

FIRST MID ILLINOIS BANCSHARES INC
Form 10-K
March 07, 2013

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, 2012

Or

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

For the transition period from _____ to _____

Commission file number 0-13368

FIRST MID-ILLINOIS BANCSHARES, INC.

(Exact name of Registrant as specified in its charter)

Delaware

37-1103704

(State or other jurisdiction of incorporation or organization)

(I.R.S. employer identification no.)

1421 Charleston Avenue, Mattoon, Illinois

61938

(Address of principal executive offices)

(Zip code)

(217) 234-7454

(Registrant's telephone number, including area code)

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

NONE

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

Common stock, par value \$4.00 per share, and related Common Stock Purchase Rights

(Title of class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes No

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

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

No

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Indicate by check mark whether the Registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark 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 Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form Yes

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

The aggregate market value of the outstanding common stock, other than shares held by persons who may be deemed affiliates of the Registrant, as of the last business day of the Registrant's most recently completed second fiscal quarter was approximately \$93,551,547. Determination of stock ownership by non-affiliates was made solely for the purpose of responding to this requirement and the Registrant is not bound by this determination for any other purpose.

As of March 7, 2013, 5,932,206 shares of the Registrant's common stock, \$4.00 par value, were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Document

Into Form 10-K Part:

Portions of the Proxy Statement for 2013 Annual Meeting of Shareholders to be held on April 24, 2013

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PART I

ITEM 1. BUSINESS

Company and Subsidiaries

First Mid-Illinois Bancshares, Inc. (the “Company”) is a financial holding company. The Company is engaged in the business of banking through its wholly owned subsidiary, First Mid-Illinois Bank & Trust, N.A. (“First Mid Bank”). The Company provides data processing services to affiliates through another wholly owned subsidiary, Mid-Illinois Data Services, Inc. (“MIDS”). The Company offers insurance products and services to customers through its wholly owned subsidiary, The Checkley Agency, Inc. doing business as First Mid Insurance Group (“First Mid Insurance”). The Company also wholly owns two statutory business trusts, First Mid-Illinois Statutory Trust I (“Trust I”), and First Mid-Illinois Statutory Trust II (“Trust II”), both unconsolidated subsidiaries of the Company.

The Company, a Delaware corporation, was incorporated on September 8, 1981, and pursuant to the approval of the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) became the holding company owning all of the outstanding stock of First National Bank, Mattoon (“First National”) on June 1, 1982. First National changed its name to First Mid-Illinois Bank & Trust, N.A. in 1992. The Company acquired all of the outstanding stock of a number of community banks or thrift institutions on the following dates, and subsequently combined their operations with those of the Company:

- Mattoon Bank, Mattoon on April 2, 1984
- State Bank of Sullivan on April 1, 1985
- Cumberland County National Bank in Neoga on December 31, 1985
- First National Bank and Trust Company of Douglas County on December 31, 1986
- Charleston Community Bank on December 30, 1987
- Heartland Federal Savings and Loan Association on July 1, 1992
- Downstate Bancshares, Inc. on October 4, 1994
- American Bank of Illinois on April 20, 2001
- Peoples State Bank of Mansfield on May 1, 2006

In 1997, First Mid Bank acquired the Charleston, Illinois branch location and the customer base of First of America Bank and in 1999 acquired the Monticello, Taylorville and DeLand branch offices and deposit base of Bank One Illinois, N.A.

First Mid Bank also opened a de novo branch in Decatur, Illinois and a banking center in the Student Union of Eastern Illinois University in Charleston, Illinois (2000); de novo branches in Champaign, Illinois and Maryville, Illinois (2002), and a de novo branch in Highland, Illinois (2005).

In 2002, the Company acquired all of the outstanding stock of First Mid Insurance, an insurance agency located in Mattoon.

In 2009, the Company opened de novo branches in Decatur and Champaign.

On September 10, 2010, the Company acquired 10 Illinois branches (the “Branches”) from First Bank, a Missouri state chartered bank, located in Bartonville, Bloomington, Galesburg, Knoxville, Peoria and Quincy, Illinois.

Employees

The Company, MIDS, First Mid Insurance and First Mid Bank, collectively, employed 400 people on a full-time equivalent basis as of December 31, 2012. The Company places a high priority on staff development, which involves extensive training, including customer service training. New employees are selected on the basis of both technical skills and customer service capabilities. None of the employees are covered by a collective bargaining agreement with the Company. The Company offers a variety of employee benefits.

Business Lines

The Company has chosen to operate in three primary lines of business—community banking and wealth management through First Mid Bank and insurance brokerage through First Mid Insurance. Of these, the community banking line contributes approximately 91% of the Company's total revenues and profits. Within the community banking line, the Company serves commercial, retail and agricultural customers with a broad array of deposit and loan related products. The wealth management line provides estate planning, investment and farm management services for individuals and employee benefit services for business enterprises. The insurance brokerage line provides commercial lines insurance to businesses as well as homeowner, automobile and other types of personal lines insurance to individuals. All three lines emphasize a "hands on" approach to service so that products and services can be tailored to fit the specific needs of existing and potential customers. Management believes that by emphasizing this personalized approach, the Company can, to a degree, diminish the trend towards homogeneous financial services, thereby differentiating the Company from competitors and allowing for slightly higher operating margins in each of the three lines.

Business Strategies

Strategy for Operations and Risk Management. Operationally, the Company centralizes most administrative and clerical tasks within its home office location in Mattoon, Illinois. This allows branches to maintain customer focus, helps assure compliance with banking regulations, keeps fixed administrative costs at as low a level as is practicable, and better manages the various forms of risk inherent in this business. This approach also makes use of technology in day-to-day banking activities thereby reducing the potential for human error. While the Company does not employ every new technology that is introduced, it attempts to be competitive with other banking organizations with respect to operational and customer technology.

The Company has a comprehensive set of operational policies and procedures that have been developed over time to address risk. These policies are intended to be as close as possible to “best practices” of the financial services industry and are subjected to continual review by management and the Board of Directors. The Company’s internal audit function incorporates procedures to determine compliance with these policies.

In the business of banking, credit risk is an important risk as losses from uncollectible loans can diminish capital, earnings and shareholder value. In order to address this risk, the lending function of First Mid Bank receives significant attention from executive management and the Board of Directors. An important element of credit risk management is the quality, experience and training of the loan officers of First Mid Bank. The Company has invested, and will continue to invest, significant resources to ensure the quality, experience and training of First Mid Bank’s loan officers in order to keep credit losses at a minimum. In addition to the human element of credit risk management, the Company’s loan policies address the additional aspects of credit risk. Most lending personnel have signature authority that allows them to lend up to a certain amount based on their own judgment as to the creditworthiness of a borrower. The amount of the signature authority is based on the lending officers’ experience and training. The Senior Loan Committee, consisting of the most experienced lenders within the organization and three non-employee members of the board of directors, must approve all underwriting decisions in excess of \$2 million and up to 75% of the legal lending limit which was \$21.1 million at December 31, 2012. The Board of Directors must approve all underwriting decisions in excess of 75% of the legal lending limit. While the underlying nature of lending will result in some amount of loan losses, First Mid Bank’s loan loss experience has been good with average net charge offs amounting to \$2.5 million (0.32% of average loans) over the past five years. Nonperforming loans were \$7.6 million (0.83% of total loans) at December 31, 2012. These percentages have historically compared well with peer financial institutions and continue to do so today.

Interest rate and liquidity risk are two other forms of risk embedded in the business of financial intermediation. The Company’s Asset Liability Management Committee, consisting of experienced individuals who monitor all aspects of interest rates and maturities of interest earning assets and interest paying liabilities, manages these risks. The underlying objectives of interest rate and liquidity risk management are to shelter the Company’s net interest margin from changes in interest rates while maintaining adequate liquidity reserves to meet unanticipated funding demands. The Company uses financial modeling technology as a tool, employing a variety of “what if” scenarios to properly plan its activities. Despite the tools and methods used to monitor this risk, a sustained unfavorable interest rate environment will lead to some amount of compression in the net interest margin. During 2012, the Company’s net interest margin decreased to 3.44% from 3.45% in 2011.

Strategy for Growth. The Company believes that growth of its revenue stream and of its customer base is vital to the goal of increasing the value of its shareholders’ investment. Management attempts to grow in two primary ways:

- by organic growth through adding new customers and selling more products and services to existing customers; and
- by acquisitions.

Virtually all of the Company's customer-contact personnel, in each of its business lines, are engaged in organic growth efforts to one degree or another. These personnel attempt to match products and services with the particular financial needs of individual customers and prospective customers. Most senior officers of the organization are required to attend monthly meetings where they report on their business development efforts and results. Executive management uses these meetings as an educational and risk management opportunity as well. Cross-selling opportunities are encouraged between the business lines.

Within the community banking line, the Company has focused on growing business operating and real estate loans. Total commercial real estate loans have increased from \$217 million at December 31, 2008 to \$316 million at December 31, 2012 primarily due to loans acquired in the acquisition of the Branches completed during the third quarter of 2010. Approximately 62% of the Company's total revenues were derived from lending activities in the fiscal year ended December 31, 2012. The Company has also focused on growing the commercial and retail deposit base through growth in checking, money markets and customer repurchase agreement balances. The wealth management line has focused its growth efforts on estate planning, investment and farm management services for individuals and employee benefit services for businesses. The insurance brokerage line has focused on increasing property and casualty and group medical insurance for businesses and personal lines insurance to individuals.

Growth through acquisitions has been an integral part of the Company's strategy for an extended period of time. When reviewing acquisition possibilities, the Company focuses on those organizations where there is a cultural fit with its existing operations and where there is a strong likelihood of adding to shareholder value. Most past acquisitions have been cash-based transactions. The Company would also consider a stock-based acquisition if the strategic and financial metrics were compelling. The Company viewed the acquisition of the First Bank Branches in the third quarter of 2010 as an opportunity to acquire selected assets, add to its deposit base and expand its geographical reach.

Historically, the Company's growth strategy has been to grow the customer base without significantly increasing the shareholder base. This requires a certain amount of financial leverage and the Company monitors its capital base carefully to satisfy all regulatory requirements while maintaining flexibility. The Company has maintained a Dividend Reinvestment Plan as well as various forms of equity compensation for directors and key managers. It has also maintained an ongoing share buy back program both as a service to shareholders and a means of maintaining optimal levels of capital. The growth strategy could include increasing the stockholder base in the future is an acquisition included a stock component.

In 2009, the Company issued and sold Series B 9% Non-Cumulative Perpetual Convertible Preferred Stock (the “Series B Preferred Stock”) issued to certain investors, and in 2011, the Company issued and sold Series C 8% Non-Cumulative Perpetual Preferred Stock (the “Series C Preferred Stock”) to certain investors. The Company also uses various forms of long-term debt to augment its capital when appropriate.

Markets and Competition

The Company has active competition in all areas in which First Mid Bank presently does business. First Mid Bank competes for commercial and individual deposits, loans, and trust business with many east central Illinois banks, savings and loan associations, and credit unions. The principal methods of competition in the banking and financial services industry are quality of services to customers, ease of access to facilities, and pricing of services, including interest rates paid on deposits, interest rates charged on loans, and fees charged for fiduciary and other banking services.

First Mid Bank operates facilities in the Illinois counties of Adams, Bond, Champaign, Christian, Coles, Cumberland, Dewitt, Douglas, Effingham, Fulton, Knox, Macon, Madison, McClean, Moultrie, Peoria and Piatt. Each facility primarily serves the community in which it is located. First Mid Bank serves twenty-five different communities with thirty-eight separate locations in the towns of Altamont, Arcola, Bartonville, Bloomington, Champaign, Charleston, Decatur, Effingham, Galesburg, Highland, Knoxville, Mansfield, Mahomet, Maryville, Mattoon, Monticello, Neoga, Peoria, Pocahontas, Quincy, Sullivan, Taylorville, Tuscola, Urbana, and Weldon Illinois. Within the areas of service, there are numerous competing financial institutions and financial services companies.

Website

The Company maintains a website at www.firstmid.com. All periodic and current reports of the Company and amendments to these reports filed with the Securities and Exchange Commission (“SEC”) can be accessed, free of charge, through this website as soon as reasonably practicable after these materials are filed with the SEC.

SUPERVISION AND REGULATION

General

Financial institutions, financial services companies, and their holding companies are extensively regulated under federal and state law. As a result, the growth and earnings performance of the Company can be affected not only by management decisions and general economic conditions, but also by the requirements of applicable state and federal statutes and regulations and the policies of various governmental regulatory authorities including, but not limited to, the Office of the Comptroller of the Currency (the “OCC”), the Federal Reserve Board, the Federal Deposit Insurance Corporation (the “FDIC”), the Internal Revenue Service and state taxing authorities. Any change in applicable laws, regulations or regulatory policies may have material effects on the business, operations and prospects of the Company and First Mid Bank. The Company is unable to predict the nature or extent of the effects that fiscal or monetary policies, economic controls or new federal or state legislation may have on its business and earnings in the future.

Federal and state laws and regulations generally applicable to financial institutions and financial services companies, such as the Company and its subsidiaries, regulate, among other things, the scope of business, investments, reserves against deposits, capital levels relative to operations, the nature and amount of collateral for loans, the establishment of branches, mergers, consolidations and dividends. The system of supervision and regulation applicable to the Company and its subsidiaries establishes a comprehensive framework for their respective operations and is intended primarily for the protection of the FDIC’s deposit insurance fund and the depositors, rather than the stockholders, of

financial institutions.

The following references to material statutes and regulations affecting the Company and its subsidiaries are brief summaries thereof and do not purport to be complete, and are qualified in their entirety by reference to such statutes and regulations. Any change in applicable law or regulations may have a material effect on the business of the Company and its subsidiaries.

Financial Modernization Legislation

The 1999 Gramm-Leach-Bliley Act (the “GLB Act”) significantly changed financial services regulation by expanding permissible non-banking activities of bank holding companies and removing certain barriers to affiliations among banks, insurance companies, securities firms and other financial services entities. These activities and affiliations can be structured through a holding company structure or, in the case of many of the activities, through a financial subsidiary of a bank. The GLB Act also established a system of federal and state regulation based on functional regulation, meaning that primary regulatory oversight for a particular activity generally resides with the federal or state regulator having the greatest expertise in the area. Banking is supervised by banking regulators, insurance by state insurance regulators and securities activities by the SEC and state securities regulators. The GLB Act also requires the disclosure of agreements reached with community groups that relate to the Community Reinvestment Act, and contains various other provisions designed to improve the delivery of financial services to consumers while maintaining an appropriate level of safety in the financial services industry.

The GLB Act repealed the anti-affiliation provisions of the Glass-Steagall Act and revises the Bank Holding Company Act of 1956 (the “BHCA”) to permit qualifying holding companies, called “financial holding companies,” to engage in, or to affiliate with companies engaged in, a full range of financial activities, including banking, insurance activities (including insurance portfolio investing), securities activities, merchant banking and additional activities that are “financial in nature,” incidental to financial activities or, in certain circumstances, complementary to financial activities. A bank holding company’s subsidiary banks must be “well-capitalized” and “well-managed” and have at least a “satisfactory” Community Reinvestment Act rating for the bank holding company to elect and maintain its status as a financial holding company.

A significant component of the GLB Act's focus on functional regulation relates to the application of federal securities laws and SEC oversight of some bank securities activities previously exempt from broker-dealer registration. Among other things, the GLB Act amended the definitions of "broker" and "dealer" under the Securities Exchange Act of 1934, as amended, to remove the blanket exemption for banks. Under the GLB Act, banks may conduct securities activities without broker-dealer registration only if the activities fall within a set of activity-based exemptions designed to allow banks to conduct only those activities traditionally considered to be primarily banking or trust activities.

