable to nondeductible interest expenses.
- (2) Loan fees, which are immaterial in relation to total taxable loan interest income for the years ended December 31, 2014, 2013 and 2012, are included as taxable loan interest income.
- (3) Nonaccrual loans are included in the average balance of taxable loans.
- (4) Long-term borrowings and subordinated debentures interest expense was reduced by interest capitalized on construction in process for 2014 and 2013.

The following table shows fluctuations in net interest income attributable to changes in the average balances of assets and liabilities and the yields earned or rates paid for the years ended December 31.

**NET INTEREST INCOME – RATE/VOLUME ANALYSIS (fully tax equivalent basis, dollars in thousands)**

	2014 Over (Under) 2013 (1)			2013 Over (Under) 2012 (1)		
	Attributable to		Total Change	Attributable to		Total Change
	Volume	Rate		Volume	Rate	
<b>Interest Income (2)</b>						
Loans:						
Taxable	\$ 12,339	\$ (5,779)	\$ 6,560	\$ 5,760	\$ (9,752)	\$ (3,992)
Tax exempt	223	(127)	96	(68)	17	(51)
Investments:						
Available for sale	8	3,032	3,040	(60)	(2,327)	(2,387)
Short-term investments	(1)	7	6	(15)	(4)	(19)
Interest bearing deposits	(15)	(2)	(17)	54	(48)	6
Total interest income	<u>12,554</u>	<u>(2,869)</u>	<u>9,685</u>	<u>5,671</u>	<u>(12,114)</u>	<u>(6,443)</u>
<b>Interest Expense</b>						
Savings deposits	11	(138)	(127)	109	(172)	(63)
Interest bearing checking accounts	664	(1,291)	(627)	226	(3,951)	(3,725)
Time deposits:						
In denominations under \$100,000	(602)	(767)	(1,369)	(998)	(1,313)	(2,311)
In denominations over \$100,000	1,061	(1,115)	(54)	(802)	(2,021)	(2,823)
Miscellaneous short-term borrowings	(45)	(57)	(102)	89	(40)	49
Long-term borrowings and subordinated debentures	(48)	15	(33)	(448)	(80)	(528)
Total interest expense	<u>1,041</u>	<u>(3,353)</u>	<u>(2,312)</u>	<u>(1,824)</u>	<u>(7,577)</u>	<u>(9,401)</u>
<b>Net Interest Income</b>	<u>\$ 11,513</u>	<u>\$ 484</u>	<u>\$ 11,997</u>	<u>\$ 7,495</u>	<u>\$ (4,537)</u>	<u>\$ 2,958</u>

- (1) The earning assets and interest bearing liabilities used to calculate interest differentials are based on average daily balances for 2014, 2013 and 2012. The changes in volume represent "changes in volume times the old rate". The changes in rate represent "changes in rate times the old volume". The changes in rate/volume were also calculated by "change in rate times change in volume" and allocated consistently based upon the relative absolute values of the changes in volume and changes in rate.
- (2) Tax exempt income was converted to a fully taxable equivalent basis at a 35 percent tax rate for 2014, 2013 and 2012. The tax equivalent rate for tax exempt loans and tax exempt securities acquired after January 1, 1983 included the TEFRA adjustment applicable to nondeductible interest expense.

Growth in the commercial loan portfolio accounted for most of the growth in loans, as well as total earning assets during both 2014 and 2013 thereby positively impacting total interest income. Management believes that the growth in the loan portfolio will likely continue in a measured, but prudent, fashion as a result of our strategic focus on commercial lending, including commercial real estate lending, and in conjunction with the general expansion and penetration of the geographical markets the Company serves, including as our ongoing expansion in the Indianapolis market. Growth in loans was funded through an increase in interest bearing deposits. Interest bearing checking accounts represented primarily by public funds increased \$141.1 million. In addition demand deposits increased \$80.9 million in 2014.

The decreases in the Company's yields on average earning assets resulted from decreases in market rates overall, including declines in loan portfolio yields during 2014 and 2013, and investment yields during 2013. One factor that contributed to the decline in investment portfolio yields throughout 2013 was an ongoing strategic realignment of the portfolio with respect to private label mortgage-backed securities. Another factor that contributed to the decline in the investment portfolio yields into 2013 was the impact of increased prepayments of agency mortgage-backed securities. In an ongoing effort to reduce the risk of incurring additional other-than-temporary impairment on certain non-agency residential mortgage-backed securities and to improve the overall quality of the securities in the investment portfolio, the Company sold the remaining non-agency residential mortgage-backed securities in September 2013 as part of the ongoing strategic realignment of its securities portfolio. These actions impacted investment portfolio performance as the proceeds from the sale of the higher yielding non-agency residential mortgage-backed securities were invested in lower yielding securities during 2013.

As a result of competitive pressures and the overall low interest rate environment in the market the Company serves, yields on commercial loans declined in 2014. These declines were impacted by more aggressive pricing on new loan opportunities, management's continued focus on growing the commercial portfolio in a prudent and responsible manner, and by the scheduled amortization of existing fixed rate commercial loans. Cost of funds declined during 2014 driven by continued declines in market rates, in particular, a decrease in the interest rate paid on the Rewards checking product.

## Provision for Loan Losses

Despite increases in the size of the overall loan portfolio, no provision for loan loss expense was recorded in 2014 or 2013, resulting in an allowance for loan losses at December 31, 2014 of \$46.3 million, which represented 1.67% of the loan portfolio, versus an allowance for loan losses of \$48.8 million at the end of 2013, which represented 1.92% of the loan portfolio. The lack of a provision in 2014 and 2013 was attributable to a number of factors but was primarily a result of stabilization or improvement in key loan quality metrics, including a decrease in net charge-offs, strong reserve coverage of nonperforming loans, a decrease in historical loss percentages, continuing signs of stabilization in economic conditions in the Company's markets and general signs of improvement in borrower performance and future prospects. In addition, management gave consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses. The Company's management continues to monitor the adequacy of the provision based on loan levels, asset quality, economic conditions and other factors that may influence the assessment of the collectability of loans.

The provision for loan loss expense was \$2.5 million in 2012, which resulted in an allowance for loan losses at December 31, 2012 of \$51.4 million, and which represented 2.28% of the loan portfolio. Key drivers of the 2012 provision included stabilization or improvement in key loan quality metrics, including a decrease in net charge-offs, strong reserve coverage of nonperforming loans, a decrease in historical loss percentages, continued signs of stabilization in economic conditions in the Company's markets and general signs of improvement in borrower performance and future prospects. In addition, management gave consideration to changes in the allocation for specific watch list credits in determining the appropriate level of the loan loss provision. Management's overall view on current credit quality was also a factor in the determination of the provision for loan losses.

## Noninterest Income

The following table presents changes in the components of noninterest income for the years ended December 31.

(dollars in thousands)	2014	2013	2012	% Change From Prior Year	
				2014	2013
Wealth advisory fees	\$ 4,072	\$ 3,847	\$ 3,823	5.8%	0.6%
Investment brokerage fees	3,370	4,736	3,061	-28.8%	54.7%
Service charges on deposit accounts	9,495	8,806	8,015	7.8%	9.9%
Loan, insurance and service fees	6,799	6,404	5,876	6.2%	9.0%
Merchant card fee income	1,549	1,265	1,130	22.5%	11.9%
Bank owned life insurance	1,393	1,653	973	-15.7%	69.9%
Other income	2,978	2,488	1,174	19.7%	111.9%
Mortgage banking income	621	1,431	2,546	-56.6%	-43.8%
Net securities gains (losses)	(224)	107	(376)	-309.3%	-128.5%
Net impairment loss recognized in earnings	0	0	(1,026)	0.0%	-100.0%
Total noninterest income	\$ 30,053	\$ 30,737	\$ 25,196	-2.2%	22.0%
Noninterest income to total revenue	22.7 %	25.4 %	22.3 %		

Noninterest income was \$30.1 million in 2014 versus \$30.7 million in 2013, a decrease of \$684,000, or 2.2%. The decrease was primarily driven by a \$1.4 million decrease in investment brokerage fees due to lower production volumes. Mortgage banking income decreased by \$810,000 due to lower refinance volumes as rates remained at historically low levels and now refinancing opportunities are not available. Noninterest income was positively impacted by a \$689,000 increase in service charges on deposit accounts driven by higher deposit fees. In addition, other income increased \$490,000, driven by income related to bank owned life insurance proceeds.

Noninterest income was \$30.7 million in 2013 versus \$25.2 million in 2012, an increase of \$5.5 million, or 22.0%. The increase was primarily driven by a \$1.7 million increase in investment brokerage fees due to a shift towards fixed income investments by clients, which generally have a more favorable revenue impact to the Company. Other income increased \$1.3 million due to fees from interest rate swaps as well as rental income from operating leases. The Company implemented an interest rate derivative program for commercial loan clients in 2013. In addition, no other-than-temporary impairment was recorded during 2013, versus \$1.0 million recorded during 2012. Noninterest income was negatively impacted by a \$1.1 million decrease in mortgage banking income in 2013 due to lower volumes as a result of higher mortgage interest rates.

## Noninterest Expense

The following table presents changes in the components of noninterest expense for the years ended December 31.

(dollars in thousands)	2014	2013	2012	% Change From Prior Year	
				2014	2013
Salaries and employee benefits	\$ 38,648	\$ 37,176	\$ 34,539	4.0%	7.6%
Net occupancy expense	3,776	3,376	3,296	11.8%	2.4%
Equipment costs	3,231	2,831	2,572	14.1%	10.1%
Data processing fees and supplies	6,171	5,635	4,378	9.5%	28.7%
Corporate and business development	3,073	2,734	2,305	12.4%	18.6%
FDIC insurance and other regulatory fees	1,936	1,855	2,097	4.4%	-11.5%
Professional fees	2,990	3,171	2,453	-5.7%	29.3%
Other expense	6,341	6,000	6,102	5.7%	-1.7%
Total noninterest expense	<u>\$ 66,166</u>	<u>\$ 62,778</u>	<u>\$ 57,742</u>	<u>5.4%</u>	<u>8.7%</u>

Noninterest expense was \$66.2 million in 2014 versus \$62.8 million in 2013, an increase of \$3.4 million, or 5.4%. Salaries and employee benefits increased by \$1.5 million, continuing to be driven by staff additions, normal annual salary increases, higher health insurance costs and higher performance based compensation costs. Data processing fees increased by \$536,000, continuing to be driven by technology related expenditures with the Company's core processor and other technology based providers to enhance the delivery of electronic banking alternatives and improve commercial product solutions.

Noninterest expense was \$62.8 million in 2013 versus \$57.7 million in 2012, an increase of \$5.0 million, or 8.7%. Salaries and employee benefits increased by \$2.6 million, driven by staff additions, normal salary increases, higher health insurance costs and higher performance based compensation costs. Data processing fees increased by \$1.3 million driven by a larger customer base as well as greater utilizations of services from the Company's core processor and related technology vendors.

## Income Taxes

The Company recognized income tax expense in 2014 of \$22.4 million, compared to \$19.6 million in 2013, and \$17.2 million in 2012. The effective tax rate in 2014 was 33.8% compared to 33.5% in 2013, and 32.7% in 2012. The effective tax rate was higher in 2014 and 2013 compared to 2012 due to an additional provision for income taxes related to a revaluation of the Company's state deferred tax items. For a detailed analysis of the Company's income taxes see Note 13 of the Notes to Consolidated Financial Statements.

## FINANCIAL CONDITION

### Overview

Total assets of the Company were \$3.443 billion as of December 31, 2014, an increase of \$267.5 million, or 8.4%, when compared to \$3.176 billion as of December 31, 2013. Total loans increased by \$227.2 million, or 9.0%, to \$2.762 billion at December 31, 2014 from \$2.535 billion at December 31, 2013. Funding for the loan growth came from a \$327.1 million increase in total deposits in 2014 offset by a \$101.5 million decrease in short-term borrowings.



## Uses of Funds

### Investment Portfolio

The amortized cost and the fair value of securities as of December 31, 2014, 2013 and 2012 were as follows:

(fully tax equivalent basis, dollars in thousands)	2014		2013		2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Securities available for sale:						
U.S. Treasury securities	\$ 986	\$ 1,004	\$ 1,001	\$ 1,017	\$ 1,002	\$ 1,037
U.S. Government sponsored agencies	0	0	0	0	5,026	5,304
Agency residential mortgage-backed securities	366,596	372,095	374,611	371,977	359,326	365,644
Non-agency residential mortgage-backed securities	0	0	0	0	6,211	6,453
State and municipal securities	99,399	102,812	95,388	95,973	83,263	88,583
Total debt securities available for sale	<u>\$ 466,981</u>	<u>\$ 475,911</u>	<u>\$471,000</u>	<u>\$468,967</u>	<u>\$454,828</u>	<u>\$467,021</u>

At year-end 2014, 2013 and 2012, there were no holdings of securities of any one issuer, other than the U.S. government, government agencies and government sponsored agencies, in an amount greater than 10% of stockholders' equity. See Note 2 for more information on these investments.

Purchases of securities available for sale totaled \$73.4 million in 2014, \$167.5 million in 2013 and \$161.6 million in 2012. Securities sales totaled \$13.8 million in 2014, \$30.0 million in 2013 and \$27.9 million in 2012. Paydowns from prepayments and scheduled payments of \$55.9 million, \$104.6 million and \$120.1 million were received in 2014, 2013 and 2012, and the amortization of premiums, net of the accretion of discounts, was \$5.4 million, \$8.9 million and \$8.2 million. Maturities and calls of securities totaled \$2.1 million, \$8.0 million and \$5.0 million in 2014, 2013 and 2012. Other-than-temporary impairment of \$1.0 million was recognized on non-agency residential mortgage-backed securities in 2012. No other-than-temporary impairment was recognized in 2014 or 2013. Purchases of securities were lower in 2014 due to the decrease in prepayments and other scheduled payments resulting in less cash flow for reinvestment. Sales of securities were higher in 2013 and 2012 than 2014 due to the strategic realignment of the investment portfolio with respect to non-agency residential mortgage-backed securities as discussed below. The investment portfolio is managed to provide for an appropriate balance between liquidity, credit risk and investment return and to limit the Company's exposure to risk to an acceptable level.

During the third quarter of 2012, the Company sold nine non-agency residential mortgage-backed securities as part of a strategic realignment of the investment portfolio. The securities sold had a book value of \$20.7 million and a fair value of \$19.5 million. The sales included all five of the non-agency residential mortgage-backed securities on which the Company had previously recognized other-than-temporary impairment. During the third quarter of 2013, the Company sold the four remaining non-agency mortgage-backed securities. The securities sold had a book value of \$3.8 million and a fair value of \$3.9 million.

The weighted average yields and maturity distribution for the securities portfolio at December 31, 2014, were as follows:

(fully tax equivalent, basis, dollars in thousands)	Within One Year		After One Within five Years		After five Years Within Ten years		Over Ten Years	
	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield	Fair Value	Yield
U.S. Treasury securities	\$ 0	0.00 %	\$ 0	0.00 %	\$ 1,004	2.25 %	\$ 0	0.00 %
Agency residential mortgage-backed securities	0	0.00 %	26,610	2.24 %	95,921	2.06 %	249,564	2.62 %
State and municipal securities	5,454	3.96 %	18,210	3.70 %	47,428	3.24 %	31,720	3.33 %
Total Securities	<u>\$ 5,454</u>	<u>3.96 %</u>	<u>\$ 44,820</u>	<u>2.83 %</u>	<u>\$144,353</u>	<u>2.44 %</u>	<u>\$281,284</u>	<u>2.70 %</u>

The company does not trade or invest in or sponsor certain unregistered investment companies defined as hedge funds and private equity funds in the Volcker Rule.

### Real Estate Mortgage Loans HFS

Real estate mortgages held for sale decreased by \$193,000 to \$1.6 million at December 31, 2014 from \$1.8 million at December 31, 2013. This asset category is subject to a high degree of variability depending on, among other things, recent mortgage loan rates and the timing of loan sales into the secondary market. The Company generally sells almost all of the mortgage loans it originates on the secondary market. Proceeds from sales totaled \$56.1 million in 2014, \$91.0 million in 2013 and \$115.2 million in

2012. After several years of historically low mortgage rates, many or most mortgagees who would benefit from refinancing have already done so, resulting in decreases in mortgage sales proceeds in 2013 and again in 2014.

## Loan Portfolio

The loan portfolio by class as of December 31, 2014, 2013, 2012, 2011 and 2010 were as follows:

(dollars in thousands)	2014	2013	2012	2011	2010
Commercial and industrial loans:					
Working capital lines of credit loans	\$ 544,043	\$ 457,690	\$ 439,638	\$ 373,768	\$ 281,546
Non-working capital loans	491,330	443,877	407,184	377,388	384,138
Total commercial and industrial loans	1,035,373	901,567	846,822	751,156	665,684
Commercial real estate and multi-family residential loans:					
Construction and land development loans	156,636	157,630	82,494	82,284	106,980
Owner occupied loans	403,154	370,386	358,617	346,669	329,760
Nonowner occupied loans	394,458	394,748	314,889	385,090	355,393
Multifamily loans	71,811	63,443	45,011	38,477	24,158
Total commercial real estate and multi-family residential loans	1,026,059	986,207	801,011	852,520	816,291
Agri-business and agricultural loans:					
Loans secured by farmland	137,407	133,458	109,147	118,224	111,961
Loans for agricultural production	136,380	120,571	115,572	119,705	117,518
Total agri-business and agricultural loans	273,787	254,029	224,719	237,929	229,479
Other commercial loans	75,715	70,770	56,807	58,278	38,778
Total commercial loans	2,410,934	2,212,573	1,929,359	1,899,883	1,750,232
Consumer 1-4 family mortgage loans:					
Closed end first mortgage loans	145,167	125,444	109,823	106,999	103,118
Open end and junior lien loans	150,220	146,946	161,366	175,694	182,325
Residential construction and land development loans	6,742	4,640	11,541	5,462	4,140
Total consumer 1-4 family mortgage loans	302,129	277,030	282,730	288,155	289,583
Other consumer loans	49,541	46,125	45,755	45,999	51,123
Total consumer loans	351,670	323,155	328,485	334,154	340,706
Subtotal	2,762,604	2,535,728	2,257,844	2,234,037	2,090,938
Less: Allowance for loan losses	(46,262)	(48,797)	(51,445)	(53,400)	(45,007)
Net deferred loan fees	(284)	(630)	(324)	(328)	(979)
Loans, net	\$ 2,716,058	\$ 2,486,301	\$ 2,206,075	\$ 2,180,309	\$ 2,044,952

The ratio of loans to total loans by portfolio segment as of December 31, 2014, 2013, 2012, 2011 and 2010 were as follows:

	2014	2013	2012	2011	2010
Commercial and industrial loans	37.48%	35.55%	37.50%	33.62%	31.84%
Commercial real estate and multi-family residential loans	37.14%	38.89%	35.48%	38.16%	39.04%
Agri-business and agricultural loans	9.91%	10.02%	9.95%	10.65%	10.98%
Other commercial loans	2.74%	2.79%	2.52%	2.61%	1.85%
Consumer 1-4 family mortgage loans	10.94%	10.93%	12.52%	12.90%	13.85%
Other consumer loans	1.79%	1.82%	2.03%	2.06%	2.44%
Total Loans	100.00%	100.00%	100.00%	100.00%	100.00%

In 2014 loan balances increased by \$227.2 million, which is net of approximately \$55.1 million in loans originated and sold and \$1.1 million transferred to other real estate in 2014. In 2013 loan balances increased by \$280.7 million, which is net of approximately \$81.7 million in loans originated and sold and \$491,000 transferred to other real estate in 2013. In 2012, loan balances increased by \$28.7 million, which is net of approximately \$119.6 million in loans originated and sold and \$413,000 transferred to other real estate in 2012.

The mix of loan types within the Company's portfolio continued a trend toward a higher percentage of the total loan portfolio being in commercial loans. This general increase in commercial loans was a result of the Company's long standing strategic plan that is focused on expanding and growing the commercial lending business.

The residential construction and land development loans class included construction loans totaling \$5.3 million, \$3.8 million, \$10.7 million, \$4.3 million, \$2.6 million and \$5.8 million as of December 31, 2014, 2013, 2012, 2011 and 2010. The Bank generally sells conforming mortgage loans which it originates on the secondary market. These loans generally represent mortgage loans that are made to clients with long-term or substantial relationships with the Bank on terms consistent with secondary market requirements. The loan classifications are based on the nature of the loans as of the loan origination date. There were no foreign loans included in the loan portfolio for the periods presented.

Repricing opportunities of the loan portfolio occur either according to predetermined adjustable rate schedules included in the related loan agreements or upon maturity of each principal payment. The following table indicates the scheduled maturities of the loan portfolio as of December 31, 2014.

(dollars in thousands)	Commercial	Residential Real Estate Mortgage	Installment	Line of Credit	Total	Percent
Within one year	\$ 1,217,825	\$ 15,937	\$ 11,083	\$ 28,884	\$ 1,273,729	46.11 %
After one year, within five years	1,054,298	46,737	21,222	75,966	1,198,223	43.37
Over five years	190,403	38,975	2,299	45,398	277,075	10.03
Nonaccrual loans	11,950	1,023	401	203	13,577	0.49
Total loans	<u>\$ 2,474,476</u>	<u>\$ 102,672</u>	<u>\$ 35,005</u>	<u>\$ 150,451</u>	<u>\$ 2,762,604</u>	<u>100.00 %</u>

At maturity, credits are reviewed and, if renewed, are renewed at rates and conditions that prevail at the time of maturity.

Loans due after one year which have a predetermined interest rate and loans due after one year which have floating or adjustable interest rates as of December 31, 2014 amounted to \$599,000 and \$877,000, respectively.

### Bank Owned Life Insurance

Bank owned life insurance increased by \$3.7 million to \$66.6 million at December 31, 2014 and by \$1.8 million to \$62.9 million at December 31, 2013 from \$61.1 million at December 31, 2012. This increase during 2014 was primarily due to purchases to help offset employee benefit plan expenses, which have continued to increase since 2002, by providing investment income from the securities the life insurance is invested in.

### Sources of Funds

The average daily deposits and borrowings and the average rates paid on those deposits and borrowings for the years ended December 31, 2014, 2013 and 2012 are summarized in the following table:

(dollars in thousands)	2014		2013		2012		% Balance Change From Prior Year	
	Balance	Rate	Balance	Rate	Balance	Rate	2014	2013
Demand deposits	\$ 498,351	0.00 %	\$ 417,471	0.00 %	\$ 354,101	0.00 %	19 %	18 %
Savings and transaction accounts:								
Regular savings	233,657	0.22	229,440	0.28	195,666	0.36	2	17
Interest bearing checking	1,169,338	0.40	1,028,224	0.51	1,002,418	0.90	14	3
Time deposits:								
Deposits of \$100,000 or more	615,764	0.84	502,470	1.04	563,116	1.43	23	(11)
Other time deposits	280,819	1.14	327,736	1.40	389,894	1.77	(14)	(16)
Total deposits	<u>\$ 2,797,929</u>	<u>0.48 %</u>	<u>\$ 2,505,341</u>	<u>0.63 %</u>	<u>\$ 2,505,195</u>	<u>0.98 %</u>	<u>12</u>	<u>0</u>
FHLB advances and other borrowings	161,774	0.88	177,433	0.89	165,281	1.23	(9)	7
Total funding sources	<u>\$ 2,959,703</u>	<u>0.61 %</u>	<u>\$ 2,682,774</u>	<u>0.76 %</u>	<u>\$ 2,670,476</u>	<u>1.15 %</u>	<u>10</u>	<u>0</u>

Time deposits as of December 31, 2014 will mature as follows:

(dollars in thousands)	\$100,000 or more	% of Total	Other	% of Total
Within three months	\$ 95,302	16.29 %	\$ 30,275	10.60 %
Over three months, within six months	119,342	20.39	34,377	12.05
Over six months, within twelve months	163,362	27.91	100,323	35.16
Over twelve months	207,205	35.41	120,404	42.19
Total time certificates of deposit	<u>\$ 585,211</u>	<u>100.00 %</u>	<u>\$ 285,379</u>	<u>100.00 %</u>

### Deposits

Average deposits increased \$292.6 million comparing December 31, 2014 to December 31, 2013. The growth in deposits consisted of \$176.8 million in core deposit growth and an increase of \$115.8 million in brokered deposits. Average interest bearing public funds transaction accounts increased by \$134.9 million, average brokered time deposits increased by \$83.3 million, average commercial demand deposits increased by \$62.2 million, average public funds time deposits increased by \$49.0 million and average

brokered transaction accounts increased by \$32.5 million. The Company believes that the prolonged low rate environment has caused depositors to shift their deposits to short-term liquid products in anticipation of higher future market deposit rates.

Average deposit growth was flat comparing December 31, 2013 to December 31, 2012. The deposit mix changed, however, with a decrease in average time deposits and an increase in average noninterest bearing demand accounts and other transaction accounts. Average commercial demand deposit accounts increased \$62.8 million, average savings accounts increased \$33.8 million and average public fund deposits increased \$17.6 million. The Company believed that the decline in average time deposits was reflective of the ongoing low interest rate environment and the consumers' desire to seek the highest rate in the market, which the Company sometimes did not match.

