

HEARTLAND FINANCIAL USA INC
Form 10-Q
May 09, 2013

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

FORM 10-Q
 QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For quarterly period ended March 31, 2013

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

For transition period _____ to _____

Commission File Number: 001-15393

HEARTLAND FINANCIAL USA, INC.
(Exact name of Registrant as specified in its charter)

Delaware
(State or other jurisdiction of incorporation or organization)

42-1405748
(I.R.S. employer identification number)

1398 Central Avenue, Dubuque, Iowa 52001
(Address of principal executive offices)(Zip Code)

(563) 589-2000
(Registrant's telephone number, including area code)

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

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

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

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

Large accelerated filer

Accelerated Filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the Registrant is a shell company (as defined by Rule 12b-2 of the Securities Exchange Act of 1934). Yes No

Indicate the number of shares outstanding of each of the classes of Registrant's common stock as of the latest practicable date: As of May 8, 2013, the Registrant had outstanding 16,917,440 shares of common stock, \$1.00 par value per share.

HEARTLAND FINANCIAL USA, INC.

Form 10-Q Quarterly Report

Part I

Item 1. Financial Statements

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Item 4. Controls and Procedures

Part II

Item 1. Legal Proceedings

Item 1A. Risk Factors

Item 2. Unregistered Sales of Issuer Securities and Use of Proceeds

Item 3. Defaults Upon Senior Securities

Item 4. Mine Safety Disclosures

Item 5. Other Information

Item 6. Exhibits

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Financial statements formatted in Extensible Business Reporting Language: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows, (v) the Consolidated Statements of Changes in Equity, and (vi) the Notes to Consolidated Financial Statements.

PART I

ITEM 1. FINANCIAL STATEMENTS
HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except per share data)

| | March 31, 2013 (Unaudited) | December 31, 2012 |
|---|-------------------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$68,450 | \$160,223 |
| Federal funds sold and other short-term investments | 6,137 | 7,831 |
| Cash and cash equivalents | 74,587 | 168,054 |
| Time deposits in other financial institutions | 3,605 | — |
| Securities: | | |
| Trading, at fair value | 694 | 380 |
| Available for sale, at fair value (cost of \$1,496,167 at March 31, 2013, and \$1,472,565 at December 31, 2012) | 1,524,569 | 1,506,075 |
| Held to maturity, at cost (fair value of \$55,846 at March 31, 2013, and \$55,982 at December 31, 2012) | 55,456 | 55,502 |
| Loans held for sale | 91,708 | 96,165 |
| Loans and leases receivable: | | |
| Held to maturity | 2,789,893 | 2,821,549 |
| Loans covered by loss share agreements | 6,741 | 7,253 |
| Allowance for loan and lease losses | (37,528) | (38,715) |
| Loans and leases receivable, net | 2,759,106 | 2,790,087 |
| Premises, furniture and equipment, net | 128,411 | 128,294 |
| Other real estate, net | 36,704 | 35,822 |
| Goodwill | 30,627 | 30,627 |
| Other intangible assets, net | 20,266 | 18,486 |
| Cash surrender value on life insurance | 75,907 | 75,480 |
| FDIC indemnification asset | 528 | 749 |
| Other assets | 98,390 | 84,832 |
| TOTAL ASSETS | \$4,900,558 | \$4,990,553 |
| LIABILITIES AND EQUITY | | |
| LIABILITIES: | | |
| Deposits: | | |
| Demand | \$971,142 | \$974,232 |
| Savings | 2,022,625 | 2,004,438 |
| Time | 848,689 | 866,990 |
| Total deposits | 3,842,456 | 3,845,660 |
| Short-term borrowings | 202,694 | 224,626 |
| Other borrowings | 336,577 | 389,025 |
| Accrued expenses and other liabilities | 104,857 | 126,703 |
| TOTAL LIABILITIES | 4,486,584 | 4,586,014 |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock (par value \$1 per share; authorized 20,604 shares; none issued or outstanding) | — | — |
| | — | — |

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | |
|--|--------------------|--------------------|
| Series A Junior Participating preferred stock (par value \$1 per share; authorized 16,000 shares; none issued or outstanding) | | |
| Series C Fixed Rate Non-Cumulative Perpetual preferred stock (par value \$1 per share; liquidation value \$81.7 million; authorized, issued and outstanding 81,698 shares) | 81,698 | 81,698 |
| Common stock (par value \$1 per share; authorized 25,000,000 shares; issued 16,866,959 shares at March 31, 2013 and 16,827,835 shares at December 31, 2012) | 16,867 | 16,828 |
| Capital surplus | 52,131 | 50,359 |
| Retained earnings | 246,675 | 236,279 |
| Accumulated other comprehensive income | 13,831 | 16,641 |
| Treasury stock at cost (1,040 shares at March 31, 2013, and 0 shares at December 31, 2012) | (26 |) — |
| TOTAL STOCKHOLDERS' EQUITY | 411,176 | 401,805 |
| Noncontrolling interest | 2,798 | 2,734 |
| TOTAL EQUITY | 413,974 | 404,539 |
| TOTAL LIABILITIES AND EQUITY | \$4,900,558 | \$4,990,553 |

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)
(Dollars in thousands, except per share data)

| | Three Months Ended | | |
|---|--------------------|-------------------|---|
| | March 31, 2013 | March 31, 2012 | |
| INTEREST INCOME: | | | |
| Interest and fees on loans and leases | \$39,827 | \$38,399 | |
| Interest on securities: | | | |
| Taxable | 4,659 | 7,572 | |
| Nontaxable | 3,198 | 2,271 | |
| Interest on interest bearing deposits in other financial institutions | 4 | — | |
| TOTAL INTEREST INCOME | 47,688 | 48,242 | |
| INTEREST EXPENSE: | | | |
| Interest on deposits | 5,076 | 5,775 | |
| Interest on short-term borrowings | 148 | 213 | |
| Interest on other borrowings (includes \$505 of interest expense related to derivatives reclassified from accumulated other comprehensive income for the three months ended March 31, 2013) | 3,797 | 4,061 | |
| TOTAL INTEREST EXPENSE | 9,021 | 10,049 | |
| NET INTEREST INCOME | 38,667 | 38,193 | |
| Provision for loan and lease losses | 637 | 2,354 | |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES | 38,030 | 35,839 | |
| NONINTEREST INCOME: | | | |
| Service charges and fees | 4,008 | 3,584 | |
| Loan servicing income | 3,371 | 1,760 | |
| Trust fees | 2,904 | 2,613 | |
| Brokerage and insurance commissions | 951 | 910 | |
| Securities gains, net (includes \$3,427 of net security gains reclassified from accumulated other comprehensive income for the three months ended March 31, 2013) | 3,427 | 3,943 | |
| Gain (loss) on trading account securities | 314 | (3 |) |
| Impairment loss on securities | — | (981 |) |
| Gains on sale of loans | 9,912 | 8,502 | |
| Valuation adjustment on mortgage servicing rights | 496 | 13 | |
| Income on bank owned life insurance | 405 | 482 | |
| Other noninterest income | 680 | 2,565 | |
| TOTAL NONINTEREST INCOME | 26,468 | 23,388 | |
| NONINTEREST EXPENSES: | | | |
| Salaries and employee benefits | 29,740 | 23,996 | |
| Occupancy | 3,185 | 2,482 | |
| Furniture and equipment | 2,051 | 1,446 | |
| Professional fees | 3,543 | 2,760 | |
| FDIC insurance assessments | 902 | 864 | |
| Advertising | 1,228 | 1,071 | |
| Intangible assets amortization | 200 | 131 | |
| Net loss on repossessed assets | 1,340 | 2,904 | |