Securities activities outside these exemptions, as a practical matter, need to be conducted by registered broker-dealer affiliate. The GLB Act also amended the Investment Advisers Act of 1940 to require the registration of banks that act as investment advisers for mutual funds. The Company believes that it has taken the necessary actions to comply with these requirements of the GLB Act and the regulations adopted under them.

Anti-Terrorism Legislation

The USA PATRIOT Act of 2001 included the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001 (the "IMLAFA"). The IMLAFA contains anti-money laundering measures affecting insured depository institutions, broker-dealers, and certain other financial institutions. The IMLAFA requires U.S. financial institutions to adopt policies and procedures to combat money laundering and grants the Secretary of the Treasury broad authority to establish regulations and to impose requirements and restrictions on financial institutions' operations. The Company has established policies and procedures for compliance with the IMLAFA and the related regulations. The Company has designated an officer solely responsible for ensuring compliance with existing regulations and monitoring changes to the regulations as they occur.

Emergency Economic Stabilization Act of 2008

In response to unprecedented financial market turmoil, the Emergency Economic Stabilization Act of 2008 ("EESA") was enacted on October 3, 2008. EESA authorizes the U.S. Treasury Department ("Treasury") to provide up to \$700 billion in funding for the financial services industry. The Treasury's authority under the Troubled Asset Relief Program ("TARP") expired October 3, 2010. The Company decided to not participate in the TARP Capital Purchase Program.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") was signed into law on July 21, 2010. Generally, the Act is effective the day after it was signed into law, but different effective dates apply to specific sections of the law. The Company will continue to evaluate the affects of these changes. Uncertainty remains as to the ultimate impact of the Act, which could have a material adverse impact either on the financial services industry as a whole, or on the Company's business, results of operations and financial condition. The Act, among other things:

- Resulted in the Federal Reserve issuing rules limiting debit-card interchange fees.

After a three-year phase-in period which begins January 1, 2013, existing trust preferred securities for holding companies with consolidated assets greater than \$15 billion and all new issuances of trust preferred securities are removed as a permitted component of a holding company's Tier 1 capital. Trust preferred securities outstanding as of May 19, 2010 that were issued by bank holding companies with total consolidated assets of less than \$15 billion, such as First Mid, will continue to count as Tier 1 capital.

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Provides for an increase in the FDIC assessment for depository institutions with assets of \$10 billion or more, increases in the minimum reserve ratio for the deposit insurance fund from 1.15% to 1.35% (however, the FDIC is to offset the effect of this increase for holding companies with total consolidated assets of less than \$10 billion, such as First Mid) and changes in the basis for determining FDIC premiums from deposits to assets.

Creates a new Consumer Financial Protection Bureau that will have rulemaking authority for a wide range of consumer protection laws that would apply to all banks and certain non-bank financial institutions and would have broad powers to supervise and enforce consumer protection laws.

Provides for new disclosure and other requirements relating to executive compensation and corporate governance.

Changes standards for Federal preemption of state laws related to federally chartered institutions and their subsidiaries.

Provides mortgage reform provisions including (i) a customer's ability to repay, (ii) restricting variable-rate lending by requiring the ability to repay to be determined for variable-rate loans by requiring lenders to evaluate using the maximum rate that will apply during the first five years of a variable-rate loan term, and (iii) making more loans subject to provisions for higher cost loans and new disclosures.

Creates a financial stability oversight council that will recommend to the Federal Reserve increasingly strict rules for capital, leverage, liquidity, risk management and other requirements as companies grow in size and complexity.

Permanently increases the deposit insurance coverage to \$250 thousand and allows depository institutions to pay interest on checking accounts.

Requires publicly-traded bank holding companies with assets of \$10 billion or more to establish a risk committee responsible for enterprise-wide risk management practices.

Basel III

In September 2010, the Basel Committee on Banking Supervision proposed higher global minimum capital standards, including a minimum Tier 1 common capital ratio and additional capital and liquidity requirements, with rules expected to be implemented between 2013 and 2019. The rules were expected to be implemented beginning on January 1, 2013, however, on November 9, 2012, the Federal Reserve Board, the FDIC and the Office of the Comptroller of the Currency announced that the implementation of the proposed rule was delayed.

On June 7, 2012, the Federal Reserve Board approved proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and First Mid Bank. The FDIC and the Office of the Comptroller of the Currency subsequently approved these proposed rules on June 12, 2012. The proposed rules implement Basel III regulatory capital reforms. The comment period for the proposed rules ended on October 22, 2012, but final rules have not yet been released.

The proposed rules include new risk-based capital and leverage ratios, which would be phased in from 2013 to 2019, and would refine the definition of what constitutes “capital” for purposes of calculating those ratios. The proposed new minimum capital level requirements applicable to the Company and First Mid Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6%; (iii) a total capital ratio of 8%; and (iv) a Tier 1 leverage ratio of 4%. The proposed rules would also establish a “capital conservation buffer” of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if its capital level falls below the buffer amount.

The proposed rules also proposed to phase out from Tier 1 capital, for institutions like the Company, under \$15 billion in assets, over a 10 year period commencing January 1, 2013, trust preferred securities and cumulative preferred stock. While uncertainty exists in both the final form of the rules and whether or not the Company will be required to adopt all of the rules, the Company is closely monitoring relevant developments.

The Company

General. As a registered bank holding company under the BHCA that has elected to become a financial holding company under the GLB Act, the Company is subject to regulation by the Federal Reserve Board. In accordance with Federal Reserve Board policy, the Company is expected to act as a source of financial strength to First Mid Bank and to commit resources to support First Mid Bank in circumstances where the Company might not do so absent such policy. The Company is subject to inspection, examination, and supervision by the Federal Reserve Board.

Activities. As a financial holding company, the Company may affiliate with securities firms and insurance companies and engage in other activities that are financial in nature or incidental or complementary to activities that are financial in nature. A bank holding company that is not also a financial holding company is limited to engaging in banking and such other activities as determined by the Federal Reserve Board to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

No Federal Reserve Board approval is required for the Company to acquire a company (other than a bank holding company, bank, or savings association) engaged in activities that are financial in nature or incidental to activities that are financial in nature, as determined by the Federal Reserve Board. However, the Company generally must give the

Federal Reserve Board after-the-fact notice of these activities. Prior Federal Reserve Board approval is required before the Company may acquire beneficial ownership or control of more than 5% of the voting shares or substantially all of the assets of a bank holding company, bank, or savings association.

If any subsidiary bank of the Company ceases to be “well-capitalized” or “well-managed” under applicable regulatory standards, the Federal Reserve Board may, among other actions, order the Company to divest its depository institution. Alternatively, the Company may elect to conform its activities to those permissible for a bank holding company that is not also a financial holding company.

If any subsidiary bank of the Company receives a rating under the Community Reinvestment Act of less than “satisfactory”, the Company will be prohibited, until the rating is raised to “satisfactory” or better, from engaging in new activities or acquiring companies other than bank holding companies, banks, or savings associations.

Capital Requirements. Bank holding companies are required to maintain minimum levels of capital in accordance with Federal Reserve Board capital adequacy guidelines. The Federal Reserve Board’s capital guidelines establish the following minimum regulatory capital requirements for bank holding companies: a risk-based requirement expressed as a percentage of total risk-weighted assets, and a leverage requirement expressed as a percentage of total assets. The risk-based requirement consists of a minimum ratio of total capital to total risk-weighted assets of 8%, at least one-half of which must be Tier 1 capital. The leverage requirement consists of a minimum ratio of Tier 1 capital to total assets of 3% for the most highly rated companies, with minimum requirements of at least 4% for all others. For purposes of these capital standards, Tier 1 capital consists primarily of permanent stockholders’ equity, which includes the Series B 9% Preferred Stock issued by the Company in 2009 and the Series C Preferred Stock issued by the Company in 2011, less intangible assets (other than certain mortgage servicing rights and purchased credit card relationships), and total capital means Tier 1 capital plus certain other debt and equity instruments which do not qualify as Tier 1 capital, limited amounts of unrealized gains on equity securities and a portion of the Company’s allowance for loan and lease losses.

The risk-based and leverage standards described above are minimum requirements, and higher capital levels will be required if warranted by the particular circumstances or risk profiles of individual banking organizations. For example, the Federal Reserve Board'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.

As of December 31, 2012, the Company had regulatory capital, calculated on a consolidated basis, in excess of the Federal Reserve Board's minimum requirements, and its capital ratios exceeded those required for categorization as well-capitalized under the capital adequacy guidelines established by bank regulatory agencies with a total risk-based capital ratio of 15.65%, a Tier 1 risk-based ratio of 14.51% and a leverage ratio of 9.66%.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of person from acquiring "control" of a bank holding company unless the Federal Reserve Board has been notified and has not objected to the transaction. Under a rebuttable presumption established by the Federal Reserve Board, the acquisition of 10% or more of a class of voting stock of a bank holding company with a class of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, such as the Company, would, under the circumstances set forth in the presumption, constitute acquisition of control of the Company.

In addition, any company is required to obtain the approval of the Federal Reserve Board under the BHCA before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of the outstanding common of the Company, or otherwise obtaining control of a "controlling influence" over the Company or First Mid Bank.

Interstate Banking and Branching. The Dodd-Frank Act expands the authority of banks to engage in interstate branching. The Dodd-Frank Act allows a state or national bank to open a de novo branch in another state if the law of the state where the branch is to be located would permit a state bank chartered by that state to open the branch.

Privacy and Security. The GLB Act establishes a minimum federal standard of financial privacy by, among other provisions, requiring banks to adopt and disclose privacy policies with respect to consumer information and setting forth certain rules with respect to the disclosure to third parties of consumer information. The Company has adopted and disseminated its privacy policies pursuant to the GLB Act. Regulations adopted under the GLB Act set standards for protecting the security, confidentiality and integrity of customer information, and require notice to regulators, and in some cases, to customers, in the event of security breaches. A number of states have adopted their own statutes requiring notification of security breaches. In addition, the GLB Act requires the disclosure of agreements reached with community groups that relate to the CRA, and contains various other provisions designed to improve the delivery of financial services to consumers while maintaining an appropriate level of safety in the financial services industry.

First Mid Bank

General. First Mid Bank is a national bank, chartered under the National Bank Act. The FDIC insures the deposit accounts of First Mid Bank. As a national bank, First Mid Bank is a member of the Federal Reserve System and is subject to the examination, supervision, reporting and enforcement requirements of the OCC, as the primary federal regulator of national banks, and the FDIC, as administrator of the deposit insurance fund.

Deposit Insurance. As an FDIC-insured institution, First Mid Bank is required to pay deposit insurance premium assessments to the FDIC. On July 21, 2010, The Dodd-Frank Act permanently raised the standard maximum deposit insurance amount from \$100,000 to \$250,000. On November 9, 2010, the FDIC issued a final rule to implement Section 343 of the Dodd-Frank Act, which provides unlimited deposit insurance coverage for "noninterest-bearing

transaction accounts” from December 31, 2010 through December 31, 2012. Also, the FDIC will no longer charge a separate assessment for the insurance of these accounts under the Dodd-Frank Act. The Company expensed \$0 during 2012 and 2011 and \$95,000 during 2010 for this program.

On February 27, 2009, the FDIC adopted a final rule setting initial base assessment rates beginning April 1, 2009, at 12 to 45 basis points and, due to extraordinary circumstances, extended the period of the restoration plan to increase the deposit insurance fund to seven years. Also on February 27, 2009, the FDIC issued final rules on changes to the risk-based assessment system which imposes rates based on an institution’s risk to the deposit insurance fund. The new rates increased the range of annual risk based assessment rates from 5 to 7 basis points to 7 to 24 basis points. The final rules both increase base assessment rates and incorporate additional assessments for excess reliance on brokered deposits and FHLB advances. This new assessment took effect April 1, 2009. The Company expensed \$0.8 million, \$1.1 million and \$1.3 million for this assessment during 2012, 2011 and 2010, respectively.

In addition to its insurance assessment, each insured bank was subject to quarterly debt service assessments in connection with bonds issued by a government corporation that financed the federal savings and loan bailout. The Company expensed \$92,000, \$103,000 and \$99,000 during 2012, 2011 and 2010, respectively, for this assessment.

On September 29, 2009, the FDIC Board proposed a Deposit Insurance Fund restoration plan that required banks to prepay, on December 30, 2009, their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. Under the plan—which applies to all banks except those with liquidity problems—banks were assessed through 2010 according to the risk-based premium schedule adopted in 2009. Beginning January 1, 2011, the base rate increases by 3 basis points. The Company recorded a prepaid expense asset of \$4,855,000 as of December 31, 2009 as a result of this plan. This asset has been amortized to non-interest expense over the past three years. The remaining balance of this asset was \$1,400,000 as of December 31, 2012 due to changes in the calculation of the assessment which resulted in less expense than the amount calculated in 2009.

OCC Assessments. All national banks are required to pay supervisory fees to the OCC to fund the operations of the OCC. The amount of such supervisory fees is based upon each institution's total assets, including consolidated subsidiaries, as reported to the OCC. During the year ended December 31, 2012, First Mid Bank paid supervisory fees to the OCC totaling \$320,000.

Capital Requirements. The OCC has established the following minimum capital standards for national banks, such as First Mid Bank: a leverage requirement consisting of a minimum ratio of Tier 1 capital to total assets of 3% for the most highly-rated banks with minimum requirements 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%, at least one-half of which must be Tier 1 capital. For purposes of these capital standards, Tier 1 capital and total capital consists of substantially the same components as Tier 1 capital and total capital under the Federal Reserve Board's capital guidelines for bank holding companies (See "The Company—Capital Requirements").

The capital requirements described above are minimum requirements. Higher capital levels will be required if warranted by the particular circumstances or risk profiles of individual institutions. For example, the regulations of the OCC provide 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.

During the year ended December 31, 2012, First Mid Bank was not required by the OCC to increase its capital to an amount in excess of the minimum regulatory requirements, and its capital ratios exceeded those required for categorization as well-capitalized under the capital adequacy guidelines established by bank regulatory agencies with a total risk-based capital ratio of 14.04%, a Tier 1 risk-based ratio of 12.89% and a leverage ratio of 8.56%.

Prompt Corrective Action. 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 "well-capitalized," "adequately-capitalized," "undercapitalized," "significantly undercapitalized" or "critically undercapitalized." Depending upon the capital category to which an institution is assigned, the regulators' corrective powers include: requiring the submission of a capital restoration plan; placing limits on asset growth and restrictions on activities; requiring the institution to issue additional capital stock (including additional voting stock) or to be acquired; restricting transactions with affiliates; restricting the interest rate the institution may pay on deposits; ordering a new election of directors of the institution; requiring that senior executive officers or directors be dismissed; prohibiting the institution from accepting deposits from correspondent banks; requiring the institution to divest certain subsidiaries; prohibiting the payment of principal or interest on subordinated debt; and in the most severe cases, appointing a conservator or receiver for the institution.

Dividends. The National Bank Act imposes limitations on the amount of dividends that may be paid by a national bank, such as First Mid Bank. Generally, a national bank may pay dividends out of its undivided profits, in such amounts and at such times as the bank's board of directors deems prudent. Without prior OCC approval, however, a national bank may not pay dividends in any calendar year which, in the aggregate, exceed the bank's year-to-date net income plus the bank's adjusted retained net income for the two preceding years.

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, First Mid Bank exceeded its minimum capital requirements under applicable guidelines as of December 31, 2012. As of December 31, 2012, approximately \$27.7 million was available to be paid as dividends to the Company by First Mid Bank. Notwithstanding the availability of funds for dividends, however, the OCC may prohibit the payment of any dividends by First Mid Bank if the OCC determines that such payment would constitute an unsafe or unsound practice.