As previously noted, the Company has substantial funding from public fund entities. A shift in funding away from public fund deposits could require the Company to execute alternate funding plans under the Contingency Funding Plan discussed in further detail under "Liquidity Risk" below.

### **Borrowings**

During 2014, average total short-term borrowings decreased \$14.2 million primarily due to a \$29.1 million decrease in securities sold under agreements to repurchase and average long-term borrowings decreased \$1.4 million due to a decrease in advances with the Federal Home Loan Bank of Indianapolis. Ending balances of total short-term borrowings decreased \$101.5 million during 2014 due to decreases in securities sold under agreements to repurchase as well as decreases in Federal Home Loan Bank of Indianapolis advances. During 2014, the Company changed the mix of wholesale funding by reducing Federal Home Loan Bank advances and increasing brokered deposits.

During 2013, average total short-term borrowings increased \$25.7 million primarily due to a \$21.5 million increase in federal funds purchased and average long-term borrowings decreased \$13.6 million due to a decrease in advances with the Federal Home Loan Bank of Indianapolis. Ending balances of total short-term borrowings increased \$140.0 million during 2013 due to an increase in Federal Home Loan Bank of Indianapolis advances late in December 2013.

### **Capital**

The Company believes that a strong, appropriately managed capital position is critical to long-term earnings and continuing growth in loans. The Company had a total risk-based capital ratio of 14.4% and a Tier I risk-based capital ratio of 13.1% as of December 31, 2014. These ratios met or exceeded the Federal Reserve's "well-capitalized" minimums of 10.0% and 6.0%, respectively. The Company also had a Tier 1 leverage ratio of 11.2% and a tangible equity ratio of 10.4%. See Note 16 – Capital Requirements for more information.

The ability to maintain these ratios is a function of the balance between net income and a prudent dividend policy. Total stockholders' equity increased by 12.3% to \$361.3 million as of December 31, 2014 from \$321.9 million as of December 31, 2013. The Company earned \$43.8 million in 2014 and \$38.8 million in 2013. The Company declared cash dividends of \$0.82 per share in 2014, which decreased equity by \$13.6 million. The Company declared cash dividends of \$0.57 per share in 2013, which decreased equity by \$9.4 million. The change in accumulated other comprehensive income, largely due to changes in the fair values of available-for-sale securities, increased equity by \$6.3 million in 2014, and decreased equity by \$8.2 million in 2013. The impact to equity due to other comprehensive income is not included in regulatory capital. Stock based compensation expense increased equity by \$2.8 million in 2014 and \$2.0 million in 2013.

## **RISK MANAGEMENT**

### **Overview**

The Company, with the oversight of the Corporate Risk Committee of the Board of Directors, has developed a company-wide risk management program to manage and mitigate the various business risks the Company is exposed to. Following is a discussion addressing the risks identified as most significant to the Company – Credit, Liquidity and Interest Rate or Market Risk. Item 7A includes additional market risk discussion.

### **Credit Risk**

Credit risk represents the risk of loss arising from an obligor's inability or failure to meet contractual payment or performance terms. Our primary credit risks result from investment and lending activities.

### **Investment Portfolio**

The Company's investment portfolio consists of Treasury securities, mortgage-backed securities and municipal bonds. During 2014, purchases in the securities portfolio consisted of primarily mortgage-backed securities and municipal bonds. As of December 31, 2014, the Company's investment in mortgage-backed securities represented approximately 78% of total securities

consisting of Collateralized Mortgage Obligations (“CMOs”), Commercial Mortgage-Backed Securities (“CMBSs”) and mortgage pools issued by Ginnie Mae, Fannie Mae and Freddie Mac. Ginnie Mae, Fannie Mae and Freddie Mac securities are each guaranteed by their respective agencies as to principal and interest. All mortgage securities purchased by the Company are within risk tolerances for price, prepayment, extension and original life risk characteristics contained in the Company’s investment policy. The Company uses Bloomberg analytics and BondEdge Fixed Income Analytics software to evaluate and monitor all purchases. Based upon the BondEdge analytics, as of December 31, 2014, the securities in the available for sale portfolio had approximately a 3.75 year effective duration with approximately a negative 12.8% change in market value in the event of a 300 basis points upward rate shock over a one-year period and an approximate positive 3.30% change in market value in the event of a 100 basis point downward rate shock over the same period. As of December 31, 2014, all mortgage-backed securities were performing in a manner consistent with management’s original ALCO modeled expectations.

### Loan Portfolio

The Company has a relatively high percentage of commercial and commercial real estate loans, most of which are extended to small or medium-sized businesses from a wide variety of industries. Traditionally, this type of lending may have more credit risk than other types of lending because of the size and diversity of the credits. The Company manages this risk by adjusting its pricing to the perceived risk of each individual credit and by diversifying the portfolio by customer, product, industry and market area.

There were no loan concentrations within industries, which exceeded ten percent of total loans, except commercial real estate and manufacturing. Commercial real estate was \$917.3 million, or 33.8% of total loans, and manufacturing was \$345.9 million, or 12.7% of total loans, at December 31, 2014. Nearly all of the Bank’s commercial, industrial, agricultural real estate mortgage, real estate construction mortgage and consumer loans are made within its basic market areas.

The following is a summary of nonperforming loans as of December 31, 2014, 2013, 2012, 2011 and 2010.

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
Commercial and industrial loans					
Past due accruing loans (90 days or more)	\$ 101	\$ 0	\$ 50	\$ 0	\$ 0
Nonaccrual loans(1)	4,230	5,616	6,713	10,174	10,560
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	<u>4,331</u>	<u>5,616</u>	<u>6,763</u>	<u>10,174</u>	<u>10,560</u>
Commercial real estate and multi-family residential loans					
Past due accruing loans (90 days or more)	0	0	0	0	0
Nonaccrual loans(1)	7,204	15,459	22,346	26,745	23,418
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	<u>7,204</u>	<u>15,459</u>	<u>22,346</u>	<u>26,745</u>	<u>23,418</u>
Agri-business and agricultural loans					
Past due accruing loans (90 days or more)	0	0	0	0	0
Nonaccrual loans(1)	486	1,114	798	853	1,283
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	<u>486</u>	<u>1,114</u>	<u>798</u>	<u>853</u>	<u>1,283</u>
Other commercial loans					
Past due accruing loans (90 days or more)	0	0	0	0	0
Nonaccrual loans(1)	30	0	0	0	0
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	<u>30</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
Consumer 1-4 family mortgage loans					
Past due accruing loans (90 days or more)	29	46	0	52	319
Nonaccrual loans(1)	1,576	1,605	895	1,646	1,112
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	<u>1,605</u>	<u>1,651</u>	<u>895</u>	<u>1,698</u>	<u>1,431</u>
Other consumer loans					
Past due accruing loans (90 days or more)	0	0	0	0	12
Nonaccrual loans(1)	51	105	77	7	218
Troubled debt restructured loans	0	0	0	0	0
Subtotal nonperforming loans	<u>51</u>	<u>105</u>	<u>77</u>	<u>7</u>	<u>230</u>
Total nonperforming loans	<u>\$ 13,707</u>	<u>\$ 23,945</u>	<u>\$ 30,879</u>	<u>\$ 39,477</u>	<u>\$ 36,922</u>

(1) Includes nonaccrual troubled debt restructured loans.

Nonperforming assets of the Company include nonperforming loans (as indicated above), nonaccrual investments and other real estate owned and repossessions, the total of which amounted to \$14.0 million and \$24.4 million at December 31, 2014 and 2013. Management is of the opinion that there are no significant foreseeable losses relating to nonperforming assets, except as discussed below.

The Bank's policy is that all loans for which the collateral is insufficient to cover all principal and accrued interest will be reclassified as nonperforming loans to the extent they are unsecured, on or before the date when the loan becomes 90 days delinquent, with the exception of other consumer loans which are not placed on nonaccrual status since these loans are charged-off when they have been delinquent from 90 to 180 days, and when the related collateral, if any, is not sufficient to offset the indebtedness. When a loan is classified as a nonaccrual loan, interest on the loan is no longer accrued, all unpaid accrued interest is reversed and interest income is subsequently recorded only to the extent cash payments are received. Accrual status is resumed when all contractually due payments are brought current and future payments are reasonably assured. Interest not recorded on nonaccrual loans is referenced in Note 4 in Item 8 below.

Nonaccrual loans were 0.50% of total loans, at year end 2014 versus 0.94% of total loans, at year end 2013. There were 73 relationships totaling \$32.0 million classified as impaired as of December 31, 2014 versus 79 relationships totaling \$43.2 million at the end of 2013. The decrease in nonaccrual loans during 2014 resulted primarily from sale proceeds received and charge offs recognized on a single commercial relationship consisting of three impaired loans totaling \$6.7 million. In addition, one commercial credit of \$1.4 million was removed from the impaired category due to improved performance. Total nonperforming loans were \$13.7 million, or 0.50% of total loans, at year end 2014 versus \$23.9 million, or 0.94% of total loans, at the end of 2013.

A loan is impaired when full payment under the original loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature not in nonaccrual or troubled debt restructured status such as residential mortgage, consumer, and credit card loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flow or at the fair value of collateral if repayment is expected solely from the collateral.

As of December 31, 2014 and 2013, all loans on nonaccrual status were also on impaired status. There were \$32.0 million and \$43.2 million of loans classified as impaired as of December 31, 2014 and 2013. The decrease in impaired loans during 2014, resulted from the three loans discussed above as well as the \$1.4 million loan removed from nonperforming status due to improved performance.

Loans renegotiated as troubled debt restructurings are those loans for which either the contractual interest rate has been reduced below market rates and/or other concessions are granted to the borrower because of a deterioration in the financial condition of the borrower which results in the inability of the borrower to meet the terms of the loan.

As of December 31, 2014, there were 34 borrowers with loans totaling \$25.7 million renegotiated as troubled debt restructurings and \$3.1 million were modified in 2014. Of these loans, \$9.2 million were excluded from troubled debt restructured loans in the previous table because they were included in nonaccrual loans and the remaining \$16.5 million were performing under their modified terms. As of December 31, 2013, there were 40 borrowers with loans totaling \$36.2 million renegotiated as troubled debt restructurings and \$3.1 million were modified in 2013. Of these loans, \$18.5 million were excluded from troubled debt restructured loans in the previous table because they were included in nonaccrual loans and the remaining \$17.7 million of troubled debt restructured loans performing under their modified terms at December 31, 2013. Of the \$10.6 million decrease of loans accounted for as troubled debt restructurings at December 31, 2014, as compared to December 31, 2013, \$6.7 million was related to three commercial credits which were sold. The Company has no commitments to lend additional funds to any of the borrowers.

The following is a summary of the loan loss experience for the years ended December 31, 2014, 2013, 2012, 2011 and 2010.

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
Amount of loans outstanding, December 31,	<u>\$ 2,762,320</u>	<u>\$ 2,535,098</u>	<u>\$ 2,257,520</u>	<u>\$ 2,233,709</u>	<u>\$ 2,089,959</u>
Average daily loans outstanding during the year ended December 31,	<u>\$ 2,650,678</u>	<u>\$ 2,343,422</u>	<u>\$ 2,216,131</u>	<u>\$ 2,148,046</u>	<u>\$ 2,049,209</u>
Allowance for loan losses, January 1,	<u>\$ 48,797</u>	<u>\$ 51,445</u>	<u>\$ 53,400</u>	<u>\$ 45,007</u>	<u>\$ 32,073</u>
Loans charged-off:					
Commercial and industrial loans	1,441	1,062	3,069	2,587	7,247
Commercial real estate and multi-family residential loans	2,560	2,069	1,108	2,514	2,791
Agri-business and agricultural loans	0	200	0	318	20
Other commercial loans	0	0	0	0	0
Consumer 1-4 family mortgage loans	439	382	1,340	1,050	1,105
Other consumer loans	245	339	405	360	579
Total loans charged-off	<u>4,685</u>	<u>4,052</u>	<u>5,922</u>	<u>6,829</u>	<u>11,742</u>
Recoveries of loans previously charged-off:					
Commercial and industrial loans	914	513	767	826	525
Commercial real estate and multi-family residential loans	928	377	203	362	0
Agri-business and agricultural loans	20	212	186	0	20
Other commercial loans	0	0	0	0	0
Consumer 1-4 family mortgage loans	153	126	148	46	34
Other consumer loans	135	176	111	188	150
Total recoveries	<u>2,150</u>	<u>1,404</u>	<u>1,415</u>	<u>1,422</u>	<u>729</u>
Net loans charged-off	<u>2,535</u>	<u>2,648</u>	<u>4,504</u>	<u>5,407</u>	<u>11,013</u>
Provision for loan loss charged to expense	<u>0</u>	<u>0</u>	<u>2,549</u>	<u>13,800</u>	<u>23,947</u>
Balance, December 31,	<u>\$ 46,262</u>	<u>\$ 48,797</u>	<u>\$ 51,445</u>	<u>\$ 53,400</u>	<u>\$ 45,007</u>
Ratio of net charge-offs during the period to average daily loans outstanding:					
Commercial and industrial loans	0.02 %	0.02 %	0.11 %	0.08 %	0.33 %
Commercial real estate and multi-family residential loans	0.06	0.07	0.04	0.10	0.14
Agri-business and agricultural loans	0.00	0.00	(0.01)	0.01	0.00
Other commercial loans	0.00	0.00	0.00	0.00	0.00
Consumer 1-4 family mortgage loans	0.01	0.01	0.05	0.05	0.05
Other consumer loans	0.01	0.01	0.01	0.01	0.02
Total ratio of net charge-offs	<u>0.10 %</u>	<u>0.11 %</u>	<u>0.20 %</u>	<u>0.25 %</u>	<u>0.54 %</u>
Ratio of allowance for loan losses to nonperforming loans	<u>337.51 %</u>	<u>203.79 %</u>	<u>166.60 %</u>	<u>135.27 %</u>	<u>121.90 %</u>

The following is a summary of the allocation for loan losses as of December 31, 2014, 2013, 2012, 2011 and 2010.

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>	<u>2011</u>	<u>2010</u>
Allocated allowance for loan losses:					
Commercial and industrial loans	\$ 22,785	\$ 21,005	\$ 22,342	\$ 22,830	\$ 21,479
Commercial real estate and multi-family residential loans	14,153	18,556	20,812	23,489	15,893
Agri-business and agricultural loans	1,790	1,682	1,403	695	1,318
Other commercial loans	319	391	240	65	270
Consumer 1-4 family mortgage loans	3,459	3,046	2,682	2,322	1,694
Other consumer loans	440	608	609	645	682
Total allocated allowance for loan losses	<u>42,946</u>	<u>45,288</u>	<u>48,088</u>	<u>50,046</u>	<u>41,336</u>
Unallocated allowance for loan losses	<u>3,316</u>	<u>3,509</u>	<u>3,357</u>	<u>3,354</u>	<u>3,671</u>
Total allowance for loan losses	<u>\$ 46,262</u>	<u>\$ 48,797</u>	<u>\$ 51,445</u>	<u>\$ 53,400</u>	<u>\$ 45,007</u>

At December 31, 2014, the allowance for loan losses was 1.67% of total loans outstanding, versus 1.92% of total loans outstanding, at December 31, 2013. Management believes the allowance for loan losses is at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions do not continue to improve, certain borrowers may experience difficulty and the level of nonperforming loans, charge-offs and delinquencies could rise and require increases in the provision for loan losses. The process of identifying probable incurred credit losses is a subjective process. Therefore, the Company maintains a general allowance to cover probable incurred credit losses within the entire portfolio. The methodology management uses to determine the adequacy of the loan loss reserve includes the considerations below.

Loans are charged against the allowance for loan losses when management believes that the principal is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance is an amount that management believes will be adequate to absorb probable incurred credit losses relating to specifically identified loans based on an evaluation of the loans by management, as well as other probable incurred losses inherent in the loan portfolio. The evaluations take into consideration such factors as changes in the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans and current economic conditions that may affect the borrower's ability to repay. Management also considers trends in adversely classified loans based upon a monthly review of those credits. An appropriate level of general allowance is determined after considering the following factors:

application of historical loss percentages, emerging market risk, commercial loan focus and large credit concentrations, new industry lending activity and current economic conditions. Federal regulations require insured institutions to classify their own assets on a regular basis. The regulations provide for three categories of classified loans: Substandard, Doubtful and Loss. The regulations also contain a Special Mention category. Special Mention is defined as loans that do not currently expose an insured institution to a sufficient degree of risk to warrant classification as Substandard, Doubtful or Loss but do possess credit deficiencies or potential weaknesses deserving management's close attention. The Company's policy is to establish a specific allowance for loan losses for any assets where management has identified conditions or circumstances that indicate an asset is impaired. If an asset or portion thereof is classified as loss, the Company's policy is to either establish specified allowances for loan losses in the amount of 100% of the portion of the asset classified loss or charge-off such amount.

At December 31, 2014, on the basis of management's review of the loan portfolio, the Company had 92 credits totaling \$155.6 million on the classified loan list versus 98 credits totaling \$165.1 million on December 31, 2013. As of December 31, 2014, the Company had \$95.4 million of assets classified as Special Mention, \$58.5 million classified as Substandard, \$611,000 classified as Doubtful and \$0 classified as Loss as compared to \$90.4 million, \$72.1 million, \$0 and \$0, respectively at December 31, 2013.

Included in the classified loan amounts for December 31, 2014 above were the following troubled debt restructured loans: one installment loan totaling \$11,000 with an allocation of \$2,000, 15 mortgage loans totaling \$1.6 million with total allocations of \$319,000, and 21 commercial loans totaling \$24.1 million with total allocations of \$3.3 million. Included in the classified loan amounts for December 31, 2013 above were the following troubled debt restructured loans: one installment loan totaling \$14,000 with an allocation of \$3,000, 15 mortgage loans totaling \$1.6 million with total allocations of \$295,000, and 24 commercial loans totaling \$34.8 million with total allocations of \$8.1 million.

Allowance estimates are developed by management taking into account actual loss experience, adjusted for current economic conditions. Allowance estimates are considered a prudent measurement of the risk in the Company's loan portfolio and are applied to individual loans based on loan type. In accordance with current accounting guidance, the allowance is provided for losses that have been incurred as of the balance sheet date and is based on past events and current economic conditions and does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. For a more thorough discussion of the allowance for loan losses methodology see the Critical Accounting Policies section of this Item 7.

The allowance for loan losses decreased 5.2%, or \$2.5 million, from \$48.8 million at December 31, 2013 to \$46.3 million at December 31, 2014. Pooled loan allocations increased \$1.4 million from \$39.5 million at December 31, 2013 to \$40.8 million at December 31, 2014, which was due to an increase in pooled loan balances as well as management's view of current credit quality and the current economic environment. Impaired loan allocations decreased \$3.9 million from \$9.3 million at December 31, 2013 to \$5.4 million at December 31, 2014. This decrease was primarily due to lower levels of classified loans as well as lower allocations on specific classified loans. The unallocated component of the allowance for loan losses was \$3.3 million and \$3.5 million at December 31, 2014 and 2013, decreasing primarily due to stabilization in the current economic conditions and the general improvement in our borrowers' performance and future prospects. While general trends in credit quality were stable or favorable, the Company believes that the unallocated component is appropriate given the uncertainty that exists regarding near term economic conditions, including the risk of an economic downturn.

The Company has experienced growth in total loans over the last three years of \$528.6 million, or 23.7%. The concentration of this loan growth was in the commercial loan portfolio, which can result in overall asset quality being influenced by a small number of credits. Management has historically considered growth and portfolio composition when determining loan loss allocations. Management believes that it is prudent to continue to provide for loan losses in a manner consistent with its historical approach due to the loan growth described above and current economic conditions.

Economic conditions in the Company's markets have generally improved and stabilized, and management is cautiously optimistic that the recovery is positively impacting its borrowers. While the recovery is not robust, commercial real estate activity and manufacturing growth is occurring. The Company's continued growth strategy promotes diversification among industries as well as continued focus on enforcement of a strong credit environment and an aggressive position in loan work-out situations. The Company believes that historical industry-specific issues in the Company's markets have improved and continue to be somewhat mitigated by its overall expansion strategy, the economic environment impacting its entire geographic footprint will continue to present challenges. While the Company has seen indications of improved economic conditions in its markets, they are not wide spread or particularly strong improvements.

## **Liquidity Risk**

Liquidity risk arises from the possibility that the Company may not be able to satisfy current or future financial commitments or may become unduly reliant on alternative funding sources.



Management maintains a liquidity position that it believes will adequately provide funding for loan demand and deposit run-off that may occur in the normal course of business. The liquidity structure is expressly detailed in the Company's Contingency Funding Plan, which is discussed below. The Company relies on a number of different sources in order to meet these potential liquidity demands. The primary sources are increases in deposit accounts and cash flows from loan payments and the securities portfolio. Given current prepayment assumptions as of the filing date of December 31, 2014, the cash flow from the securities portfolio is expected to provide approximately \$84 million of potential contingent funding in 2015.

The Company has approval of \$1.331 billion in secondary sources available as of December 31, 2014, of which \$225.4 million was utilized. The Company had \$270.0 million in federal funds lines with twelve correspondent banks, of which \$500,000 was drawn on as of December 31, 2014. The Company has Board of Directors approval to borrow up to \$800.0 million at the FHLB, but, given the Company's current collateral structure and outstanding borrowings as of December 31, 2014, the Company could have only borrowed up to \$115.9 million under this authority based on utilization of \$105.0 million at December 31, 2014. The Company also has additional collateral that could be pledged to the FHLB of \$171.1 million as of December 31, 2014. Further, the Company had available capacity at the Federal Reserve Bank of Chicago of up to \$160.2 million given its current collateral structure and the terms of these facilities at December 31, 2014. The Company also has established relationships in the brokered time deposit and brokered money market sectors, as well as the CDARS One-Way Buy program, to easily access these funds when desired with settlement of funds in one to two weeks' time.

The Company had all of its securities in the available for sale portfolio at December 31, 2014, allowing the Company maximum flexibility to sell securities to meet funding demands. Management believes the majority of the securities in the available for sale portfolio are of high quality and marketable. Approximately 78% of this portfolio is comprised of U.S. government agency securities or mortgage-backed securities directly or indirectly backed by the U.S. government. In addition, the Company has historically sold the majority of its originated mortgage loans on the secondary market to reduce interest rate risk and to create an additional source of funding.

The Company has a formalized Contingency Funding Plan ("CFP"). The Board of Directors and management recognize the importance of liquidity during times of normal operations and in times of stress. The formal CFP was developed to ensure that the multiple liquidity sources available to the Company are readily available. The CFP specifically considers liquidity at the Bank and the Company level. The CFP identifies the potential funding sources at the Bank level, which includes the FHLB, the Federal Reserve Bank, brokered deposits, certificates of deposit available from CDARS, repurchase agreements and Fed Funds. The CFP also addresses the Bank's ability to liquidate its securities portfolio. The CFP at the Holding Company level establishes a minimum cash coverage limit of 2 times annual operating expenses; it also gives consideration to the possibility of establishing a holding company committed line of credit, as well as the ability to transfer securities from the Bank to the Company.

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

The following table discloses information on the maturity of the Company's contractual long-term obligations. Certificates of deposit listed are those with original maturities of 1 year or more as of December 31, 2014.

(dollars in thousands)	Payments Due by Period				
	Total	One year or less	1-3 years	3-5 years	After 5 years
Certificates of deposit	\$ 227,862	\$ 132,354	\$ 77,228	\$ 18,270	\$ 10
Long-term debt	35	0	0	35	0
Operating leases	3,797	262	487	460	2,588
Pension and SERP plans	3,379	422	814	689	1,454
Subordinated debentures	30,928	0	0	0	30,928
Total contractual long-term cash obligations	<u>\$ 266,001</u>	<u>\$ 133,038</u>	<u>\$ 78,529</u>	<u>\$ 19,454</u>	<u>\$ 34,980</u>

During the normal course of business, the Company becomes a party to financial instruments with off-balance sheet risk in order to meet the financing needs of its customers. These financial instruments include commitments to make loans and open-ended revolving lines of credit. The Company follows the same credit policy (including requiring collateral, if deemed appropriate) to make such commitments as is followed for those loans that are recorded in its financial statements.

The Company's exposure to credit losses in the event of nonperformance is represented by the contractual amount of the commitments. Management does not expect any significant losses as a result of these commitments. Off-balance sheet transactions are more fully discussed in Note 18 in the consolidated financial statements.

The following table discloses information on the maturity of the Company's commitments.

	Amount of Commitment Expiration Per Period		
	Total Amount Committed	One year or less	Over one year
(dollars in thousands)			
Unused loan commitments	\$1,180,017	\$ 740,014	\$ 440,003
Commercial letters of credit	62	62	0
Standby letters of credit	52,500	43,686	8,814
Total commitments and letters of credit	<u>\$1,232,579</u>	<u>\$ 783,762</u>	<u>\$ 448,817</u>

## Interest Rate Risk

Interest rate risk is the risk that the estimated fair value of the Company's assets, liabilities and derivative financial instruments will decline as a result of changes in interest rates or financial market volatility, or that net income will be significantly reduced by interest rate changes.