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | | |
|--|----------|----------|---|
| Other noninterest expenses | 4,558 | 4,486 | |
| TOTAL NONINTEREST EXPENSES | 46,747 | 40,140 | |
| INCOME BEFORE INCOME TAXES | 17,751 | 19,087 | |
| Income taxes (includes \$1,099 of income tax expense reclassified from accumulated other comprehensive income for the three months ended March 31, 2013) | 5,199 | 6,272 | |
| NET INCOME | 12,552 | 12,815 | |
| Net (income) loss available to noncontrolling interest, net of tax | (64 |) 26 | |
| NET INCOME ATTRIBUTABLE TO HEARTLAND | 12,488 | 12,841 | |
| Preferred dividends and discount | (408 |) (1,021 |) |
| NET INCOME AVAILABLE TO COMMON STOCKHOLDERS | \$12,080 | \$11,820 | |
| EARNINGS PER COMMON SHARE - BASIC | \$0.72 | \$0.72 | |
| EARNINGS PER COMMON SHARE - DILUTED | \$0.70 | \$0.71 | |
| CASH DIVIDENDS DECLARED PER COMMON SHARE | \$0.10 | \$0.10 | |

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
 (Dollars in thousands)

| | Three Months Ended | |
|--|--------------------|-------------------|
| | March 31, 2013 | March 31, 2012 |
| NET INCOME | \$12,552 | \$12,815 |
| OTHER COMPREHENSIVE INCOME | | |
| Securities: | | |
| Net change in unrealized gain on securities available for sale | (1,657 |) 6,852 |
| Reclassification adjustment for net gain realized in net income | (3,451 |) (2,962 |
| Net change in non-credit related other than temporary impairment | 24 | (683 |
| Income taxes | 1,901 | (1,200 |
| Other comprehensive income (loss) on securities available for sale | (3,183 |) 2,007 |
| Derivatives used in cash flow hedging relationships: | | |
| Unrealized gain (loss) on derivatives | 82 | (73 |
| Reclassification adjustment for net loss on derivatives realized in net income | 505 | 494 |
| Income taxes | (214 |) (157 |
| Other comprehensive income on cash flow hedges | 373 | 264 |
| Other comprehensive income (loss) | (2,810 |) 2,271 |
| Comprehensive income | 9,742 | 15,086 |
| Less: comprehensive (income) loss attributable to noncontrolling interest | (64 |) 26 |
| COMPREHENSIVE INCOME ATTRIBUTABLE TO HEARTLAND | \$9,678 | \$15,112 |

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Dollars in thousands, except per share data)

| | Three Months Ended | |
|--|--------------------|-----------------|
| | March 31, 2013 | March 31, 2012 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | \$12,552 | \$12,815 |
| Adjustments to reconcile net income to net cash provided (used) by operating activities: | | |
| Depreciation and amortization | 2,310 | 1,753 |
| Provision for loan and lease losses | 637 | 2,354 |
| Net amortization of premium on securities | 7,604 | 3,413 |
| Securities gains, net | (3,427) | (3,943) |
| (Increase) decrease in trading account securities | (314) | 3 |
| Impairment loss on securities | — | 981 |
| Stock based compensation | 989 | 759 |
| Loss on sale of OREO and other repossessed property | 502 | 2,063 |
| Loans originated for sale | (448,971) | (273,974) |
| Proceeds on sales of loans held for sale | 463,340 | 232,544 |
| Net gains on sales of loans held for sale | (9,912) | (8,502) |
| Decrease in accrued interest receivable | 508 | 779 |
| (Increase) decrease in prepaid expenses | (398) | 707 |
| Decrease in accrued interest payable | (213) | (634) |
| Valuation adjustment on mortgage servicing rights | (496) | (13) |
| Other, net | (12,346) | 953 |
| NET CASH PROVIDED (USED) BY OPERATING ACTIVITIES | 12,365 | (27,942) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchase of time deposits in other financial institutions | (3,605) | — |
| Proceeds from the sale of securities available for sale | 92,795 | 124,364 |
| Proceeds from the maturity of and principal paydowns on securities available for sale | 65,461 | 76,453 |
| Proceeds from the maturity of and principal paydowns on securities held to maturity | 140 | 371 |
| Purchase of securities available for sale | (207,458) | (124,246) |
| Net (increase) decrease in loans and leases | 25,014 | (57,734) |
| Purchase of bank owned life insurance policies | — | (4,571) |
| Capital expenditures | (2,812) | (3,403) |
| Proceeds on sale of OREO and other repossessed assets | 3,513 | 10,051 |
| NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES | (26,952) | 21,285 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Net increase in demand deposits and savings accounts | 15,097 | 87,343 |
| Net decrease in time deposit accounts | (18,301) | (21,697) |
| Net decrease in short-term borrowings | (21,932) | (40,548) |
| Proceeds from other borrowings | — | 10,126 |
| Repayments of other borrowings | (52,448) | (5,584) |
| Purchase of treasury stock | (258) | (308) |
| Proceeds from issuance of common stock | 1,038 | 260 |
| Excess tax benefits on exercised stock options | 16 | 23 |
| Dividends paid | (2,092) | (2,670) |

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | |
|---|----------|-----------|
| NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES | (78,880 |) 26,945 |
| Net increase (decrease) in cash and cash equivalents | (93,467 |) 20,288 |
| Cash and cash equivalents at beginning of year | 168,054 | 129,834 |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD | \$74,587 | \$150,122 |
| Supplemental disclosures: | | |
| Cash paid for income/franchise taxes | \$3,375 | \$290 |
| Cash paid for interest | \$9,234 | \$10,683 |
| Loans transferred to OREO | \$4,843 | \$8,722 |
| Purchases of securities available for sale, accrued, not paid | \$59,877 | \$24,871 |
| Sales of securities available for sale, accrued, not settled | \$19,307 | \$— |

See accompanying notes to consolidated financial statements.

HEARTLAND FINANCIAL USA, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN EQUITY (Unaudited)

(Dollars in thousands, except per share data)

| | Heartland Financial USA, Inc. Stockholders' Equity | | | | | | | |
|---|--|-----------------|--------------------|----------------------|---|-------------------|-----------------------------|-----------------|
| | Preferred Stock | Common Stock | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Non-controlling Interest | Total Equity |
| Balance at January 1, 2012 | \$81,698 | \$16,612 | \$43,333 | \$198,182 | \$12,147 | \$(1,754) | \$2,675 | \$352,893 |
| Comprehensive income | | | | 12,841 | 2,271 | | (26) | 15,086 |
| Cash dividends declared: | | | | | | | | |
| Preferred, \$12.50 per share | | | | (1,021) | | | | (1,021) |
| Common, \$0.10 per share | | | | (1,649) | | | | (1,649) |
| Purchase of 19,805 shares of common stock | | | | | | (308) | | (308) |
| Issuance of 21,554 shares of common stock | | | (207) | | | 490 | | 283 |
| Commitments to issue common stock | | | 759 | | | | | 759 |
| Balance at March 31, 2012 | \$81,698 | \$16,612 | \$43,885 | \$208,353 | \$14,418 | \$(1,572) | \$2,649 | \$366,043 |
| Balance at January 1, 2013 | \$81,698 | \$16,828 | \$50,359 | \$236,279 | \$16,641 | \$— | \$2,734 | \$404,539 |
| Comprehensive income | | | | 12,488 | (2,810) | | 64 | 9,742 |
| Cash dividends declared: | | | | | | | | |
| Preferred, \$5.00 per share | | | | (408) | | | | (408) |
| Common, \$0.10 per share | | | | (1,684) | | | | (1,684) |
| Purchase of 10,050 shares of common stock | | | | | | (258) | | (258) |
| Issuance of 48,134 shares of common stock | | 39 | 783 | | | 232 | | 1,054 |
| Commitments to issue common stock | | | 989 | | | | | 989 |
| | \$81,698 | \$16,867 | \$52,131 | \$246,675 | \$13,831 | \$(26) | \$2,798 | \$413,974 |

Balance at March
31, 2013

See accompanying notes to consolidated financial
statements.