Affiliate and Insider Transactions. First Mid Bank is subject to certain restrictions under federal law, including Regulation W of the Federal Reserve Board, on extensions of credit to the Company and its subsidiaries, on investments in the stock or other securities of the Company and its subsidiaries and the acceptance of the stock or other securities of the Company or its subsidiaries as collateral for loans. Certain limitations and reporting requirements are also placed on extensions of credit by First Mid Bank to its directors and officers, to directors and officers of the Company and its subsidiaries, to principal stockholders of the Company, and to “related interests” of such directors, officers and principal stockholders.

First Mid Bank is subject to restrictions under federal law that limits certain transactions with the Company, including loans, other extensions of credit, investments or asset purchases. Such transactions by a banking subsidiary with any one affiliate are limited in amount to 10% of the bank’s capital and surplus and, with all affiliates together, to an aggregate of 20% of the bank’s capital and surplus. Furthermore, such loans and extensions of credit, as well as certain other transactions, are required to be secured in specified amounts. These and certain other transactions, including any payment of money to the Company, must be on terms and conditions that are or in good faith would be offered to nonaffiliated companies.

In addition, federal law and regulations may affect the terms upon which any person becoming a director or officer of the Company or one of its subsidiaries or a principal stockholder of the Company may obtain credit from banks with which First Mid Bank maintains a correspondent relationship.

Safety and Soundness Standards. 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 guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the institution’s primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. The preamble to the guidelines states that the agencies expect to require a compliance plan from an institution whose failure to meet one or more of the guidelines are of such severity that it could threaten the safety and soundness of the institution. Failure to submit an acceptable plan, or failure to comply with a plan that has been accepted by the appropriate federal regulator, would constitute grounds for further enforcement action.

Community Reinvestment Act. First Mid Bank is subject to the Community Reinvestment Act (CRA). The CRA and the regulations issued thereunder are intended to encourage banks to help meet the credit needs of their service areas, including low and moderate income neighborhoods, consistent with the safe and sound operations of the banks. These regulations also provide for regulatory assessment of a bank's record in meeting the needs of its service area when considering applications to establish branches, merger applications and applications to acquire the assets and assume the liabilities of another bank. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 requires federal banking agencies to make public a rating of a bank's performance under the CRA. In the case of a bank holding company, the CRA performance record of its bank subsidiaries is reviewed by federal banking agencies in connection with the filing of an application to acquire ownership or control of shares or assets of a bank or thrift or to merge with any other bank holding company. An unsatisfactory record can substantially delay or block the transaction. First Mid Bank received a satisfactory CRA rating from its regulator in its most recent CRA examination.

Consumer Laws and Regulations. In addition to the laws and regulations discussed above, First Mid Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Equal Credit Opportunity Act, the Fair Housing Act, the Fair Credit Reporting Act, the Fair and Accurate Credit Transactions Act and the Real Estate Settlement Procedures Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions must deal with customers when taking deposits, making loans to or marketing to or engaging in other types of transactions with such customers. Failure to comply with these laws and regulations could lead to substantial penalties, operating restrictions and reputational damage to the financial institution.

Supplemental Item – Executive Officers of the Registrant

The executive officers of the Company are elected annually by the Company’s board of directors and are identified below.

Name (Age)	Position With Company
William S. Rowland (65)	Chairman of the Board of Directors, President and Chief Executive Officer
Joseph R. Dively (53)	Senior Executive Vice President
Michael L. Taylor (44)	Executive Vice President and Chief Financial Officer
John W. Hedges (64)	Executive Vice President
Laurel G. Allenbaugh (52)	Executive Vice President
Eric S. McRae (47)	Executive Vice President
Charles A. LeFebvre (43)	Executive Vice President
Christopher L. Slabach (50)	Senior Vice President
Clay M. Dean (38)	Senior Vice President

William S. Rowland, age 65, has been Chairman of the Board of Directors, President and Chief Executive Officer of the Company since May 1999. He served as Executive Vice President of the Company from 1997 to 1999 and as Treasurer and Chief Financial Officer from 1989 to 1999. He also serves as Chairman of the Board of Directors and Chief Executive Officer of First Mid Bank.

Joseph R. Dively, age 53, has been the Senior Executive Vice President of the Company and the President of First Mid Bank since May 2011. He was with Consolidated Communications Holdings, Inc. in Mattoon, Illinois from 2003 to May 2011.

Michael L. Taylor, age 44, has been the Executive Vice President and Chief Financial Officer of the Company since May 2007. He served as Vice President and Chief Financial Officer from May 2000 to May 2007. He was with AMCORE Bank in Rockford, Illinois from 1996 to 2000.

John W. Hedges, age 64, has been Executive Vice President of the Company since September 1999 and Senior Executive Vice President and Chief Credit Officer of First Mid Bank since May 2011. He served as President of First Mid Bank from September 1999 to May 2011. He was with National City Bank in Decatur, Illinois from 1976 to 1999.

Laurel G. Allenbaugh, age 52, has been Executive Vice President of Operations since April 2008. She served as Vice President of Operations from February 2000 to April 2008. She served as Controller of the Company and First Mid Bank from 1990 to February 2000 and has been President of MIDS since 1998.

Eric S. McRae, age 47, has been Executive Vice President of the Company and Executive Vice President, Senior Lender of First Mid Bank since December 2008. He served as President of the Decatur region from 2001 to December 2008.

Charles A. LeFebvre, age 43, has been Executive Vice President of the Company since 2008 and Executive Vice President of the Trust and Wealth Management Division of First Mid Bank since 2007. He was an attorney with the law firm of Thomas, Mamer & Haughey from 2001 to 2007.

Christopher L. Slabach, age 50, has been Senior Vice President of the Company since 2007 and Senior Vice President, Risk Management of First Mid Bank since 2008. He served as Vice President, Audit of the Company from 1998 to 2007.

Clay M. Dean, age 38, has been Senior Vice President of the Company and Senior Vice President Chief Deposit Services Officer of First Mid Bank since November 2012. He served as Senior Vice President Director of Treasury Management of First Mid bank from 2010 to 2012.

ITEM
1A. RISK FACTORS

Various risks and uncertainties, some of which are difficult to predict and beyond the Company's control, could negatively impact the Company. As a financial institution, the Company is exposed to interest rate risk, liquidity risk, credit risk, operational risk, risks from economic or market conditions, and general business risks among others. Adverse experience with these or other risks could have a material impact on the Company's financial condition and results of operations, as well as the value of its common stock.

Difficult economic conditions and market disruption have adversely impacted the banking industry and financial markets generally and may continue to significantly affect the business, financial condition, or results of operations of the Company. The Company's success depends, to a certain extent, upon economic and political conditions, local and national, as well as governmental monetary policies. Conditions such as inflation, recession, unemployment, changes in interest rates, money supply and other factors beyond the Company's control may adversely affect its asset quality, deposit levels and loan demand and, therefore, its earnings.

Dramatic declines in the housing market beginning in the latter half of 2007, with falling home prices and increasing foreclosures, unemployment and underemployment, have negatively impacted the credit performance of mortgage loans and resulted in significant write-downs of asset values by some financial institutions. The resulting write-downs to assets of financial institutions have caused many financial institutions to merge with other institutions and, in some cases, to seek government assistance or bankruptcy protection.

The capital and credit markets, including the fixed income markets, have been experiencing volatility and disruption for the past several years. In some cases, the markets have produced downward pressure on stock prices and credit capacity for certain issuers without regard to those issuers' financial strength.

Many lenders and institutional investors have reduced and, in some cases, ceased to provide funding to borrowers, including to other financial institutions because of concern about the stability of the financial markets and the strength of counterparties. It is difficult to predict how long these economic conditions will exist, and which of our markets, products or other businesses will ultimately be affected. Accordingly, the resulting lack of available credit, lack of confidence in the financial sector, decreased consumer confidence, increased volatility in the financial markets and reduced business activity could materially and adversely affect the Company's business, financial condition and results of operations.

As a result of the challenges presented by economic conditions, the Company has faced the following risks in connection with these events:

Inability of borrowers to make timely repayments of their loans, or decreases in value of real estate collateral securing the payment of such loans resulting in significant credit losses, which results in increased delinquencies, foreclosures and customer bankruptcies, any of which could have a material adverse effect on the Company's operating results.

Increased regulation of the banking industry, including heightened legal standards and regulatory requirements. Compliance with such regulation increases costs and may limit the Company's ability to pursue business opportunities.

Further disruptions in the capital markets or other events, including actions by rating agencies and deteriorating investor expectations, may result in an inability to borrow on favorable terms or at all from other financial institutions.

The Company's profitability depends significantly on economic conditions in the geographic region in which it operates. A large percentage of the Company's loans are to individuals and businesses in Illinois, consequently, any

decline in the economy of this market area could have a materially adverse effect on the Company's financial condition and results of operations.

Decline in the strength and stability of other financial institutions may adversely affect the Company's business. The actions and commercial soundness of other financial institutions could affect the Company's ability to engage in routine funding transactions. Financial services institutions are interrelated as a result of clearing, counterparty or other relationships. The Company has exposure to different counterparties, and executes transactions with various counterparties in the financial industry. Recent defaults by financial services institutions, and even rumors or questions about one or more financial services institutions or the financial services industry in general, led to market-wide liquidity problems in recent year and could lead to losses or defaults by the Company or by other institutions. Many of these transactions expose the Company to credit risk in the event of default of its counterparty or client. Any such losses could materially and adversely affect the Company's results of operations.

Changes in interest rates may negatively affect our earnings. Changes in market interest rates and prices may adversely affect the Company's financial condition or results of operations. The Company's net interest income, its largest source of revenue, is highly dependent on achieving a positive spread between the interest earned on loans and investments and the interest paid on deposits and borrowings. Changes in interest rates could negatively impact the Company's ability to attract deposits, make loans, and achieve a positive spread resulting in compression of the net interest margin.

The Company may not have sufficient cash or access to cash to satisfy current and future financial obligations, including demands for loans and deposit withdrawals, funding operating costs, payment of preferred stock dividends and for other corporate purposes. This type of liquidity risk arises whenever the maturities of financial instruments included in assets and liabilities differ. The Company's liquidity can be affected by a variety of factors, including general economic conditions, market disruption, operational problems affecting third parties or the Company, unfavorable pricing, competition, the Company's credit rating and regulatory restrictions. (See "Liquidity" herein for management's actions to mitigate this risk.)

If the Company were unable to borrow funds through access to capital markets, it may not be able to meet the cash flow requirements of its depositors, creditors, and borrowers, or the operating cash needed to fund corporate expansion and other corporate activities. Starting in the middle of 2007, there has been significant turmoil and volatility in worldwide financial markets which, although there has been some improvement, is still ongoing. These conditions have resulted in a disruption in the liquidity of financial markets, and could directly impact the Company to the extent it needs to access capital markets to raise funds to support its business and overall liquidity position. This situation could affect the cost of such funds or the Company's ability to raise such funds. If the Company were unable to access any of these funding sources when needed, it might be unable to meet customers' needs, which could adversely impact its financial condition, results of operations, cash flows, and level of regulatory-qualifying capital. For further discussion, see the "Liquidity" section.

Loan customers or other counter-parties may not be able to perform their contractual obligations resulting in a negative impact on the Company's earnings. Overall economic conditions affecting businesses and consumers, including the current difficult economic conditions and market disruptions, could impact the Company's credit losses. In addition, real estate valuations could also impact the Company's credit losses as the Company maintains \$665 million in loans secured by commercial, agricultural, and residential real estate. A significant decline in real estate values could have a negative effect on the Company's financial condition and results of operations. In addition, the Company's total loan balances by industry exceeded 25% of total risk-based capital for each of four industries as of December 31, 2012. A listing of these industries is contained in under "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations -- Loans" herein. A significant change in one of these industries such as a significant decline in agricultural crop prices, could adversely impact the Company's credit losses.

Continued deterioration in the real estate market could lead to additional losses, which could have a material adverse effect on the business, financial condition and results of operations or the Company. Commercial and commercial real estate loans generally involve higher credit risks than residential real estate and consumer loans. Because payments on loans secured by commercial real estate or equipment are often dependent upon the successful operation and management of the underlying assets, repayment of such loans may be influenced to a great extent by conditions in the market or the economy. Increases in commercial and consumer delinquency levels or declines in real estate market values would require increased net charge-offs and increases in the allowance for loan and lease losses, which could have a material adverse effect on our business, financial condition and results of operations and prospects.

The allowance for loan losses may prove inadequate or be negatively affected by credit risk exposures. The Company's business depends on the creditworthiness of its customers. Management periodically reviews the allowance for loan and lease losses for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. There is no certainty that the allowance for loan losses will be adequate over time to cover credit losses in the portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets. If the credit quality of the customer base materially decreases, if the risk profile of a market, industry or group of customers changes materially, or if the allowance for loan losses is not adequate, the Company's business, financial condition, liquidity, capital, and results of operations could be materially adversely affected.

Declines in the value of securities held in the investment portfolio may negatively affect the Company's earnings. The value of an investment in the portfolio could decrease due to changes in market factors. The market value of certain investment securities is volatile and future declines or other-than-temporary impairments could materially adversely affect the Company's future earnings and regulatory capital. Continued volatility in the market value of certain of the investment securities, whether caused by changes in market perceptions of credit risk, as reflected in the expected market yield of the security, or actual defaults in the portfolio could result in significant fluctuations in the value of the securities. This could have a material adverse impact on the Company's accumulated other comprehensive loss and shareholders' equity depending upon the direction of the fluctuations.

Furthermore, future downgrades or defaults in these securities could result in future classifications as other-than-temporarily impaired. The Company has invested in trust preferred securities issued by financial institutions and insurance companies, corporate securities of financial institutions, and stock in the Federal Home Loan Bank of Chicago and Federal Reserve Bank of Chicago. Deterioration of the financial stability of the underlying financial institutions for these investments could result in other-than-temporary impairment charges to the Company and could have a material impact on future earnings. For further discussion of the Company's investments, see Note 4 – "Investment Securities."

If the Company's stock price declines from levels at December 31, 2012, management will evaluate the goodwill balances for impairment, and if the values of the businesses have declined, the Company could recognize an impairment charge for its goodwill. Management performed an annual goodwill impairment assessment as of September 30, 2012. Based on these analyses, management concluded that the fair value of the Company's reporting units exceeded the fair value of its assets and liabilities and, therefore, goodwill was not considered impaired. It is possible that management's assumptions and conclusions regarding the valuation of the Company's lines of business could change adversely, which could result in the recognition of impairment for goodwill, which could have a material effect on the Company's financial position and future results of operations.

The Series B Preferred Stock and Series C Preferred Stock impacts net income available to common stockholders and earnings per share. As long as shares of the Series B Preferred Stock and Series C Preferred Stock are outstanding, no dividends may be paid on the Company's common stock unless all dividends on the Series B and Series C Preferred Stock have been paid in full. The dividends declared on the Series B Preferred Stock and Series C Preferred Stock reduce the net income available to common stockholders and earnings per share.

Holders of the Series B Preferred Stock and Series C Preferred Stock have rights that are senior to those of common stockholders. The Series B Preferred Stock and Series C Preferred Stock is senior to the shares of common stock and holders of the Series B Preferred Stock and Series C Preferred Stock have certain rights and preferences that are senior to holders of common stock. The Series B Preferred Stock and Series C Preferred Stock will rank senior to the common stock and all other equity securities designated as ranking junior to the Series B Preferred Stock and Series C Preferred Stock. So long as any shares of the Series B Preferred Stock and Series C Preferred Stock remain outstanding, unless all accrued and unpaid dividends for all prior dividend periods have been paid or are contemporaneously declared and paid in full, no dividend shall be paid or declared on common stock or other junior stock, other than a dividend payable solely in common stock.