Interest rate risk represents the Company's primary market risk exposure. The Company does not have material exposure to foreign currency exchange risk and does not maintain a trading portfolio. The Corporate Risk Committee of the Board of Directors annually reviews and approves the ALCO policy and the Derivatives and Hedging policy used to manage interest rate risk. These policies set guidelines for balance sheet structure, which are designed to protect the Company from the impact that interest rate changes could have on net income, but it does not necessarily indicate the effect on future net interest income. Given the Company's mix of interest bearing liabilities and interest earning assets on December 31, 2014 and using changes in the interest rate environment over a one-year period, the net interest margin could be expected to decline in a falling interest rate environment and increase in a rising interest rate environment. Earnings can also be affected by the monetary and fiscal policies of the U.S. Government and its agencies, particularly the Federal Reserve Board. During 2014, the Federal Reserve Board's Federal Open Market Committee ("FOMC") kept the target federal funds rate at a range of 0% to .25%. The FOMC began to taper its bond buying in early 2014 and concluded its asset purchase program in October 2014, acknowledging that 'there has been substantial improvement in the outlook for the labor market since the program began. The FOMC also changed its long-standing forward guidance on short-term interest rates, which had pegged the unemployment rate threshold for considering a change at 6.5 percent. The FOMC said it will evaluate progress toward its economic objectives using a wide array of indicators (including measures of labor market conditions, indicators of inflation pressures / inflation expectations and readings on financial developments). The FOMC has stressed that any decision will be data-dependent. Near the end of 2014, the FOMC also added to its guidance, stating that 'it can be patient in beginning to normalize the stance of monetary policy. Due to the low rate environment and competitive markets for commercial loan pricing, there was a reduction in the Company's yield on earning assets of 7 basis points. This decrease in the yield on earning assets was entirely offset by a decrease in the rates paid on deposit accounts and purchased funds. The rate paid on deposit accounts and purchased funds decreased 14 basis points for 2014. While other factors affected the net margin in 2014, including the increase in assets, the combined result of the decreases in the yield on earning assets and in the rates paid on deposits and purchased funds led to an increase in the net margin from 3.26% for 2013 to 3.32% for 2014. Future changes in the net interest margin will be dependent upon multiple factors including further actions by the FOMC during 2015 in response to economic conditions, competitive pressures in the various markets served, and changes in the structure of the balance sheet as a result of changes in customer demands for products and services.

The Company utilizes computer modeling software to stress test the balance sheet under a wide variety of interest rate scenarios. The model quantifies the income impact of changes in customer preference for products, basis risk between the assets and the liabilities that support them and the risk inherent in different yield curves, as well as other factors. The ALCO committee reviews these possible outcomes and makes loan, investment and deposit decisions that maintain reasonable balance sheet structure in light of potential interest rate movements. It is the objective of the Company to monitor and manage risk exposure to net interest income caused by changes in interest rates. It is the goal of the Company's asset/liability function to provide optimum and stable net interest income. To accomplish this, management uses two asset liability tools. GAP/Interest Rate Sensitivity Reports and Net Interest Income Simulation Modeling are constructed, presented and monitored monthly. Management believes that the Company's liquidity and interest sensitivity position at December 31, 2014, remained adequate to meet the Company's primary goal of achieving optimum interest margins while avoiding undue interest rate risk. The Company places its greatest credence in net interest income simulation modeling. The GAP/Interest Rate Sensitivity Report is believed by the Company's management to have two major shortfalls. The GAP/Interest Rate Sensitivity Report fails to precisely gauge how often an interest rate sensitive product reprices, nor is it able to measure the magnitude of potential future rate movements. Although management does not consider GAP ratios in planning, the information can be used in a general fashion to look at asset and liability mismatches. The Company's cumulative repricing GAP ratio as of December 31, 2014 for the next 12 months using a scenario in which interest rates remained unchanged was a negative 3.44% of earning assets.

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

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

Results for the base, falling 100 basis points, rising 100 basis points, and rising 300 basis points interest rate scenarios are listed below based upon the Company's rate sensitive assets and liabilities at December 31, 2014. The net interest income shown represents cumulative net interest income over a twelve-month time horizon. Balance sheet assumptions used for the base scenario are the same for the rising and falling simulations.

	Base	Falling (100 Basis Points)	Rising (100 Basis Points)	Rising (300 Basis Points)
<u>(dollars in thousands)</u>				
Net interest income	\$ 106,130	\$ 96,092	\$ 112,927	\$ 129,297
Variance from Base		\$ (10,038)	\$ 6,797	\$ 23,167
Percent of change from Base		(9.46) %	6.40 %	21.83 %

The effects of price changes and inflation can vary substantially for most financial institutions. While management believes that inflation affects the growth of total assets, it believes that it is difficult to assess the overall impact. Management believes this to be the case due to the fact that generally neither the timing nor the magnitude of the inflationary changes in the consumer price index ("CPI") coincides with changes in interest rates. The price of one or more of the components of the CPI may fluctuate considerably and thereby influence the overall CPI without having a corresponding effect on interest rates or upon the cost of those goods and services normally purchased by the Company. In years of high inflation and high interest rates, intermediate and long-term interest rates tend to increase, thereby adversely impacting the market values of investment securities, mortgage loans and other long-term fixed rate loans. In addition, higher short-term interest rates caused by inflation tend to increase the cost of funds. In other years, the reverse situation may occur.

## ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

### Market Risk

The Company's primary market risk exposure is interest rate risk. The Company does not have a material exposure to foreign currency exchange rate risk and does not maintain a trading portfolio.

The following table provides information regarding the Company's financial instruments that are sensitive to changes in interest rates. For loans, securities and liabilities with contractual maturities, the table presents principal cash flows and related weighted-average interest rates by contractual maturities, as well as the Company's assumptions relative to the impact of interest-rate fluctuations on the prepayment of residential and home equity loans and mortgage-backed securities. Core deposits such as noninterest bearing deposits, interest-bearing checking, savings and money market deposits that have no contractual maturity, are shown based on historical experience that indicates some portion of the balances are retained over time. Weighted-average variable rates are based upon rates existing at the reporting date. For more information on the Company's interest rate sensitivity see the Interest Rate Risk discussion in Item 7. above.

	2014							
	Principal/Notional Amount Maturing in:							
(dollars in thousands)	Year 1	Year 2	Year 3	Year 4	Year 5	Thereafter	Total	Fair Value 12/31/2014
<b>Rate sensitive assets:</b>								
Fixed interest rate loans	\$ 333,368	\$ 206,657	\$ 172,915	\$ 110,013	\$ 56,696	\$ 49,786	\$ 929,435	\$ 920,831
Average interest rate	4.55%	4.54%	4.41%	4.47%	4.53%	4.75%		
Variable interest rate loans	\$ 952,816	\$ 293,736	\$ 143,631	\$ 116,818	\$ 97,855	\$ 228,029	\$ 1,832,885	\$ 1,824,198
Average interest rate	3.38%	3.21%	3.28%	3.47%	3.07%	3.52%		
Total loans	\$ 1,286,184	\$ 500,393	\$ 316,546	\$ 226,831	\$ 154,551	\$ 277,815	\$ 2,762,320	\$ 2,745,029
Average interest rate	3.68%	3.76%	3.90%	3.95%	3.60%	3.74%		
Fixed interest rate securities	\$ 123,950	\$ 84,363	\$ 58,737	\$ 51,015	\$ 47,255	\$ 101,629	\$ 466,949	\$ 475,879
Average interest rate	2.82%	2.65%	2.42%	2.45%	2.43%	2.53%		
Variable interest rate securities	\$ 14	\$ 9	\$ 5	\$ 2	\$ 1	\$ 1	\$ 32	\$ 32
Average interest rate	5.78%	5.82%	6.07%	6.26%	6.53%	8.20%		
Other interest-bearing assets	\$ 15,257	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 15,257	\$ 15,257
Average interest rate	0.30%	0.00%	0.00%	0.00%	0.00%	0.00%		
Total earning assets	\$ 1,425,405	\$ 584,765	\$ 375,288	\$ 277,848	\$ 201,807	\$ 379,445	\$ 3,244,558	\$ 3,236,197
Average interest rate	3.57%	3.60%	3.67%	3.68%	3.33%	3.42%		
<b>Rate sensitive liabilities:</b>								
Noninterest bearing checking	\$ 24,930	\$ 0	\$ 0	\$ 0	\$ 0	\$ 554,565	\$ 579,495	\$ 579,495
Average interest rate	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%		
Savings & interest bearing checking	\$ 61,019	\$ 19,847	\$ 25,642	\$ 267,912	\$ 12,414	\$ 1,036,201	\$ 1,423,035	\$ 1,423,035
Average interest rate	0.21%	0.14%	0.23%	0.46%	0.10%	0.38%		
Time deposits	\$ 542,981	\$ 193,806	\$ 86,276	\$ 14,443	\$ 32,751	\$ 333	\$ 870,590	\$ 876,953
Average interest rate	0.84%	1.33%	1.18%	1.13%	1.81%	0.92%		
Total deposits	\$ 628,930	\$ 213,653	\$ 111,918	\$ 282,355	\$ 45,165	\$ 1,591,099	\$ 2,873,120	\$ 2,879,483
Average interest rate	0.74%	1.22%	0.96%	0.49%	1.34%	0.25%		
Fixed interest rate borrowings	\$ 500	\$ 0	\$ 0	\$ 35	\$ 0	\$ 0	\$ 535	\$ 540
Average interest rate	0.46%	0.00%	0.00%	6.24%	0.00%	0.00%		
Variable interest rate borrowings	\$ 115,983	\$ 10,981	\$ 10,981	\$ 10,981	\$ 10,981	\$ 30,928	\$ 190,835	\$ 191,120
Average interest rate	0.42%	0.18%	0.18%	0.18%	0.18%	3.31%		
Total funds	\$ 745,413	\$ 224,634	\$ 122,899	\$ 293,371	\$ 56,146	\$ 1,622,027	\$ 3,064,490	\$ 3,071,144
Average interest rate	0.69%	1.17%	0.89%	0.48%	1.11%	0.30%		

## ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Stockholders and Board of Directors  
Lakeland Financial Corporation  
Warsaw, Indiana

We have audited the accompanying consolidated balance sheets of Lakeland Financial Corporation as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2014. We also have audited Lakeland Financial Corporation's internal control over financial reporting as of December 31, 2014, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Lakeland Financial Corporation's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the effectiveness of the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lakeland Financial Corporation as of December 31, 2014 and 2013, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2014 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, Lakeland Financial Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2014, based on criteria established in the 2013 *Internal Control—Integrated Framework* issued by COSO.

Crowe Horwath LLP

Indianapolis, Indiana  
March 4, 2015

**CONSOLIDATED BALANCE SHEETS (in thousands except share data)**

<b>December 31</b>	<b>2014</b>	<b>2013</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 75,381	\$ 55,727
Short-term investments	15,257	7,378
Total cash and cash equivalents	90,638	63,105
Securities available for sale (carried at fair value)	475,911	468,967
Real estate mortgage loans held for sale	1,585	1,778
Loans, net of allowance for loan losses of \$46,262 and \$48,797	2,716,058	2,486,301
Land, premises and equipment, net	41,983	39,335
Bank owned life insurance	66,612	62,883
Federal Reserve and Federal Home Loan Bank Stock	9,413	10,732
Accrued interest receivable	8,662	8,577
Goodwill	4,970	4,970
Other assets	27,452	29,116
Total assets	<u>\$ 3,443,284</u>	<u>\$ 3,175,764</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Noninterest bearing deposits	\$ 579,495	\$ 479,606
Interest bearing deposits	2,293,625	2,066,462
Total deposits	2,873,120	2,546,068
Short-term borrowings		
Federal funds purchased	500	11,000
Securities sold under agreements to repurchase	54,907	104,876
Other short-term borrowings	105,000	146,000
Total short-term borrowings	160,407	261,876
Long-term borrowings	35	37
Subordinated debentures	30,928	30,928
Accrued interest payable	2,946	2,918
Other liabilities	14,463	11,973
Total liabilities	3,081,899	2,853,800
Commitments, off-balance sheet risks and contingencies (Notes 1 and 18)		
<b>STOCKHOLDERS' EQUITY</b>		
Common stock: 90,000,000 shares authorized, no par value		
16,550,324 shares issued and 16,465,621 outstanding as of December 31, 2014		
16,475,716 shares issued and 16,377,449 outstanding as of December 31, 2013	96,121	93,249
Retained earnings	263,345	233,108
Accumulated other comprehensive income (loss)	3,830	(2,494)
Treasury stock, at cost (2014 - 84,703 shares, 2013 - 98,267 shares)	(2,000)	(1,988)
Total stockholders' equity	361,296	321,875
Noncontrolling interest	89	89
Total equity	361,385	321,964
Total liabilities and stockholders' equity	<u>\$ 3,443,284</u>	<u>\$ 3,175,764</u>

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

**CONSOLIDATED STATEMENTS OF INCOME (in thousands except share and per share data)**

<b>Years Ended December 31</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
<b>NET INTEREST INCOME</b>			
Interest and fees on loans			
Taxable	\$ 105,317	\$ 98,757	\$ 102,749
Tax exempt	470	402	441
Interest and dividends on securities			
Taxable	8,176	5,398	8,311
Tax exempt	3,281	3,124	2,800
Interest on short-term investments	44	55	68
Total interest income	<u>117,288</u>	<u>107,736</u>	<u>114,369</u>
Interest on deposits	13,568	15,745	24,667
Interest on borrowings			
Short-term	388	490	441
Long-term	1,029	1,062	1,590
Total interest expense	<u>14,985</u>	<u>17,297</u>	<u>26,698</u>
<b>NET INTEREST INCOME</b> .....	<b>102,303</b>	<b>90,439</b>	<b>87,671</b>
Provision for loan losses	<u>0</u>	<u>0</u>	<u>2,549</u>
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b> .....	<b>102,303</b>	<b>90,439</b>	<b>85,122</b>
<b>NONINTEREST INCOME</b>			
Wealth advisory fees	4,072	3,847	3,823
Investment brokerage fees	3,370	4,736	3,061
Service charges on deposit accounts	9,495	8,806	8,015
Loan, insurance and service fees	6,799	6,404	5,876
Merchant card fee income	1,549	1,265	1,130
Bank owned life insurance income	1,393	1,653	973
Other income	2,978	2,488	1,174
Mortgage banking income	621	1,431	2,546
Net securities gains (losses)	(224)	107	(376)
Other-than-temporary impairment loss on available for sale securities:			
Total impairment losses recognized on securities	0	0	(1,026)
Loss recognized in other comprehensive income	0	0	0
Net impairment loss recognized in earnings	<u>0</u>	<u>0</u>	<u>(1,026)</u>
Total noninterest income .....	<b>30,053</b>	<b>30,737</b>	<b>25,196</b>
<b>NONINTEREST EXPENSE</b>			
Salaries and employee benefits	38,648	37,176	34,539
Net occupancy expense	3,776	3,376	3,296
Equipment costs	3,231	2,831	2,572
Data processing fees and supplies	6,171	5,635	4,378
Corporate and business development	3,073	2,734	2,305
FDIC insurance and other regulatory fees	1,936	1,855	2,097
Professional fees	2,990	3,171	2,453
Other expense	6,341	6,000	6,102
Total noninterest expense .....	<u>66,166</u>	<u>62,778</u>	<u>57,742</u>
<b>INCOME BEFORE INCOME TAX EXPENSE</b>	<b>66,190</b>	<b>58,398</b>	<b>52,576</b>
Income tax expense	22,385	19,559	17,182
<b>NET INCOME</b> .....	<b>\$ 43,805</b>	<b>\$ 38,839</b>	<b>\$ 35,394</b>
<b>BASIC WEIGHTED AVERAGE COMMON SHARES</b>	<b>16,535,530</b>	<b>16,436,131</b>	<b>16,323,870</b>
<b>BASIC EARNINGS PER COMMON SHARE</b>	<b>\$ 2.65</b>	<b>\$ 2.36</b>	<b>\$ 2.17</b>
<b>DILUTED WEIGHTED AVERAGE COMMON SHARES</b>	<b>16,781,455</b>	<b>16,634,338</b>	<b>16,482,937</b>
<b>DILUTED EARNINGS PER COMMON SHARE</b>	<b>\$ 2.61</b>	<b>\$ 2.33</b>	<b>\$ 2.15</b>

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

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (in thousands)**

**Years Ended December 31**

	<b>2014</b>	<b>2013</b>	<b>2012</b>
Net income	<b>\$ 43,805</b>	<b>\$ 38,839</b>	<b>\$ 35,394</b>
Other comprehensive income			
Change in securities available for sale:			
Unrealized holding gain (loss) on securities available for sale arising during the period	<b>10,739</b>	<b>(14,119)</b>	<b>(820)</b>
Reclassification adjustment for (gains)/losses included in net income	<b>224</b>	<b>(107)</b>	<b>376</b>
Reclassification adjustment for other than temporary impairment	<b>0</b>	<b>0</b>	<b>1,026</b>
Net securities gain (loss) activity during the period	<b>10,963</b>	<b>(14,226)</b>	<b>582</b>
Tax effect	<b>(4,358)</b>	<b>5,571</b>	<b>(230)</b>
Net of tax amount	<b>6,605</b>	<b>(8,655)</b>	<b>352</b>
Defined benefit pension plans:			
Net gain (loss) on defined benefit pension plans	<b>(654)</b>	<b>550</b>	<b>112</b>
Amortization of net actuarial loss	<b>197</b>	<b>244</b>	<b>220</b>
Net gain (loss) activity during the period	<b>(457)</b>	<b>794</b>	<b>332</b>
Tax effect	<b>176</b>	<b>(322)</b>	<b>(134)</b>
Net of tax amount	<b>(281)</b>	<b>472</b>	<b>198</b>
Total other comprehensive income (loss), net of tax	<b>6,324</b>	<b>(8,183)</b>	<b>550</b>
Comprehensive income	<b>\$ 50,129</b>	<b>\$ 30,656</b>	<b>\$ 35,944</b>

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



**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (in thousands except share and per share data)**

	Common Stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
	Shares	Amount				
Balance at January 1, 2012	16,145,772	\$ 87,380	\$ 181,903	\$ 5,139	\$(1,222)	\$ 273,200
Net income			35,394			35,394
Other comprehensive income (loss), net of tax				550		550
Comprehensive income (loss)						35,944
Cash dividends declared, \$0.835 per share			(13,643)			(13,643)
Treasury shares purchased under deferred directors' plan	(15,864)	421			(421)	0
Stock activity under equity incentive plans	160,228	894				894
Stock based compensation expense		1,344				1,344
Balance at December 31, 2012	16,290,136	90,039	203,654	5,689	(1,643)	297,739
Net income			38,839			38,839
Other comprehensive income (loss), net of tax				(8,183)		(8,183)
Comprehensive income (loss)						30,656
Cash dividends declared, \$0.57 per share			(9,385)			(9,385)
Treasury shares purchased under deferred directors' plan	(14,174)	399			(399)	0
Treasury stock sold and distributed under deferred directors' plan	3,018	(54)			54	0
Stock activity under equity incentive plans	98,469	903				903
Stock based compensation expense		1,962				1,962
Balance at December 31, 2013	16,377,449	93,249	233,108	(2,494)	(1,988)	321,875
Net income			43,805			43,805
Other comprehensive income (loss), net of tax				6,324		6,324
Comprehensive income (loss)						50,129
Cash dividends declared, \$0.82 per share			(13,568)			(13,568)
Treasury shares purchased under deferred directors' plan	(11,467)	444			(444)	0
Treasury stock sold and distributed under deferred directors' plan	25,031	(432)			432	0
Stock activity under equity incentive plans	74,608	57				57
Stock based compensation expense		2,803				2,803
Balance at December 31, 2014	16,465,621	\$ 96,121	\$ 263,345	\$ 3,830	\$(2,000)	\$ 361,296

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

**CONSOLIDATED STATEMENTS OF CASH FLOWS (in thousands)**

<b>Years Ended December 31</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Cash flows from operating activities:			
Net income	\$ 43,805	\$ 38,839	\$ 35,394
Adjustments to reconcile net income to net cash from operating activities:			
Depreciation	3,412	2,993	2,790
Provision for loan losses	0	0	2,549
(Gain) Loss on sale and write down of other real estate owned	(159)	(10)	(99)
Amortization of intangible assets	0	47	52
Amortization of loan servicing rights	526	585	728
Net change in loan servicing rights valuation allowance	0	(42)	(66)
Loans originated for sale	(55,107)	(81,671)	(119,647)
Net gain on sales of loans	(1,202)	(2,561)	(2,805)
Proceeds from sale of loans	56,065	91,016	115,163
Net loss on sale of premises and equipment	24	15	3
Net (gain) loss on securities available for sale	224	(107)	376
Impairment on available for sale securities	0	0	1,026
Net securities amortization	5,420	8,765	8,209
Stock based compensation expense	2,803	1,962	1,344
Earnings on life insurance	(1,393)	(1,631)	(955)
Tax benefit of stock option exercises	(50)	(146)	(112)
Net change:			
Interest receivable and other assets	(1,368)	5,860	5,057
Interest payable and other liabilities	2,700	(949)	1,585
Total adjustments	11,895	24,126	15,198
Net cash from operating activities	55,700	62,965	50,592
Cash flows from investing activities:			
Proceeds from sale of securities available for sale	13,766	29,995	27,855
Proceeds from maturities, calls and principal paydowns of securities available for sale	57,970	112,624	125,107
Purchases of securities available for sale	(73,361)	(167,450)	(161,621)
Purchase of life insurance	(3,181)	(140)	(20,227)
Proceeds from loans sold to others	4,307	0	0
Net increase in total loans	(235,165)	(280,717)	(28,728)
Proceeds from sales of land, premises and equipment	232	1	2
Purchases of land, premises and equipment	(6,565)	(7,504)	(2,899)
Proceeds from sales of other real estate owned	1,426	671	1,791
Proceeds from life insurance	778	0	0
Net cash from investing activities	(239,793)	(312,520)	(58,720)
Cash flows from financing activities:			
Net increase/(decrease) in total deposits	327,052	(35,688)	169,060
Net increase/(decrease) in short-term borrowings	(101,469)	139,993	(20,107)
Payments on long-term borrowings	(2)	(15,001)	(2)
Common dividends paid	(13,555)	(9,372)	(13,630)
Preferred dividends paid	(13)	(13)	(13)
Proceeds related to equity incentive plans	57	903	894
Purchase of treasury stock	(444)	(399)	(421)
Net cash from financing activities	211,626	80,423	135,781
Net change in cash and cash equivalents	27,533	(169,132)	127,653
Cash and cash equivalents at beginning of the year	63,105	232,237	104,584
Cash and cash equivalents at end of the year	\$ 90,638	\$ 63,105	\$ 232,237
Cash paid during the year for:			
Interest	\$ 14,957	\$ 19,137	\$ 27,514
Income taxes	21,185	17,280	12,728
Supplemental non-cash disclosures:			
Loans transferred to other real estate	1,101	491	413
Property transferred to held for sale	249	0	0

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

## **NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **Nature of Operations and Principles of Consolidation:**

The consolidated financial statements include Lakeland Financial Corporation (the “Holding Company”) and its wholly-owned subsidiaries, Lake City Bank (the “Bank”) and LCB Risk Management, Inc., together referred to as (the “Company”). On December 18, 2006, LCB Investments II, Inc. was formed as a wholly owned subsidiary of the Bank incorporated in Nevada to manage a portion of the Bank’s investment portfolio beginning in 2007. On December 21, 2006, LCB Funding, Inc., a real estate investment trust incorporated in Maryland, was formed as a wholly owned subsidiary of LCB Investments II, Inc. On December 28, 2012, LCB Risk Management, Inc., a captive insurance company incorporated in Nevada, was formed as a wholly owned subsidiary of the Holding Company. All intercompany transactions and balances are eliminated in consolidation.

The Company provides financial services through the Bank, a full-service commercial bank with 46 branch offices in fourteen counties in Northern and Central Indiana. The Company provides commercial, retail, trust and investment services to its customers. Commercial products include commercial loans and technology-driven solutions to meet commercial customers’ treasury management needs such as internet business banking and on-line treasury management services. Retail banking clients are provided a wide array of traditional retail banking services, including lending, deposit and investment services. Retail lending programs are focused on mortgage loans, home equity lines of credit and traditional retail installment loans. The Company provides credit card services to retail and commercial customers through its retail card program and merchant processing activity. The Company provides wealth advisory and trust clients with traditional personal and corporate trust services. The Company also provides retail brokerage services, including an array of financial and investment products such as annuities and life insurance. Other financial instruments, which represent potential concentrations of credit risk, include deposit accounts in other financial institutions.