HEARTLAND FINANCIAL USA, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: BASIS OF PRESENTATION

The interim unaudited consolidated financial statements contained herein should be read in conjunction with the audited consolidated financial statements and accompanying notes to the consolidated financial statements for the fiscal year ended December 31, 2012, included in the Form 10-K of Heartland Financial USA, Inc. ("Heartland") filed with the Securities and Exchange Commission on March 15, 2013. Accordingly, footnote disclosures which would substantially duplicate the disclosure contained in the audited consolidated financial statements have been omitted.

The financial information of Heartland included herein has been prepared in accordance with U.S. generally accepted accounting principles for interim financial reporting and has been prepared pursuant to the rules and regulations for reporting on Form 10-Q and Rule 10-01 of Regulation S-X. Such information reflects all adjustments (consisting of normal recurring adjustments), that are, in the opinion of management, necessary for a fair presentation of the financial position and results of operations for the periods presented. The results of the interim period ended March 31, 2013, are not necessarily indicative of the results expected for the year ending December 31, 2013.

Heartland evaluated subsequent events through the filing date of its quarterly report on Form 10-Q with the SEC.

Earnings Per Share

Basic earnings per share is determined using net income available to common stockholders and weighted average common shares outstanding. Diluted earnings per share is computed by dividing net income available to common stockholders by the weighted average common shares and assumed incremental common shares issued. Amounts used in the determination of basic and diluted earnings per share for the three-month periods ended March 31, 2013 and 2012, are shown in the table below:

| (Dollars and number of shares in thousands, except per share data) | Three Months Ended | |
|---|--------------------|----------------|
| | March 31, 2013 | March 31, 2012 |
| Net income attributable to Heartland | \$12,488 | \$12,841 |
| Preferred dividends and discount | (408 |) (1,021 |
| Net income available to common stockholders | \$12,080 | \$11,820 |
| Weighted average common shares outstanding for basic earnings per share | 16,852 | 16,490 |
| Assumed incremental common shares issued upon exercise of stock options | 335 | 240 |
| Weighted average common shares for diluted earnings per share | 17,187 | 16,730 |
| Earnings per common share — basic | \$0.72 | \$0.72 |
| Earnings per common share — diluted | \$0.70 | \$0.71 |
| Number of antidilutive stock options excluded from diluted earnings per share computation | 105 | 509 |

Stock-Based Compensation

Heartland may grant, through its Nominating and Compensation Committee (the "Compensation Committee"), non-qualified and incentive stock options, stock appreciation rights, stock awards, restricted stock, restricted stock units and cash incentive awards, under its 2012 Long-Term Incentive Plan (the "Plan"). The Plan, which was approved by stockholders in May 2012 and replaced Heartland's 2005 Long-Term Incentive Plan with respect to grants after such approval, reserved 396,469 shares of common stock at March 31, 2013, for issuance under future awards that may be granted under the Plan to employees and directors of, and service providers to, Heartland or its subsidiaries.

Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 718, "Compensation-Stock Compensation" requires the measurement of the cost of employee services received in exchange for an award of equity instruments based upon the fair value of the award on the grant date. The cost of the award is based upon its fair value estimated on the date of grant and recognized in the income statement over the vesting period of the award. The fair value of stock options is estimated on the date of grant using the Black-Scholes model. The fair market value of restricted stock and restricted stock units is based on the fair value of the underlying shares of common stock on the date of grant.

Options

Although the Plan provides authority to the Compensation Committee to grant stock options, no options were granted during the first three months of 2013 and 2012. Prior to 2009, options were typically granted annually with an expiration date ten years after the date of grant. Vesting was generally over a five-year service period with portions of a grant becoming exercisable at three years, four years, and five years after the date of grant. A summary of the status of the stock options as of March 31, 2013 and 2012, and changes during three months ended March 31, 2013 and 2012, follows:

| | 2013 | | 2012 | |
|---------------------------------|---------|------------------------------------|---------|------------------------------------|
| | Shares | Weighted-Average Exercise Price | Shares | Weighted-Average Exercise Price |
| Outstanding at January 1 | 377,907 | \$22.62 | 570,762 | \$21.06 |
| Granted | — | — | — | — |
| Exercised | (9,835 |) 16.69 | (12,500 |) 9.89 |
| Forfeited | (1,800 |) 26.68 | (5,250 |) 20.62 |
| Outstanding at March 31 | 366,272 | \$22.76 | 553,012 | \$21.32 |
| Options exercisable at March 31 | 366,272 | \$22.76 | 505,295 | \$21.58 |

At March 31, 2013, the vested options totaled 366,272 shares with a weighted average exercise price of \$22.76 per share and a weighted average remaining contractual life of 3.36 years. The intrinsic value for the vested options as of March 31, 2013, was \$1.4 million. The intrinsic value for the total of all options exercised during the three months ended March 31, 2013, was \$84,000.

The exercise price of stock options granted is established by the Compensation Committee, but the exercise price for the stock options may not be less than the fair market value of the shares on the date that the option is granted or, if greater, the par value of a share of stock. Each option granted is exercisable in full at any time or from time to time, subject to vesting provisions, as determined by the Compensation Committee and as provided in the option agreement, but such time may not exceed ten years from the grant date. Cash received from options exercised for the three months ended March 31, 2013, was \$164,000, with a related tax benefit of \$16,000. Cash received from options exercised for the three months ended March 31, 2012, was \$124,000, with a related tax benefit of \$23,000.

Restricted Stock Units

The Plan also permits the Compensation Committee to grant other stock-based benefits, including restricted stock units ("RSUs"). On January 22, 2013, the Compensation Committee granted time-based RSUs with respect to 72,595 shares of common stock and on January 17, 2012, granted time-based RSUs with respect to 94,001 shares of common stock, to selected officers. The time-based RSUs, which represent the right, without payment, to receive shares of Heartland common stock at a specified date in the future based on specific vesting conditions, vest over five years in three equal installments on the third, fourth and fifth anniversaries of the grant date, will be settled in common stock upon vesting, and will not be entitled to dividends until vested. The 2012 time-based RSUs terminate upon termination of employment, except that they continue to vest after retirement if retirement occurs after the employee has attained age 62 and has provided at least five years of service to Heartland. The 2013 time-based RSUs may vest at retirement, at the discretion of the Compensation Committee, provided that the participant signs a non-solicitation and non-compete agreement.