The Company also may not purchase, redeem or otherwise acquire for consideration any shares of its common stock or other junior stock unless it has paid in full all accrued dividends on the Series B Preferred Stock and Series C Preferred Stock for all prior dividend periods. The Series B Preferred Stock and Series C Preferred Stock are entitled to a liquidation preference over shares of common stock in the event of the Company's liquidation, dissolution or winding up.

The Company may issue additional common stock or other equity securities in the future which could dilute the ownership interest of existing stockholders. In order to maintain capital at desired or regulatory-required levels or to replace existing capital, the Company may be required to issue additional shares of common stock, or securities convertible into, exchangeable for or representing rights to acquire shares of common stock. The Company may sell these shares at prices below the current market price of shares, and the sale of these shares may significantly dilute stockholder ownership. The Company could also issue additional shares in connection with acquisitions of other financial institutions.

Human error, inadequate or failed internal processes and systems, and external events may have adverse effects on the Company. Operational risk includes compliance or legal risk, which is the risk of loss from violations of, or noncompliance with, laws, rules, regulations, prescribed practices, or ethical standards. Operational risk also encompasses transaction risk, which includes losses from fraud, error, the inability to deliver products or services, and loss or theft of information. Losses resulting from operational risk could take the form of explicit charges, increased operational costs, harm to the Company's reputation or forgone opportunities. Any of these could potentially have a material adverse effect on the Company's financial condition and results of operations.

The Company is exposed to various business risks that could have a negative effect on the financial performance of the Company. These risks include: changes in customer behavior, changes in competition, new litigation or changes to existing litigation, claims and assessments, environmental liabilities, real or threatened acts of war or terrorist activity, adverse weather, changes in accounting standards, legislative or regulatory changes, taxing authority interpretations, and an inability on the Company's part to retain and attract skilled employees.

In addition to these risks identified by the Company, investments in the Company's common stock involve risk. The market price of the Company's common stock may fluctuate significantly in response to a number of factors including: volatility of stock market prices and volumes, rumors or erroneous information, changes in market valuations of similar companies, changes in securities analysts' estimates of financial performance, and variations in quarterly or annual operating results.

If the Company is unable to make favorable acquisitions or successfully integrate our acquisitions, the Company's growth could be impacted. In the past several years, the Company has completed acquisitions of banks and bank branches from other institutions. We may continue to make such acquisitions in the future. When the Company evaluates acquisition opportunities, the Company evaluates whether the target institution has a culture similar to the Company, experienced management and the potential to improve the financial performance of the Company. If the

Company fails to successfully identify, complete and integrate favorable acquisitions, the Company could experience slower growth. Acquiring other banks or bank branches involves various risks commonly associated with acquisitions, including, among other things: potential exposure to unknown or contingent liabilities or asset quality issues of the target institution, difficulty and expense of integrating the operations and personnel of the target institution, potential disruption to the Company (including diversion of management's time and attention), difficulty in estimating the value of the target institution, and potential changes in banking or tax laws or regulations that may affect the target institution.

ITEM
1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The Company's headquarters is located at 1421 Charleston Avenue, Mattoon Illinois . This location is also used by the loan and deposit operations departments of First Mid Bank. In addition, the Company owns a facility located at 1500 Wabash Avenue, Mattoon, Illinois, which it is currently leasing to a non-affiliated third party.

The main office of First Mid Bank is located at 1515 Charleston Avenue, Mattoon, Illinois and is owned by First Mid Bank. First Mid Bank also owns a building located at 1520 Charleston Avenue, which is used by MIDS for its data processing and by the Company and First Mid Bank for back room operations. First Mid Bank also conducts business through numerous facilities, owned and leased, located in seventeen counties throughout Illinois. Of the thirty-seven other banking offices operated by First Mid Bank, twenty-three are owned and fourteen are leased from non-affiliated third parties.

First Mid Insurance leases a facility located at 100 Lerna Road South, Mattoon, Illinois.

None of the properties owned by the Corporation are subject to any major encumbrances. The Company believes these facilities are suitable and adequate to operate its banking and related business. The net investment of the Company and subsidiaries in real estate and equipment at December 31, 2012 was \$29.7 million.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

The Company's common stock was held by approximately 586 shareholders of record as of December 31, 2012 and is included for quotation on the over-the-counter electronic bulletin board.

The following table shows the high and low bid prices per share of the Company's common stock for the indicated periods. These quotations represent inter-dealer prices without retail mark-ups, mark-downs or commissions and may not necessarily represent actual transactions.

Quarter	High	Low
2012		
4th	\$25.50	\$22.00
3rd	\$27.00	\$22.17
2nd	\$26.00	\$21.60
1st	\$23.45	\$18.45
2011		
4th	\$20.00	\$18.00
3rd	\$18.95	\$18.00
2nd	\$19.00	\$17.80
1st	\$19.00	\$16.85

The following table sets forth the cash dividends per share on the Company's common stock for the last two years.

Date Declared	Date Paid	Dividend Per Share
10/23/2012	12/7/2012	\$0.210
4/24/2012	6/8/2012	\$0.210
12/13/2011	1/9/2012	\$0.210
4/27/2011	6/7/2011	\$0.190

The Company's shareholders are entitled to receive such dividends as are declared by the Board of Directors, which considers payment of dividends semi-annually. The ability of the Company to pay dividends, as well as fund its operations, is dependent upon receipt of dividends from First Mid Bank. Regulatory authorities limit the amount of dividends that can be paid by First Mid Bank without prior approval from such authorities. For further discussion of First Mid Bank's dividend restrictions, see Item 1 – "Business" – "First Mid Bank" – "Dividends" and Note 16 – "Dividend Restrictions" herein. The Board of Directors of the Company declared cash dividends semi-annually during the two years ended December 31, 2012 and 2011.

During 2012, the Board of Directors voted to pay the dividend scheduled to be paid in January 2013 prior to year-end 2012 due to the uncertainty of the federal income and capital gains tax rates. Accordingly, there were three dividends paid during 2012. The Company expects to resume its practice of paying semi-annual dividends in 2013 subject to Board of Director approval.

The following table summarizes share repurchase activity for the fourth quarter of 2012:

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs at End of Period
October 1, 2012 – October 31, 2012	—	\$0.00	—	\$1,895,000
November 1, 2012 – November 30, 2012	14,723	\$24.56	14,723	\$6,533,000
December 1, 2012 – December 31, 2012	80,640	\$23.73	80,640	\$4,620,000
Total	95,363	\$23.86	95,363	\$4,620,000

Since August 5, 1998, the Board of Directors has approved repurchase programs pursuant to which the Company may repurchase a total of approximately \$66.7 million of the Company's common stock. The repurchase programs approved by the Board of Directors are as follows:

- On August 5, 1998, repurchases of up to 3%, or \$2 million, of the Company's common stock.
- In March 2000, repurchases up to an additional 5%, or \$4.2 million of the Company's common stock.
- In September 2001, repurchases of \$3 million of additional shares of the Company's common stock.
- In August 2002, repurchases of \$5 million of additional shares of the Company's common stock.
- In September 2003, repurchases of \$10 million of additional shares of the Company's common stock.
- On April 27, 2004, repurchases of \$5 million of additional shares of the Company's common stock.
- On August 23, 2005, repurchases of \$5 million of additional shares of the Company's common stock.
- On August 22, 2006, repurchases of \$5 million of additional shares of the Company's common stock.
- On February 27, 2007, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 13, 2007, repurchases of \$5 million of additional shares of the Company's common stock.
- On December 16, 2008, repurchases of \$2.5 million of additional shares of the Company's common stock.
- On May 26, 2009, repurchases of \$5 million of additional shares of the Company's common stock.
- On February 22, 2011, repurchases of \$5 million of additional shares of the Company's common stock.
- On November 13, 2012 repurchases of \$5 million of additional shares of the Company's common stock.

ITEM 6. SELECTED FINANCIAL DATA

The following sets forth a five-year comparison of selected financial data (dollars in thousands, except per share data).

	2012	2011	2010	2009	2008	
Summary of Operations						
Interest income	\$55,767	\$56,772	\$50,883	\$51,409	\$57,066	
Interest expense	6,157	8,504	10,756	15,837	21,344	
Net interest income	49,610	48,268	40,127	35,572	35,722	
Provision for loan losses	2,647	3,101	3,737	3,594	3,559	
Other income	18,310	15,787	13,820	13,455	15,264	
Other expense	42,838	43,053	36,927	33,212	31,460	
Income before income taxes	22,435	17,901	13,283	12,221	15,967	
Income tax expense	8,410	6,529	4,522	4,007	5,443	
Net income	14,025	11,372	8,761	8,214	10,524	
Dividends on preferred shares	4,252	3,576	2,240	1,821	—	
Net income available to common stockholders	\$9,773	\$7,796	\$6,521	\$6,393	\$10,524	
Per Common Share Data						
Basic earnings per share	\$1.62	\$1.29	\$1.07	\$1.04	\$1.69	
Diluted earnings per share	1.62	1.29	1.07	1.04	1.67	
Dividends declared per share	0.42	0.40	0.38	0.38	0.38	
Book value per common share	17.53	16.18	14.46	14.23	13.50	
Capital Ratios						
Total capital to risk-weighted assets	15.65	% 14.48	% 12.84	% 15.76	% 11.99	%
Tier 1 capital to risk-weighted assets	14.51	% 13.37	% 11.71	% 14.57	% 11.02	%
Tier 1 capital to average assets	9.66	% 8.99	% 7.42	% 10.63	% 8.41	%
Financial Ratios						
Net interest margin	3.44	% 3.45	% 3.51	% 3.40	% 3.73	%
Return on average assets	0.91	% 0.76	% 0.72	% 0.74	% 1.03	%
Return on average common equity	9.53	% 8.36	% 7.20	% 9.56	% 12.87	%
Dividend on common shares payout ratio	25.93	% 31.01	% 35.51	% 36.54	% 22.49	%
Average equity to average assets	9.76	% 8.88	% 9.44	% 9.59	% 8.00	%
Allowance for loan losses as a percent of total loans	1.29	% 1.29	% 1.29	% 1.35	% 1.02	%
Year End Balances						
Total assets	\$1,578,032	\$1,500,956	\$1,468,245	\$1,095,155	\$1,049,700	
Net loans, including loans held for sale	899,289	848,954	794,188	691,288	734,351	
Total deposits	1,274,065	1,170,734	1,212,710	840,410	806,354	
Total equity	156,687	140,967	112,265	111,221	82,778	
Average Balances						
Total assets	\$1,543,453	\$1,502,794	\$1,219,353	\$1,108,669	\$1,022,734	
Net loans, including loans held for sale	866,912	796,520	708,367	692,961	733,681	
Total deposits	1,236,598	1,212,206	972,811	744,043	795,786	
Total equity	150,578	133,444	115,151	106,295	81,793	

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

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of the Company and its subsidiaries years ended December 31, 2012, 2011 and 2010. This discussion and analysis should be read in conjunction with the consolidated financial statements, related notes and selected financial data appearing elsewhere in this report.

Forward-Looking Statements

This report may contain certain forward-looking statements, such as discussions of the Company's pricing and fee trends, credit quality and outlook, liquidity, new business results, expansion plans, anticipated expenses and planned schedules. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project," or similar expressions. Actual results could differ materially from the results indicated by these statements because the realization of those results is subject to many risks and uncertainties, including those described in Item 1A. "Risk Factors" and other sections of the Company's Annual Report on Form 10-K and the Company's other filings with the SEC, and changes in interest rates, general economic conditions and those in the Company's market area, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios and the valuation of the investment portfolio, the Company's success in raising capital, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area and accounting principles, policies and guidelines. Furthermore, forward-looking statements speak only as of the date they are made. Except as required under the federal securities laws or the rules and regulations of the SEC, we do not undertake any obligation to update or review any forward-looking information, whether as a result of new information, future events or otherwise.

For the Years Ended December 31, 2012, 2011 and 2010

Overview

This overview of management's discussion and analysis highlights selected information in this document and may not contain all of the information that is important to you. For a more complete understanding of trends, events, commitments, uncertainties, liquidity, capital resources, and critical accounting estimates, you should carefully read this entire document. These have an impact on the Company's financial condition and results of operations.

Net income was \$14.02 million, \$11.37 million, and \$8.76 million and diluted earnings per share were \$1.62, \$1.29, and \$1.07 for the years ended December 31, 2012, 2011 and 2010, respectively. The increases in net income and earnings per share in 2012 was primarily the result of an increase in net interest income due to an increase in the size of the balance sheet and lower rates paid on deposit balances resulting in less interest expense for the year, no impairment charges recorded for investment securities, an increase in mortgage banking income and a reduction of other real estate owned expenses. The following table shows the Company's annualized performance ratios for the years ended December 31, 2012, 2011 and 2010:

	2012	2011	2010	
Return on average assets	0.91	% 0.76	% 0.72	%
Return on average common equity	9.53	% 8.36	% 7.20	%
Average common equity to average assets	9.76	% 8.88	% 9.44	%

Total assets at December 31, 2012, 2011 and 2010 were \$1.58 billion, \$1.50 billion, and \$1.47 billion, respectively. Net loan balances increased to \$899.3 million at December 31, 2012, from \$849 million at December 31, 2011 from \$794.2 million at December 31, 2010. Of the increase in 2012, \$46.9 million or 93% was due to increases in loans secured by real estate. Of the increase in 2011, \$53.8 million or 98% was due to increases in loans secured by real estate and commercial and industrial loans.

Total deposit balances increased to \$1.27 billion at December 31, 2012 from \$1.17 billion at December 31, 2011 and from \$1.21 billion at December 31, 2010. The increase in 2012 was due to a decline in increases in non-interest bearing and savings account balances offset by higher rate CDs that matured and were not replaced. The decrease in 2011 was due to a decline in money market balances and higher rate CDs that matured and were not replaced.

Net interest margin, defined as net interest income divided by average interest-earning assets, was 3.44% for 2012, 3.45% for 2011 and 3.51% for 2010. The decrease during 2012 was the result of a greater decline in asset yields for loans and investments than deposit rates due to the continued historically low level of interest rates. The decrease during 2011 was primarily the result of the impact of the increase in liquidity resulting from the acquisition of the Branches as the difference between loans (\$135 million) and deposits (\$337 million) was initially held as Federal Funds sold and interest bearing balances until deployed.

Net interest income increased to \$49.6 million in 2012 from \$48.3 million in 2011 and \$40.1 million in 2010. The ability of the Company to continue to grow net interest income is largely dependent on management's ability to succeed in its overall business development efforts. Management expects these efforts to continue but does not intend to compromise credit quality and prudent management of the maturities of interest-earning assets and interest-paying liabilities in order to achieve growth.

Non-interest income increased to \$18.3 million in 2012 compared to \$15.8 million in 2011 and \$13.8 million in 2010. The primary reason for the increase of \$2.5 million or 16% from 2011 to 2012 was increases in trust revenue and mortgage banking revenue and no other-than-temporary impairment charges on investment securities. The primary reason for the increase of \$2 million or 14.2% from 2010 to 2011 was increases in ATM and debit fees, an increase in trust revenues and less other-than-temporary impairment charges on investment securities.

Non-interest expenses decreased \$215,000, to \$42.8 million in 2012 compared to \$43.1 million in 2011, and \$36.9 million in 2010. The decrease during 2012 was primarily due to a decline in expenses from other real estate owned offset by an increase in salaries and benefits expenses. The increase during 2011 was primarily due to additional expenses incurred as a result of operating the acquisition of the Branches for a full year, as well as increases in other real estate owned expenses.