### **Use of Estimates:**

To prepare financial statements in conformity with U.S. generally accepted accounting principles (“GAAP”), management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and the disclosures provided and future results could differ

### **Cash Flows:**

Cash and cash equivalents include cash, demand deposits in other financial institutions and short-term investments with maturities of 90 days or less. Cash flows are reported net for customer loan and deposit transactions, and short-term borrowings.

### **Securities:**

Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income (loss), net of tax. Trading securities are bought for sale in the near term and are carried at fair value, with changes in unrealized holding gains and losses included in income. Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity.

Purchase premiums or discounts are recognized in interest income using the interest method over the terms of the securities or overestimated lives for mortgage-backed securities. Gains and losses on sales are based on the amortized cost of the security sold and recorded on the trade date. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) other-than-temporary impairment (OTTI) related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

### Real Estate Mortgage Loans Held for Sale:

Loans held for sale are reported at the lower of cost or fair value on an aggregate basis. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Loan sales occur on the delivery date agreed to in the relevant commitment agreement. The Company retains servicing on the majority of loans sold. The carrying value of loans sold is reduced by the amount allocated to the servicing right. The gain or loss on the sale of loans is the difference between the carrying value of the loans sold and the funds received from the sale.

### Loans:

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the loan term. All classes of commercial and industrial, commercial real estate and multi-family residential, agri-business and agricultural, other commercial and consumer 1-4 family mortgage loans for which collateral is insufficient to cover all principal and accrued interest are reclassified as nonaccrual loans, on or before the date when the loan becomes 90 days delinquent. When a loan is classified as a nonaccrual loan, interest on the loan is no longer accrued, all unpaid accrued interest is reversed and interest income is subsequently recorded on the cash-basis or cost-recovery method. Accrual status is resumed when all contractually due payments are brought current and future payments are reasonably assured. Other consumer loans are not placed on a nonaccrual status since these loans are charged-off when they have been delinquent from 90 to 180 days, and when the related collateral, if any, is not sufficient to offset the indebtedness. Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The recorded investment in loans is the loan balance plus unamortized net deferred loan costs less unamortized net deferred loan fees. The total amount of accrued interest on loans as of both December 31, 2014 and 2013 was \$6.2 million.

### Allowance for Loan Losses:

The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the inability to fully collect a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The Company has an established process to determine the adequacy of the allowance for loan losses that generally includes consideration of the following factors: changes in the nature and volume of the loan portfolio, overall portfolio quality and current economic conditions that may affect the borrowers' ability to repay. Consideration is not limited to these factors, although they represent the most commonly cited factors. This evaluation is inherently subjective, as it requires estimates that are susceptible to significant revision as more information becomes available or as future events change. 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.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. A detailed analysis is performed on loans that are classified but determined not to be impaired which incorporates probability of default with a loss given default scenario to develop non-specific allocations for such loan pools. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent three years. This actual loss experience is supplemented with other environmental factors based on the risks present for each portfolio segment. These factors include consideration of the following: levels of, and trends in, delinquencies and impaired loans; levels of, and trends in, charge-offs and recoveries over the historical three and five year periods; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedure, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: commercial and industrial, commercial real estate and multi-family residential, agri-business and agricultural, other commercial, consumer 1-4 family mortgage and other consumer. The risk characteristics of each of the identified portfolio segments are as follows:

Commercial and Industrial – Borrowers may be subject to industry conditions including decreases in product demand; increases in material or other production costs that cannot be immediately recaptured in the sales or distribution cycle; interest rate increases that could have an adverse impact on profitability; non-payment of credit that has been extended under normal vendor terms for goods sold or services; and interruption related to the importing or exporting of production materials or sold products.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Commercial Real Estate and Multi-Family Residential – Borrowers may be subject to potential adverse market conditions that cause a decrease in market value or lease rates; the potential for environmental impairment from events occurring on subject or neighboring properties; and obsolescence in location or function. Multi-Family Residential is also subject to adverse market conditions associated with a change in governmental or personal funding sources for tenants; over supply of units in a specific region; a shift in population; and reputational risks. Construction and Land Development risks include slower absorption than anticipated on speculative projects; deterioration in market conditions that may impact a project's value; unforeseen costs not considered in the original construction budget; or any other factors that may impact the completion or success of the project.

Agri-business and Agricultural – Borrowers may be subject to adverse market or weather conditions including changes in local or foreign demand; lower yields than anticipated; political or other impact on storage, distribution or use; and exposure to increasing commodity prices which result in higher production, distribution or exporting costs.

Other Commercial – Borrowers may be subject to the uninterrupted flow of funds to states and other political subdivisions for the purpose of debt repayments on loans held by the Bank.

Consumer 1-4 Family Mortgage – Borrowers may be subject to adverse employment conditions in the local economy leading to increased default rates; decreased market values from oversupply in a geographic area; and impact to borrowers' ability to maintain payments in the event of incremental rate increases on adjustable rate mortgages.

Other Consumer – Borrowers may be subject to adverse employment conditions in the local economy which may lead to higher default rates; and decreases in the value of underlying collateral.

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans, for which the terms have been modified and a concession has been granted for borrowers experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired and may be either accruing or non-accruing. Nonaccrual troubled debt restructurings follow the same policy as described above for other loans. Impairment for troubled debt restructurings is measured at the present value of estimated future cash flows using the loan's effective rate at inception or at discounted collateral value for collateral dependent loans. Impairment is evaluated individually or in total for smaller-balance loans of similar nature such as all classes of consumer 1-4 family and other consumer loans, and individually for all classes of commercial and industrial, commercial real estate and multi-family, agri-business and agricultural and other commercial loans. The Company analyzes commercial loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for Special Mention, Substandard and Doubtful grade loans and annually on Pass grade loans over \$150,000. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral less anticipated costs to sell if repayment is expected solely from the collateral. All classes of commercial and industrial, commercial real estate and multifamily residential, agri-business and agricultural, other commercial and consumer 1-4 family mortgage loans that become delinquent beyond 90 days are analyzed and a charge-off is taken when it is determined that the underlying collateral, if any, is not sufficient to offset the indebtedness.

Troubled debt restructured loans are considered for removal from troubled debt restructuring status in the year following modification or at time of subsequent restructuring for loans with cumulative principal forgiveness if the interest rate is considered a market rate at the time of modification and it has been performing according to the terms of the modification for a reasonable period of time long enough to observe an ability to repay under the modified terms. If removed from troubled debt restructuring status, the loan continues to be evaluated for impairment with either the present value of estimated future cash flows using the loan's effective rate at inception or at discounted collateral value for collateral dependent loans. In addition, troubled debt restructured loans with subsequent modifications that do not have cumulative principal forgiveness are considered for removal from troubled debt restructuring status at the time of the subsequent modification if the following circumstances exist: (1) at the time of the subsequent restructuring, the borrower is not experiencing financial difficulties; (2) under the terms of the subsequent restructuring agreement no concession has been granted to the borrower; and (3) the subsequent restructuring agreement includes market terms that are no less favorable than those that would be offered for comparable new debt. Upon meeting these criteria, the loan is no longer individually evaluated for impairment and is no longer disclosed as a troubled debt restructuring.

## **NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

### **Investments in Limited Partnerships:**

The Company enters into and invests in limited partnerships in order to invest in affordable housing projects for the primary purpose of obtaining available tax benefits. The Company is a limited partner in these investments and, as such, the Company is not involved in the management or operation of such investments. These investments are accounted for using the equity method of accounting. Under the equity method of accounting, the Company records its share of the partnership's earnings or losses in its income statement and adjusts the carrying amount of the investments on the consolidated balance sheet. These investments are evaluated for impairment when events indicate the carrying amount may not be recoverable. The investments recorded at December 31, 2014 and 2013 were \$3.7 million and \$1.9 million, respectively and are included with other assets in the consolidated balance sheet. The Company also has a commitment to fund an additional \$1.0 million in one of the limited partnerships, which is included with other liabilities in the consolidated balance sheet.

### **Foreclosed Assets:**

Assets acquired through loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines, a valuation allowance is recorded through expense. Costs incurred after acquisition are expensed. At December 31, 2014 and 2013, the balance of other real estate owned was \$284,000 and \$469,000 and are included with other assets on the consolidated balance sheet.

### **Land, Premises and Equipment:**

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the useful lives of the assets. Premises assets have useful lives between 5 and 40 years. Equipment assets have useful lives between 3 and 7 years.

### **Loan Servicing Rights:**

Servicing rights are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in mortgage banking income. Fair value is based on a valuation model that calculates the present value of estimated future net servicing income. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as loan type, term and interest rate. Any impairment of a grouping is reported as a valuation allowance, to the extent that fair value is less than the carrying amount. If the Company later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. Changes in the valuation allowance are reported with mortgage banking income on the income statement. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

The carrying value of mortgage servicing rights was \$2.4 million and \$2.5 million as of December 31, 2014 and 2013.

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans were \$330.3 million and \$332.8 million at December 31, 2014 and 2013. Custodial escrow balances maintained in connection with serviced loans were \$1.3 million at year end 2014 and 2013.

Servicing fee income/(loss), which is included in loan, insurance and service fees on the income statement, is recorded for fees earned for servicing loans. Fees earned for servicing loans are based on a contractual percentage of the outstanding principal amount of the loan and are recorded as income when earned. The amortization of servicing rights is netted against mortgage banking income. Servicing fees totaled \$930,000, \$816,000 and \$765,000 for the years ended December 31, 2014, 2013 and 2012, respectively. Late fees and ancillary fees related to loan servicing are not material.

### **Transfers of Financial Assets:**

Transfers of financial assets are accounted for as sales, when control over the assets has been relinquished. Control over transferred assets is deemed to be surrendered when the assets have been isolated from the Company, the transferee obtains the right

## **NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

(free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### **Mortgage Banking Derivatives:**

Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free standing derivatives. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. The Company enters into forward commitments for the future delivery of mortgage loans when interest rate locks are entered into, in order to hedge the change in interest rates resulting from its commitments to fund the loans. Changes in fair values of these derivatives are included in mortgage banking income.

### **Interest Rate Swap Derivatives:**

The Company offers a derivative product to certain creditworthy commercial banking customers. This product allows the commercial banking customers to enter into an agreement with the Company to swap a variable rate loan to a fixed rate. These derivative products are designed to reduce, eliminate or modify the borrower's interest rate exposure. The extension of credit incurred in connection with these derivative products is subject to the same approval and underwriting standards as traditional credit products. The Company limits its risk exposure by simultaneously entering into a similar, offsetting swap agreement with a separate, well-capitalized and highly rated counterparty previously approved by the Company's Asset Liability Committee. By using these interest rate swap arrangements, the Company is also better insulated from the interest rate risk associated with underwriting fixed-rate loans and is better able to meet customer demand for fixed rate loans. These derivative contracts are not designated against specific assets or liabilities and, therefore, do not qualify for hedge accounting. The derivatives are recorded as assets and liabilities on the balance sheet at fair value with changes in fair value recorded in other income for both the commercial banking customer swaps and the related offsetting swaps.

The notional amount of the interest rate swaps at December 31, 2014 and 2013 was \$162.8 million and \$109.5 million for both the swaps between the customer and the Company and the Company and the counterparty. The fair value of the interest rate swap asset was \$1.2 million and \$627,000 and the fair value of the interest rate swap liability was \$1.2 million and \$592,000, respectively at December 31, 2014 and 2013.

### **Bank Owned Life Insurance:**

At December 31, 2014 and 2013, the Company owned \$64.7 million and \$61.2 million of life insurance policies on certain officers to provide a life insurance benefit for these officers. At December 31, 2014 and 2013 the Company also owned \$1.9 million and \$1.7 million of variable life insurance on certain officers related to a deferred compensation plan. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, i.e., the cash surrender value adjusted for other changes or other amounts due that are probable at settlement.

### **Goodwill and Other Intangible Assets:**

All goodwill on the Company's consolidated balance sheet resulted from business combinations prior to January 1, 2009 and represents the excess of the purchase price over the fair value of acquired tangible assets and liabilities and identifiable intangible assets. Goodwill is not amortized, but assessed at least annually for impairment and any such impairment will be recognized in the period identified.

### **FHLB and Federal Reserve Bank Stock:**

FHLB and Federal Reserve Bank stock are carried at cost in other assets, classified as a restricted security and are periodically evaluated for impairment based on ultimate recoverability of par value. Both cash and stock dividends are reported as income.

### **Repurchase Agreements:**

Substantially all repurchase agreement liabilities represent amounts advanced by various customers. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

## **NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

### **Long-term Assets:**

Premises and equipment, and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

### **Benefit Plans:**

The Company has a noncontributory defined benefit pension plan, which covered substantially all employees until the plan was frozen effective April 1, 2000. Funding of the plan equals or exceeds the minimum funding requirement determined by the actuary. Pension expense is the net of interest cost, return on plan assets and amortization of gains and losses not immediately recognized. Benefits are based on years of service and compensation levels. The Company maintains a 401(k) profit sharing plan for all employees meeting certain age and service requirements. The Company contributions are based upon the percentage of budgeted net income earned during the year. An employee deferred compensation plan is available to certain employees with returns based on investments in mutual funds. The Company maintains a directors' deferred compensation plan. Effective January 1, 2003, the directors' deferred compensation plan was amended to restrict the deferral to be in stock only and deferred directors' fees are included in equity. The Company acquires shares on the open market and records such shares as treasury stock.

### **Stock Compensation:**

Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant adjusted for the present value of expected dividends is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. Certain of the restricted stock awards are performance based, as more fully discussed in Note 15.

### **Income Taxes:**

Annual consolidated federal and state income tax returns are filed by the Company. Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Income tax expense is recorded based on the amount of taxes due on its tax return plus net deferred taxes computed based upon the expected future tax consequences of temporary differences between carrying amounts and tax basis of assets and liabilities, using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is more likely of being realized on examination than not. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

### **Off-Balance Sheet Financial Instruments:**

Financial instruments include credit instruments, such as commitments to make loans and standby letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. The fair value of standby letters of credit is recorded as a liability during the commitment period.

### **Earnings Per Common Share:**

Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options, stock awards and warrants. Earnings and dividends per share are restated for all stock splits and dividends through the date of issue of the financial statements. The common shares included in treasury stock for 2014 and 2013 include 84,703 and 98,267 shares, respectively, of Company common stock that has been purchased under the directors' deferred compensation plan described above. Because these shares are held in trust for the participants, they are treated as outstanding when computing the weighted-average common shares outstanding for the calculation of both basic and diluted earnings per share.



## **NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)**

### **Comprehensive Income:**

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale and changes in the funded status of the pension plan, which are also recognized as separate components of equity.

### **Loss Contingencies:**

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there currently are such matters that will have a material effect on the financial statements.

### **Restrictions on Cash:**

The Company was required to have \$9.6 million and \$11.7 million of cash on hand or on deposit with the Federal Reserve Bank to meet regulatory reserve and clearing requirements at year-end 2014 and 2013. The Company met this requirement both years.

### **Dividend Restriction:**

Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Company or by the Company to its stockholders. These restrictions currently pose no practical limit on the ability of the Bank or Company to pay dividends at historical levels.

### **Fair Value of Financial Instruments:**

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 5. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

### **Operating Segments:**

The Company's chief decision-makers monitor and evaluate financial performance on a Company-wide basis. All of the Company's financial service operations are similar and considered by management to be aggregated into one reportable operating segment. While the Company has assigned certain management responsibilities by region and business-line, the Company's chief decision-makers monitor and evaluate financial performance on a Company-wide basis. The majority of the Company's revenue is from the business of banking and the Company's assigned regions have similar economic characteristics, products, services and customers. Accordingly, all of the Company's operations are considered by management to be aggregated in one reportable operating segment.

### **Adoption of New Accounting Standards:**

There were no new accounting standards adopted during the year ended December 31, 2014 that had a material impact on the Company's financial statements.

### **Newly Issued But Not Yet Effective Accounting Standards:**

In May 2014, the FASB issued new accounting guidance related to revenue recognition. This new standard will replace all current U.S. GAAP guidance on this topic and eliminate all industry-specific guidance. The new revenue recognition standard provides a unified model to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration for which the entity expects to be entitled in exchange for those goods or services. This guidance will be effective for the Company beginning January 1, 2017 and can be applied either retrospectively to each period presented or as a cumulative-effect adjustment as of the date of adoption. Management is evaluating the impact of adopting this new accounting standard on our financial statements.

In January 2014, the FASB issued updated guidance related to the accounting for investments in qualified affordable housing projects. The amendment permits reporting entities to make an accounting policy election to account for investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). To

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

qualify for the proportional amortization method, all of the following conditions must be met: (1) It is probable that the tax credits allocable to the investor will be available. (2) The investor does not have the ability to exercise significant influence over the operating and financial policies of the limited liability entity. (3) Substantially all of the projected benefits are from tax credits and other tax benefits (for example, tax benefits generated from the operating losses of the investment). (4) The investor's projected yield based solely on the cash flows from the tax credits and other tax benefits is positive. (5) The investor is a limited liability investor in the limited liability entity for both legal and tax purposes, and the investor's liability is limited to its capital investment. The decision to apply the proportional amortization method of accounting is an accounting policy decision that should be applied consistently to all qualifying affordable housing project investments rather than a decision to be applied to individual investments. For those investments in qualified affordable housing projects not accounted for using the proportional amortization method, the investment should be accounted for as an equity method investment or a cost method investment in accordance with Subtopic 970-323. The new requirements are effective for public companies in fiscal years, and interim periods within those years, beginning after December 15, 2014. Adopting this standard is not expected to have a significant impact on the Company's financial condition or results of operations.

In January 2014, the FASB issued updated guidance related to the reclassification of residential real estate collateralized consumer mortgage loans upon foreclosure. The amendments in this update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The new requirements are effective for public companies in fiscal years, and interim periods within those years, beginning after December 15, 2014. Adopting this standard is not expected to have a significant impact on the Company's financial condition or results of operations.

### Reclassifications:

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

## NOTE 2 – SECURITIES

Information related to the fair value and amortized cost of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) at December 31 is provided in the tables below.

<u>(dollars in thousands)</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gain</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<b>2014</b>				
U.S. Treasury securities	\$ 986	\$ 18	\$ 0	\$ 1,004
Agency residential mortgage-backed securities	366,596	7,178	(1,679)	372,095
State and municipal securities	99,399	3,857	(444)	102,812
Total	<u>\$ 466,981</u>	<u>\$ 11,053</u>	<u>\$ (2,123)</u>	<u>\$ 475,911</u>
<b>2013</b>				
U.S. Treasury securities	\$ 1,001	\$ 16	\$ 0	\$ 1,017
Agency residential mortgage-backed securities	374,611	5,301	(7,935)	371,977
State and municipal securities	95,388	2,597	(2,012)	95,973
Total	<u>\$ 471,000</u>	<u>\$ 7,914</u>	<u>\$ (9,947)</u>	<u>\$ 468,967</u>

There was no other-than-temporary impairment recognized in accumulated other comprehensive income for securities available for sale at December 31, 2014 and 2013.

**NOTE 2 – SECURITIES (continued)**

Information regarding the fair value and amortized cost of available for sale debt securities by maturity as of December 31, 2014 is presented below. Maturity information is based on contractual maturity for all securities other than mortgage-backed securities. Actual maturities of securities may differ from contractual maturities because borrowers may have the right to prepay the obligation without prepayment penalty.

<u>(dollars in thousands)</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 5,405	\$ 5,454
Due after one year through five years	17,382	18,210
Due after five years through ten years	46,504	48,432
Due after ten years	31,094	31,720
	<u>100,385</u>	<u>103,816</u>
Mortgage-backed securities	366,596	372,095
Total debt securities . . . . .	<u>\$ 466,981</u>	<u>\$ 475,911</u>

Security proceeds, gross gains and gross losses for 2014, 2013 and 2012 were as follows:

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Sales of securities available for sale			
Proceeds	\$ 13,766	\$ 29,995	\$ 27,855
Gross gains	3	1,077	824
Gross losses	231	972	1,203

Security proceeds for 2012 are net of other-than-temporary impairment previously recognized on several non-agency mortgage-backed securities sold.

The Company sold four securities with a total book value of \$14.0 million and a total fair value of \$13.8 million during 2014. The remaining gains during 2014 were from calls. The Company sold twelve securities with a total book value of \$29.9 million and a total fair value of \$30.0 million during 2013. The sales included the four remaining non-agency residential mortgage-backed securities. The remaining gains during 2013 were from calls. The Company sold twelve securities with a total book value of \$28.2 million and a total fair value of \$27.9 million during 2012. The sales included nine non-agency residential mortgage-backed securities, including all five on which the Company had previously recognized other-than-temporary impairment. The remaining gains during 2012 were from calls.

Securities with carrying values of \$202.4 million and \$244.3 million were pledged as of December 31, 2014 and 2013, as collateral for deposits of public funds, securities sold under agreements to repurchase, borrowings from the FHLB and for other purposes as permitted or required by law.

## NOTE 2 – SECURITIES (continued)

Information regarding securities with unrealized losses as of December 31, 2014 and 2013 is presented below. The tables distribute the securities between those with unrealized losses for less than twelve months and those with unrealized losses for twelve months or more.

	Less than 12 months		12 months or more		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<u>(dollars in thousands)</u>						
<b>2014</b>						
Agency residential mortgage-backed securities	\$ 33,420	\$ (148)	\$ 102,512	\$ (1,531)	\$ 135,932	\$ (1,679)
State and municipal securities	2,458	(28)	16,391	(416)	18,849	(444)
Total temporarily impaired	<u>\$ 35,878</u>	<u>\$ (176)</u>	<u>\$ 118,903</u>	<u>\$ (1,947)</u>	<u>\$ 154,781</u>	<u>\$ (2,123)</u>
<b>2013</b>						
Agency residential mortgage-backed securities	\$ 177,779	\$ (6,444)	\$ 34,093	\$ (1,491)	\$ 211,872	\$ (7,935)
State and municipal securities	24,610	(1,102)	8,037	(910)	32,647	(2,012)
Total temporarily impaired	<u>\$ 202,389</u>	<u>\$ (7,546)</u>	<u>\$ 42,130</u>	<u>\$ (2,401)</u>	<u>\$ 244,519</u>	<u>\$ (9,947)</u>

The number of securities with unrealized losses as of December 31, 2014 and 2013 is presented below.

	Less than 12 months	12 months or more	Total
<b>2014</b>			
Agency residential mortgage-backed securities	9	27	36
State and municipal securities	8	29	37
Total temporarily impaired	<u>17</u>	<u>56</u>	<u>73</u>
<b>2013</b>			
Agency residential mortgage-backed securities	49	10	59
State and municipal securities	59	12	71
Total temporarily impaired	<u>108</u>	<u>22</u>	<u>130</u>

There were no debt securities with credit losses recognized in income during 2014 or 2013.

Ninety-nine percent of the securities are backed by the U.S. government, government agencies, government sponsored agencies or are A-rated or better, except for certain non-local or local municipal securities, which are not rated. For the government, government-sponsored agency and municipal securities, management did not have concerns of credit losses and there was nothing to indicate that full principal will not be received. Management considered the unrealized losses on these securities to be primarily interest rate driven and does not expect material losses given current market conditions unless the securities are sold. However, at this time management does not have the intent to sell and it is more likely than not that it will not be required to sell these securities before the recovery of their amortized cost basis.

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

### NOTE 3 – LOANS

Total loans outstanding as of the years ended December 31, 2014 and 2013 consisted of the following:

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>
Commercial and industrial loans:		
Working capital lines of credit loans	\$ 544,043	\$ 457,690
Non-working capital loans	491,330	443,877
Total commercial and industrial loans	<u>1,035,373</u>	<u>901,567</u>
Commercial real estate and multi-family residential loans:		
Construction and land development loans	156,636	157,630
Owner occupied loans	403,154	370,386
Nonowner occupied loans	394,458	394,748
Multi-family loans	71,811	63,443
Total commercial real estate and multi-family residential loans	<u>1,026,059</u>	<u>986,207</u>
Agri-business and agricultural loans:		
Loans secured by farmland	137,407	133,458
Loans for agricultural production	136,380	120,571
Total agri-business and agricultural loans	<u>273,787</u>	<u>254,029</u>
Other commercial loans	75,715	70,770
Total commercial loans	<u>2,410,934</u>	<u>2,212,573</u>
Consumer 1-4 family mortgage loans:		
Closed end first mortgage loans	145,167	125,444
Open end and junior lien loans	150,220	146,946
Residential construction and land development loans	6,742	4,640
Total consumer 1-4 family mortgage loans	<u>302,129</u>	<u>277,030</u>
Other consumer loans	49,541	46,125
Total consumer loans	<u>351,670</u>	<u>323,155</u>
Subtotal . . . . .	2,762,604	2,535,728
Less: Allowance for loan losses	(46,262)	(48,797)
Net deferred loan fees	(284)	(630)
Loans, net . . . . .	<u>\$ 2,716,058</u>	<u>\$ 2,486,301</u>

The recorded investment in loans does not include accrued interest.

## NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY

The following tables present the activity and balance in the allowance for loan losses by portfolio segment for the year ended December 31, 2014, 2013 and 2012:

<u>(dollars in thousands)</u>	Commercial and Industrial	Commercial Real Estate and Multi-family Residential	Agri-business and Agricultural	Other Commercial	Consumer 1-4 Family Mortgage	Other Consumer	Unallocated	Total
<b>December 31, 2014</b>								
Beginning balance	\$ 21,005	\$ 18,556	\$ 1,682	\$ 391	\$ 3,046	\$ 608	\$ 3,509	\$ 48,797
Provision for loan losses	2,307	(2,771)	88	(115)	699	(15)	(193)	0
Loans charged-off	(1,441)	(2,560)	0	0	(439)	(245)	0	(4,685)
Recoveries	914	928	20	0	153	135	0	2,150
Net loans charged-off	(527)	(1,632)	20	0	(286)	(110)	0	(2,535)
Ending balance	<u>\$ 22,785</u>	<u>\$ 14,153</u>	<u>\$ 1,790</u>	<u>\$ 276</u>	<u>\$ 3,459</u>	<u>\$ 483</u>	<u>\$ 3,316</u>	<u>\$ 46,262</u>
<u>(dollars in thousands)</u>								
<b>December 31, 2013</b>								
Beginning balance	\$ 22,342	\$ 20,812	\$ 1,403	\$ 240	\$ 2,682	\$ 609	\$ 3,357	\$ 51,445
Provision for loan losses	(788)	(564)	267	151	620	162	152	0
Loans charged-off	(1,062)	(2,069)	(200)	0	(382)	(339)	0	(4,052)
Recoveries	513	377	212	0	126	176	0	1,404
Net loans charged-off	(549)	(1,692)	12	0	(256)	(163)	0	(2,648)
Ending balance	<u>\$ 21,005</u>	<u>\$ 18,556</u>	<u>\$ 1,682</u>	<u>\$ 391</u>	<u>\$ 3,046</u>	<u>\$ 608</u>	<u>\$ 3,509</u>	<u>\$ 48,797</u>
<u>(dollars in thousands)</u>								
<b>December 31, 2012</b>								
Beginning balance	\$ 22,830	\$ 23,489	\$ 695	\$ 65	\$ 2,322	\$ 645	\$ 3,354	\$ 53,400
Provision for loan losses	1,814	(1,772)	705	(11)	1,552	258	3	2,549
Loans charged-off	(3,069)	(1,108)	0	0	(1,340)	(405)	0	(5,922)
Recoveries	767	203	3	186	148	111	0	1,418
Net loans charged-off	(2,302)	(905)	3	186	(1,192)	(294)	0	(4,504)
Ending balance	<u>\$ 22,342</u>	<u>\$ 20,812</u>	<u>\$ 1,403</u>	<u>\$ 240</u>	<u>\$ 2,682</u>	<u>\$ 609</u>	<u>\$ 3,357</u>	<u>\$ 51,445</u>

## NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)

The following tables present balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method as of December 31, 2014 and 2013:

	Commercial and Industrial	Commercial Real Estate and Multi-family Residential	Agri-business and Agricultural	Other Commercial	Consumer 1-4 Family Mortgage	Other Consumer	Unallocated	Total
(dollars in thousands)								
<b>December 31, 2014</b>								
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 3,306	\$ 1,531	\$ 14	\$ 15	\$ 482	\$ 73	\$ 0	\$ 5,421
Collectively evaluated for impairment	19,479	12,622	1,776	261	2,977	410	3,316	40,841
Total ending allowance balance	<u>\$ 22,785</u>	<u>\$ 14,153</u>	<u>\$ 1,790</u>	<u>\$ 276</u>	<u>\$ 3,459</u>	<u>\$ 483</u>	<u>\$ 3,316</u>	<u>\$ 46,262</u>
Loans:								
Loans individually evaluated for impairment	\$ 14,702	\$ 13,005	\$ 486	\$ 30	\$ 3,614	\$ 127	\$ 0	\$ 31,964
Loans collectively evaluated for impairment	1,020,897	1,011,858	273,388	75,684	299,189	49,340	0	2,730,356
Total ending loans balance	<u>\$ 1,035,599</u>	<u>\$ 1,024,863</u>	<u>\$ 273,874</u>	<u>\$ 75,714</u>	<u>\$ 302,803</u>	<u>\$ 49,467</u>	<u>\$ 0</u>	<u>\$ 2,762,320</u>
	Commercial and Industrial	Commercial Real Estate and Multi-family Residential	Agri-business and Agricultural	Other Commercial	Consumer 1-4 Family Mortgage	Other Consumer	Unallocated	Total
(dollars in thousands)								
<b>December 31, 2013</b>								
Allowance for loan losses:								
Ending allowance balance attributable to loans:								
Individually evaluated for impairment	\$ 4,144	\$ 4,598	\$ 38	\$ 0	\$ 479	\$ 57	\$ 0	\$ 9,316
Collectively evaluated for impairment	16,861	13,959	1,644	391	2,566	551	3,509	39,481
Total ending allowance balance	<u>\$ 21,005</u>	<u>\$ 18,557</u>	<u>\$ 1,682</u>	<u>\$ 391</u>	<u>\$ 3,045</u>	<u>\$ 608</u>	<u>\$ 3,509</u>	<u>\$ 48,797</u>
Loans:								
Loans individually evaluated for impairment	\$ 16,196	\$ 22,204	\$ 1,114	\$ 0	\$ 3,594	\$ 119	\$ 0	\$ 43,227
Loans collectively evaluated for impairment	885,651	962,673	253,011	70,766	273,812	45,958	0	2,491,871
Total ending loans balance	<u>\$ 901,847</u>	<u>\$ 984,877</u>	<u>\$ 254,125</u>	<u>\$ 70,766</u>	<u>\$ 277,406</u>	<u>\$ 46,077</u>	<u>\$ 0</u>	<u>\$ 2,535,098</u>

**NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)**

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2014:

<u>(dollars in thousands)</u>	<u>Unpaid Principal Balance</u>	<u>Recorded Investment</u>	<u>Allowance for Loan Losses Allocated</u>
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 21	\$ 21	\$ 0
Non-working capital loans	1,673	279	0
Commercial real estate and multi-family residential loans:			
Construction and land development loans	526	526	0
Owner occupied loans	554	374	0
Nonowner occupied loans	3,030	3,036	0
Agri-business and agricultural loans:			
Loans secured by farmland	603	283	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	724	712	0
Open end and junior lien loans	317	317	0
Residential construction loans	129	129	0
Other consumer loans	1	1	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	1,409	1,408	837
Non-working capital loans	15,557	12,994	2,469
Commercial real estate and multi-family residential loans:			
Construction and land development loans	449	448	107
Owner occupied loans	5,298	5,297	1,213
Nonowner occupied loans	3,324	3,324	211
Agri-business and agricultural loans:			
Loans secured by farmland	381	203	14
Other commercial loans	30	30	15
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	2,505	2,375	474
Open end and junior lien loans	81	81	8
Other consumer loans	126	126	73
Total	<u>\$ 36,738</u>	<u>\$ 31,964</u>	<u>\$ 5,421</u>



**NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)**

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

<u>(dollars in thousands)</u>	<u>Unpaid Principal Balance</u>	<u>Recorded Investment</u>	<u>Allowance for Loan Losses Allocated</u>
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 63	\$ 63	\$ 0
Commercial real estate and multi-family residential loans:			
Owner occupied loans	377	196	0
Agri-business and agricultural loans:			
Loans secured by farmland	604	604	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	688	689	0
Open end and junior lien loans	81	81	0
Residential construction loans	150	150	0
Other consumer loans	1	1	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	5,251	2,641	984
Non-working capital loans	15,345	13,492	3,160
Commercial real estate and multi-family residential loans:			
Construction and land development loans	2,795	2,795	585
Owner occupied loans	5,553	4,681	723
Nonowner occupied loans	15,163	14,532	3,290
Agri-business and agricultural loans:			
Loans secured by farmland	1,008	510	38
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	3,469	2,463	442
Open end and junior lien loans	211	211	37
Other consumer loans	118	118	57
Total	<u>\$ 50,877</u>	<u>\$ 43,227</u>	<u>\$ 9,316</u>

**NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)**

The following table presents loans individually evaluated for impairment by class of loans as of December 31, 2014:

<u>(dollars in thousands)</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Interest Income Recognized</u>
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 154	\$ 1	\$ 1
Non-working capital loans	174	1	1
Commercial real estate and multi-family residential loans:			
Construction and land development loans	265	0	0
Owner occupied loans	218	0	0
Nonowner occupied loans	1,019	139	139
Agri-business and agricultural loans:			
Loans secured by farmland	240	0	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	697	0	0
Open end and junior lien loans	210	0	0
Residential construction loans	139	0	0
Other consumer loans	1	0	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	1,845	66	57
Non-working capital loans	13,806	513	513
Commercial real estate and multi-family residential loans:			
Construction and land development loans	1,977	45	46
Owner occupied loans	3,416	72	70
Nonowner occupied loans	7,220	0	0
Agri-business and agricultural loans:			
Loans secured by farmland	381	0	0
Other commercial loans	5	0	0
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	2,680	74	77
Open end and junior lien loans	63	0	0
Other consumer loans	98	2	2
Total	<u>\$ 34,608</u>	<u>\$ 913</u>	<u>\$ 906</u>

**NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)**

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

<u>(dollars in thousands)</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Interest Income Recognized</u>
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 64	\$ 0	\$ 0
Non-working capital loans	8	0	0
Commercial real estate and multi-family residential loans:			
Owner occupied loans	482	0	0
Agri-business and agricultural loans:			
Loans secured by farmland	512	0	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	379	0	0
Open end and junior lien loans	35	0	0
Residential construction loans	39	0	0
Other consumer loans	1	0	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	2,934	50	52
Non-working capital loans	13,957	540	544
Commercial real estate and multi-family residential loans:			
Construction and land development loans	3,537	84	92
Owner occupied loans	3,771	109	118
Nonowner occupied loans	20,108	337	344
Multifamily loans	48	0	0
Agri-business and agricultural loans:			
Loans secured by farmland	442	0	0
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	2,488	56	68
Open end and junior lien loans	70	0	0
Other consumer loans	90	1	1
Total	<u>\$ 48,965</u>	<u>\$ 1,177</u>	<u>\$ 1,219</u>

**NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)**

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

<u>(dollars in thousands)</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Interest Income Recognized</u>
With no related allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	\$ 10	\$ 0	\$ 0
Non-working capital loans	108	0	0
Commercial real estate and multi-family residential loans:			
Owner occupied loans	530	0	0
Nonowner occupied loans	259	17	17
Multifamily loans	83	0	0
Agri-business and agricultural loans:			
Loans secured by farmland	307	0	0
Loans for ag production	51	0	0
Consumer 1-4 family loans:			
Closed end first mortgage loans	339	0	0
Open end and junior lien loans	25	0	0
With an allowance recorded:			
Commercial and industrial loans:			
Working capital lines of credit loans	4,085	55	54
Non-working capital loans	17,062	667	681
Commercial real estate and multi-family residential loans:			
Construction and land development loans	2,145	48	48
Owner occupied loans	5,157	90	84
Nonowner occupied loans	27,830	363	380
Agri-business and agricultural loans:			
Loans secured by farmland	410	0	0
Loans for agricultural production	68	0	0
Other commercial loans	0	0	0
Consumer 1-4 family mortgage loans:			
Closed end first mortgage loans	1,870	36	50
Open end and junior lien loans	343	0	0
Other consumer loans	26	0	0
Total	<u>\$ 60,708</u>	<u>\$ 1,276</u>	<u>\$ 1,314</u>

#### NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)

Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The following table presents the aging of the recorded investment in past due loans as of December 31, 2014 by class of loans:

<u>(dollars in thousands)</u>	<u>Loans Not Past Due</u>	<u>30-89 Days Past Due</u>	<u>Greater than 90 Days Past Due</u>	<u>Nonaccrual</u>	<u>Total Past Due</u>	<u>Total</u>
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 543,613	\$ 0	\$ 0	\$ 632	\$ 632	\$ 544,245
Non-working capital loans	487,655	0	101	3,598	3,699	491,354
Commercial real estate and multi-family residential loans:						
Construction and land development loans	155,711	0	0	526	526	156,237
Owner occupied loans	399,028	800	0	3,049	3,849	402,877
Nonowner occupied loans	390,394	31	0	3,629	3,660	394,054
Multi-family loans	71,695	0	0	0	0	71,695
Agri-business and agricultural loans:						
Loans secured by farmland	136,923	0	0	485	485	137,408
Loans for agricultural production	136,466	0	0	0	0	136,466
Other commercial loans	75,684	0	0	30	30	75,714
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	142,615	1,198	20	1,051	2,269	144,884
Open end and junior lien loans	150,551	235	9	398	642	151,193
Residential construction loans	6,597	0	0	129	129	6,726
Other consumer loans	49,308	108	0	51	159	49,467
Total	<u>\$ 2,746,240</u>	<u>\$ 2,372</u>	<u>\$ 130</u>	<u>\$ 13,578</u>	<u>\$ 16,080</u>	<u>\$ 2,762,320</u>

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

<u>(dollars in thousands)</u>	<u>Loans Not Past Due</u>	<u>30-89 Days Past Due</u>	<u>Greater than 90 Days Past Due</u>	<u>Nonaccrual</u>	<u>Total Past Due</u>	<u>Total</u>
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 456,136	\$ 0	\$ 0	\$ 1,819	\$ 1,819	\$ 457,955
Non-working capital loans	440,050	46	0	3,796	3,842	443,892
Commercial real estate and multi-family residential loans:						
Construction and land development loans	156,594	0	0	544	544	157,138
Owner occupied loans	366,955	0	0	3,156	3,156	370,111
Nonowner occupied loans	382,478	0	0	11,758	11,758	394,236
Multi-family loans	63,392	0	0	0	0	63,392
Agri-business and agricultural loans:						
Loans secured by farmland	132,347	0	0	1,113	1,113	133,460
Loans for agricultural production	120,665	0	0	0	0	120,665
Other commercial loans	70,766	0	0	0	0	70,766
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	122,370	1,645	0	1,165	2,810	125,180
Open end and junior lien loans	147,123	135	46	291	472	147,595
Residential construction loans	4,481	0	0	150	150	4,631
Other consumer loans	45,826	145	0	106	251	46,077
Total	<u>\$ 2,509,183</u>	<u>\$ 1,971</u>	<u>\$ 46</u>	<u>\$ 23,898</u>	<u>\$ 25,915</u>	<u>\$ 2,535,098</u>

## NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)

### Troubled Debt Restructurings:

Troubled debt restructured loans are included in the totals for impaired loans. The Company has allocated \$3.4 million and \$8.3 million of specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2014 and 2013. The Company is not committed to lend additional funds to debtors whose loans have been modified in a troubled debt restructuring.

(dollars in thousands)

	2014	2013
Accruing troubled debt restructured loans	\$ 16,492	\$ 17,714
Nonaccrual troubled debt restructured loans	9,161	18,531
Total troubled debt restructured loans	<u>\$ 25,653</u>	<u>\$ 36,245</u>

During the year ending December 31, 2014 certain loans were modified as troubled debt restructurings. The modified terms of these loans include one or a combination of the following: inadequate compensation for the terms of the restructure or renewal; a modification of the repayment terms which delays principal repayment for some period; or renewal terms offered to borrowers in financial distress where no additional credit enhancements were obtained at the time of renewal.

There were renewal terms offered to one borrower under financial duress which did not require additional compensation or consideration, and the terms offered would not have been readily available in the marketplace for loans bearing similar risk profiles. In this instance, it was determined that a concession had been granted. It is difficult to quantify the concession granted due to an absence of readily available market terms to be used for comparison. The borrower engaged in retail sales, where the collateral and cash flow did not support the loan with a recorded investment of \$159,000.

Additional concessions were granted to borrowers with previously identified troubled debt restructured loans during 2014. One loan with a balance of \$173,000 was rewritten under terms that are not readily available in the marketplace. Terms in the current loan agreement include an amortization period that exceeds those of similar type loans for a borrower enduring financial hardship. This concession was granted without additional compensation. Another concession included further forgiveness of principal if the terms of the restructured loan are met during the life of the loan. This borrower had a recorded investment of \$2.7 million at the time of the modification. These concessions are not included in table below.

Renegotiated interest rates include loans with a reduction in rate for the remaining life of the loan. There were modifications to borrowers at rates that were not readily available in the marketplace that were considered concessions.

The following table presents loans by class modified as new troubled debt restructurings that occurred during the year ending December 31, 2014:

	All Modifications			Interest Rate Reductions			Modified Repayment Terms	
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Interest at Pre-Modification Rate	Interest at Post-Modification Rate	Number of Loans	Extension Period or Range (in months)
(dollars in thousands)								
Troubled Debt Restructurings								
Commercial and industrial loans:								
Non-working capital loans	2	\$ 433	\$ 433	0	\$ 0	\$ 0	2	12-15
Commercial real estate and multi-family residential loans:								
Owner occupied loans	3	2,639	2,710	1	89	95	2	12-24
Total	<u>5</u>	<u>\$ 3,072</u>	<u>\$ 3,143</u>	<u>1</u>	<u>\$ 89</u>	<u>\$ 95</u>	<u>4</u>	<u>12-24</u>

For period ending December 31, 2014, the commercial and industrial troubled debt restructurings described above increased the allowance for loan losses by \$205,000 and the commercial real estate and multi-family residential loan troubled debt restructuring described above increased the allowance for loan losses by \$171,000.

No charge-offs resulted from any troubled debt restructurings described above during the period ending December 31, 2014.

#### NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (continued)

During the year ending December 31, 2013 certain loans were modified as troubled debt restructurings. The modified terms of these loans include one or a combination of the following: inadequate compensation for the terms of the restructure or renewal; a reduction in the interest rate on a loan to one that would not be readily available in the marketplace for borrowers with a similar risk profile; a modification of the repayment terms which delays principal repayment for some period; or renewal terms offered to borrowers in financial distress where no additional credit enhancements were obtained at the time of renewal.

There were renewal terms offered on various loans to borrowers under financial duress which did not require additional compensation or consideration, and the terms offered would not have been readily available in the marketplace for loans bearing similar risk profiles. In these instances, it was determined that a concession had been granted. It is difficult to quantify the concession granted due to an absence of readily available market terms to be used for comparison. The renewals during the first three months of 2013 were to one borrower engaged in land development, where the aggregate recorded investment totaled \$763,000. No renewals during the three months ended June 30, 2013 were determined to be troubled debt restructures. During the three months ended September 30, 2013, the Bank renegotiated terms on a loan totaling \$75,000 where the collateral and cash flow did not support the loan. During the three months ending December 31, 2013 one loan totaling \$524,000 was granted an extension although the borrower was not in complete compliance with the terms of the previous agreements financial reporting requirements.

Renegotiated interest rates include loans with a reduction in rate for the remaining life of the loan.

The following table presents loans by class modified as new troubled debt restructurings that occurred during the period ending December 31, 2013:

	All Modifications			Interest Rate Reductions		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Interest at Pre-Modification Rate	Interest at Post-Modification Rate
<u>(dollars in thousands)</u>						
Troubled Debt Restructurings						
Commercial real estate and multi-family residential loans:						
Construction and land development loans	6	\$ 2,197	\$ 2,197	6	\$ 84	\$ 63
Owner occupied loans	1	524	524	0	0	0
Consumer 1-4 family loans:						
Closed end first mortgage loans	4	317	327	2	142	158
Total	11	\$ 3,038	\$ 3,048	8	\$ 226	\$ 221

	Principal and Interest Forgiveness				
	Number of Loans	Principal at Pre-Modification Rate	Principal at Post-Modification Rate	Interest at Pre-Modification Rate	Interest at Post-Modification Rate
<u>(dollars in thousands)</u>					
Troubled Debt Restructurings					
Consumer 1-4 family loans:					
Closed end first mortgage loans	2	\$ 156	\$ 161	\$ 164	\$ 149
Total	2	\$ 156	\$ 161	\$ 164	\$ 149

For the period ending December 31, 2013, the commercial real estate and multi-family residential loan troubled debt restructurings described above decreased the allowance for loan losses by \$405,000 and the consumer 1-4 family loan troubled debt restructurings described above increased the allowance for loan losses by \$56,000. Five of the commercial real estate and multi-family residential loan that decreased the provision during 2013 had modifications during the first month of the year and had improved their positions during the remainder of the year, which warranted the decrease in allocation.

One of the commercial real estate and multi-family residential loan troubled debt restructurings described above had a charge-off of \$365,000 during the period ending December 31, 2013.

**NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (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 period ending December 31:

(dollars in thousands)	2014		2013	
	<u>Number of Loans</u>	<u>Recorded Investment</u>	<u>Number of Loans</u>	<u>Recorded Investment</u>
Troubled Debt Restructurings that Subsequently Defaulted				
Commercial real estate and multi-family residential loans:				
Construction and land development loans	<u>0</u>	<u>\$ 0</u>	<u>1</u>	<u>\$ 763</u>
Total	<u>0</u>	<u>\$ 0</u>	<u>1</u>	<u>\$ 763</u>

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

The troubled debt restructurings that subsequently defaulted, as described above, decreased the allowance for loan losses by \$170,000 and did not result in any charge-offs during the period ending December 31, 2013.

During the first quarter of 2014 the Company sold, to an independent party, three loans totaling \$6.7 million, representing a single commercial relationship. The three loans were accounted for as troubled debt restructurings. The Company received proceeds of \$4.3 million and recognized charge-offs of \$2.4 million as a result of the sale. The amount charged-off had previously been reserved for by the Company.

**Credit Quality Indicators:**

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes commercial loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for Special Mention, Substandard and Doubtful grade loans and annually on Pass grade loans over \$150,000.

The Company uses the following definitions for risk ratings:

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

**Substandard.** Loans classified as Substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized as 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 characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.



#### NOTE 4 – ALLOWANCE FOR LOAN LOSSES AND CREDIT QUALITY (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 with the exception of consumer troubled debt restructurings which are evaluated and listed with Substandard commercial grade loans and consumer nonaccrual loans which are evaluated individually and listed with Not Rated loans. Loans listed as not rated are consumer loans included in groups of homogenous loans which are analyzed for credit quality indicators utilizing delinquency status. As of December 31, 2014, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

<u>(dollars in thousands)</u>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Not Rated</u>	<u>Total</u>
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 504,806	\$ 28,485	\$ 10,343	\$ 611	\$ 0	\$ 544,245
Non-working capital loans	436,735	31,781	20,324	0	2,514	491,354
Commercial real estate and multi-family residential loans:						
Construction and land development loans	150,442	1,033	4,762	0	0	156,237
Owner occupied loans	369,520	20,960	12,397	0	0	402,877
Nonowner occupied loans	375,702	12,512	5,840	0	0	394,054
Multi-family loans	71,695	0	0	0	0	71,695
Agri-business and agricultural loans:						
Loans secured by farmland	136,923	0	485	0	0	137,408
Loans for agricultural production	136,466	0	0	0	0	136,466
Other commercial loans	75,680	0	30	0	4	75,714
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	39,156	0	2,199	0	103,529	144,884
Open end and junior lien loans	8,400	291	2,015	0	140,487	151,193
Residential construction loans	0	0	0	0	6,726	6,726
Other consumer loans	15,879	290	75	0	33,223	49,467
Total	<u>\$ 2,321,404</u>	<u>\$ 95,352</u>	<u>\$ 58,470</u>	<u>\$ 611</u>	<u>\$ 286,483</u>	<u>\$ 2,762,320</u>

As of December 31, 2013, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

<u>(dollars in thousands)</u>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Not Rated</u>	<u>Total</u>
Commercial and industrial loans:						
Working capital lines of credit loans	\$ 431,069	\$ 15,212	\$ 11,674	\$ 0	\$ 0	\$ 457,955
Non-working capital loans	384,415	37,727	19,659	0	2,091	443,892
Commercial real estate and multi-family residential loans:						
Construction and land development loans	148,338	763	8,037	0	0	157,138
Owner occupied loans	333,795	23,687	12,629	0	0	370,111
Nonowner occupied loans	367,108	9,180	17,948	0	0	394,236
Multi-family loans	63,392	0	0	0	0	63,392
Agri-business and agricultural loans:						
Loans secured by farmland	132,331	0	1,113	0	16	133,460
Loans for agricultural production	120,665	0	0	0	0	120,665
Other commercial loans	70,766	0	0	0	0	70,766
Consumer 1-4 family mortgage loans:						
Closed end first mortgage loans	29,092	0	2,316	0	93,772	125,180
Open end and junior lien loans	8,291	1,863	0	0	137,441	147,595
Residential construction loans	0	0	0	0	4,631	4,631
Other consumer loans	10,722	416	291	0	34,648	46,077
Total	<u>\$ 2,099,984</u>	<u>\$ 88,848</u>	<u>\$ 73,667</u>	<u>\$ 0</u>	<u>\$ 272,599</u>	<u>\$ 2,535,098</u>

## NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS

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

- Level 1** Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.
- Level 2** Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.
- Level 3** Significant unobservable inputs that reflect a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

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

Securities: Securities available for sale are valued primarily by a third party pricing service. The fair values of securities available for sale are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or pricing models which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). These models utilize the market approach with standard inputs that include, but are not limited to benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data. For certain municipal securities that are not rated and observable inputs about the specific issuer are not available, fair values are estimated using observable data from other municipal securities presumed to be similar or other market data on other non-rated municipal securities (Level 3 inputs).