In addition to the time-based RSUs referenced in the preceding paragraph, the Compensation Committee granted performance-based RSUs with respect to 40,990 shares of common stock on January 22, 2013, and performance-based RSUs with respect to 49,801 shares of common stock on January 17, 2012, to Heartland executives and subsidiary

presidents. These performance-based RSUs vest based first on performance measures tied to Heartland's earnings and assets on December 31 of the grant year, and then on time-based vesting conditions. For the grants in 2013, vesting occurs on December 31, 2015, and for the grants in 2012, vesting occurs on December 31, 2014.

Total compensation costs recorded for stock options and RSUs were \$989,000, and \$759,000 for the three months ended March 31, 2013 and 2012, respectively. As of March 31, 2013, there were \$4.9 million of total unrecognized compensation costs related to the 2005 and 2012 Long-Term Incentive Plans for stock options and RSUs which are expected to be recognized through 2016.

Effect of New Financial Accounting Standards

In July 2012, the FASB issued ASU No. 2012-02, "Testing Indefinite-Lived Intangible Assets for Impairment," which permits an entity to make a qualitative assessment to determine whether it is more likely than not that an indefinite-lived intangible asset, other than goodwill, is impaired. Currently, entities are required to quantitatively test indefinite-lived intangible assets for impairment at least annually and more frequently if indicators of impairment exist. Under the new standard, if an entity concludes, based on an evaluation of all relevant qualitative factors, that it is not more likely than not that the fair value of an indefinite-lived intangible asset is less than its carrying amount, it will not be required to perform the quantitative impairment test for that asset. Heartland adopted this standard on January 1, 2013, and the adoption did not have an impact on the results of operations, financial position and liquidity.

In September 2012, the FASB issued ASU No. 2012-06, "Subsequent Accounting for an Indemnification Asset Recognized at the Acquisition Date as a Result of a Government-Assisted Acquisition of a Financial Institution," to address diversity in practice about how to subsequently measure an indemnification asset for a government-assisted acquisition that includes a loss-sharing agreement. This guidance requires a reporting entity to account for a change in the subsequent measurement of the indemnification asset on the same basis as the changes in the asset subject to indemnification. Heartland adopted this standard on January 1, 2013, and the adoption did not have a material impact on the accounting for its loss share receivable from the FDIC under its various loss share agreements.

In February 2013, the FASB issued ASU No. 2013-02, "Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income," to address further disclosure of reclassification amounts out of other comprehensive income. The guidance requires that a reporting entity present, either in a single note or parenthetically on the face of the financial statements, the effect of significant amounts reclassified from each component of accumulated other comprehensive income based on its source and income statement line items affected by the reclassification. Heartland adopted this standard on January 1, 2013, and the adoption did not have an impact on the results of operations, financial position and liquidity.

NOTE 2: SECURITIES

The amortized cost, gross unrealized gains and losses, and estimated fair values of securities available for sale as of March 31, 2013, and December 31, 2012, are summarized in the table below, in thousands:

| Securities available for sale | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|--|----------------|------------------------|-------------------------|----------------------|
| March 31, 2013 | | | | |
| U.S. government corporations and agencies | \$7,885 | \$289 | \$— | \$8,174 |
| Mortgage-backed securities | 1,049,782 | 16,230 | (6,098) | 1,059,914 |
| Obligations of states and political subdivisions | 418,168 | 19,221 | (2,018) | 435,371 |
| Total debt securities | 1,475,835 | 35,740 | (8,116) | 1,503,459 |
| Equity securities | 20,332 | 778 | — | 21,110 |
| Total | \$1,496,167 | \$36,518 | \$(8,116) | \$1,524,569 |
| December 31, 2012 | | | | |
| U.S. government corporations and agencies | \$21,002 | \$443 | \$(1) | \$21,444 |
| Mortgage-backed securities | 1,027,234 | 19,002 | (10,035) | 1,036,201 |
| Obligations of states and political subdivisions | 403,077 | 23,560 | (192) | 426,445 |
| Total debt securities | 1,451,313 | 43,005 | (10,228) | 1,484,090 |
| Equity securities | 21,252 | 733 | — | 21,985 |
| Total | \$1,472,565 | \$43,738 | \$(10,228) | \$1,506,075 |

At both March 31, 2013, and December 31, 2012, the amortized cost of the available for sale securities is net of \$184,000 of credit related other-than-temporary impairment ("OTTI").

The amortized cost, gross unrealized gains and losses and estimated fair values of held to maturity securities as of March 31, 2013, and December 31, 2012, are summarized in the table below, in thousands:

| Securities held to maturity | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
|--|----------------|------------------------|-------------------------|----------------------|
| March 31, 2013 | | | | |
| Mortgage-backed securities | \$6,994 | \$470 | \$(80) | \$7,384 |
| Obligations of states and political subdivisions | 48,462 | — | — | 48,462 |
| Total | \$55,456 | \$470 | \$(80) | \$55,846 |
| December 31, 2012 | | | | |
| Mortgage-backed securities | \$7,040 | \$492 | \$(12) | \$7,520 |
| Obligations of states and political subdivisions | 48,462 | — | — | 48,462 |
| Total | \$55,502 | \$492 | \$(12) | \$55,982 |

At March 31, 2013, the amortized cost of the held to maturity securities is net of \$797,000 of credit related OTTI and \$588,000 of non-credit related OTTI. At December 31, 2012, \$797,000 of credit related OTTI and \$612,000 of non-credit related OTTI was recorded.

Approximately 82% of Heartland's mortgage-backed securities are issuances of government-sponsored enterprises.

The following tables summarize, in thousands, the amount of unrealized losses, defined as the amount by which cost or amortized cost exceeds fair value, and the related fair value of investments with unrealized losses in Heartland's securities portfolio as of March 31, 2013, and December 31, 2012. The investments were segregated into two categories: those that have been in a continuous unrealized loss position for less than 12 months and those that have been in a continuous unrealized loss position for 12 or more months. The reference point for determining how long an investment was in an unrealized loss position was March 31, 2012, and December 31, 2011, respectively. Securities for which Heartland has taken credit-related OTTI write-downs are categorized as being "less than 12 months" or "12 months or longer" in a continuous loss position based on the point in time that the fair value declined to below the cost basis and not the period of time since the credit-related OTTI write-down.

| Securities available for sale | Less than 12 months | | 12 months or longer | | Total | |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| March 31, 2013 | | | | | | |
| U.S. government corporations and agencies | \$— | \$— | \$— | \$— | \$— | \$— |
| Mortgage-backed securities | 351,727 | (5,376) | 19,056 | (722) | 370,783 | (6,098) |
| Obligations of states and political subdivisions | 105,855 | (2,018) | — | — | 105,855 | (2,018) |
| Total temporarily impaired securities | \$457,582 | \$(7,394) | \$19,056 | \$(722) | \$476,638 | \$(8,116) |
| December 31, 2012 | | | | | | |
| U.S. government corporations and agencies | \$1,517 | \$(1) | \$— | \$— | \$1,517 | \$(1) |
| Mortgage-backed securities | 332,842 | (9,121) | 24,489 | (914) | 357,331 | (10,035) |
| Obligations of states and political subdivisions | 22,503 | (192) | — | — | 22,503 | (192) |
| Total temporarily impaired securities | \$356,862 | \$(9,314) | \$24,489 | \$(914) | \$381,351 | \$(10,228) |

| Securities held to maturity | Less than 12 months | | 12 months or longer | | Total | |
|--|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| March 31, 2013 | | | | | | |
| Mortgage-backed securities | \$— | \$— | \$3,254 | \$(80) | \$3,254 | \$(80) |
| Obligations of states and political subdivisions | — | — | — | — | — | — |
| Total temporarily impaired securities | \$— | \$— | \$3,254 | \$(80) | \$3,254 | \$(80) |
| December 31, 2012 | | | | | | |
| Mortgage-backed securities | \$— | \$— | \$3,296 | \$(12) | \$3,296 | \$(12) |
| Obligations of states and political subdivisions | — | — | — | — | — | — |
| Total temporarily impaired securities | \$— | \$— | \$3,296 | \$(12) | \$3,296 | \$(12) |