Following is a summary of the factors that contributed to the changes in net income (in thousands):

	2012 vs 2011	2011 vs 2010
Net interest income	\$1,342	\$8,141
Provision for loan losses	454	636
Other income, including securities transactions	2,523	1,967
Other expenses	215	(6,126)
Income taxes	(1,881)	(2,007)
Increase in net income	\$2,653	\$2,611

Credit quality is an area of importance to the Company. Year-end total nonperforming loans were \$7.6 million at December 31, 2012 compared to \$7.4 million at December 31, 2011 and \$10.4 million at December 31, 2010. The increase in 2012 was primarily the result of additional loans becoming past-due and put on non-accrual. The decrease in 2011 was primarily a result of loans that paid-off or became current during the year and loans transferred to other real estate owned during the year as a result of continued deterioration in economic conditions including increased unemployment, reduction in cash flow from increased vacancies in commercial properties, and declines in property values. Other real estate owned balances totaled \$1.2 million at December 31, 2012 compared to \$4.6 million at December 31, 2011 and \$6.1 million at December 31, 2010. The Company's provision for loan losses was \$2.6 million for 2012 compared to \$3.1 million for 2011 and \$3.7 million for 2010. At December 31, 2012, the composition of the loan portfolio remained similar to year-end 2011. Loans secured by both commercial and residential real estate comprised of 72% of the loan portfolio for both December 31, 2012 and 2011.

The Company also held investments in three trust preferred securities with a fair value of \$585,000 and unrealized losses of \$4.4 million at December 31, 2012 compared to four trust preferred securities with a fair value of \$719,000 and unrealized losses of \$4.9 million at December 31, 2011. On July 3, 2012, the company's holding in PreTSL VI was redeemed in full. The payment received was sufficient to pay-off the book value of the security of \$123,000, reverse the recorded OTTI impairment of \$127,000 and recover previously unrecorded interest of \$11,500. During 2012, the Company recorded no other-than-temporary impairment charges for the credit portion of the unrealized losses of these securities compared to \$886,000 during 2011 and \$1.4 million during 2010. The charges during 2011 and 2010 established a new, lower amortized cost basis for these securities and reduced non-interest income. See Note 4 – "Investment Securities" for additional details regarding these investments.

The Company's capital position remains strong and the Company has consistently maintained regulatory capital ratios above the "well-capitalized" standards. The Company's Tier 1 capital ratio to risk weighted assets ratio at December 31, 2012, 2011, and 2010 was 14.51%, 13.37%, and 11.71%, respectively. The Company's total capital to risk weighted assets ratio at December 31, 2012, 2011, and 2010 was 15.65%, 14.48%, and 12.84%, respectively. The increase in

2012 was primarily the result of an increase in retained earnings due to the Company's net income and the issuance of \$8,250,000 of Series C Preferred Stock. (See "Preferred Stock" in Note 1 to consolidated financial statements for more detailed information.) The increase in 2011 was primarily the result of an increase in retained earnings due to the Company's net income and the issuance of \$19,150,000 of Series C Preferred Stock. (See "Preferred Stock" in Note 1 to consolidated financial statements for more detailed information.)

The Company's liquidity position remains sufficient to fund operations and meet the requirements of borrowers, depositors, and creditors. The Company maintains various sources of liquidity to fund its cash needs. See "Liquidity" herein for a full listing of its sources and anticipated significant contractual obligations.

The Company enters into financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include lines of credit, letters of credit and other commitments to extend credit. The total outstanding commitments at December 31, 2012, 2011 and 2010 were \$234.9 million, \$228.6 million, and \$169.3 million, respectively. See Note 17 – "Commitments and Contingent Liabilities" herein for further information.

Critical Accounting Policies and Use of Significant Estimates

The Company has established various accounting policies that govern the application of U.S. generally accepted accounting principles in the preparation of the Company's financial statements. The significant accounting policies of the Company are described in the footnotes to the consolidated financial statements. Certain accounting policies involve significant judgments and assumptions by management that have a material impact on the carrying value of certain assets and liabilities; management considers such accounting policies to be critical accounting policies. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from these judgments and assumptions, which could have a material impact on the carrying values of assets and liabilities and the results of operations of the Company.

Allowance for Loan Losses. The Company believes the allowance for loan losses is the critical accounting policy that requires the most significant judgments and assumptions used in the preparation of its consolidated financial statements. An estimate of potential losses inherent in the loan portfolio are determined and an allowance for those losses is established by considering factors including historical loss rates, expected cash flows and estimated collateral values. In assessing these factors, the Company use organizational history and experience with credit decisions and related outcomes. The allowance for loan losses represents the best estimate of losses inherent in the existing loan portfolio. The allowance for loan losses is increased by the provision for loan losses charged to expense and reduced by loans charged off, net of recoveries. The Company evaluates the allowance for loan losses quarterly. If the underlying assumptions later prove to be inaccurate based on subsequent loss evaluations, the allowance for loan losses is adjusted.

The Company estimates the appropriate level of allowance for loan losses by separately evaluating impaired and nonimpaired loans. A specific allowance is assigned to an impaired loan when expected cash flows or collateral do not justify the carrying amount of the loan. The methodology used to assign an allowance to a nonimpaired loan is more subjective. Generally, the allowance assigned to nonimpaired loans is determined by applying historical loss rates to existing loans with similar risk characteristics, adjusted for qualitative factors including the volume and severity of identified classified loans, changes in economic conditions, changes in credit policies or underwriting standards, and changes in the level of credit risk associated with specific industries and markets. Because the economic and business climate in any given industry or market, and its impact on any given borrower, can change rapidly, the risk profile of the loan portfolio is continually assessed and adjusted when appropriate. Notwithstanding these procedures, there still exists the possibility that the assessment could prove to be significantly incorrect and that an immediate adjustment to the allowance for loan losses would be required.

Other Real Estate Owned. Other real estate owned acquired through loan foreclosure is initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. The adjustment at the time of foreclosure is recorded through the allowance for loan losses. Due to the subjective nature of establishing the fair value when the asset is acquired, the actual fair value of the other real estate owned or foreclosed asset could differ from the original estimate. If it is determined that fair value temporarily declines subsequent to foreclosure, a valuation allowance is recorded through noninterest expense. Operating costs associated with the assets after acquisition are also recorded as noninterest expense. Gains and losses on the disposition of other real estate owned and foreclosed assets are netted and posted to other noninterest expense.

Investment in Debt and Equity Securities. The Company classifies its investments in debt and equity securities as either held-to-maturity or available-for-sale in accordance with Statement of Financial Accounting Standards (SFAS) No. 115, "Accounting for Certain Investments in Debt and Equity Securities," which was codified into ASC 320. Securities classified as held-to-maturity are recorded at cost or amortized cost. Available-for-sale securities are carried at fair value. Fair value calculations are based on quoted market prices when such prices are available. If quoted

market prices are not available, estimates of fair value are computed using a variety of techniques, including extrapolation from the quoted prices of similar instruments or recent trades for thinly traded securities, fundamental analysis, or through obtaining purchase quotes. Due to the subjective nature of the valuation process, it is possible that the actual fair values of these investments could differ from the estimated amounts, thereby affecting the financial position, results of operations and cash flows of the Company. If the estimated value of investments is less than the cost or amortized cost, the Company evaluates whether an event or change in circumstances has occurred that may have a significant adverse effect on the fair value of the investment. If such an event or change has occurred and the Company determines that the impairment is other-than-temporary, a further determination is made as to the portion of impairment that is related to credit loss. The impairment of the investment that is related to the credit loss is expensed in the period in which the event or change occurred. The remainder of the impairment is recorded in other comprehensive income.

Deferred Income Tax Assets/Liabilities. The Company's net deferred income tax asset arises from differences in the dates that items of income and expense enter into our reported income and taxable income. Deferred tax assets and liabilities are established for these items as they arise. From an accounting standpoint, deferred tax assets are reviewed to determine if they are realizable based on the historical level of taxable income, estimates of future taxable income and the reversals of deferred tax liabilities. In most cases, the realization of the deferred tax asset is based on future profitability. If the Company were to experience net operating losses for tax purposes in a future period, the realization of deferred tax assets would be evaluated for a potential valuation reserve.

Additionally, the Company reviews its uncertain tax positions annually under FASB Interpretation No. 48 (FIN No. 48), "Accounting for Uncertainty in Income Taxes," codified within ASC 740. An uncertain 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 actually recognized is the largest amount of tax benefit that is greater than 50% likely to be recognized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded. A significant amount of judgment is applied to determine both whether the tax position meets the "more likely than not" test as well as to determine the largest amount of tax benefit that is greater than 50% likely to be recognized. Differences between the position taken by management and that of taxing authorities could result in a reduction of a tax benefit or increase to tax liability, which could adversely affect future income tax expense.

Impairment of Goodwill and Intangible Assets. Core deposit and customer relationships, which are intangible assets with a finite life, are recorded on the Company's balance sheets. These intangible assets were capitalized as a result of past acquisitions and are being amortized over their estimated useful lives of up to 15 years. Core deposit intangible assets, with finite lives will be tested for impairment when changes in events or circumstances indicate that its carrying amount may not be recoverable. Core deposit intangible assets were tested for impairment during 2012 as part of the goodwill impairment test and no impairment was deemed necessary.

As a result of the Company's acquisition activity, goodwill, an intangible asset with an indefinite life, is reflected on the balance sheets. Goodwill is evaluated for impairment annually, unless there are factors present that indicate a potential impairment, in which case, the goodwill impairment test is performed more frequently than annually.

Fair Value Measurements. The fair value of a financial instrument is defined as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The Company estimates the fair value of a financial instrument using a variety of valuation methods. Where financial instruments are actively traded and have quoted market prices, quoted market prices are used for fair value. When the financial instruments are not actively traded, other observable market inputs, such as quoted prices of securities with similar characteristics, may be used, if available, to determine fair value. When observable market prices do not exist, the Company estimates fair value. The Company's valuation methods consider factors such as liquidity and concentration concerns. Other factors such as model assumptions, market dislocations, and unexpected correlations can affect estimates of fair value. Imprecision in estimating these factors can impact the amount of revenue or loss recorded.

SFAS No. 157, "Fair Value Measurements", which was codified into ASC 820, establishes a framework for measuring the fair value of financial instruments that considers the attributes specific to particular assets or liabilities and establishes a three-level hierarchy for determining fair value based on the transparency of inputs to each valuation as of the fair value measurement date. The three levels are defined as follows:

Level 1 — quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 — inputs include quoted prices for similar assets and liabilities in active markets, quoted prices of identical or similar assets or liabilities in markets that are not active, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 — inputs that are unobservable and significant to the fair value measurement.

At the end of each quarter, the Company assesses the valuation hierarchy for each asset or liability measured. From time to time, assets or liabilities may be transferred within hierarchy levels due to changes in availability of observable market inputs to measure fair value at the measurement date. Transfers into or out of hierarchy levels are based upon the fair value at the beginning of the reporting period. A more detailed description of the fair values measured at each level of the fair value hierarchy can be found in Note 11 – "Disclosures of Fair Values of Financial Instruments."

Acquisition

On September 10, 2010, First Mid Bank completed the acquisition of certain assets and the assumption of certain liabilities with respect to 10 branches of First Bank located in Bartonville, Bloomington, Galesburg, Knoxville, Peoria and Quincy, Illinois. Excluding the purchase accounting adjustments, the acquisition included the assumption of approximately \$336 million in deposits and the purchase of approximately \$135 million of loans and \$5.3 million of premises and equipment associated with the acquired branch locations. First Mid Bank received cash of \$178.3 million to assume the net liabilities less the purchase price of \$15.7 million (4.77% of core deposits assumed). The

acquisition resulted in goodwill of \$8.4 million. See Note 19—"Business Combinations" in the notes to the financial statements for additional information related to the transaction.

Results of Operations

Net Interest Income

The largest source of operating revenue for the Company is net interest income. Net interest income represents the difference between total interest income earned on earning assets and total interest expense paid on interest-bearing liabilities. The amount of interest income is dependent upon many factors, including the volume and mix of earning assets, the general level of interest rates and the dynamics of changes in interest rates. The cost of funds necessary to support earning assets varies with the volume and mix of interest-bearing liabilities and the rates paid to attract and retain such funds.

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The Company's average balances, interest income and expense and rates earned or paid for major balance sheet categories are set forth in the following table (dollars in thousands):

	Year Ended December 31, 2012			Year Ended December 31, 2011			Year Ended December 31, 2010			Average Rate
	Average Balance	Interest	Average Rate	Average Balance	Interest	Average Rate	Average Balance	Interest		
ASSETS										
Interest-bearing deposits	\$ 16,559	\$ 40	0.24	% \$83,877	\$ 213	0.25	% \$75,558	\$ 186	0.25	%
Federal funds sold	41,484	37	0.09	% 78,227	69	0.09	% 65,644	85	0.13	%
Certificates of deposit investments	10,714	57	0.53	% 11,651	78	0.67	% 9,473	110	1.16	%
Investment securities										
Taxable	458,158	9,970	2.18	% 388,108	9,819	2.53	% 249,636	7,746	3.10	%
Tax-exempt (1)	49,198	1,714	3.48	% 30,971	1,194	3.86	% 23,251	953	4.10	%
Loans (2) (3)	866,912	43,949	5.07	% 807,463	45,399	5.62	% 718,669	41,803	5.82	%
Total earning assets	1,443,025	55,767	3.85	% 1,400,297	56,772	4.05	% 1,142,231	50,883	4.45	%
Cash and due from banks	35,125			31,554			21,378			
Premises and equipment	30,234			29,374			19,454			
Other assets	46,646			52,512			46,592			
Allowance for loan losses	(11,577)			(10,943)			(10,302)			
Total assets	\$ 1,543,453			\$ 1,502,794			\$ 1,219,353			
LIABILITIES AND STOCKHOLDERS' EQUITY										
Deposits:										
Demand deposits, interest-bearing	\$ 511,199	1,443	0.28	% \$499,184	2,325	0.47	% \$421,743	3,190	0.76	%
Savings deposits	281,831	1,186	0.42	% 251,268	1,481	0.59	% 165,337	1,279	0.77	%
Time deposits	224,350	2,214	0.99	% 264,508	2,919	1.10	% 243,606	4,002	1.64	%
Securities sold under agreements										
to repurchase	113,443	117	0.10	% 108,240	172	0.16	% 76,758	133	0.17	%
FHLB advances	10,619	308	2.90	% 20,238	765	3.78	% 26,092	1,090	4.18	%
Federal funds purchased	59	—	0.68	% 14	—	0.55	% 8	—	0.47	%
Subordinated debentures	20,620	563	2.73	% 20,620	770	3.73	% 20,620	1,053	4.39	%
Other debt	4,035	326	8.00	% 927	72	8.00	% 642	9	2.76	%
Total interest-bearing liabilities	1,166,156	6,157	0.53	% 1,164,999	8,504	0.73	% 954,806	10,756	1.13	%
Demand deposits	219,218			197,246			142,125			
Other liabilities	7,501			7,105			7,271			
Stockholders' equity	150,578			133,444			115,151			
Total liabilities & equity	\$ 1,543,453			\$ 1,502,794			\$ 1,219,353			
Net interest income		\$ 49,610			\$ 48,268			\$ 40,127		

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Net interest spread	3.32 %	3.32 %	3.32 %
Impact of non-interest bearing funds	0.12 %	0.13 %	0.19 %
Net yield on interest-earning assets	3.44 %	3.45 %	3.51 %

(1) The tax-exempt income is not recorded on a tax equivalent basis.