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

Securities pricing is obtained from a third party pricing service and is tested at least annually against prices from another third party provider and reviewed with a market value price tolerance variance of +/-3%, an individual security market value tolerance of +/- \$50,000 and an aggregate market value tolerance of +/- \$500,000 for all securities. If any securities fall outside any of these tolerance thresholds, they are reviewed in more detail to determine why the variance exists. Changes in market value are reviewed monthly in aggregate yield by security type and any material differences are reviewed to determine why they exist. At least annually, the pricing methodology of the pricing service is received and reviewed to support the fair value levels used by the Company. A detailed pricing evaluation is requested and reviewed on any security determined to be fair valued using unobservable inputs by the pricing service.

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

Interest rate swap derivatives: Our derivatives are traded in an over-the-counter market where quoted market prices are not always available. Therefore, the fair values of derivatives are determined using quantitative models that utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services. The fair value of interest rate swap derivatives is determined by pricing or valuation models using observable market data as of the measurement date (Level 2).

## NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)

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

Mortgage servicing rights: As of December 31, 2014, the fair value of the Company's Level 3 servicing assets for residential mortgage loans ("MSRs") was \$3.1 million, none of which are currently impaired and therefore are carried at amortized cost. These residential mortgage loans have a weighted average interest rate of 4.05%, a weighted average maturity of 19 years and are secured by homes generally within the Company's market area of Northern Indiana. A valuation model is used to estimate fair value by stratifying the portfolios on the basis of certain risk characteristics, including loan type and interest rate. Impairment is estimated based on an income approach. The inputs used include estimates of prepayment speeds, discount rate, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, late fees, and float income. The most significant assumption used to value MSRs is prepayment rate. Prepayment rates are estimated based on published industry consensus prepayment rates. At December 31, 2014, the constant prepayment speed ("PSA") used was 212 and discount rate used was 9.4%. At December 31, 2013, the PSA used was 185 and the discount rate used was 9.4%.

At December 31, 2014, the sensitivity of the current fair value of MSRs to an immediate 10% and 20% adverse change in the PSA and discount rate was (\$134,000) and (\$256,000), respectively for the PSA, and was (\$88,000) and (\$171,000), respectively for the discount rate. These sensitivities are hypothetical and should not be relied upon. As the figures indicate, changes in value based on a 10% and 20% variation in assumptions generally cannot be extrapolated because the relationship of the change in assumption to the change in value may not be linear. Also, in this example, the effect of a variation in a particular assumption on the value of the MSR is calculated without changing any other assumption; however, in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments), which might magnify or counteract the sensitivities.

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

# NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)

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

	December 31, 2014			
	Fair Value Measurements Using			Assets
(dollars in thousands)	Level 1	Level 2	Level 3	at Fair Value
Assets				
U.S. Treasury securities	\$ 1,004	\$ 0	\$ 0	\$ 1,004
Mortgage-backed securities	0	372,095	0	372,095
State and municipal securities	0	101,962	850	102,812
Total Securities	1,004	474,057	850	475,911
Mortgage banking derivative	0	96	0	96
Interest rate swap derivative	0	1,191	0	1,191
Total assets	\$ 1,004	\$ 475,344	\$ 850	\$ 477,198
Liabilities				
Mortgage banking derivative	0	11	0	11
Interest rate swap derivative	0	1,242	0	1,242
Total liabilities	\$ 0	\$ 1,253	\$ 0	\$ 1,253

	December 31, 2013			
	Fair Value Measurements Using			Assets
(dollars in thousands)	Level 1	Level 2	Level 3	at Fair Value
Assets				
U.S. Treasury securities	\$ 1,017	\$ 0	\$ 0	\$ 1,017
Mortgage-backed securities	0	371,977	0	371,977
State and municipal securities	0	94,998	975	95,973
Total Securities	1,017	466,975	975	468,967
Mortgage banking derivative	0	142	0	142
Interest rate swap derivative	0	627	0	627
Total assets	\$ 1,017	\$ 467,744	\$ 975	\$ 469,736
Liabilities				
Mortgage banking derivative	0	2	0	2
Interest rate swap derivative	0	592	0	592
Total liabilities	\$ 0	\$ 594	\$ 0	\$ 594

There were no transfers between Level 1 and Level 2 during 2014 and 2013.

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 years ended December 31, 2014 and 2013:

(dollars in thousands)	Non-Agency Residential Mortgage-Backed Securities		State and Municipal Securities	
	2014	2013	2014	2013
Balance of recurring Level 3 assets at January 1	\$ 0	\$ 2,859	\$ 975	\$ 988
Transfers into Level 3	0	3,334	0	0
Changes in fair value of securities included in other comprehensive income	0	(158)	0	(13)
Principal payments	0	(2,183)	(125)	0
Sales	0	(3,852)	0	0
Balance of recurring Level 3 assets at December 31	\$ 0	\$ 0	\$ 850	\$ 975

The fair value of two non-agency residential mortgage-backed securities with a fair value of \$3.3 million as of March 31, 2013 were transferred out of Level 2 and into Level 3 because of a lack of observable market data for these investments. The Company's policy is to recognize transfers as of the end of the reporting period. As a result, the fair value for these non-agency residential mortgage-backed securities was transferred on March 31, 2013. The securities were subsequently sold in the third quarter of 2013. The Company no longer owns any non-agency residential mortgage backed securities.

# **NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)**

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

<b>Quantitative Information about Level 3 Fair Value Measurements</b>				
<u>(dollars in thousands)</u>	<u>Fair Value at 12/31/2014</u>	<u>Valuation Technique</u>	<u>Unobservable Input</u>	<u>Range of Inputs (Average)</u>
State and municipal securities	\$ 850	Price to type, par, call	Discount to benchmark index	0-6% (2.49%)
<b>Quantitative Information about Level 3 Fair Value Measurements</b>				
<u>(dollars in thousands)</u>	<u>Fair Value at 12/31/2013</u>	<u>Valuation Technique</u>	<u>Unobservable Input</u>	<u>Range of Inputs (Average)</u>
State and municipal securities	\$ 975	Price to type, par, call	Discount to benchmark index	0-6% (2.21%)

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

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

	December 31, 2014			
	Fair Value Measurements Using			Assets
(dollars in thousands)	Level 1	Level 2	Level 3	at Fair Value
Assets				
Impaired loans:				
Commercial and industrial loans:				
Working capital lines of credit loans	\$ 0	\$ 0	\$ 531	\$ 531
Non-working capital loans	0	0	2,257	2,257
Commercial real estate and multi-family residential loans:				
Construction and land development loans	0	0	341	341
Owner occupied loans	0	0	4,084	4,084
Nonowner occupied loans	0	0	3,113	3,113
Agri-business and agricultural loans:				
Loans secured by farmland	0	0	189	189
Other commercial loans	0	0	15	15
Consumer 1-4 family mortgage loans:				
Closed end first mortgage loans	0	0	399	399
Open end and junior lien loans	0	0	73	73
Other consumer loans	0	0	29	29
Total impaired loans	\$ 0	\$ 0	\$ 11,031	\$ 11,031
Other real estate owned	0	0	75	75
Total assets	\$ 0	\$ 0	\$ 11,106	\$ 11,106

## NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)

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

	December 31, 2013			
	Fair Value Measurements Using			Assets
(dollars in thousands)	Level 1	Level 2	Level 3	at Fair Value
Assets				
Impaired loans:				
Commercial and industrial loans:				
Working capital lines of credit loans	\$ 0	\$ 0	\$ 920	\$ 920
Non-working capital loans	0	0	3,097	3,097
Commercial real estate and multi-family residential loans:				
Construction and land development loans	0	0	2,210	2,210
Owner occupied loans	0	0	3,958	3,958
Nonowner occupied loans	0	0	8,938	8,938
Agri-business and agricultural loans:				
Loans secured by farmland	0	0	472	472
Consumer 1-4 family mortgage loans:				
Closed end first mortgage loans	0	0	409	409
Open end and junior lien loans	0	0	174	174
Other consumer loans	0	0	50	50
Total impaired loans	\$ 0	\$ 0	\$ 20,228	\$ 20,228
Other real estate owned	0	0	75	75
Total assets	\$ 0	\$ 0	\$ 20,303	\$ 20,303

The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at December 31, 2014:

(dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Average	Range of Inputs
Impaired loans:					
Commercial and industrial	\$ 2,788	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	40%	(11% - 68%)
Impaired loans:					
Commercial real estate	7,538	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	25%	(6% - 50%)
Impaired loans:					
Agri-business and agricultural	189	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	7%	
Impaired loans:					
Other commercial	15	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	50%	
Impaired loans:					
Consumer 1-4 family mortgage	472	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	32%	(3% - 77%)
Impaired loans:					
Other consumer	29	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	43%	(33% - 50%)
Other real estate owned	75	Appraisals	Discount to reflect current market conditions	49%	

## NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)

The following table presents the valuation methodology and unobservable inputs for Level 3 assets measured at fair value on a non-recurring basis at December 31, 2013:

<u>(dollars in thousands)</u>	<u>Fair Value</u>	<u>Valuation Methodology</u>	<u>Unobservable Inputs</u>	<u>Average</u>	<u>Range of Inputs</u>
Impaired loans:					
Commercial and industrial	\$ 4,017	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	29%	(3% - 93%)
Impaired loans:					
Commercial real estate	15,106	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	22%	(3% - 45%)
Impaired loans:					
Agri-business and agricultural	472	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	8%	(4% - 12%)
Consumer 1-4 family mortgage	583	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	33%	(6% - 77%)
Impaired loans:					
Other consumer	50	Collateral based measurements	Discount to reflect current market conditions and ultimate collectability	53%	(28% - 98%)
Other real estate owned	75	Appraisals	Discount to reflect current market conditions	49%	

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a gross carrying amount of \$14.5 million, with a valuation allowance of \$3.5 million at December 31, 2014, resulting in a net reduction in provision for loan losses of \$2.8 million for the year ended December 31, 2014. At December 31, 2013, impaired loans had a gross carrying amount of \$26.5 million, with a valuation allowance of \$6.3 million, resulting in a net reduction in provision for loans losses of \$3.7 million for the year ending December 31, 2013.

Other real estate owned measured at fair value less costs to sell, at December 31, 2014 and 2013 had a net carrying amount of \$75,000, which is made up of the outstanding balance of \$147,000, net of a valuation allowance of \$72,000, which was all written down during 2012.

**NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)**

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments at December 31, 2014. Items which are not financial instruments are not included.

(dollars in thousands)	December 31, 2014				
	Carrying Value	Estimated Fair Value			Total
		Level 1	Level 2	Level 3	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 90,638	\$ 90,638	\$ 0	\$ 0	\$ 90,638
Securities available for sale	475,911	1,004	474,057	850	475,911
Real estate mortgages held for sale	1,585	0	1,612	0	1,612
Loans, net	2,716,058	0	0	2,698,767	2,698,767
Federal Home Loan Bank stock	5,993	N/A	N/A	N/A	N/A
Federal Reserve Bank stock	3,420	N/A	N/A	N/A	N/A
Accrued interest receivable	8,662	3	2,312	6,347	8,662
<b>Financial Liabilities:</b>					
Certificates of deposit	(870,590)	0	(876,953)	0	(876,953)
All other deposits	(2,002,530)	(2,002,530)	0	0	(2,002,530)
Securities sold under agreements to repurchase	(54,907)	0	(54,907)	0	(54,907)
Federal funds purchased	(500)	0	(500)	0	(500)
Other short-term borrowings	(105,000)	0	(105,001)	0	(105,001)
Long-term borrowings	(35)	0	(40)	0	(40)
Subordinated debentures	(30,928)	0	0	(31,212)	(31,212)
Standby letters of credit	(379)	0	0	(379)	(379)
Accrued interest payable	(2,946)	(109)	(2,834)	(3)	(2,946)

The following table contains the estimated fair values and the related carrying values of the Company's financial instruments at December 31, 2013. Items which are not financial instruments are not included.

(dollars in thousands)	December 31, 2013				
	Carrying Value	Estimated Fair Value			Total
		Level 1	Level 2	Level 3	
<b>Financial Assets:</b>					
Cash and cash equivalents	\$ 63,105	\$ 63,105	\$ 0	\$ 0	\$ 63,105
Securities available for sale	468,967	1,017	466,975	975	468,967
Real estate mortgages held for sale	1,778	0	1,800	0	1,800
Loans, net	2,486,301	0	0	2,490,593	2,490,593
Federal Home Loan Bank stock	7,312	N/A	N/A	N/A	N/A
Federal Reserve Bank stock	3,420	N/A	N/A	N/A	N/A
Accrued interest receivable	8,577	0	2,297	6,280	8,577
<b>Financial Liabilities:</b>					
Certificates of deposit	(727,809)	0	(736,088)	0	(736,088)
All other deposits	(1,818,259)	(1,818,259)	0	0	(1,818,259)
Securities sold under agreements to repurchase	(104,876)	0	(104,876)	0	(104,876)
Federal funds purchased	(11,000)	0	(11,000)	0	(11,000)
Other short-term borrowings	(146,000)	0	(146,002)	0	(146,002)
Long-term borrowings	(37)	0	(43)	0	(43)
Subordinated debentures	(30,928)	0	0	(31,217)	(31,217)
Standby letters of credit	(312)	0	0	(312)	(312)
Accrued interest payable	(2,918)	(125)	(2,790)	(3)	(2,918)

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



## NOTE 5 – FAIR VALUES OF FINANCIAL INSTRUMENTS (continued)

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

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

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

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

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

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

Federal funds purchased – The carrying amount of federal funds purchased approximate fair value resulting in a Level 2 classification.

Other short-term borrowings – The fair value of other short-term borrowings is estimated using discounted cash flow analysis based on current borrowing rates resulting in a Level 2 classification.

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

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

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

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

## NOTE 6 – LAND, PREMISES AND EQUIPMENT, NET

Land, premises and equipment and related accumulated depreciation were as follows at December 31, 2014 and 2013:

(dollars in thousands)

	2014	2013
Land	\$ 12,937	\$ 12,588
Premises	31,953	32,202
Equipment	26,829	24,600
Total cost	71,719	69,390
Less accumulated depreciation	29,736	30,055
Land, premises and equipment, net	\$ 41,983	\$ 39,335

The Company had land, premises and equipment of \$249,000 held for sale and included in other assets as of December 31, 2014.

## NOTE 7 – GOODWILL AND OTHER INTANGIBLE ASSETS

### Goodwill

There have been no changes in the \$5.0 million carrying amount of goodwill since 2002.

Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value, which is determined through a two step impairment test. Step 1 of the impairment test includes the determination of the carrying value of our single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. The Company determined the fair value of our reporting unit and compared it to its carrying amount. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Our annual impairment analysis as of May 31, 2014, indicated that the Step 2 analysis was not necessary. Circumstances did not substantially change during the second half of the year such that the Company did not believe it was necessary to do an additional impairment analysis.

## NOTE 8 – DEPOSITS

The following table details certain types of deposits as of December 31, 2014 and 2013:

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>
Time deposits of \$100,000 to \$250,000	\$ 254,137	\$ 218,157
Time deposits of \$250,000 or more	331,074	218,086
Public fund deposits	748,563	634,290
Brokered deposits	142,429	29,755

At December 31, 2014, the scheduled maturities of time deposits were as follows:

<u>(dollars in thousands)</u>	<u>Amount</u>
Maturing in 2015	\$ 542,981
Maturing in 2016	193,806
Maturing in 2017	86,276
Maturing in 2018	14,443
Maturing in 2019	32,751
Thereafter	333
Total time deposits .....	<u>\$ 870,590</u>

## NOTE 9 – BORROWINGS

Long-term borrowings at December 31 consisted of:

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>
Federal Home Loan Bank of Indianapolis Notes, 6.15%, Due January 15, 2018	\$ 35	\$ 37

Long-term borrowings mature as follows:

<u>(dollars in thousands)</u>	<u>Amount</u>
2015	\$ 0
2016	0
2017	0
2018	35
2019	0

## NOTE 9 – BORROWINGS (continued)

Other short-term borrowings consisted of:

(dollars in thousands)

	2014	2013
Federal Home Loan Bank of Indianapolis Notes, 0.50%, Due June 30, 2014	\$ 0	\$ 146,000
Federal Home Loan Bank of Indianapolis Notes, 0.43%, Due June 29, 2015	105,000	0
Total	<u>\$ 105,000</u>	<u>\$ 146,000</u>

The outstanding FHLB advance at December 31, 2014 of \$105.0 million may be prepaid with no penalty. All FHLB notes require monthly interest payments and are secured by residential real estate loans and securities with a carrying value of \$353.9 million and \$320.5 million at December 31, 2014 and 2013. At December 31, 2014, the Company owned \$6.0 million of FHLB stock, which also secures debts owed to the FHLB of \$105.0 million. The Company is authorized by the Board of Directors to borrow up to \$800.0 million at the FHLB, but availability is limited to \$115.9 million based on collateral and outstanding borrowings. Federal Reserve Discount Window borrowings were secured by commercial loans with a carrying value of \$217.7 million as of December 31, 2014. The Company had a borrowing capacity of \$160.2 million at the Federal Reserve Bank at December 31, 2014. There were no borrowings outstanding at the Federal Reserve Bank at December 31, 2014 and 2013.

Securities sold under agreements to repurchase are secured by mortgage-backed securities with a carrying amount of \$94.2 million and \$125.1 million at year-end 2014 and 2013.

Securities sold under agreements to repurchase (“repo accounts”) represent collateralized borrowings with customers located primarily within the Company’s service area. Substantially all repo accounts mature on demand, with the remaining maturing in less than one year. Repo accounts are not covered by federal deposit insurance and are secured by securities owned. The Company retains the right to substitute similar type securities and has the right to withdraw all excess collateral applicable to repo accounts whenever the collateral values are in excess of the related repurchase liabilities. At December 31, 2014, there were no material amounts of securities at risk with any one customer. The Company maintains control of these securities through the use of third-party safekeeping arrangements.

The following is a schedule, at the end of the year indicated, of statistical information relating to securities sold under agreement to repurchase maturing within one year and secured by either U.S. government agency securities or mortgage-backed securities classified as other debt securities. There were no other categories of short-term borrowings for which the average balance outstanding during the period was 30 percent or more of stockholders' equity at the end of each period.

(dollars in thousands)

	2014	2013	2012
Securities sold under agreements to repurchase			
Outstanding at year end	\$ 54,907	\$ 104,876	\$ 121,883
Approximate average interest rate at year end	0.18 %	0.29 %	0.35 %
Highest amount outstanding as of any month end during the year	\$ 96,236	\$ 114,312	\$ 130,389
Approximate average outstanding during the year	\$ 78,120	\$ 107,252	\$ 119,150
Approximate average interest rate during the year	0.24 %	0.32 %	0.37 %

## NOTE 10 – SUBORDINATED DEBENTURES

Lakeland Statutory Trust II, a trust formed by the Company (the “Trust”), issued \$30.0 million of floating rate trust preferred securities on October 1, 2003 as part of a privately placed offering of such securities. The Company issued \$30.9 million of subordinated debentures to the Trust in exchange for the proceeds of the Trust. The Company holds a controlling interest in the Trust, but does not have a majority of voting rights; therefore the Trust is considered a variable interest entity. The Company is not considered the primary beneficiary of this Trust; therefore, the Trust is not consolidated in the Company’s financial statements, but rather the subordinated debentures are shown as a liability. The Company’s investment in the common stock of the Trust was \$928,000 and is included in other assets.

Subject to the Company having received prior approval of the Federal Reserve, if required, the Company may redeem the subordinated debentures, in whole or in part, but in all cases in a principal amount with integral multiples of \$1,000, on any interest payment date on or after October 1, 2008 at 100% of the principal amount, plus accrued and unpaid interest. The subordinated debentures must be redeemed no later than 2033. These securities are considered Tier I capital (with certain limitations applicable) under current regulatory guidelines and, subject to certain limitations, will also be considered Tier 1 capital under Basel III. The floating rate of the trust preferred securities and subordinated debentures are equal to the three-month London Interbank Offered Rate (“LIBOR”) plus 3.05%, which was 3.3051%, 3.2966% and 3.361% December 31, 2014, 2013 and 2012, respectively.

## NOTE 11 – PENSION AND OTHER POSTRETIREMENT PLANS

In April 2000, the Lakeland Financial Corporation Pension Plan was frozen. The Company also maintains a Supplemental Executive Retirement Plan (“SERP”) for select officers that was established as a funded, non-qualified deferred compensation plan. Currently, seven retired officers are the only participants in the SERP. The measurement date for both the pension plan and SERP is December 31, 2014 and 2013.

Information as to the Company’s employee benefit plans at December 31, 2014 and 2013 is as follows:

<u>(dollars in thousands)</u>	<b>Pension Benefits</b>		<b>SERP Benefits</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Change in benefit obligation:				
Beginning benefit obligation	\$ 2,454	\$ 2,867	\$ 1,096	\$ 1,141
Interest cost	119	116	50	45
Actuarial (gain)/loss	398	(276)	258	47
Benefits paid	(186)	(253)	(137)	(137)
Ending benefit obligation	<u>2,785</u>	<u>2,454</u>	<u>1,267</u>	<u>1,096</u>
Change in plan assets (primarily equity and fixed income investments and money market funds), at fair value:				
Beginning plan assets	1,700	1,528	1,068	964
Actual return	121	265	79	161
Employer contribution	206	160	4	80
Benefits paid	(186)	(253)	(137)	(137)
Ending plan assets	<u>1,841</u>	<u>1,700</u>	<u>1,014</u>	<u>1,068</u>
Funded status at end of year	<u>\$ (944)</u>	<u>\$ (754)</u>	<u>\$ (253)</u>	<u>\$ (28)</u>

Amounts recognized in the consolidated balance sheets consist of:

<u>(dollars in thousands)</u>	<b>Pension Benefits</b>		<b>SERP Benefits</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Funded status included in other liabilities	\$ (944)	\$ (754)	\$ (253)	\$ (28)

Amounts recognized in accumulated other comprehensive income consist of:

<u>(dollars in thousands)</u>	<b>Pension Benefits</b>		<b>SERP Benefits</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
Net actuarial loss	\$ 1,925	\$ 1,640	\$ 812	\$ 640

The accumulated benefit obligation for the pension plan was \$2.8 million and \$2.5 million, respectively, for December 31, 2014 and 2013. The accumulated benefit obligation for the SERP was \$1.3 million and \$1.1 million, respectively for December 31, 2014 and 2013.

## NOTE 11 – PENSION AND OTHER POSTRETIREMENT PLANS (continued)

Net pension expense and other amounts recognized in other comprehensive income include the following:

(dollars in thousands)	Pension Benefits			SERP Benefits		
	2014	2013	2012	2014	2013	2012
Net pension expense:						
Service cost	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Interest cost	119	116	127	50	45	51
Expected return on plan assets	(125)	(121)	(138)	(73)	(74)	(75)
Recognized net actuarial loss	117	151	137	80	93	83
Settlement cost	0	91	252	0	0	0
Net pension expense	<u>\$ 111</u>	<u>\$ 237</u>	<u>\$ 378</u>	<u>\$ 57</u>	<u>\$ 64</u>	<u>\$ 59</u>
Net loss/(gain)	\$ 402	\$ (510)	\$ (109)	\$ 252	\$ (40)	\$ (3)
Amortization of net loss	(117)	(151)	(137)	(80)	(93)	(83)
Total recognized in other comprehensive income	<u>\$ 285</u>	<u>\$ (661)</u>	<u>\$ (246)</u>	<u>\$ 172</u>	<u>\$ (133)</u>	<u>\$ (86)</u>
Total recognized in net pension expense and other comprehensive income	<u>\$ 396</u>	<u>\$ (424)</u>	<u>\$ 132</u>	<u>\$ 229</u>	<u>\$ (69)</u>	<u>\$ (27)</u>

The estimated net loss (gain) for the defined benefit pension plan and SERP that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is \$162,000 for the pension plan and \$82,000 for the SERP. The settlement cost was related to participants taking lump sum distributions from the pension plan during 2013 and 2012.

For 2014 and 2013, the assumed form of payment elected by active participants upon retirement was changed from a single life annuity to a lump sum to reflect participant trends. The lump sum assumed interest rates below for December 31, 2014 and 2013 reflect the mortality table in effect for 2015 and 2014, respectively. For 2014, the mortality assumption was changed to the RP-2014 Mortality Table projected to 2024 with Projection Scale MP-2014 as of December 31, 2014 to reflect improved mortality expectations.