Heartland reviews the investment securities portfolio on a quarterly basis to monitor its exposure to OTTI. A determination as to whether a security's decline in fair value is other-than-temporary takes into consideration numerous factors and the relative significance of any single factor can vary by security. Some factors Heartland may consider in the OTTI analysis include the length of time the security has been in an unrealized loss position, changes in security ratings, financial condition of the issuer, as well as security and industry specific economic conditions. In addition, with regard to debt securities, Heartland may also evaluate payment structure, whether there are defaulted payments or expected defaults, prepayment speeds, and the value of any underlying collateral. For certain debt securities in unrealized loss positions, Heartland prepares cash flow analyses to compare the present value of cash flows expected to be collected from the security with the amortized cost basis of the security. During the first quarter of 2012, Heartland experienced deterioration in the credit support on three private label mortgage-backed securities which resulted in a credit-related OTTI loss. The underlying collateral on these securities experienced an increased level of defaults and a slowing of voluntary prepayments causing the present value of the forward expected cash flows, using prepayment and default vectors, to be below the amortized cost basis of the securities. Based on Heartland's evaluation, a \$981,000 OTTI on three private label mortgage-backed securities attributable to credit-related losses was recorded in March 2012. The other-than-temporary credit-related losses were \$797,000 in the held to maturity category and \$184,000 in the available for sale category.

The remaining unrealized losses on Heartland's mortgage-backed securities are the result of changes in market interest rates or widening of market spreads subsequent to the initial purchase of the securities and not related to concerns regarding the underlying credit of the issuers or the underlying collateral. It is expected that the securities will not be settled at a price less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates or widening market spreads and not credit quality, and because Heartland has the intent and ability to hold these investments until a market price recovery or to maturity and does not believe it will be required to sell the securities before maturity, these investments are not considered other-than-temporarily impaired.

Unrealized losses on Heartland's obligations of states and political subdivisions are the result of changes in market interest rates or widening of market spreads subsequent to the initial purchase of the securities. Management monitors the published credit ratings of these securities and the stability of the underlying municipalities. Because the decline in fair value is attributable to changes in interest rates or widening market spreads due to insurance company downgrades and not underlying credit quality, and because Heartland has the intent and ability to hold these investments until a market price recovery or to maturity and does not believe it will be required to sell the securities before maturity, these investments are not considered other-than-temporarily impaired.

There were no gross realized gains or losses on the sale of available for sale securities with OTTI write-downs for the periods ended March 31, 2013, or December 31, 2012.

The following table shows the detail of total OTTI write-downs included in earnings, in thousands:

| | Three Months Ended | |
|---|--------------------|----------------|
| | March 31, 2013 | March 31, 2012 |
| Available for sale debt securities: | | |
| Mortgage backed securities | \$— | \$184 |
| Held to maturity debt securities: | | |
| Mortgage backed securities | — | 797 |
| Total debt security OTTI write-downs included in earnings | \$— | \$981 |

The following table shows the detail of OTTI write-downs on debt securities included in earnings and the related changes in other accumulated comprehensive income (AOCI) for the same securities, in thousands:

| | Three Months Ended | |
|--|--------------------|----------------|
| | March 31, 2013 | March 31, 2012 |
| Recorded as part of gross realized losses: | | |
| Credit related OTTI | \$— | \$981 |
| Intent to sell OTTI | — | — |
| Total recorded as part of gross realized losses | — | 981 |
| Recorded directly to AOCI for non-credit related impairment: | | |
| Residential mortgage backed securities | — | 683 |
| Accretion of non-credit related impairment | (24 |) — |
| Total changes to AOCI for non-credit related impairment | (24 |) 683 |
| Total OTTI losses (accretion) recorded on debt securities, net | \$(24 |) \$1,664 |

The following table presents a rollforward of the credit loss component of OTTI recognized in earnings for debt securities still owned by Heartland. The credit loss component of the amortized cost represents the difference between the present value of expected future cash flows discounted using the security's current effective interest rate and the amortized cost basis of the security prior to considering credit losses. OTTI recognized in earnings for credit impaired debt securities is presented as additions and is classified into one of two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or if the debt security was previously credit impaired (subsequent credit impairments). The credit loss component is reduced if Heartland sells, intends to sell, or if management believes they will be required to sell previously credit impaired debt securities. Additionally, the credit loss component is reduced if Heartland receives, expects to receive cash flows in excess of what was previously expected to be received over the remaining life of the credit impaired debt security, the security matures or is fully written down.

Changes in the credit loss component of the credit impaired debt securities that Heartland does not intend to sell were, in thousands:

| | Three Months Ended | |
|--|--------------------|----------------|
| | March 31, 2013 | March 31, 2012 |
| Credit loss component, beginning of period | \$981 | \$— |
| Additions: | | |
| Initial credit impairments | — | 981 |
| Subsequent credit impairments | — | — |
| Total additions | — | 981 |
| Reductions: | | |
| For securities sold | — | — |
| Due to change in intent to sell or requirement to sell | — | — |
| For recoveries of previous credit impairments | — | — |
| Total reductions | — | — |
| Credit loss component, end of period | \$981 | \$981 |

NOTE 3: LOANS AND LEASES

Loans and leases as of March 31, 2013, and December 31, 2012, were as follows, in thousands:

| | March 31, 2013 | December 31, 2012 |
|--|----------------|-------------------|
| Loans and leases receivable held to maturity: | | |
| Commercial | \$693,235 | \$712,308 |
| Commercial real estate | 1,297,583 | 1,289,184 |
| Agricultural and agricultural real estate | 314,606 | 328,311 |
| Residential real estate | 240,453 | 249,689 |
| Consumer | 246,996 | 245,678 |
| Gross loans and leases receivable held to maturity | 2,792,873 | 2,825,170 |
| Unearned discount | (479) | (676) |
| Deferred loan fees | (2,501) | (2,945) |
| Total net loans and leases receivable held to maturity | 2,789,893 | 2,821,549 |
| Loans covered under loss share agreements: | | |
| Commercial and commercial real estate | 2,738 | 3,074 |
| Agricultural and agricultural real estate | 453 | 748 |
| Residential real estate | 2,722 | 2,645 |
| Consumer | 828 | 786 |
| Total loans covered under loss share agreements | 6,741 | 7,253 |
| Allowance for loan and lease losses | (37,528) | (38,715) |
| Loans and leases receivable, net | \$2,759,106 | \$2,790,087 |

Heartland has certain lending policies and procedures in place that are designed to provide for an acceptable level of credit risk. The board of directors reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management and the board with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and nonperforming loans and potential problem loans. Diversification in the loan portfolio is also a means of managing risk associated with fluctuations in economic conditions.