(2) Nonaccrual loans have been included in the average balances.

(3) Includes loans held for sale.

Changes in net interest income may also be analyzed by segregating the volume and rate components of interest income and interest expense. The following table summarizes the approximate relative contribution of changes in average volume and interest rates to changes in net interest income for the past two years (in thousands):

	2012 Compared to 2011			2011 Compared to 2010		
	Increase – (Decrease)			Increase – (Decrease)		
	Total Change	Volume (1)	Rate (1)	Total Change	Volume (1)	Rate (1)
Earning Assets:						
Interest-bearing deposits	\$(173)	\$(165)	\$(8)	\$27	\$27	\$—
Federal funds sold	(32)	(32)	—	(16)	14	(30)
Certificates of deposit investments	(21)	(6)	(15)	(32)	21	(53)
Investment securities:						
Taxable	151	1,623	(1,472)	2,073	3,694	(1,621)
Tax-exempt (2)	520	645	(125)	241	301	(60)
Loans (3)	(1,450)	3,191	(4,641)	3,596	5,062	(1,466)
Total interest income	(1,005)	5,256	(6,261)	5,889	9,119	(3,230)
Interest-Bearing Liabilities:						
Deposits:						
Demand deposits, interest-bearing	(882)	57	(939)	(865)	514	(1,379)
Savings deposits	(295)	166	(461)	202	550	(348)
Time deposits	(705)	(425)	(280)	(1,083)	320	(1,403)
Securities sold under agreements to repurchase						
FHLB advances	(55)	8	(63)	39	48	(9)
Federal funds purchased	(457)	(307)	(150)	(325)	(228)	(97)
Subordinated debentures	—	—	—	—	—	—
Other debt	(207)	—	(207)	(283)	—	(283)
Total interest expense	254	254	—	63	5	58
Net interest income	(2,347)	(247)	(2,100)	(2,252)	1,209	(3,461)
	\$1,342	\$5,503	\$(4,161)	\$8,141	\$7,910	\$231

(1) Changes attributable to the combined impact of volume and rate have been allocated proportionately to the change due to volume and the change due to rate.

(2) The tax-exempt income is not recorded on a tax equivalent basis.

(3) Nonaccrual loans are not material and have been included in the average balances.

Net interest income increased \$1.3 million or 2.8% in 2012 compared to an increase of \$8.1 million or 20.3% in 2011. The increase in net interest income in 2012 was primarily due to a greater increase in investment and loan balances offset by declines in interest-bearing asset rates compared to declines in rates of interest-bearing liabilities during the same period. The increase in net interest income in 2011 was primarily due to an increase in earning assets.

In 2012, average earning assets increased by \$42.7 million or 3% and average interest-bearing liabilities increased \$1.2 million or .1% compared with 2011. In 2011, average earning assets increased by \$258.1 million, or 22.6%, and average interest-bearing liabilities increased \$210.2 million or 22% compared with 2010. Changes in average balances are shown below:

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Average interest-bearing deposits held by the Company decreased \$67.3 million or 80.2% in 2012 compared to 2011. In 2011, average interest-bearing deposits held by the Company increased \$8.3 million or 11% compared to 2010.

Average federal funds sold decreased \$36.7 million or 46.9% in 2012 compared to 2011. In 2011, average federal funds sold increased \$12.6 million or 19.2% compared to 2010.

Average certificates of deposit investments decreased \$.9 million or 7.7% in 2012 compared to 2011. In 2011, average certificates of deposit investments increased \$2.2 million or 23.2% compared to 2010.

Average loans increased by \$59.4 million or 7.4% in 2012 compared to 2011. In 2011, average loans increased by \$88.8 million or 12.4% compared to 2010.

Average securities increased by \$88.3 million or 21.1% in 2012 compared to 2011. In 2011, average securities increased by \$146.2 million or 53.6% compared to 2010.

Average deposits increased by \$2.4 million or .2% in 2012 compared to 2011. In 2011, average deposits increased by \$184.3 million or 22.2% compared to 2010.

Average securities sold under agreements to repurchase increased by \$5.2 million or 4.8% in 2012 compared to 2011. In 2011, average securities sold under agreements to repurchase increased by \$31.5 million or 41% compared to 2010.

Average borrowings and other debt decreased by \$6.5 million or 15.6% in 2012 compared to 2011. In 2011, average borrowings and other debt decreased by \$5.6 million or 11.8% compared to 2010.

The federal funds rate remained at a range of 0% to .30% at December 31, 2012, 2011 and 2010.

Net interest margin decreased to 3.44% compared to 3.45% in 2011 and 3.51% in 2010. Asset yields decreased by 20 basis points in 2012, and interest-bearing liabilities decreased by 20 basis points.

To compare the tax-exempt yields on interest-earning assets to taxable yields, the Company also computes non-GAAP net interest income on a tax equivalent basis where the interest earned on tax-exempt securities is adjusted to an amount comparable to interest subject to normal income taxes, assuming a federal tax rate of 34% (referred to as the tax equivalent adjustment). The tax equivalent basis adjustments to net interest income for 2012, 2011 and 2010 were \$1,038,000, \$615,000, and \$491,000, respectively. The net yield on interest-earning assets on a tax equivalent basis was 3.51% in 2012, 3.51% in 2011 and 3.57% in 2010.

Provision for Loan Losses

The provision for loan losses in 2012 was \$2,647,000 in 2012 compared to \$3,101,000 in 2011 and \$3,737,000 in 2010. Nonperforming loans increased to \$7,593,000 at December 31, 2012 from \$7,440,000 at December 31, 2011 and compared to \$10,434,000 at December 31, 2010. The increase in 2012 was primarily due to additional loans becoming past due and being put on non-accrual. The decrease in 2011 was primarily due to loans that paid-off or became current during the year and loans transferred to other real estate owned during the year. Net charge-offs were \$1,991,000 during 2012, \$2,374,000 during 2011 and \$2,806,000 during 2010. For information on loan loss experience and nonperforming loans, see "Nonperforming Loans and Repossessed Assets" and "Loan Quality and Allowance for Loan Losses" herein.

Other Income

An important source of the Company's revenue is derived from other income. The following table sets forth the major components of other income for the last three years (in thousands):

	2012	2011	2010	\$ Change From Prior Year	
				2012	2011
Trust	\$3,330	\$3,030	\$2,601	\$300	\$429
Brokerage	688	650	536	38	114

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Insurance commissions	1,813	1,786	1,779	27	7
Service charges	4,808	4,817	4,662	(9) 155
Securities gains	934	486	543	448	(57)
Impairment recoveries (losses) on securities	127	(886) (1,418) 1,013	532
Mortgage banking	1,509	788	776	721	12
ATM / debit card revenue	3,554	3,483	2,869	71	614
Other	1,547	1,633	1,472	(86) 161
Total other income	\$18,310	\$15,787	\$13,820	\$2,523	\$1,967

Total non-interest income increased to \$18.3 million in 2012 compared to \$15.8 million in 2011 and \$13.8 million in 2010. The primary reasons for the more significant year-to-year changes in other income components are as follows:

Trust revenues increased \$300,000 or 9.9% in 2012 to \$3,330,000 from \$3,030,000 in 2011 compared to \$2,601,000 in 2010. The increase from 2011 to 2012 in trust revenues was due to an increase in revenues from Personal Trust and Agency accounts and retirement services accounts during the year. Trust assets were \$633.8 million at December 31, 2012 compared to \$546.7 million at December 31, 2011 and \$507.5 million at December 31, 2010.

Revenue from brokerage annuity sales increased \$38,000 or 5.8% to \$688,000 in 2012 from \$650,000 in 2011 compared to \$536,000 in 2010. The increase from 2011 to 2012 was due an increase in commissions received from the sale of annuities.

Insurance commissions increased \$27,000 or 1.5% to \$1,813,000 in 2012 from \$1,786,000 in 2011 compared to \$1,779,000 in 2010. The increase from 2011 to 2012 was due to an increase in property and casualty insurance commissions during 2012 compared to 2011.

Fees from service charges decreased \$9,000 or .2% to \$4,808,000 in 2012 from \$4,817,000 in 2011 compared to \$4,662,000 in 2010. The decrease from 2011 to 2012 was due to lower transaction account fees. The increase from 2010 to 2011 was primarily due to an increase in the number of accounts resulting from the Branches acquired during the third quarter of 2010.

Net securities gains in 2012 were \$934,000 up \$448,000 or 92% from \$486,000 in 2011 and \$543,000 in 2010. Several securities in the investment portfolio were sold to improve the overall portfolio mix and the margin in 2012 and 2011.

During 2012, the Company received payment for the redemption of one of its investments in trust preferred securities that resulted in the reversal of \$127,000 of previous other-than-temporary impairment charges. During 2011, the Company recorded other-than-temporary impairment charges amounting to \$886,000 for its investments in four trust preferred securities compared to \$1,418,000 during 2010. See Note 4 - Investment Securities in the notes to the financial statements for a more detailed description of these charges.

Mortgage banking income increased \$721,000 or 91.5% to \$1,509,000 in 2012 from \$788,000 in 2011 compared to \$776,000 in 2010. The increase from 2011 to 2012 was due to an increase in the volume of loans originated and sold by First Mid Bank due to lower interest rates on various loan types. Loans sold balances are as follows:

\$101 million (representing 796 loans) in 2012
\$60 million (representing 500 loans) in 2011
\$64 million (representing 570 loans) in 2010

First Mid Bank generally releases the servicing rights on loans sold into the secondary market.

Revenue from ATMs and debit cards increased \$71,000 or 2% to \$3,554,000 in 2012 from \$3,483,000 in 2011 compared to \$2,869,000 in 2010. The increase from 2011 to 2012 was due to an increase in the number of transactions processed offset by lower fees received for processing these transactions. The increase from 2010 to 2011 was due to increased usage primarily as a result of the increase in customers after the Branches acquired during the third quarter of 2010.

Other income decreased \$86,000 or 5.3% in 2012 to \$1,547,000 from \$1,633,000 in 2011 compared to \$1,472,000 in 2010. The decrease from 2011 to 2012 was primarily due to non-recurring income received in 2011 for distribution of an investment in other assets and decreases in various other expenses. The increase from 2011 to 2010 was primarily due to the non-recurring income received for distribution of an investment in other assets and an increase in rental income from buildings acquired in the Branch acquisition during the third quarter of 2010 offset by a decrease in rental income in 2010 from a repossessed property sold during 2011.

Other Expense

The major categories of other expense include salaries and employee benefits, occupancy and equipment expenses and other operating expenses associated with day-to-day operations. The following table sets forth the major components of other expense for the last three years (in thousands):

				\$ Change From Prior Year	
	2012	2011	2010	2012	2011
Salaries and benefits	\$23,433	\$22,247	\$18,649	\$1,186	\$3,598
Occupancy and equipment	8,088	7,960	5,851	128	2,109
Other real estate owned, net	390	1,471	1,076	(1,081)) 395
FDIC insurance assessment expense	875	1,167	1,508	(292)) (341)
Amortization of other intangibles	773	1,134	814	(361)) 320
Stationery and supplies	609	581	610	28	(29)
Legal and professional fees	2,093	2,070	2,361	23	(291)
Marketing and promotion	1,014	1,050	940	(36)) 110
Other	5,563	5,373	5,118	190	255
Total other expense	\$42,838	\$43,053	\$36,927	\$(215)) \$6,126

Total non-interest expense decreased to \$42.8 million in 2012 from \$43.1 million in 2011 and \$36.9 million in 2010. The primary reasons for the more significant year-to-year changes in other expense components are as follows:

Salaries and employee benefits, the largest component of other expense, increased \$1,186,000 or 5.3% to \$23,433,000 from \$22,247,000 in 2011, compared to \$18,649,000 in 2010. The increase in 2012 was primarily due to an increase in incentive compensation expense as a result of achieving desired objectives in 2012 compared to 2011 and merit raises for continuing employees. The increase in 2011 was primarily due to the addition of 76 full-time equivalent employees resulting from the Branches acquired at the end of the third quarter of 2010, an increase in incentive compensation expense as a result of achieving desired objectives in 2011 compared to 2010 and merit raises for continuing employees. There were 400 full-time equivalent employees at December 31, 2012, compared to 402 at December 31, 2011, and 419 at December 31, 2010.

Occupancy and equipment expense increased \$128,000 or 1.6% to \$8,088,000 in 2012 from \$7,960,000 in 2011, compared to \$5,851,000 in 2010. The increase in 2012 was primarily due to increases in building depreciation expense and other expenses associated with the Company's purchase of a building in Mattoon, Illinois in 2011. The increase in 2011 was primarily due to increases in building rent and expenses for computer software and software maintenance for existing and newly acquired Branches and expenses associated with the Company's purchase of a building in Mattoon, Illinois in 2011.

Net other real estate owned expense decreased \$1,081,000 or 73.5% to \$390,000 from \$1,471,000 in 2011, compared to \$1,076,000 in 2010. The decrease in 2012 was due to less expenses for maintenance, insurance and property taxes resulting from less properties owned and fewer losses on properties sold compared to 2011. The increase in 2011 was due to more write downs on properties held and an increase in repairs and real estate tax expenses on properties held during 2011 compared to 2010.

FDIC insurance expense decreased \$292,000 or 25% to \$875,000 from \$1,167,000 in 2011, compared to \$1,508,000 in 2010. The decrease in 2012 was due to a full year of assessments calculated under the new rules implemented during the second quarter of 2011 and lower assessment rates during 2012 compared to 2011. The decrease in 2011 was due to a decrease in expense resulting from a change in the calculation of the insurance assessment during the second quarter of 2011.

Amortization of other intangibles expense decreased \$361,000 or 31.8% to \$773,000 from \$1,134,000 in 2011, compared to \$814,000 in 2010. The decrease in 2012 was due to the customer list intangibles becoming fully amortized during the first quarter of 2012 and less amortization expense for core deposit intangibles. The increase in 2011 was due to amortization of the additional core deposit intangible asset resulting from the Branches acquired in the third quarter of 2010.

Other operating expenses increased \$190,000 or 3.5% to \$5,563,000 from \$5,373,000 in 2011, compared to \$5,118,000 in 2010. In 2012, the increase was due to increases in various expenses. In 2011, this increase was primarily due to additional expenses incurred following the acquisition of the Branches.

On a net basis, all other categories of operating expenses increased \$15,000 or .4% to \$3,716,000 from \$3,701,000 in 2011, compared to \$3,911,000 in 2010. The decrease in 2011 was primarily due to a decrease in legal expenses associated with the acquisition of the Branches during 2010 partially offset by increased legal and other professional expenses associated with the Company's issuance of Series C Preferred Stock during 2011.

Income Taxes

Income tax expense amounted to \$8,410,000 in 2012 compared to \$6,529,000 in 2011, and \$4,522,000 in 2010. Effective tax rates were 37.5%, 36.5%, and 34.0%, respectively, for 2012, 2011 and 2010. Beginning January 1, 2011, the State of Illinois increased the corporate income tax rate to 9.5% compared to 7.3% previously. This was the primary cause of the increase in the Company's effective tax rate in 2011. The increase in the Company's effective tax rate in 2012 was primarily due to a decline in the amount of tax-exempt securities held by the Company.

The Company adopted the provisions of FASB Interpretation No. 48 (FIN 48), "Accounting for Uncertainty in Income Taxes," which was codified within ASC 740, on January 1, 2007. The implementation of FIN 48 did not impact the Company's financial statements. The Company files U.S. federal and state of Illinois income tax returns. The Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2008.