	Pension Benefits			SERP Benefits		
	2014	2013	2012	2014	2013	2012
The following assumptions were used in calculating the net benefit obligation:						
Weighted average discount rate	3.61%	5.00%	4.00%	3.61%	5.00%	4.00%
Rate of increase in future compensation	N/A	N/A	N/A	N/A	N/A	N/A
Lump sum assumed interest rates						
First 5 years	1.29%	1.24%	N/A	N/A	N/A	N/A
Next 15 years	3.81%	4.47%	N/A	N/A	N/A	N/A
All future years	4.88%	5.52%	N/A	N/A	N/A	N/A
The following assumptions were used in calculating the net pension expense:						
Weighted average discount rate	5.00%	4.00%	4.50%	5.00%	4.00%	4.50%
Rate of increase in future compensation	N/A	N/A	N/A	N/A	N/A	N/A
Expected long-term rate of return	7.75%	7.75%	7.75%	7.75%	7.75%	7.75%

### Pension Plan and SERP Assets

The Company's investment strategies are to invest in a prudent manner for the purpose of providing benefits to participants in the pension plan and the SERP. The investment strategies are targeted to maximize the total return of the portfolio net of inflation, spending and expenses. Risk is controlled through diversification of asset types and investments in domestic and international equities and fixed income securities. The target allocations for plan assets are shown in the tables below. Equity securities primarily include investments in common stocks. Debt securities include government agency and commercial bonds. Other investments consist of money market mutual funds.

**NOTE 11 – PENSION AND OTHER POSTRETIREMENT PLANS (continued)**

The weighted average expected long-term rate of return on pension plan and SERP assets is developed in consultation with the plans actuary. It is primarily based upon industry trends and consensus rates of return which are then adjusted to reflect the specific asset allocations and historical rates of return of the Company's plan assets. The following assumptions were used in determining the total long term rate of return: equity securities were assumed to have a long-term rate of return of approximately 9.75% and debt securities were assumed to have a long-term rate of return of approximately 4.75%. These rates of return were adjusted to reflect an approximate target allocation of 60% equity securities and 40% debt securities with a small downward adjustment due to investments in the "Other" category, which consist of low yielding money market mutual funds.

Certain asset types and investment strategies are prohibited including, the investment in commodities, options, futures, short sales, margin transactions and non-marketable securities.

The Company's pension plan asset allocation at year-end 2014 and 2013, target allocation for 2015, and expected long-term rate of return by asset category are as follows:

<u>Asset Category</u>	<u>Target Allocation</u> <b>2015</b>	<u>Percentage of Plan Assets at Year End</u>		<u>Weighted Average Expected Long-Term Rate of Return</u>
		<b>2014</b>	<b>2013</b>	
Equity securities	55-65%	<b>60%</b>	60%	<b>9.80%</b>
Debt securities	35-45%	<b>35%</b>	25%	<b>4.73%</b>
Other	5-10%	<b>5%</b>	15%	<b>0.25%</b>
Total		<b>100%</b>	<b>100%</b>	<b>7.75%</b>

The Company's SERP plan asset allocation at year-end 2014 and 2013, target allocation for 2015, and expected long-term rate of return by asset category are as follows:

<u>Asset Category</u>	<u>Target Allocation</u> <b>2015</b>	<u>Percentage of Plan Assets at Year End</u>		<u>Weighted Average Expected Long-Term Rate of Return</u>
		<b>2014</b>	<b>2013</b>	
Equity securities	55-65%	<b>65%</b>	61%	<b>9.60%</b>
Debt securities	35-45%	<b>32%</b>	30%	<b>4.60%</b>
Other	5-10%	<b>3%</b>	9%	<b>0.25%</b>
Total		<b>100%</b>	<b>100%</b>	<b>7.75%</b>

**Fair Value of Pension Plan and SERP Assets**

Fair value is the exchange price that would be received for an asset in the principal or most advantageous market for the asset in an orderly transaction between market participants on the measurement date. Also a fair value hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

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

Equity and debt securities: The fair values of securities are determined on a recurring basis by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or pricing models, which utilize significant observable inputs such as matrix pricing. This is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

# **NOTE 11 – PENSION AND OTHER POSTRETIREMENT PLANS (continued)**

The fair values of the Company's pension plan assets at December 31, 2014, by asset category are as follows:

<u>Asset Category</u> (dollars in thousands)	<u>Total</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Observable Inputs (Level 2 )</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Equity securities - US large cap common stocks	\$ 540	\$ 540	\$ 0	\$ 0
Equity securities - US large cap stock mutual funds	255	255	0	0
Equity securities - US mid cap stock mutual funds	144	144	0	0
Equity securities - US small cap stock mutual funds	25	25	0	0
Equity securities - international stock mutual funds	108	108	0	0
Equity securities - emerging markets stock mutual funds	24	24	0	0
Debt securities - intermediate term bond mutual funds	242	242	0	0
Debt securities - short term bond mutual funds	259	259	0	0
Debt securities - world bond mutual funds	94	94	0	0
Debt securities - commercial	55	0	55	0
Cash - money market account	91	91	0	0
Total	<u>\$ 1,837</u>	<u>\$ 1,782</u>	<u>\$ 55</u>	<u>\$ 0</u>

Total pension plan assets available for benefits also include \$4,000 in accrued interest and dividend income.

The fair values of the Company's pension plan assets at December 31, 2013, by asset category are as follows:

<u>Asset Category</u> (dollars in thousands)	<u>Total</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Observable Inputs (Level 2 )</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Equity securities - US large cap common stocks	\$ 484	\$ 484	\$ 0	\$ 0
Equity securities - US large cap stock mutual funds	258	258	0	0
Equity securities - US mid cap stock mutual funds	145	145	0	0
Equity securities - international stock mutual funds	119	119	0	0
Equity securities - emerging markets stock mutual funds	21	21	0	0
Debt securities - intermediate term bond mutual funds	127	127	0	0
Debt securities - short term bond mutual funds	211	211	0	0
Debt securities - world bond mutual funds	29	29	0	0
Debt securities - commercial	56	0	56	0
Cash - money market account	246	246	0	0
Total	<u>\$ 1,696</u>	<u>\$ 1,640</u>	<u>\$ 56</u>	<u>\$ 0</u>

Total pension plan assets available for benefits also include \$4,000 in accrued interest and dividend income.

There were no significant transfers between Level 1 and Level 2 during 2014 and 2013.

**NOTE 11 – PENSION AND OTHER POSTRETIREMENT PLANS (continued)**

The fair values of the Company's SERP assets at December 31, 2014, by asset category are as follows:

<b>Asset Category</b> <b>(dollars in thousands)</b>	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Observable Inputs (Level 2 )</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Equity securities - US large cap common stocks	\$ 144	\$ 144	\$ 0	\$ 0
Equity securities - US large cap stock mutual funds	371	371	0	0
Equity securities - US mid cap stock mutual funds	75	75	0	0
Equity securities - US small cap stock mutual funds	15	15	0	0
Equity securities - international stock mutual funds	54	54	0	0
Debt securities - intermediate term bond mutual funds	65	65	0	0
Debt securities - short term bond mutual funds	169	169	0	0
Debt securities - world bond mutual funds	32	32	0	0
Debt securities - commercial	60	0	60	0
Cash - money market account	26	26	0	0
Total	<u>\$ 1,011</u>	<u>\$ 951</u>	<u>\$ 60</u>	<u>\$ 0</u>

Total SERP plan assets available for benefits also include \$3,000 in accrued interest and dividend income.

The fair values of the Company's SERP assets at December 31, 2013, by asset category are as follows:

<b>Asset Category</b> <b>(dollars in thousands)</b>	<b>Total</b>	<b>Quoted Prices in Active Markets for Identical Assets (Level 1)</b>	<b>Significant Observable Inputs (Level 2 )</b>	<b>Significant Unobservable Inputs (Level 3)</b>
Equity securities - US large cap common stocks	\$ 140	\$ 140	\$ 0	\$ 0
Equity securities - US large cap stock mutual funds	374	374	0	0
Equity securities - US mid cap stock mutual funds	76	76	0	0
Equity securities - international stock mutual funds	59	59	0	0
Debt securities - intermediate term bond mutual funds	72	72	0	0
Debt securities - short term bond mutual funds	150	150	0	0
Debt securities - world bond mutual funds	34	34	0	0
Debt securities - commercial	62	0	62	0
Cash - money market account	98	98	0	0
Total	<u>\$ 1,065</u>	<u>\$ 1,003</u>	<u>\$ 62</u>	<u>\$ 0</u>

Total SERP plan assets available for benefits also include \$3,000 in accrued interest and dividend income.

There were no significant transfers between Level 1 and Level 2 during 2014 and 2013.

**Contributions**

The Company expects to contribute \$318,000 to its pension plan and \$110,000 to its SERP plan in 2015.



**NOTE 11 – PENSION AND OTHER POSTRETIREMENT PLANS (continued)****Estimated Future Benefit Payments**

The following benefit payments are expected to be paid over the next ten years:

<b>Plan Year</b> <b>(dollars in thousands)</b>	<b>Pension Benefits</b>	<b>SERP Benefits</b>
2015	\$ 286	\$ 136
2016	318	133
2017	233	130
2018	270	127
2019	169	123
2020-2024	922	532

**NOTE 12 – OTHER BENEFIT PLANS****401(k) Plan**

The Company maintains a 401(k) profit sharing plan for all employees meeting certain age and service requirements. The 401(k) plan allows employees to contribute up to the maximum amount allowable under the Internal Revenue Code, which are matched based upon the percentage of budgeted net income earned during the year on the first 6% of the compensation contributed. The expense recognized from matching was \$1.5 million in 2014 and \$1.4 million in 2013 and 2012.

**Deferred Compensation Plan**

Effective January 1, 2004, the Company adopted the Lake City Bank Deferred Compensation Plan. The purpose of the deferred compensation plan is to extend full 401(k) type retirement benefits to certain individuals without regard to statutory limitations under tax qualified plans. A liability is accrued by the Company for its obligation under this plan. The expense recognized for each of the last three years was \$67,000, \$282,000 and \$137,000 resulting in a deferred compensation liability of \$2.1 million, \$1.8 million and \$1.4 million as of year-end 2014, 2013 and 2012. The deferred compensation plan is funded solely by participant contributions and does not receive a Company match.

**Employee Agreements**

Under employment agreements with certain executives, certain events leading to separation from the Company could result in cash payments totaling \$4.4 million as of December 31, 2014. On December 31, 2014, no amounts were accrued on these contingent obligations.

**Directors' Deferred Compensation and Cash Plans**

The Company maintains a directors' deferred compensation plan and a cash plan. The amount owed directors for fees under the deferred directors' compensation and cash plans as of December 31, 2014 and 2013 was \$2.2 million. The related expense for the deferred directors' compensation and cash plans as of December 31, 2014, 2013 and 2012 was \$469,000, \$488,000 and \$480,000.

**NOTE 13 – INCOME TAXES**

Income tax expense for the years ended December 31, 2014, 2013 and 2012 consisted of the following:

<b>(dollars in thousands)</b>	<b>2014</b>	<b>2013</b>	<b>2012</b>
Current federal	\$ 18,877	\$ 17,181	\$ 15,181
Deferred federal	1,118	183	1,175
Current state	1,650	1,387	877
Deferred state	740	808	(51)
Total income tax expense . . . . .	<u>\$ 22,385</u>	<u>\$ 19,559</u>	<u>\$ 17,182</u>

**NOTE 13 – INCOME TAXES (continued)**

Income tax expense included an expense (benefit) of (\$89,000), \$43,000 and (\$150,000) applicable to security transactions for 2014, 2013 and 2012. The differences between financial statement tax expense and amounts computed by applying the statutory federal income tax rate of 35% for 2014, 2013 and 2012 to income before income taxes were as follows:

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
Income taxes at statutory federal rate of 35%	\$ 23,167	\$ 20,439	\$ 18,402
Increase (decrease) in taxes resulting from:			
Tax exempt income	(1,301)	(1,222)	(1,122)
Nondeductible expense	196	180	182
State income tax, net of federal tax effect	1,656	1,396	554
Captive insurance premium income	(378)	(391)	0
Tax credits	(233)	(243)	(253)
Bank owned life insurance	(631)	(578)	(340)
Reserve for unrecognized tax benefits	(64)	(25)	(45)
Other	(27)	3	(196)
Total income tax expense . . . . .	<u>\$ 22,385</u>	<u>\$ 19,559</u>	<u>\$ 17,182</u>

The net deferred tax asset recorded in the consolidated balance sheets at December 31, 2014 and 2013 consisted of the following:

<u>(dollars in thousands)</u>	<u>2014</u>	<u>2013</u>
Deferred tax assets:		
Bad debts	\$ 18,300	\$ 19,902
Pension and deferred compensation liability	1,224	1,215
Non-qualified stock options	444	638
Nonaccrual loan interest	2,127	1,760
Long-term incentive plan	1,186	1,605
Other	346	32
	<u>23,627</u>	<u>25,152</u>
Deferred tax liabilities:		
Accretion	153	152
Depreciation	3,843	3,336
Loan servicing rights	994	1,080
State taxes	704	963
Deferred loan fees	61	63
Intangible assets	1,883	1,925
FHLB stock dividends	33	88
REIT spillover dividend	1,085	1,178
Prepaid expenses	884	895
Other	373	0
	<u>10,013</u>	<u>9,680</u>
Valuation allowance	0	0
Net deferred tax asset . . . . .	<u>\$ 13,614</u>	<u>\$ 15,472</u>

In addition to the net deferred tax assets included above, the deferred income tax asset/liability allocated to the unrealized net gain/(loss) on securities available for sale included in equity was \$3.5 million and (\$895,000) for 2014 and 2013. The deferred income tax liability allocated to the pension plan and SERP included in equity was \$1.1 million and \$924,000 for 2014 and 2013.

During the second quarter of 2013, the Indiana legislature approved new tax rates for financial institutions which will lower their state income tax rate from 8.5% to 6.5%. The decrease will be phased in over four years, beginning in 2014. This lower state tax rate going forward will reduce the benefit provided by the Company's existing deferred tax items. As a result of the revaluation of the Company's state deferred tax items, the Company recorded a non-cash adjustment for state tax expense of \$465,000 in 2013.

### NOTE 13 – INCOME TAXES (continued)

During the first quarter of 2014, the Indiana legislature approved new tax rates for financial institutions. The tax rate, currently 8.0%, is scheduled to drop to 6.5% for 2017. The new legislation further reduces the rate to 4.9%, phased-in beginning in 2019. This lower state tax rate going forward will reduce the benefit provided by the Company's existing deferred tax items. As a result of the revaluation of the Company's state deferred tax items, the Company recorded a non-cash adjustment for state tax expense of \$431,000 in 2014.

#### Unrecognized Tax Benefits

A reconciliation of the beginning and ending amount of unrecognized tax benefits:

(dollars in thousands)	2014	2013
Balance January 1,	\$ 64	\$ 89
Additions based on tax positions related to the current year	0	5
Additions for tax positions of prior years	0	0
Reductions for tax positions of prior years	(42)	0
Reductions due to the statute of limitations	(22)	(30)
Settlements	0	0
Balance at December 31, .....	<u>\$ 0</u>	<u>\$ 64</u>

The Company did not have any unrecognized tax benefits at December 31, 2014. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months.

No interest or penalties were recorded in the income statement and no amount was accrued for interest and penalties for the period ending December 31, 2014, 2013 and 2012. Should the accrual of any interest or penalties relative to unrecognized tax benefits be necessary, it is the Company's policy to record such accruals in its income taxes accounts.

The Company and its subsidiaries file a consolidated U.S. federal tax return and a combined unitary return in the States of Indiana and Michigan. These returns are subject to examinations by authorities for all years after 2011.

### NOTE 14 – RELATED PARTY TRANSACTIONS

Loans to principal officers, directors, and their affiliates as of December 31, 2014 and 2013 were as follows:

(dollars in thousands)	2014	2013
Beginning balance	\$ 124,605	\$ 87,808
New loans and advances	112,940	171,214
Effect of changes in related parties	0	0
Repayments and renewals	(108,977)	(134,417)
Ending balance .....	<u>\$ 128,568</u>	<u>\$ 124,605</u>

Deposits from principal officers, directors, and their affiliates at year-end 2014 were \$5.7 million plus an additional \$4.3 million included in securities sold under agreements to repurchase. Deposits from principal officers, directors, and their affiliates at year-end 2013 were \$5.6 million plus an additional \$3.7 million included in securities sold under agreements to repurchase.

### NOTE 15 – STOCK BASED COMPENSATION

Effective April 8, 2008, the Company adopted the Lakeland Financial Corporation 2008 Equity Incentive Plan (the "2008 Plan"), which was approved by the Company's stockholders. At its inception there were 750,000 shares of common stock reserved for grants of stock options, stock appreciation rights, stock awards and cash incentive awards to employees of the Company, its subsidiaries and Board of Directors. Effective April 9, 2013, the Company adopted the Lakeland Financial Corporation 2013 Equity Incentive Plan (the "2013 Plan"), which was also approved by the Company's stockholders. At its inception the remaining shares of common stock available to grant under the 2008 Plan of 290,578 were transferred to the 2013 Plan and reserved for grants of stock options, stock appreciation rights, stock awards and cash incentive awards to employees of the Company, its subsidiaries and Board of Directors. Nonvested shares from the 2008 Plan that are unused at vesting are added to the shares available to grant of the 2013 Plan. As of December 31, 2014, 215,275 were available for future grants. Certain stock awards provide for accelerated vesting if there is a change in control. The Company has a policy of issuing new shares to satisfy exercises of stock awards.

## NOTE 15 – STOCK BASED COMPENSATION (continued)

Included in net income for the years ended December 31, 2014, 2013 and 2012 was employee stock compensation expense of \$2.8 million, \$2.0 million and \$1.3 million, and a related tax benefit of \$1.1 million, \$795,000 and \$545,000, respectively.

### Stock Options

The equity incentive plan requires that the exercise price for options be the market price on the date the options are granted. The maximum option term is ten years and the awards usually vest over three years. The fair value of each stock option is estimated with the Black Scholes pricing model, using the following weighted-average assumptions as of the grant date for stock options granted during the years presented. Expected volatilities are based on historical volatility of the Company's stock over the immediately preceding expected life period, as well as other factors known on the grant date that would have a significant effect on the stock price during the expected life period. The expected stock option life used is the historical option life of the similar employee base or Board of Directors. The turnover rate is based on historical data of the similar employee base as a group and the Board of Directors as a group. The risk-free interest rate is the Treasury rate on the date of grant corresponding to the expected life period of the stock option.

There were no stock option grants in 2014, 2013 or 2012.

A summary of the activity in the stock option plan as of December 31, 2014 and changes during the period then ended follows:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Outstanding at beginning of the year	71,000	\$ 22.89		
Granted	0			
Exercised	(13,082)	22.65		
Forfeited	0			
Outstanding at end of the year	57,918	\$ 22.95	2.5	\$ 1,188,653
Options exercisable at end of the year	57,918	\$ 22.95	2.5	\$ 1,188,653

The following table presents information on stock awards exercised for the years ended December 31, 2014, 2013 and 2012.

(dollars in thousands)	2014	2013	2012
Total intrinsic value	\$ 204	\$ 589	\$ 541
Cash received	7	757	782
Actual tax benefit realized for tax deductions	50	146	112

There were no modifications of stock option awards during the years ended December 31, 2014, 2013 and 2012.

As of December 31, 2014, there was no unrecognized compensation cost related to nonvested stock options granted under the plan.

### Restricted Stock Awards and Units

The fair value of restricted stock awards and units is the closing price of the Company's common stock on the date of grant adjusted for the present value of expected dividends. The restricted stock awards fully vest on the third anniversary of the grant date, with the exception of 13,750 shares listed below, which vested on the grant date.

A summary of the changes in the Company's nonvested shares for the year follows:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value
Nonvested at January 1, 2014	7,150	\$ 25.37
Granted	16,750	37.29
Vested	(13,750)	37.71
Forfeited	(250)	25.37
Nonvested at December 31, 2014	9,900	\$ 28.40

## NOTE 15 – STOCK BASED COMPENSATION (continued)

As of December 31, 2014, there was \$92,000 of total unrecognized compensation cost related to nonvested shares granted under the plan. The cost is expected to be recognized over a weighted period of 2.04 years. The total fair value of shares vested during the years ended December 31, 2014, 2013 and 2012 was \$598,000, \$536,000 and \$1.5 million.

### Performance Stock Units

The fair value of stock awards is the closing price of the Company's common stock on the date of grant adjusted for the present value of expected dividends. The stock awards fully vest on the third anniversary of the grant date. The 2014-2016, 2013-2015 and 2012-2014 Long-Term Incentive Plans must be paid in stock and have performance conditions which include revenue growth, diluted earnings per share growth and average return on beginning equity growth. Shares granted below include the number of shares assumed granted based on meeting the performance criteria of the 2014-2016, 2013-2015 and 2012-2014 Long-Term Incentive Plans at December 31, 2014.

			Weighted-Average Grant-Date Fair Value
Nonvested Shares	Shares		
Nonvested at January 1, 2014	176,594	\$	22.67
Granted	96,410		35.26
Vested	(55,534)		19.78
Forfeited	0		0.00
Nonvested at December 31, 2014	217,470	\$	28.99

As of December 31, 2014 and 2013, there was \$2.7 million and \$1.5 million of total unrecognized compensation cost related to nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted period of 1.55 years, 1.53 years and 1.51 years, respectively. The total fair value of shares vested during the year ended December 31, 2014 was \$2.0 million. At December 31, 2014, 2013 and 2012, 55,534, 44,894 and 50,160 shares vested, respectively.

## NOTE 16 – CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS

The Company became a financial holding company effective May 30, 2012 and is now required to be well capitalized under the applicable regulatory guidelines. The Company and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet certain heightened minimum capital requirements can initiate certain mandatory, and possibly discretionary, actions by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weighting and other factors.

The quantitative measures established by regulation to ensure capital adequacy that were in effect on December 31, 2014, require the Company and the Bank to maintain minimum capital amounts and ratios (set forth in the following table) of Total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined in the regulation), and of Tier I capital (as defined in the regulation) to average assets (as defined). Management believes, as of the years ended December 31, 2014 and 2013, that the Company and the Bank met all capital adequacy requirements to which they are subject.

The capital adequacy requirements were heightened by the Basel III Rules, which went into effect on January 1, 2015 with a phase-in period for certain aspects of the rule through 2019. Management believes that the Company and the Bank are currently in compliance with the capital adequacy requirements to which they are subject.

# **NOTE 16 – CAPITAL REQUIREMENTS AND RESTRICTIONS ON RETAINED EARNINGS (continued)**

As of December 31, 2014, the most recent notification from the federal regulators categorized the Company and the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company and the Bank must maintain minimum Total risk-based capital ratios, Tier I risk-based capital ratios and Tier I leverage capital ratios as set forth in the table. There have been no conditions or events since that notification that management believes have changed the Company and the Bank's category.

(dollars in thousands)	Actual		Minimum Required For Capital Adequacy Purposes		Minimum Required to Be Well Capitalized Under Prompt Corrective Action Regulations	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2014:						
Total Capital (to Risk Weighted Assets)						
Consolidated	\$ 418,827	14.36%	\$ 233,286	8.00%	\$ 291,607	10.00%
Bank	\$ 403,454	13.87%	\$ 232,787	8.00%	\$ 290,984	10.00%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	\$ 382,254	13.11%	\$ 116,643	4.00%	\$ 174,964	6.00%
Bank	\$ 366,958	12.61%	\$ 116,394	4.00%	\$ 174,591	6.00%
Tier I Capital (to Average Assets)						
Consolidated	\$ 382,254	11.22%	\$ 136,265	4.00%	\$ 170,332	5.00%
Bank	\$ 366,958	10.84%	\$ 135,420	4.00%	\$ 169,276	5.00%
As of December 31, 2013:						
Total Capital (to Risk Weighted Assets)						
Consolidated	\$ 382,951	14.23%	\$ 215,229	8.00%	\$ 269,036	10.00%
Bank	\$ 373,685	13.92%	\$ 214,704	8.00%	\$ 268,380	10.00%
Tier I Capital (to Risk Weighted Assets)						
Consolidated	\$ 349,134	12.98%	\$ 107,614	4.00%	\$ 161,422	6.00%
Bank	\$ 339,949	12.67%	\$ 107,352	4.00%	\$ 161,028	6.00%
Tier I Capital (to Average Assets)						
Consolidated	\$ 349,134	11.25%	\$ 124,152	4.00%	\$ 155,190	5.00%
Bank	\$ 339,949	10.98%	\$ 123,809	4.00%	\$ 154,761	5.00%

The Bank is required to obtain the approval of the Indiana Department of Financial Institutions for the payment of any dividend if the total amount of all dividends declared by the Bank during the calendar year, including the proposed dividend, would exceed the sum of the retained net income for the year-to-date combined with the retained net income for the previous two years. Indiana law defines "retained net income" to mean the net income of a specified period, calculated under the consolidated report of income instructions, less the total amount of all dividends declared for the specified period. As of December 31, 2014, approximately \$59.6 million was available to be paid as dividends to the Company by the Bank.