The commercial and commercial real estate loan portfolio includes a wide range of business loans, including lines of credit for working capital and operational purposes and term loans for the acquisition of equipment and real estate. Although most loans are made on a secured basis, loans may be made on an unsecured basis where warranted by the

overall financial condition of the borrower. Terms of commercial business loans generally range from one to five years. Commercial loans and leases are primarily made based on the identified cash flow of the borrower and secondarily on the underlying collateral provided by the

borrower. The collateral for most of these loans and leases is based upon a discount from its market value. The primary repayment risks of commercial loans and leases are that the cash flow of the borrowers may be unpredictable, and the collateral securing these loans may fluctuate in value. Heartland seeks to minimize these risks in a variety of ways. The underwriting analysis includes credit verification, analysis of global cash flows, appraisals and a review of the financial condition of the borrower. Personal guarantees are frequently required as a tertiary form of repayment. In addition, when underwriting loans for commercial real estate, careful consideration is given to the property's operating history, future operating projections, current and projected occupancy, location and physical condition. Heartland also utilizes government guaranteed lending through the U.S. Small Business Administration and the USDA Rural Development Business and Industry Program to assist customers with longer-term funding and to reduce risk.

Agricultural loans, many of which are secured by crops, machinery and real estate, are provided to finance capital improvements and farm operations as well as acquisitions of livestock and machinery. Agricultural loans present unique credit risks relating to adverse weather conditions, loss of livestock due to disease or other factors, declines in market prices for agricultural products and the impact of government regulations. The ultimate repayment of agricultural loans is dependent upon the profitable operation or management of the agricultural entity. In underwriting agricultural loans, lending personnel work closely with their customers to review budgets and cash flow projections for the ensuing crop year. These budgets and cash flow projections are monitored closely during the year and reviewed with the customers at least annually. Lending personnel also work closely with governmental agencies, including the Farm Service Agency, to help agricultural customers obtain credit enhancement products such as loan guarantees or interest assistance.

Heartland originates first-lien, adjustable-rate and fixed-rate, one-to-four-family residential real estate loans for the construction, purchase or refinancing of a single family residential property. These loans are principally collateralized by owner-occupied properties and are amortized over 10 to 30 years. Heartland typically sells longer-term, low-rate, residential mortgage loans in the secondary market with servicing rights retained. This practice allows Heartland to better manage interest rate risk and liquidity risk. The Heartland bank subsidiaries participate in lending programs sponsored by U.S. government agencies such as Veterans Administration and Federal Home Administration when justified by market conditions.

Consumer lending includes motor vehicle, home improvement, home equity and small personal credit lines. Consumer loans typically have shorter terms, lower balances, higher yields and higher risks of default than one- to four-family residential mortgage loans. Consumer loan collections are dependent on the borrower's continuing financial stability, and are therefore more likely to be affected by adverse personal circumstances. Risk is reduced through underwriting criteria, which include credit verification, appraisals, a review of the borrower's financial condition, and personal cash flows. A security interest, with title insurance when necessary, is taken in the underlying real estate. Heartland's consumer finance subsidiary, Citizens Finance Co., typically lends to borrowers with past credit problems or limited credit histories, which comprise approximately 27% of Heartland's total consumer loan portfolio.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Heartland's policy is to discontinue the accrual of interest income on any loan or lease when, in the opinion of management, there is a reasonable doubt as to the timely collection of the interest and principal, normally when a loan or lease is 90 days past due. When interest accruals are deemed uncollectible, interest credited to income in the current year is reversed and interest accrued in prior years is charged to the allowance for loan and lease losses. Nonaccrual loans and leases are returned to an accrual status when, in the opinion of management, the financial position of the borrower indicates that there is no longer any reasonable doubt as to the timely payment of interest and principal.

Under Heartland's credit practices, a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loan

impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, except where more practical, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent.

The following table shows the balance in the allowance for loan and lease losses at March 31, 2013, and December 31, 2012, and the related loan balances, disaggregated on the basis of impairment methodology, in thousands. Loans evaluated under ASC 310-10-35 include loans on nonaccrual status and troubled debt restructurings, which are individually evaluated for impairment, and other impaired loans deemed to have similar risk characteristics. All other loans are collectively evaluated for impairment under ASC 450-20. Heartland has made no changes to the accounting for the allowance for loan and lease losses policy during 2013.

| | Allowance For Loan and Lease Losses | | | Gross Loans and Leases Receivable Held to Maturity | | |
|---|-------------------------------------|---------------------------------|----------|---|--|-------------|
| | Ending Balance Under ASC 310-10-35 | Ending Balance Under ASC 450-20 | Total | Ending Balance Evaluated for Impairment Under ASC 310-10-35 | Ending Balance Evaluated for Impairment Under ASC 450-20 | Total |
| March 31, 2013 | | | | | | |
| Commercial | \$1,026 | \$8,273 | \$9,299 | \$8,457 | \$684,778 | \$693,235 |
| Commercial real estate | 964 | 14,226 | 15,190 | 37,194 | 1,260,389 | 1,297,583 |
| Agricultural and agricultural real estate | 176 | 2,019 | 2,195 | 13,222 | 301,384 | 314,606 |
| Residential real estate | 796 | 2,470 | 3,266 | 7,305 | 233,148 | 240,453 |
| Consumer | 1,530 | 6,048 | 7,578 | 5,055 | 241,941 | 246,996 |
| Total | \$4,492 | \$33,036 | \$37,528 | \$71,233 | \$2,721,640 | \$2,792,873 |
| December 31, 2012 | | | | | | |
| Commercial | \$1,350 | \$10,038 | \$11,388 | \$9,031 | \$703,277 | \$712,308 |
| Commercial real estate | 1,112 | 13,361 | 14,473 | 45,583 | 1,243,601 | 1,289,184 |
| Agricultural and agricultural real estate | 109 | 2,029 | 2,138 | 16,128 | 312,183 | 328,311 |
| Residential real estate | 783 | 2,760 | 3,543 | 7,443 | 242,246 | 249,689 |
| Consumer | 1,270 | 5,903 | 7,173 | 5,391 | 240,287 | 245,678 |
| Total | \$4,624 | \$34,091 | \$38,715 | \$83,576 | \$2,741,594 | \$2,825,170 |

The following table presents nonaccrual loans, accruing loans past due 90 days or more and troubled debt restructured loans not covered under loss share agreements at March 31, 2013, and December 31, 2012, in thousands. There were no nonaccrual leases, accruing leases past due 90 days or more or restructured leases at March 31, 2013, and December 31, 2012.

| | March 31, 2013 | December 31, 2012 |
|---|----------------|-------------------|
| Nonaccrual loans | \$30,282 | \$38,675 |
| Nonaccrual troubled debt restructured loans | 2,074 | 4,481 |
| Total nonaccrual loans | \$32,356 | \$43,156 |
| Accruing loans past due 90 days or more | 454 | — |
| Performing troubled debt restructured loans | \$24,473 | \$21,121 |

Heartland had \$26.5 million of troubled debt restructured loans at March 31, 2013, of which \$2.1 million were classified as nonaccrual and \$24.5 million were accruing according to the restructured terms. Heartland had \$25.6 million of troubled debt restructured loans at December 31, 2012, of which \$4.5 million were classified as nonaccrual and \$21.1 million were accruing according to the restructured terms.