Analysis of Balance Sheets

Securities

The Company's overall investment objectives are to insulate the investment portfolio from undue credit risk, maintain adequate liquidity, insulate capital against changes in market value and control excessive changes in earnings while optimizing investment performance. The types and maturities of securities purchased are primarily based on the Company's current and projected liquidity and interest rate sensitivity positions.

The following table sets forth the amortized cost of the available-for-sale and held-to-maturity securities for the last three years (dollars in thousands):

	December 31, 2012		2011		2010			
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield		
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 180,851	1.75	% \$ 164,812	1.99	% \$ 152,086	1.90	%	
Obligations of states and political subdivisions	53,064	3.62	% 38,879	3.92	% 26,599	4.05	%	
Mortgage-backed securities: GSE residential	252,310	2.81	% 254,930	3.17	% 158,936	3.72	%	
Trust preferred securities	4,974	3.50	% 5,625	4.05	% 6,595	3.74	%	
Other securities	9,663	1.92	% 9,561	1.92	% 2,035	2.48	%	
Total securities	\$ 500,862	2.53	% \$ 473,807	2.81	% 346,251	2.94	%	

At December 31, 2012, the Company's investment portfolio increased by \$27.1 million from December 31, 2011 due to the purchase of various securities. When purchasing investment securities, the Company considers its overall liquidity and interest rate risk profile, as well as the adequacy of expected returns relative to the risks assumed.

The table below presents the credit ratings as of December 31, 2012 for certain investment securities (in thousands):

	Amortized Cost	Estimated Fair Value	Average Credit Rating of Fair Value at December 31, 2012 (1)					
			AAA	AA +/-	A +/-	BBB +/-	< BBB -	Not rated
U.S. Treasury securities and obligations of U.S. government corporations and agencies	\$ 180,851	\$ 182,169	\$ 182,169	\$—	\$—	\$—	\$—	\$—
Obligations of state and political subdivisions	53,064	56,207	3,254	41,406	6,964	1,384	—	3,199
Mortgage-backed securities (2)	252,310	259,460	—	—	—	—	—	259,460
Trust preferred securities	4,974	585	—	—	—	—	585	—

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Other securities	9,663	9,888	—	—	7,930	1,898	—	60
Total investments	\$500,862	\$508,309	\$185,423	\$41,406	\$14,894	\$3,282	\$585	\$262,719

(1) Credit ratings reflect the lowest current rating assigned by a nationally recognized credit rating agency.

(2) Mortgage-backed securities include mortgage-backed securities (MBS) and collateralized mortgage obligation (CMO) issues from the following government sponsored enterprises: FHLMC, FNMA, GNMA and FHLB. While MBS and CMOs are no longer explicitly rated by credit rating agencies, the industry recognizes that they are backed by agencies which have an implied government guarantee.

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The trust preferred securities are three trust preferred pooled securities issued by FTN Financial Securities Corp. (“FTN”). The following table contains information regarding these securities as of December 31, 2012:

Deal name	PreTSL I	PreTSL II	PreTSL XXVIII
Class	Mezzanine	Mezzanine	Mezzanine C-1
Book value	\$513,000	\$809,000	\$3,652,000
Fair value	\$297,000	\$219,000	\$69,000
Unrealized gains/(losses)	\$(216,000)	\$(590,000)	\$(3,583,000)
Other-than-temporary impairment recorded in earnings	\$691,000	\$2,187,000	\$1,111,000
Lowest credit rating assigned	Ca	Ca	C
Number of performing banks	12	14	27
Number of issuers in default	4	4	9
Number of issuers in deferral	1	5	9
Original collateral	\$303,112,000	\$334,170,000	\$360,850,000
Actual defaults & deferrals as a % of original collateral	22.8 %	26.0 %	25.2 %
Remaining collateral	\$177,000,000	\$183,200,000	\$353,616,000
Actual defaults & deferrals as a % of remaining collateral	39.0 %	47.5 %	2,570.0 %
Expected defaults & deferrals as a % of remaining collateral	36.6 %	45.7 %	34.3 %
Performing collateral	\$108,000,000	\$96,200,000	\$262,616,000
Current balance of class	\$90,533,716	\$122,047,807	\$37,111,400
Subordination	\$131,121,879	\$185,063,249	\$301,063,079
Excess subordination	\$(23,121,879)	\$(88,863,249)	\$(30,420,834)
Excess subordination as a % of remaining performing collateral	(21.4)%	(92.4)%	(11.9)%
Discount rate (1)	9.74 %	9.68 %	1.60%-4.95%
Expected defaults & deferrals as a % of remaining collateral (2)	2% / .36	2% / .36	2% / .36
Recovery assumption (3)	10 %	10 %	10 %
Prepayment assumption (4)	1 %	1 %	1 %

(1) The discount rate for floating rate bonds is a compound interest formula based on the LIBOR forward curve for each payment date

(2) 2% annually for 2 years and 36 basis points annually thereafter

(3) With 2 year lag

(4) Additional assumptions regarding prepayments:

Banks with more than \$15 billion in total assets as of 12/31/2009:

(a) For fixed rate TruPS, all securities will be called in one year

(b) For floating rate TruPS, (1) all securities with spreads greater than 250 bps will be called in one year (2) all securities with spreads between 150 bps and 250 bps will be called at a rate of 5% annually (3) all securities with spreads less than 150 bps will be called at a rate of 1% annually

Banks with less than \$15 billion in total assets as of 12/31/2009:

(a) For fixed rate TruPS, (1) all securities with coupons greater than 8% that were issued by healthy banks with the capacity to prepay will be called in one year (2) All remaining fixed rate securities will be called at a rate of 1% annually

(b) For floating rate TruPs, all securities will be called at a rate of 1% annually

The trust preferred pooled securities are Collateralized Debt Obligations (“CDOs”) backed by a pool of debt securities issued by financial institutions. The collateral consists of trust-preferred securities and subordinated debt securities issued by banks, bank holding companies and insurance companies. Performing collateral is the amount of remaining collateral less the balances of collateral in deferral or default. Subordination is the amount of performing collateral in excess of the current balance of a specified class and all classes senior to the specified class. Excess subordination is the amount that the performing collateral balance exceeds the current outstanding balance of the specific class, plus all senior classes. It is a static measure of credit enhancement, but does not incorporate all of the structural elements of the security deal. This amount can also be impacted by future defaults and deferrals, deferring balances that cure or redemptions of securities by issuers. A negative excess subordination indicates that the current performing collateral of the security would be insufficient to pay the current principal balance of the class notes after all of the senior classes’ notes were paid. However, the performing collateral balance excludes the collateral of issuers currently deferring their interest payments. Because these issuers are expected to resume payment in the future (within five years of the first deferred interest period), a negative excess subordination does not necessarily mean a class note holder will not receive a greater than projected or even full payment of cash flow at maturity.

During the year ended December 31, 2011 the Company was receiving “payment in kind” (“PIK”) in lieu of cash interest on all of its trust preferred securities investments as and to the extent described below. During 2012, the Company began receiving its full interest payments on PreTSL I and partial interest payments on PreTSL II. Also during 2012, the company’s holding in PreTSL VI was redeemed in full. The payment received was sufficient to pay-off the book value of the security of \$123,000, reverse the recorded OTTI impairment of \$127,000 and recover previously unrecorded interest of approximately \$11,500.

The Company’s use of “PIK” does not indicate that additional securities have been issued in satisfaction of any outstanding obligation; rather, it indicates that a coverage test of a class or tranche directly senior to the class in question has failed and interest received on the PIK note is being capitalized, which means the principal balance is being increased. Once the coverage test is met, the capitalized interest will be paid in cash and current cash interest payments will resume.

The Company’s trust preferred securities investments all allow, under the terms of the issue, for issuers to defer interest for up to five consecutive years. After five years, if not cured, the securities are considered to be in default and the trustee may demand payment in full of principal and accrued interest. Issuers are also considered to be in default in the event of the failure of the issuer or a subsidiary. The structuring of these trust preferred securities provides for a waterfall approach to absorbing losses whereby lower classes or tranches are initially impacted and more senior tranches are only impacted after lower tranches can no longer absorb losses. Likewise, the waterfall approach also applies to principal and interest payments received, as senior tranches have priority over lower tranches in the receipt of payments. Both deferred and defaulted issuers are considered non-performing, and the trustee calculates, on a quarterly or semi-annual basis, certain coverage tests prior to the payment of cash interest to owners of the various tranches of the securities. The coverage tests are compared to an over-collateralization target that states the balance of performing collateral as a percentage of the tranche balance plus the balance of all senior tranches. The tests must show that performing collateral is sufficient to meet requirements for the senior tranches, both in terms of cash flow and collateral value, before cash interest can be paid to subordinate tranches. As a result of the cash flow waterfall provisions within the structure of these securities, when a senior tranche fails its coverage test, all of the cash flows that would have been paid to lower tranches are paid to the senior tranche and recorded as a reduction of the senior tranches’ principal. This principal reduction in the senior tranche continues until the coverage test of the senior tranche is passed or the principal of the tranche is paid in full. For so long as the cash flows are being diverted to the senior tranches, the amount of interest due and payable to the subordinate tranches is capitalized and recorded as an increase in the principal value of the tranche. The Company’s trust preferred securities investments are in the mezzanine tranches or classes which are subordinate to one of more senior tranches of their respective issues. The Company is receiving PIK for these securities due to failure of the required senior tranche coverage tests described. These

securities are projected to remain in full or partial PIK status for a period of one to eleven years.

The impact of payment of PIK to subordinate tranches is to strengthen the position of the senior tranches by reducing the senior tranches' principal balances relative to available collateral and cash flow. The impact to the subordinate tranches is to increase principal balances, decrease cash flow, and increase credit risk to the tranches receiving the PIK. The risk to holders of a security of a tranche in PIK status is that the total cash flow will not be sufficient to repay all principal and capitalized interest related to the investment.

During the fourth quarter of 2010, after analysis of the expected future cash flows and the timing of resumed interest payments, the Company determined that placing all of the trust preferred securities on non-accrual status was the most prudent course of action. The Company stopped all accrual of interest and ceased to capitalize any PIK to the principal balance of the securities. The Company intends to keep these securities on non-accrual status until the scheduled interest payments resume on a regular basis and any previously recorded PIK has been paid. The PIK status of these securities, among other factors, indicates potential other-than-temporary impairment ("OTTI") and accordingly, the Company performed further detailed analysis of the investments' cash flows and the credit conditions of the underlying issuers. This analysis incorporates, among other things, the waterfall provisions and any resulting PIK status of these securities to determine if cash flow will be sufficient to pay all principal and interest due to the investment tranche held by the Company.

See discussion below and Note 4 – Investment Securities in the notes to the financial statements for more detail regarding this analysis. Based on this analysis, the Company believes the amortized costs recorded for its trust preferred securities investments accurately reflects the position of these securities at December 31, 2012 and 2011.

Other-than-temporary Impairment of Securities

Declines in the fair value, or unrealized losses, of all available for sale investment securities, are reviewed to determine whether the losses are either a temporary impairment or OTTI. Temporary adjustments are recorded when the fair value of a security fluctuates from its historical cost. Temporary adjustments are recorded in accumulated other comprehensive income, and impact the Company's equity position. Temporary adjustments do not impact net income. A recovery of available for sale security prices also is recorded as an adjustment to other comprehensive income for securities that are temporarily impaired, and results in a positive impact to the Company's equity position.

OTTI is recorded when the fair value of an available for sale security is less than historical cost, and it is probable that all contractual cash flows will not be collected. Investment securities are evaluated for OTTI on at least a quarterly basis. In conducting this assessment, the Company evaluates a number of factors including, but not limited to:

- how much fair value has declined below amortized cost;
- how long the decline in fair value has existed;
- the financial condition of the issuers;
- contractual or estimated cash flows of the security;
- underlying supporting collateral;
- past events, current conditions and forecasts;
- significant rating agency changes on the issuer; and
- the Company's intent and ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value.

If the Company intends to sell the security or if it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, the entire amount of OTTI is recorded to noninterest income, and therefore, results in a negative impact to net income. Because the available for sale securities portfolio is recorded at fair value, the conclusion as to whether an investment decline is other-than-temporarily impaired, does not significantly impact the Company's equity position, as the amount of the temporary adjustment has already been reflected in accumulated other comprehensive income/loss.

If the Company does not intend to sell the security and it is not more-likely-than-not it will be required to sell the security before recovery of its amortized cost basis, only the amount related to credit loss is recognized in earnings. In determining the portion of OTTI that is related to credit loss, the Company compares the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. The remaining portion of OTTI, related to other factors, is recognized in other comprehensive earnings, net of applicable taxes.

The term "other-than-temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value are not necessarily favorable, or that there is a general lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. See Note 4 -- Investment Securities in the notes to the financial statements for a discussion of the Company's evaluation and, when applicable, charges for OTTI.

Loans

The loan portfolio (net of unearned interest) is the largest category of the Company's earning assets. The following table summarizes the composition of the loan portfolio, including loans held for sale, for the last five years (in thousands):

	2012	% Outstanding Loans	2011	2010	2009	2008
Construction and land development	\$31,341	3.4	% \$23,136	\$20,379	\$28,041	\$40,362
Farm loans	86,271	9.5	% 72,585	64,992	62,330	65,647
1-4 Family residential properties	186,498	20.5	% 181,849	179,527	180,415	200,204
Multifamily residential properties	44,863	4.9	% 19,846	22,146	19,467	23,833
Commercial real estate	316,322	34.7	% 321,001	300,825	226,400	217,307

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Loans secured by real estate	665,295	73.0	%	618,417	587,869	516,653	547,353
Agricultural loans	61,014	6.7	%	63,257	58,307	54,144	54,098
Commercial and industrial loans	160,299	17.6	%	150,716	126,319	105,351	109,324
Consumer loans	16,264	1.8	%	16,271	19,655	20,815	25,806
All other loans	8,193	0.9	%	11,413	12,431	3,787	5,357
Total loans	\$911,065	100.0	%	\$860,074	\$804,581	\$700,750	\$741,938

Loan balances increased by \$51 million or 5.9% from December 31, 2011 to December 31, 2012 primarily due to originations of loans secured by real estate and commercial and industrial loans. Loan balances increased by \$55.5 million or 6.9% from December 31, 2010 to December 31, 2011 primarily due to originations of loans secured by real estate and commercial and industrial loans. The balances of loans sold into the secondary market were \$101 million in 2012 compared to \$60 million in 2011. The balance of real estate loans held for sale, included in the balances shown above, amounted to \$212,000 and \$1,046,000 as of December 31, 2012 and 2011, respectively.

All of the loans acquired in the acquisition of the Branches during 2010 were performing loans. The fair value of the loans acquired was determined using a discounted cash flow analysis. The difference between the fair value and acquired value of the purchased loans of \$2.1 million (a discount of approximately 1.6% of the total loans acquired) is being accreted to interest income over the remaining term of the loans. The unaccreted balance of this discount at December 31, 2012 and 2011 is \$503,000 and \$906,000, respectively.

Commercial and commercial real estate loans generally involve higher credit risks than residential real estate and consumer loans. Because payments on loans secured by commercial real estate or equipment are often dependent upon the successful operation and management of the underlying assets, repayment of such loans may be influenced to a great extent by conditions in the market or the economy. The Company does not have any sub-prime mortgages or credit card loans outstanding which are also generally considered to be higher credit risk.