The payment of dividends by any financial institution or its holding company is affected by the requirement to maintain adequate capital pursuant to applicable capital adequacy guidelines and regulations, and a financial institution generally is prohibited from paying any dividends if, following payment thereof, the institution would be undercapitalized. As described above, the Bank exceeded its minimum capital requirements under applicable guidelines as of December 31, 2014. Notwithstanding the availability of funds for dividends, however, the FDIC may prohibit the payment of any dividends by the Bank if the FDIC determines such payment would constitute an unsafe or unsound practice.

## NOTE 17 – OFFSETTING ASSETS AND LIABILITIES

The following tables summarize gross and net information about financial instruments and derivative instruments that are offset in the statement of financial position or that are subject to an enforceable master netting arrangement at December 31, 2014 and 2013.

December 31, 2014						
(dollars in thousands)	Gross Amounts of Recognized Assets/ Liabilities	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Assets presented in the Statement of Financial Position	Gross Amounts Not Offset in the Statement of Financial Position		Net
				Financial Instruments	Cash Received	
<b>Assets</b>						
Interest Rate Swap Derivatives	\$ 1,191	\$ 0	\$ 1,191	\$ 0	\$ 0	\$ 1,191
Total Assets	<u>\$ 1,191</u>	<u>\$ 0</u>	<u>\$ 1,191</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 1,191</u>
<b>Liabilities</b>						
Interest Rate Swap Derivatives	\$ 1,242	\$ 0	\$ 1,242	\$ 0	\$ (1,242)	\$ 0
Repurchase Agreements	54,907	0	54,907	(54,907)	0	0
Total Liabilities	<u>\$ 56,149</u>	<u>\$ 0</u>	<u>\$ 56,149</u>	<u>\$ (54,907)</u>	<u>\$ (1,242)</u>	<u>\$ 0</u>

December 31, 2013						
(dollars in thousands)	Gross Amounts of Recognized Assets/ Liabilities	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Assets presented in the Statement of Financial Position	Gross Amounts Not Offset in the Statement of Financial Position		Net
				Financial Instruments	Cash Received	
<b>Assets</b>						
Interest Rate Swap Derivatives	\$ 627	\$ 0	\$ 627	\$ 0	\$ (260)	\$ 367
Total Assets	<u>\$ 627</u>	<u>\$ 0</u>	<u>\$ 627</u>	<u>\$ 0</u>	<u>\$ (260)</u>	<u>\$ 367</u>
<b>Liabilities</b>						
Interest Rate Swap Derivatives	\$ 592	\$ 0	\$ 592	\$ 0	\$ 0	\$ 592
Repurchase Agreements	104,876	0	104,876	(104,876)	0	0
Total Liabilities	<u>\$ 105,468</u>	<u>\$ 0</u>	<u>\$ 105,468</u>	<u>\$ (104,876)</u>	<u>\$ 0</u>	<u>\$ 592</u>

If an event of default occurs causing an early termination of an interest rate swap derivative, any early termination amount payable to one party by the other party may be reduced by set-off against any other amount payable by the one party to the other party. If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions.

## NOTE 18 – COMMITMENTS, OFF-BALANCE SHEET RISKS AND CONTINGENCIES

During the normal course of business, the Company becomes a party to financial instruments with off-balance sheet risk in order to meet the financing needs of its customers. These financial instruments include commitments to make loans and open-ended revolving lines of credit. Amounts as of the years ended December 31, 2014 and 2013, were as follows:

	2014		2013	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
(dollars in thousands)				
Commercial loan lines of credit	\$ 45,294	\$ 967,282	\$ 79,457	\$ 828,405
Commercial letters of credit	0	62	0	80
Standby letters of credit	0	52,500	0	33,575
Real estate mortgage loans	3,439	1,589	3,865	2,233
Real estate construction mortgage loans	1,875	4,936	927	1,821
Home equity mortgage open-ended revolving lines	0	149,706	0	139,555
Consumer loan open-ended revolving lines	0	5,896	0	5,013
Total	<u>\$ 50,608</u>	<u>\$ 1,181,971</u>	<u>\$ 84,249</u>	<u>\$ 1,010,682</u>

The index on variable rate commercial loan commitments is principally the Company's base rate, which is the national prime rate. Interest rate ranges on commitments and open-ended revolving lines of credit for years ended December 31, 2014 and 2013, were as follows:

	2014		2013	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commercial loan	2.44-7.50 %	1.46-8.25 %	1.83-10.00 %	1.67-7.50 %
Real estate mortgage loan	3.13-4.75 %	2.88-5.75 %	3.38-4.75 %	3.38-4.88 %
Consumer loan open-ended revolving line	N/A	2.50-15.00 %	N/A	2.50-15.00 %

Commitments, excluding open-ended revolving lines, generally have fixed expiration dates of one year or less. Open-ended revolving lines are monitored for proper performance and compliance on a monthly basis. Since many commitments expire without being drawn upon, the total commitment amount does not necessarily represent future cash requirements. The Company follows the same credit policy (including requiring collateral, if deemed appropriate) to make such commitments as it follows for those loans that are recorded in its financial statements.

The Company's exposure to credit losses in the event of nonperformance is represented by the contractual amount of the commitments. Management does not expect any significant losses as a result of these commitments.



## NOTE 19 – PARENT COMPANY STATEMENTS

The Company operates primarily in the banking industry, which accounts for substantially all of its revenues, operating income and assets. Presented below are parent only financial statements:

### CONDENSED BALANCE SHEETS

(dollars in thousands)	December 31,	
	2014	2013
<b>ASSETS</b>		
Deposits with Lake City Bank	\$ 427	\$ 950
Deposits with other depository institutions	7,654	0
Cash	8,081	950
Investments in banking subsidiary	376,000	342,690
Investments in other subsidiaries	3,394	2,313
Other assets	4,980	7,107
Total assets	<u>\$ 392,455</u>	<u>\$ 353,060</u>
<b>LIABILITIES</b>		
Dividends payable and other liabilities	\$ 231	\$ 257
Subordinated debt	30,928	30,928
<b>STOCKHOLDERS' EQUITY</b>	<u>361,296</u>	<u>321,875</u>
Total liabilities and stockholders' equity	<u>\$ 392,455</u>	<u>\$ 353,060</u>

### CONDENSED STATEMENTS OF INCOME

(dollars in thousands)	Years Ended December 31,		
	2014	2013	2012
Dividends from Lake City Bank, Lakeland Statutory Trust II	\$ 18,362	\$ 9,524	\$ 15,745
Other income	182	98	85
Interest expense on subordinated debt	(1,048)	(1,061)	(1,123)
Miscellaneous expense	(3,462)	(2,651)	(1,976)
<b>INCOME BEFORE INCOME TAXES AND EQUITY IN</b>			
<b>UNDISTRIBUTED INCOME OF SUBSIDIARIES</b>	14,034	5,910	12,731
Income tax benefit	1,691	1,387	1,187
<b>INCOME BEFORE EQUITY IN UNDISTRIBUTED</b>			
<b>INCOME OF SUBSIDIARIES</b>	15,725	7,297	13,918
Equity in undistributed income of subsidiaries	28,080	31,542	21,476
<b>NET INCOME</b>	<u>\$ 43,805</u>	<u>\$ 38,839</u>	<u>\$ 35,394</u>
<b>COMPREHENSIVE INCOME</b>	<u>\$ 50,129</u>	<u>\$ 30,656</u>	<u>\$ 35,944</u>

### CONDENSED STATEMENTS OF CASH FLOWS

(dollars in thousands)	Years Ended December 31,		
	2014	2013	2012
Cash flows from operating activities:			
Net income	\$ 43,805	\$ 38,839	\$ 35,394
Adjustments to net cash from operating activities:			
Equity in undistributed income of subsidiaries	(28,080)	(31,543)	(21,475)
Other changes	5,348	989	265
Net cash from operating activities	21,073	8,285	14,184
Cash flows from investing activities	0	0	(250)
Proceeds from issuance of common stock	57	903	894
Repurchase of common stock	(444)	(399)	(421)
Dividends paid	(13,555)	(9,372)	(13,630)
Cash flows from financing activities	(13,942)	(8,868)	(13,157)
Net increase in cash and cash equivalents	7,131	(583)	777
Cash and cash equivalents at beginning of the year	950	1,533	756
Cash and cash equivalents at end of the year	<u>\$ 8,081</u>	<u>\$ 950</u>	<u>\$ 1,533</u>

**NOTE 20 – EARNINGS PER SHARE**

Following are the factors used in the earnings per share computations:

	2014	2013	2012
Basic earnings per common share:			
Net income	\$ 43,805,000	\$ 38,839,000	\$ 35,394,000
Weighted-average common shares outstanding	16,535,530	16,436,131	16,323,870
Basic earnings per common share	<u>\$ 2.65</u>	<u>\$ 2.36</u>	<u>\$ 2.17</u>
Diluted earnings per common share:			
Net income	\$ 43,805,000	\$ 38,839,000	\$ 35,394,000
Weighted-average common shares outstanding for basic earnings per common share	16,535,530	16,436,131	16,323,870
Add: Dilutive effect of assumed exercise of warrant	92,547	61,436	38,224
Add: Dilutive effect of assumed exercises of stock options and awards	153,378	136,771	120,843
Average shares and dilutive potential common shares	<u>16,781,455</u>	<u>16,634,338</u>	<u>16,482,937</u>
Diluted earnings per common share	<u>\$ 2.61</u>	<u>\$ 2.33</u>	<u>\$ 2.15</u>

There were no antidilutive stock options for 2014, 2013 and 2012.

**NOTE 21 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)**

The following tables summarize the changes within each classification of accumulated other comprehensive income (loss) for December 31, 2014 and 2013 all shown net of tax:

	Unrealized Gains and Losses on Available- for-Sales Securities	Defined Benefit Pension Items	Total
<u>(dollars in thousands)</u>			
Balance at December 31, 2013	\$ (1,138)	\$ (1,356)	\$ (2,494)
Other comprehensive income before reclassification	6,471	(399)	6,072
Amounts reclassified from accumulated other comprehensive income (loss)	134	118	252
Net current period other comprehensive income	6,605	(281)	6,324
Balance at December 31, 2014	<u>\$ 5,467</u>	<u>\$ (1,637)</u>	<u>\$ 3,830</u>

	Unrealized Gains and Losses on Available- for-Sales Securities	Defined Benefit Pension Items	Total
<u>(dollars in thousands)</u>			
Balance at December 31, 2012	\$ 7,517	\$ (1,828)	\$ 5,689
Other comprehensive income before reclassification	(8,591)	327	(8,264)
Amounts reclassified from accumulated other comprehensive income (loss)	(64)	145	81
Net current period other comprehensive income	(8,655)	472	(8,183)
Balance at December 31, 2013	<u>\$ (1,138)</u>	<u>\$ (1,356)</u>	<u>\$ (2,494)</u>

**NOTE 21 – ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS) (continued)**

Reclassifications out of accumulated comprehensive income for the years ended December 31, 2014 and 2013 are as follows:

<b>Details about Accumulated Other Comprehensive Income Components</b>	<b>Amount Reclassified From Accumulated Other Comprehensive Income</b>	<b>Affected Line Item in the Statement Where Net Income is Presented</b>
<b>2014</b>		
<u>(dollars in thousands)</u>		
Unrealized gains and losses on available-for-sale securities	\$ (224)	Net securities gains (losses)
Tax effect	90	Income tax expense
	<u>(134)</u>	Net of tax
Amortization of defined benefit pension items <sup>(1)</sup>	(197)	Salaries and employee benefits
Tax effect	79	Income tax expense
	<u>(118)</u>	Net of tax
Total reclassifications for the period	<u>\$ (252)</u>	Net of tax
<b>2013</b>		
<u>(dollars in thousands)</u>		
Unrealized gains and losses on available-for-sale securities	\$ 107	Net securities gains (losses)
Tax effect	(43)	Income tax expense
	<u>64</u>	Net of tax
Amortization of defined benefit pension items <sup>(1)</sup>	(244)	Salaries and employee benefits
Tax effect	99	Income tax expense
	<u>(145)</u>	Net of tax
Total reclassifications for the period	<u>\$ (81)</u>	Net of tax

(1) Included in the computation of net pension plan expense as more fully discussed in Note 11.

**NOTE 22 – SELECTED QUARTERLY DATA (UNAUDITED) (in thousands except per share data)**

<b>2014</b>	<b>4th Quarter</b>	<b>3rd Quarter</b>	<b>2nd Quarter</b>	<b>1st Quarter</b>
Interest income	\$ 30,023	\$ 29,745	\$ 29,250	\$ 28,270
Interest expense	3,919	3,780	3,696	3,590
Net interest income . . . . .	26,104	25,965	25,554	24,680
Provision for loan losses	0	0	0	0
Net interest income after provision	26,104	25,965	25,554	24,680
Noninterest income	7,163	7,871	7,592	7,427
Noninterest expense	16,632	16,660	16,084	16,790
Income tax expense	5,565	5,665	5,750	5,405
Net income . . . . .	\$ 11,070	\$ 11,511	\$ 11,312	\$ 9,912
Basic earnings per common share	\$ 0.67	\$ 0.70	\$ 0.68	\$ 0.60
Diluted earnings per common share	\$ 0.66	\$ 0.69	\$ 0.68	\$ 0.59
<b>2013</b>	<b>4th Quarter</b>	<b>3rd Quarter</b>	<b>2nd Quarter</b>	<b>1st Quarter</b>
Interest income	\$ 28,050	\$ 26,970	\$ 26,424	\$ 26,292
Interest expense	3,752	3,998	4,512	5,035
Net interest income . . . . .	24,298	22,972	21,912	21,257
Provision for loan losses	0	0	0	0
Net interest income after provision	24,298	22,972	21,912	21,257
Noninterest income	7,878	7,809	7,569	7,481
Noninterest expense	16,528	16,266	15,091	14,893
Income tax expense	5,060	4,746	5,154	4,599
Net income . . . . .	\$ 10,588	\$ 9,769	\$ 9,236	\$ 9,246
Basic earnings per common share	\$ 0.64	\$ 0.59	\$ 0.56	\$ 0.56
Diluted earnings per common share	\$ 0.63	\$ 0.59	\$ 0.56	\$ 0.56

## NOTE 23 – WARRANT

On February 27, 2009, the Company entered into a Letter Agreement with the Treasury, pursuant to which the Company issued (i) 56,044 shares of the Company's Series A Preferred Stock and (ii) the Warrant to purchase 396,538 shares of the Company's common stock, no par value, for an aggregate purchase price of \$56,044,000 in cash. This transaction was conducted in accordance with the CPP.

The Warrant has a 10-year term and is immediately exercisable upon its issuance, with an exercise price, subject to anti-dilution adjustments, equal to \$21.20 per share of the common stock (trailing 20-day Lakeland average closing price as of December 17, 2008, which was the last trading day prior to date of receipt of Treasury's preliminary approval for our participation in the CPP). The Warrant was valued using the Black-Scholes model with the following assumptions: market price of \$17.45; exercise price of \$21.20; risk-free interest rate of 3.02%; expected life of 10 years; expected dividend rate on common stock of 4.5759% and volatility of common stock price of 41.8046%. This resulted in a value of \$4.4433 per share of common stock underlying the Warrant.

On December 3, 2009, the Company was notified by Treasury that, as a result of the Company's completion of our November 18, 2009 Qualified Equity Offering, the amount of the Warrant was reduced by 50% to 198,269 shares. In accordance with the terms of the Warrant, the number of shares issuable upon exercise and the exercise price are adjusted each time the Company pays a dividend to its stockholders in excess of the dividend paid at the time the warrant was issued. In 2014, the Company paid four dividends in excess of dividend paid at the time the Warrant was issued. In 2013, the Company paid three dividends in excess of the dividend paid at the time the Warrant was issued. Based on the formula set forth in the warrant, at December 31, 2013, the amount of shares issuable upon exercise of the Warrant was 200,710 and the exercise price was \$20.9422. Based on the formula set forth in the Warrant, at December 31, 2014, the amount of shares issuable upon exercise of the Warrant was 201,780 and the exercise price was \$20.8312.

On June 9, 2010, the Company redeemed the Series A Preferred Stock and accreted the remaining unamortized discount on these shares. The Company did not repurchase the Warrant, and the Warrant was sold by Treasury to an independent, third party. The Warrant has not been exercised as of December 31, 2014.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

Within the prior two years of the date of the most recent financial statement, there have been no changes in or disagreements with the Company's accountants.

### **ITEM 9A. CONTROLS AND PROCEDURES**

a) An evaluation was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of December 31, 2014. Based on that evaluation, the Company's management, including the Chief Executive Officer and Chief Financial Officer, concluded that the Company's disclosure controls and procedures were effective.

### **b) MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities and Exchange Act of 1934. The Company's internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles ("GAAP").

The Company's internal control over financial reporting includes those policies and procedures that: (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2014. In making this assessment, management used the 2013 criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on our assessment and those criteria, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2014.

The Company's independent registered public accounting firm has issued their report on the Company's internal control over financial reporting. That report appears under the heading, Report of Independent Registered Public Accounting Firm.

c) There have been no changes in the Company's internal controls during the previous fiscal quarter, ended December 31, 2014, that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting.

### **ITEM 9B. OTHER INFORMATION**

Not applicable.

## **PART III**

### **ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information appearing in the definitive Proxy Statement, for the Annual Meeting of Stockholders to be held on April 14, 2015, as filed with the SEC on March 5, 2015, on Form DEF 14A, is incorporated herein by reference in response to this Item.

### **ITEM 11. EXECUTIVE COMPENSATION**

The information appearing in the definitive Proxy Statement, for the Annual Meeting of Stockholders to be held on April 14, 2015, as filed with the SEC on March 5, 2015, on Form DEF 14A, is incorporated herein by reference in response to this Item.

### **ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED SHAREHOLDER MATTERS**

The information appearing in the definitive Proxy Statement, for the Annual Meeting of Stockholders to be held on April 14, 2015, as filed with the SEC on March 5, 2015, on Form DEF 14A, is incorporated herein by reference in response to this Item.

See Item 5 above for equity compensation plan information.

## ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information appearing in the definitive Proxy Statement, for the Annual Meeting of Stockholders to be held on April 14, 2015, as filed March 5, 2015, on Form DEF 14A, is incorporated herein by reference in response to this Item. Certain additional information on related party transactions is also included in Note 14 to the Company's financial statements contained in Item 8.

## ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information appearing in the definitive Proxy Statement, for the Annual Meeting of Stockholders to be held on April 14, 2015, as filed March 5, 2015, on Form DEF 14A, is incorporated herein by reference in response to this Item.

## PART IV

## ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

The documents listed below are filed as a part of this report:

(a) Exhibits

Exhibit No.	Document	Incorporated by reference to
3.1	Amended and Restated Articles of Incorporation of Lakeland Financial Corporation	Exhibit 3.1 to the Company's Form 8-K filed on March 2, 2009
3.2	Amendment to Amended and Restated Articles of Incorporation of Lakeland Financial Corporation	Exhibit 3.2 to the Company's Form 10-K for the fiscal year ended December 31, 2012
3.3	Amended and Restated Bylaws of Lakeland Financial Corporation	Exhibit 3.1 to the Company's Form 8-K filed on December 5, 2011
4.1	Form of Common Stock Certificate	Exhibit 4.1 to the Company's Form 10-K for the fiscal year ended December 31, 2003
4.2	Form of Warrant to Purchase Shares of Common Stock	Exhibit 4.2 to the Company's Form 10-K for the fiscal year ended December 31, 2012
4.3	Form of Indenture for Trust Preferred Issuance	Exhibit 4.1 to the Company's Form 10-K for the fiscal year ended December 31, 2003
10.1	Lakeland Financial Corporation 2008 Equity Incentive Plan	Exhibit 10.3 to the Company's Form S-8 filed on March 14, 2008
10.2	Lakeland Financial Corporation 401(k) Plan	Exhibit 10.1 to the Company's Form S-8 filed on October 23, 2000
10.3	Amended and Restated Lakeland Financial Corporation Director's Fee Deferral Plan	Exhibit 10.4 to the Company's Form 10-K for the fiscal year ended December 31, 2008
10.4	Form of Change in Control Agreement entered into with Michael L. Kubacki and Charles D. Smith	Exhibit 10.1 of the Company's Form 10-K for the fiscal year ended December 31, 2001

10.5	Form of Change in Control Agreement entered into with David M. Findlay and Kevin L. Deardorff	Exhibit 10.5 of the Company's Form 10-K for the fiscal year ended December 31, 2001
10.6	Form of First Amendment of Change to Control Agreement entered into with Michael L. Kubacki, David M. Findlay, Charles D. Smith and Kevin L. Deardorff	Exhibit 10.5 to the Company's Form 10-K for the fiscal year ended December 31, 2008
10.7	Form of Second Amendment to Change in Control Agreement entered into with Michael L. Kubacki, David M. Findlay and Kevin L. Deardorff	Exhibit 10.1 to the Company's Form 8-K filed on December 19, 2011
10.8	Employee Deferred Compensation Plan and Form of Agreement	Exhibit 10.7 to the Company's Form 10-K for the fiscal year ended December 31, 2008
10.9	Schedule of Board Fees	Attached hereto
10.10	Form of Option Grant Agreement	Exhibit 10.10 to the Company's Form 10-K for the fiscal year ended December 31, 2004
10.11	Executive Incentive Bonus Plan	Exhibit 10.11 to the Company's Form 10-K for the fiscal year ended December 31, 2004
10.12	Amended and Restated Long Term Incentive Plan	Exhibit 10.1 to the Company's Form 10-Q for the quarter ended September 30, 2009
10.13	Retirement Transition Agreement, dated July 12, 2011, between Charles D. Smith and the Company	Exhibit 10.1 to the Company's Form 8-K filed on July 13, 2011
10.14	Form of Change of Control Agreement entered into with Eric H. Ottinger	Exhibit 10.1 to the Company's Form 8-K filed March 1, 2011
10.15	First Amendment to Change in Control Agreement entered into with Eric H. Ottinger	Exhibit 10.2 to the Company's Form 8-K filed on December 19, 2011
10.16	Form of Change in Control Agreement entered into with Michael E. Gavin	Exhibit 10.3 to the Company's Form 8-K filed on December 19, 2011
10.17	Lakeland Financial Corporation 2013 Equity Incentive Plan	Appendix A to the Definitive Proxy Statement on Form DEF-14A filed on March 4 2013
10.18	Form of Restricted Stock Award Agreement	Exhibit 4.3 to the Company's Form S-8 filed on July 9, 2013
10.19	Form of Nonqualified Stock Option Award Agreement	Exhibit 4.4 to the Company's Form S-8 filed on July 9, 2013



10.20	Form of Restricted Stock Unit Award Agreement	Exhibit 4.5 to the Company's Form S-8 filed on July 9, 2013
10.21	Transitional Employment Agreement, dated September 4, 2013, by and among the Company, the Bank and Michael L. Kubacki	Exhibit 10.1 to the Company's Form 8-K filed on September 4, 2013
21.0	Subsidiaries	Attached hereto
23.1	Consent of Independent Registered Public Accounting Firm	Attached hereto
31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-15(e)/15d-15(e) and 13(a)-15(f)/15d-15(f)	Attached hereto
31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-15(e)/15d-15(e) and 13(a)-15(f)/15d-15(f)	Attached hereto
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Attached hereto
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Attached hereto

## SIGNATURES

Pursuant to the requirements of Section 15(d) of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

### LAKELAND FINANCIAL CORPORATION

Date: March 5, 2015

By /s/ Michael L. Kubacki  
Michael L. Kubacki, Executive Chairman

Pursuant to the requirements of the Securities and Exchange Act of 1934, this report has been signed by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ David M. Findlay David M. Findlay	Principal Executive Officer and Director	March 5, 2015
/s/ Lisa M. O'Neill Lisa M. O'Neill	Principal Financial Officer	March 5, 2015
/s/ Teresa A. Bartman Teresa A. Bartman	Principal Accounting Officer	March 5, 2015
/s/ Blake W. Augsburger Blake W. Augsburger	Director	March 5, 2015
/s/ Robert E. Bartels, Jr. Robert E. Bartels, Jr.	Director	March 5, 2015
/s/ Daniel F. Evans, Jr. Daniel F. Evans, Jr.	Director	March 5, 2015
/s/ Thomas A. Hiatt Thomas A. Hiatt	Director	March 5, 2015
/s/ Michael L. Kubacki Michael L. Kubacki	Executive Chairman and Director	March 5, 2015
/s/ Charles E. Niemier Charles E. Niemier	Director	March 5, 2015
/s/ Emily E. Pichon Emily E. Pichon	Director	March 5, 2015

/s/ Steven D. Ross Steven D. Ross	Director	March 5, 2015
/s/ Brian J. Smith Brian J. Smith	Director	March 5, 2015
/s/ Bradley J. Toothaker Bradley J. Toothaker	Director	March 5, 2015
/s/ Ronald D. Truex Ronald D. Truex	Director	March 5, 2015
/s/ M. Scott Welch M. Scott Welch	Director	March 5, 2015