The following tables provide information on troubled debt restructured loans that were modified during the three months ended March 31, 2013, and March 31, 2012, in thousands:

| | Three Months Ended March 31, 2013 | | | Three Months Ended March 31, 2012 | | |
|---|--------------------------------------|--|---|--------------------------------------|--|---|
| | Number of Loans | Pre- Modification Recorded Investment | Post- Modification Recorded Investment | Number of Loans | Pre- Modification Recorded Investment | Post- Modification Recorded Investment |
| Commercial | 2 | \$4,670 | \$4,670 | — | \$— | \$— |
| Commercial real estate | — | — | — | — | — | — |
| Total commercial and commercial real estate | 2 | 4,670 | 4,670 | — | — | — |
| Agricultural and agricultural real estate | 3 | 2,576 | 2,576 | — | — | — |
| Residential real estate | 2 | 646 | 646 | 1 | 19 | 19 |
| Consumer | — | — | — | — | — | — |
| Total | 7 | \$7,892 | \$7,892 | 1 | \$19 | \$19 |

The pre-modification and post-modification recorded investment represents amounts as of the date of loan modification. Since the modifications on these loans have been only interest rate concessions and term extensions, not principal reductions, the pre-modification and post-modification recorded investment amounts are the same.

The following tables provide information on troubled debt restructured loans for which there was a payment default during the three months ended March 31, 2013, and March 31, 2012, in thousands, that had been modified during the twelve-month period prior to the default:

| | With Payment Defaults During the Following Periods | | | |
|---|--|------------------------|--------------------------------------|------------------------|
| | Three Months Ended March 31, 2013 | | Three Months Ended March 31, 2012 | |
| | Number of Loans | Recorded Investment | Number of Loans | Recorded Investment |
| Commercial | — | \$— | — | \$— |
| Commercial real estate | — | — | 1 | 640 |
| Total commercial and commercial real estate | — | — | 1 | 640 |
| Agricultural and agricultural real estate | — | — | — | — |
| Residential real estate | — | — | — | — |
| Consumer | — | — | — | — |
| Total | — | \$— | 1 | \$640 |

Heartland's internal rating system is a series of grades reflecting management's risk assessment, based on its analysis of the borrower's financial condition. The "pass" category consists of all loans that are not in the "nonpass" category, categorized into a range of loan grades that reflect increasing, though still acceptable, risk. Movement of risk through the various grade levels in the pass category is monitored for early identification of credit deterioration. The "nonpass" category consists of special mention, substandard, doubtful and loss loans. The "special mention" rating is attached to loans where the borrower exhibits negative financial trends due to borrower specific or systemic conditions that, if left uncorrected, threaten its capacity to meet its debt obligations. The borrower is believed to have sufficient financial flexibility to react to and resolve its negative financial situation. These credits are closely monitored for improvement or deterioration. The "substandard" rating is assigned to loans that are inadequately protected by the current sound net worth and paying capacity of the borrower and may be further at risk due to deterioration in the value of collateral pledged. Well-defined weaknesses jeopardize liquidation of the debt. These loans are still considered collectible, however, a distinct possibility exists that Heartland will sustain some loss if deficiencies are not corrected.

Substandard loans may exhibit some or all of the following weaknesses: deteriorating trends, lack of earnings, inadequate debt service capacity, excessive debt and/or lack of liquidity. The "doubtful" rating is assigned to loans where identified weaknesses make collection or liquidation in full, on the basis of existing facts, conditions and values, highly questionable and improbable. These borrowers are usually in default, lack liquidity and capital, as well as, resources necessary to remain an operating entity. Specific pending events, such as capital injections, liquidations or perfection of liens on additional collateral, may strengthen the credit, thus deferring classification of the loan as loss until exact status can be determined. The "loss" rating is assigned to loans considered uncollectible. As of March 31, 2013, Heartland had no loans

classified as doubtful or loss. Loans are placed on "nonaccrual" when management does not expect to collect payments of principal and interest in full or when principal or interest has been in default for a period of 90 days or more, unless the loan is both well secured and in the process of collection.

The following table presents loans and leases not covered by loss share agreements by credit quality indicator at March 31, 2013, and December 31, 2012, in thousands:

| | Pass | Nonpass | Total |
|--|-------------|-----------|-------------|
| March 31, 2013 | | | |
| Commercial | \$644,980 | \$48,255 | \$693,235 |
| Commercial real estate | 1,139,334 | 158,249 | 1,297,583 |
| Total commercial and commercial real estate | 1,784,314 | 206,504 | 1,990,818 |
| Agricultural and agricultural real estate | 271,019 | 43,587 | 314,606 |
| Residential real estate | 222,487 | 17,966 | 240,453 |
| Consumer | 236,793 | 10,203 | 246,996 |
| Total gross loans and leases receivable held to maturity | \$2,514,613 | \$278,260 | \$2,792,873 |
| December 31, 2012 | | | |
| Commercial | \$661,118 | \$51,190 | \$712,308 |
| Commercial real estate | 1,134,784 | 154,400 | 1,289,184 |
| Total commercial and commercial real estate | 1,795,902 | 205,590 | 2,001,492 |
| Agricultural and agricultural real estate | 286,264 | 42,047 | 328,311 |
| Residential real estate | 227,925 | 21,764 | 249,689 |
| Consumer | 235,232 | 10,446 | 245,678 |
| Total gross loans and leases receivable held to maturity | \$2,545,323 | \$279,847 | \$2,825,170 |

The nonpass category in the table above is comprised of approximately 52% special mention and 48% substandard as of March 31, 2013. The percent of nonpass loans on nonaccrual status as of March 31, 2013, was 12%. As of December 31, 2012, the nonpass category in the table above was comprised of approximately 50% special mention and 50% substandard. The percent of nonpass loans on nonaccrual status as of December 31, 2012, was 15%. Changes in credit risk are monitored on a continuous basis and changes in risk ratings are made when identified. All impaired loans are reviewed at least annually.

The following table sets forth information regarding Heartland's accruing and nonaccrual loans and leases not covered by loss share agreements at March 31, 2013, and December 31, 2012, in thousands:

| | Accruing Loans and Leases | | | Total Past Due | Current | Nonaccrual | Total Loans and Leases |
|--|---------------------------|------------------------|--------------------------------|-------------------|-------------|------------|---------------------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | | | | |
| March 31, 2013 | | | | | | | |
| Commercial | \$5,245 | \$624 | \$— | \$5,869 | \$685,082 | \$2,284 | \$693,235 |
| Commercial real estate | 1,781 | 350 | 404 | 2,535 | 1,274,874 | 20,174 | 1,297,583 |
| Total commercial and commercial real estate | 7,026 | 974 | 404 | 8,404 | 1,959,956 | 22,458 | 1,990,818 |
| Agricultural and agricultural real estate | 1,086 | 10 | — | 1,096 | 313,222 | 288 | 314,606 |
| Residential real estate | 2,006 | — | — | 2,006 | 232,241 | 6,206 | 240,453 |
| Consumer | 1,953 | 634 | 50 | 2,637 | 240,955 | 3,404 | 246,996 |
| Total gross loans and leases receivable held to maturity | \$12,071 | \$1,618 | \$454 | \$14,143 | \$2,746,374 | \$32,356 | \$2,792,873 |
| December 31, 2012 | | | | | | | |
| Commercial | \$1,143 | \$525 | \$— | \$1,668 | \$708,459 | \$2,181 | \$712,308 |
| Commercial real estate | 1,631 | 494 | — | 2,125 | 1,259,112 | 27,947 | 1,289,184 |
| Total commercial and commercial real estate | 2,774 | 1,019 | — | 3,793 | 1,967,571 | 30,128 | 2,001,492 |
| Agricultural and agricultural real estate | 687 | — | — | 687 | 324,545 | 3,079 | 328,311 |
| Residential real estate | 1,278 | 234 | — | 1,512 | 241,860 | 6,317 | 249,689 |
| Consumer | 2,434 | 803 | — | 3,237 | 238,809 | 3,632 | 245,678 |
| Total gross loans and leases receivable held to maturity | \$7,173 | \$2,056 | \$— | \$9,229 | \$2,772,785 | \$43,156 | \$2,825,170 |