The following table summarizes the loan portfolio geographically by branch region as of December 31, 2012 and 2011 (dollars in thousands):

	December 31, 2012		December 31, 2011		
	Principal balance	% Outstanding Loans	Principal balance	% Outstanding loans	
Mattoon region	\$183,657	20.2	% \$163,446	19.0	%
Charleston region	51,179	5.6	% 48,716	5.7	%
Sullivan region	128,650	14.1	% 120,369	14.0	%
Effingham region	63,910	7.0	% 75,750	8.8	%
Decatur region	218,318	24.0	% 197,063	22.9	%
Peoria region	156,370	17.2	% 143,955	16.7	%
Highland region	108,981	11.9	% 110,775	12.9	%
Total all regions	\$911,065	100.0	% \$860,074	100.0	%

Loans are geographically dispersed among these regions located in central and southwestern Illinois. While these regions have experienced some economic stress during 2012 and 2011, the Company does not consider these locations high risk areas since these regions have not experienced the significant declines in real estate values seen in some other areas in the United States.

The Company does not have a concentration, as defined by the regulatory agencies, in construction and land development loans or commercial real estate loans as a percentage of total risk-based capital for the periods shown above. At December 31, 2012 and 2011, the Company did have industry loan concentrations in excess of 25% of total risk-based capital in the following industries (dollars in thousands):

	December 31, 2012		December 31, 2011		
	Principal balance	% Outstanding Loans	Principal balance	% Outstanding Loans	
Other grain farming	\$124,367	13.65	% \$120,061	13.17	%
Lessors of non-residential buildings	89,940	9.87	% 82,557	9.50	%
Lessors of residential buildings & dwellings	59,848	6.57	% 44,009	5.06	%
Hotels and motels	45,783	5.03	% 46,842	5.64	%

The Company had no further industry loan concentrations in excess of 25% of total risk-based capital.

The following table presents the balance of loans outstanding as of December 31, 2012, by contractual maturities (in thousands):

	Maturity (1)			Total
	One year or less(2)	Over 1 through 5 years	Over 5 years	
Construction and land development	\$17,866	\$6,649	\$6,826	\$31,341
Farm loans	11,904	39,859	34,508	86,271
1-4 Family residential properties	24,646	84,463	77,389	186,498
Multifamily residential properties	888	17,893	26,082	44,863
Commercial real estate	47,509	178,914	89,899	316,322
Loans secured by real estate	102,813	327,778	234,704	665,295
Agricultural loans	45,144	14,814	1,056	61,014
Commercial and industrial loans	110,283	42,117	7,899	160,299
Consumer loans	3,546	12,367	351	16,264
All other loans	805	1,840	5,548	8,193
Total loans	\$262,591	\$398,916	\$249,558	\$911,065

(1) Based upon remaining contractual maturity.

(2) Includes demand loans, past due loans and overdrafts.

As of December 31, 2012, loans with maturities over one year consisted of approximately \$580.7 million in fixed rate loans and approximately \$67.8 million in variable rate loans. The loan maturities noted above are based on the contractual provisions of the individual loans. The Company has no general policy regarding renewals and borrower requests, which are handled on a case-by-case basis.

Nonperforming Loans and Nonperforming Other Assets

Nonperforming loans include: (a) loans accounted for on a nonaccrual basis; (b) accruing loans contractually past due ninety days or more as to interest or principal payments; and (c) loans not included in (a) and (b) above which are defined as “troubled debt restructurings”. Repossessed assets include primarily repossessed real estate and automobiles.

The Company’s policy is to discontinue the accrual of interest income on any loan for which principal or interest is ninety days past due. The accrual of interest is discontinued earlier when, in the opinion of management, there is reasonable doubt as to the timely collection of interest or principal. Once interest accruals are discontinued, accrued but uncollected interest is charged against current year income. Subsequent receipts on non-accrual loans are recorded as a reduction of principal, and interest income is recorded only after principal recovery is reasonably assured. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal.

Restructured loans are loans on which, due to deterioration in the borrower’s financial condition, the original terms have been modified in favor of the borrower or either principal or interest has been forgiven.

Repossessed assets represent property acquired as the result of borrower defaults on loans. These assets are recorded at estimated fair value, less estimated selling costs, at the time of foreclosure or repossession. Write-downs occurring at foreclosure are charged against the allowance for loan losses. On an ongoing basis, properties are appraised as required by market indications and applicable regulations. Write-downs for subsequent declines in value are recorded

in non-interest expense in other real estate owned along with other expenses related to maintaining the properties.

The following table presents information concerning the aggregate amount of nonperforming loans and repossessed assets (in thousands):

	December 31,					
	2012	2011	2010	2009	2008	
Nonaccrual loans	\$7,573	\$6,723	\$9,332	\$12,720	\$7,285	
Restructured loans which are performing in accordance with revised terms	20	717	1,102	—	—	
Total nonperforming loans	7,593	7,440	10,434	12,720	7,285	
Repossessed assets	1,229	4,606	6,199	2,896	2,400	
Total nonperforming loans and repossessed assets	\$8,822	\$12,046	\$16,633	\$15,616	\$9,685	
Nonperforming loans to loans, before allowance for loan losses	0.83	% 0.87	% 1.30	% 1.82	% 0.98	%
Nonperforming loans and repossessed assets to loans, before allowance for loan losses	0.98	% 1.40	% 2.07	% 2.23	% 1.31	%

The \$850,000 increase in nonaccrual loans during 2012 resulted from the net of \$4,403,000 of loans put on nonaccrual status, offset by \$331,000 of loans transferred to other real estate owned, \$632,000 of loans charged off and \$2,590,000 of loans becoming current or paid-off. The following table summarizes the composition of nonaccrual loans (in thousands):

	December 30, 2012		December 31, 2011		
	Balance	% of Total	Balance	% of Total	
Construction and land development	\$1,522	20.1	% \$833	12.4	%
Farm loans	418	5.5	% 532	7.9	%
1-4 Family residential properties	1,899	25.1	% 1,712	25.5	%
Commercial real estate	2,063	27.2	% 2,245	33.4	%
Loans secured by real estate	5,902	77.9	% 5,322	79.2	%
Agricultural loans	930	12.3	% 673	10.0	%
Commercial and industrial loans	704	9.3	% 720	10.7	%
Consumer loans	37	0.5	% 8	0.1	%
Total loans	\$7,573	100.0	% \$6,723	100.0	%

Interest income that would have been reported if nonaccrual and restructured loans had been performing totaled \$173,000, \$239,000 and \$428,000 for the years ended December 31, 2012, 2011 and 2010, respectively.

The \$3,377,000 decrease in repossessed assets during 2012 resulted from the net of \$780,000 of additional assets repossessed, \$3,791,000 of repossessed assets sold and \$366,000 of further write-downs of repossessed assets to current market value. The following table summarizes the composition of repossessed assets (in thousands):

	December 31, 2012		December 31, 2011		
	Balance	% of Total	Balance	% of Total	
Construction and land development	\$278	22.6	% \$694	15.1	%
1-4 family residential properties	539	43.9	% 571	12.4	%
Multi-family residential properties	30	2.4	% 43	0.9	%
Commercial real estate	340	27.7	% 3,298	71.6	%
Total real estate	1,187	96.6	% 4,606	100.0	%
Consumer Loans	42	3.4	% —	—	

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Total repossessed collateral	\$1,229	100.0	%	\$4,606	100.0	%
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Repossessed assets sold during 2012 resulted in net losses of \$273,000, of which \$268,000 was related to real estate asset sales and \$5,000 was related to other repossessed assets sales. Repossessed assets sold during 2011 resulted in net gains of \$173,000, of which net gains of \$174,000 were related to real estate asset sales and a net loss of \$1,000 was related to other repossessed assets sales.

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Loan Quality and Allowance for Loan Losses

The allowance for loan losses represents management's estimate of the reserve necessary to adequately account for probable losses existing in the current portfolio. The provision for loan losses is the charge against current earnings that is determined by management as the amount needed to maintain an adequate allowance for loan losses. In determining the adequacy of the allowance for loan losses, and therefore the provision to be charged to current earnings, management relies predominantly on a disciplined credit review and approval process that extends to the full range of the Company's credit exposure. The review process is directed by overall lending policy and is intended to identify, at the earliest possible stage, borrowers who might be facing financial difficulty. Once identified, the magnitude of exposure to individual borrowers is quantified in the form of specific allocations of the allowance for loan losses. Management considers collateral values and guarantees in the determination of such specific allocations. Additional factors considered by management in evaluating the overall adequacy of the allowance include historical net loan losses, the level and composition of nonaccrual, past due and renegotiated loans, trends in volumes and terms of loans, effects of changes in risk selection and underwriting standards or lending practices, lending staff changes, concentrations of credit, industry conditions and the current economic conditions in the region where the Company operates.

Given the current state of the economy, management did assess the impact of the recession on each category of loans and adjusted historical loss factors for more recent economic trends. Management utilizes a five-year loss history as one of several components in assessing the probability of inherent future losses. Given the continued weakened economic conditions, management also increased its allocation to various loan categories for economic factors during 2012 and 2011. Some of the economic factors include the potential for reduced cash flow for commercial operating loans from reduction in sales or increased operating costs, decreased occupancy rates for commercial buildings, reduced levels of home sales for commercial land developments, the uncertainty regarding grain prices, drought conditions and increased operating costs for farmers, and increased levels of unemployment and bankruptcy impacting consumer's ability to pay. Each of these economic uncertainties was taken into consideration in developing the level of the reserve. Management considers the allowance for loan losses a critical accounting policy.

Management recognizes there are risk factors that are inherent in the Company's loan portfolio. All financial institutions face risk factors in their loan portfolios because risk exposure is a function of the business. The Company's operations (and therefore its loans) are concentrated in east central Illinois, an area where agriculture is the dominant industry. Accordingly, lending and other business relationships with agriculture-based businesses are critical to the Company's success. At December 31, 2012, the Company's loan portfolio included \$147.3 million of loans to borrowers whose businesses are directly related to agriculture. Of this amount, \$124.4 million was concentrated in other grain farming. Total loans to borrowers whose businesses are directly related to agriculture increased \$11.4 million from \$135.8 million at December 31, 2011 while loans concentrated in other grain farming increased \$4.3 million from \$120.1 million at December 31, 2011.

While the Company adheres to sound underwriting practices, including collateralization of loans, any extended period of low commodity prices, drought conditions, significantly reduced yields on crops and/or reduced levels of government assistance to the agricultural industry could result in an increase in the level of problem agriculture loans and potentially result in loan losses within the agricultural portfolio. Drought conditions present during the second and third quarters of 2012 are expected to reduce the 2012 crop yields. The impact on the cash flow of agricultural customers is mitigated to some extent because most of these customers maintain crop insurance. The Company does not expect the drought conditions to have a material impact on the allowance for loan losses.

In addition, the Company has \$45.8 million of loans to motels and hotels. The performance of these loans is dependent on borrower specific issues as well as the general level of business and personal travel within the region. While the Company adheres to sound underwriting standards, a prolonged period of reduced business or

personal travel could result in an increase in nonperforming loans to this business segment and potentially in loan losses. The Company also has \$89.9 million of loans to lessors of non-residential buildings and \$59.8 million of loans to lessors of residential buildings and dwellings.

The structure of the Company's loan approval process is based on progressively larger lending authorities granted to individual loan officers, loan committees, and ultimately the Board of Directors. Outstanding balances to one borrower or affiliated borrowers are limited by federal regulation; however, limits well below the regulatory thresholds are generally observed. The vast majority of the Company's loans are to businesses located in the geographic market areas served by the Company's branch bank system. Additionally, a significant portion of the collateral securing the loans in the portfolio is located within the Company's primary geographic footprint. In general, the Company adheres to loan underwriting standards consistent with industry guidelines for all loan segments.

The Company minimizes credit risk by adhering to sound underwriting and credit review policies. Management and the board of directors of the Company review these policies at least annually. Senior management is actively involved in business development efforts and the maintenance and monitoring of credit underwriting and approval. The loan review system and controls are designed to identify, monitor and address asset quality problems in an accurate and timely manner. On a quarterly basis, the board of directors and management review the status of problem loans and determine a best estimate of the allowance. In addition to internal policies and controls, regulatory authorities periodically review asset quality and the overall adequacy of the allowance for loan losses.

Analysis of the allowance for loan losses for the past five years and of changes in the allowance for these periods is summarized as follows (dollars in thousands):

	2012	2011	2010	2009	2008	
Average loans outstanding, net of unearned income	\$866,912	\$807,463	\$718,669	\$701,521	\$740,083	
Allowance-beginning of period	11,120	10,393	9,462	7,587	6,118	
Charge-offs:						
Real estate-mortgage	1,423	2,625	2,551	1,240	1,640	
Commercial, financial & agricultural	699	881	287	287	479	
Installment	79	92	103	176	119	
Other	170	162	181	176	184	
Total charge-offs	2,371	3,760	3,122	1,879	2,422	
Recoveries:						
Real estate-mortgage	137	1,171	146	6	75	
Commercial, financial & agricultural	85	97	35	27	98	
Installment	67	28	29	31	38	
Other	91	90	106	96	121	
Total recoveries	380	1,386	316	160	332	
Net charge-offs	1,991	2,374	2,806	1,719	2,090	
Provision for loan losses	2,647	3,101	3,737	3,594	3,559	
Allowance-end of period	\$11,776	\$11,120	\$10,393	\$9,462	\$7,587	
Ratio of annualized net charge-offs to average loans	0.23	% 0.29	% 0.39	% 0.25	% 0.28	%
Ratio of allowance for loan losses to loans outstanding (less unearned interest at end of period)	1.29	% 1.29	% 1.29	% 1.35	% 1.02	%
Ratio of allowance for loan losses to nonperforming loans	155.1	% 149.5	% 99.6	% 74.4	% 104.1	%

The ratio of the allowance for loan losses to nonperforming loans is 155.1% as of December 31, 2012 compared to 149.5% as of December 31, 2011. Management believes that the overall estimate of the allowance for loan losses appropriately accounts for probable losses attributable to current exposures.

The Company minimizes credit risk by adhering to sound underwriting and credit review policies. These policies are reviewed at least annually, and the Board of Directors approves all changes. Senior management is actively involved in business development efforts and the maintenance and monitoring of credit underwriting and approval. The loan review system and controls are designed to identify, monitor and address asset quality problems in an accurate and timely manner. At least quarterly, the Board of Directors reviews the status of problem loans. In addition to internal policies and controls, regulatory authorities periodically review asset quality and the overall adequacy of the allowance for loan losses.

During 2012, the Company had net charge-offs of \$2.0 million compared to \$2.4 million in 2011. During 2012, the Company's significant charge-offs included \$506,000 on commercial real estate loans of seven borrowers, \$174,000 on one residential real estate loan and \$4,347,000 on commercial operating loans of six borrowers. During 2011, the Company's significant charge-offs included \$378,000 on commercial loans of two borrowers and \$1,746,000 of commercial real estate mortgage loans of six borrowers. The Company also had a significant recovery of \$1,050,000 on a commercial real estate loan of one borrower that was charged off in a prior year. During 2010, the Company's

significant charge-offs included \$2,076,000 of commercial real estate mortgage loans of four borrowers.

At December 31, 2012 the allowance for loan losses amounted to \$11.8 million or 1.3% of total loans, and 155% of nonperforming loans. At December 31, 2011 the allowance for loan losses amounted to \$11.1 million or 1.3% of total loans and 150% of nonperforming loans.

The allowance is allocated to the individual loan categories by a specific allocation for all classified loans plus a percentage of loans not classified based on historical losses and other factors. The allowance for loan losses, in management's judgment, is allocated as follows to cover probable loan losses (dollars in thousands):

	December 31, 2012		December 31, 2011		December 31, 2010	
	Allowance for loan losses	% of loans to total loans	Allowance for loan losses	% of loans to total loans	Allowance for loan losses	% of loans to total loans
Residential real estate	\$726	19.7 %	\$636	21.5 %	440	25.1 %
Commercial / Commercial re						