The majority of Heartland's impaired loans are those that are nonaccrual, are past due 90 days or more and still accruing or have had their terms restructured in a troubled debt restructuring. The following tables present, for impaired loans not covered by loss share agreements and by category of loan, the unpaid balance that was contractually due at March 31, 2013, and December 31, 2012; the outstanding loan balance recorded on the consolidated balance sheets at March 31, 2013, and December 31, 2012; any related allowance recorded for those loans as of March 31, 2013, and December 31, 2012; the average outstanding loan balance recorded on the consolidated balance sheets during the three months ended March 31, 2013, and year ended December 31, 2012; and the interest income recognized on the impaired loans during the three months ended March 31, 2013, and year ended December 31, 2012, in thousands:

| | Unpaid Contractual Balance | Loan Balance | Related Allowance Recorded | Year-to-Date Avg. Loan Balance | Year-to-Date Interest Income Recognized |
|---|----------------------------------|-----------------|----------------------------------|--------------------------------------|--|
| March 31, 2013 | | | | | |
| Impaired loans with a related allowance: | | | | | |
| Commercial | \$2,561 | \$2,561 | \$1,026 | \$2,631 | \$19 |
| Commercial real estate | 7,007 | 6,043 | 964 | 5,667 | 89 |
| Total commercial and commercial real estate | 9,568 | 8,604 | 1,990 | 8,298 | 108 |
| Agricultural and agricultural real estate | 1,447 | 1,447 | 176 | 1,447 | 18 |
| Residential real estate | 3,562 | 3,536 | 796 | 3,274 | 19 |
| Consumer | 3,473 | 3,473 | 1,530 | 3,479 | 25 |
| Total loans held to maturity | \$18,050 | \$17,060 | \$4,492 | \$16,498 | \$170 |
| Impaired loans without a related allowance: | | | | | |
| Commercial | \$6,266 | \$5,896 | \$— | \$5,485 | \$65 |
| Commercial real estate | 39,718 | 31,151 | — | 34,884 | 164 |
| Total commercial and commercial real estate | 45,984 | 37,047 | — | 40,369 | 229 |
| Agricultural and agricultural real estate | 11,782 | 11,775 | — | 11,859 | 123 |
| Residential real estate | 4,314 | 3,769 | — | 3,727 | 16 |
| Consumer | 1,608 | 1,582 | — | 1,455 | 5 |
| Total loans held to maturity | \$63,688 | \$54,173 | \$— | \$57,410 | \$373 |
| Total impaired loans held to maturity: | | | | | |
| Commercial | \$8,827 | \$8,457 | \$1,026 | \$8,116 | \$84 |
| Commercial real estate | 46,725 | 37,194 | 964 | 40,551 | 252 |
| Total commercial and commercial real estate | 55,552 | 45,651 | 1,990 | 48,667 | 336 |
| Agricultural and agricultural real estate | 13,229 | 13,222 | 176 | 13,306 | 141 |
| Residential real estate | 7,876 | 7,305 | 796 | 7,001 | 35 |
| Consumer | 5,081 | 5,055 | 1,530 | 4,934 | 30 |
| Total impaired loans held to maturity | \$81,738 | \$71,233 | \$4,492 | \$73,908 | \$542 |

| | Unpaid Contractual Balance | Loan Balance | Related Allowance Recorded | Year-to-Date Avg. Loan Balance | Year-to-Date Interest Income Recognized |
|---|----------------------------------|-----------------|----------------------------------|--------------------------------------|--|
| December 31, 2012 | | | | | |
| Impaired loans with a related allowance: | | | | | |
| Commercial | \$2,904 | \$2,904 | \$1,350 | \$5,082 | \$88 |
| Commercial real estate | 6,403 | 6,384 | 1,112 | 12,671 | 813 |
| Total commercial and commercial real estate | 9,307 | 9,288 | 2,462 | 17,753 | 901 |
| Agricultural and agricultural real estate | 1,493 | 1,493 | 109 | 379 | 83 |
| Residential real estate | 3,197 | 3,170 | 783 | 2,737 | 89 |
| Consumer | 3,876 | 3,836 | 1,270 | 3,781 | 204 |
| Total loans held to maturity | \$17,873 | \$17,787 | \$4,624 | \$24,650 | \$1,277 |
| Impaired loans without a related allowance: | | | | | |
| Commercial | \$6,596 | \$6,127 | \$— | \$3,813 | \$186 |
| Commercial real estate | 48,967 | 39,199 | — | 41,814 | 689 |
| Total commercial and commercial real estate | 55,563 | 45,326 | — | 45,627 | 875 |
| Agricultural and agricultural real estate | 14,654 | 14,635 | — | 13,728 | 539 |
| Residential real estate | 4,741 | 4,273 | — | 3,861 | 65 |
| Consumer | 1,708 | 1,555 | — | 1,630 | 18 |
| Total loans held to maturity | \$76,666 | \$65,789 | \$— | \$64,846 | \$1,497 |
| Total impaired loans held to maturity: | | | | | |
| Commercial | \$9,500 | \$9,031 | \$1,350 | \$8,895 | \$274 |
| Commercial real estate | 55,370 | 45,583 | 1,112 | 54,485 | 1,502 |
| Total commercial and commercial real estate | 64,870 | 54,614 | 2,462 | 63,380 | 1,776 |
| Agricultural and agricultural real estate | 16,147 | 16,128 | 109 | 14,107 | 622 |
| Residential real estate | 7,938 | 7,443 | 783 | 6,598 | 154 |
| Consumer | 5,584 | 5,391 | 1,270 | 5,411 | 222 |
| Total impaired loans held to maturity | \$94,539 | \$83,576 | \$4,624 | \$89,496 | \$2,774 |

On July 2, 2009, Heartland acquired all deposits of The Elizabeth State Bank in Elizabeth, Illinois through its subsidiary Galena State Bank & Trust Co. based in Galena, Illinois, in a whole bank loss sharing transaction facilitated by the FDIC. As of July 2, 2009, The Elizabeth State Bank had loans of \$42.7 million. The estimated fair value of the loans acquired was \$37.8 million.

The acquired loans and other real estate owned are covered by two loss share agreements between the FDIC and Galena State Bank & Trust Co., which affords Galena State Bank & Trust Co. significant loss protection. Under the loss share agreements, the FDIC covers 80% of the covered loan and other real estate owned losses (referred to as covered assets) up to \$10 million and 95% of losses in excess of that amount. The term for loss sharing on

non-residential real estate losses is five years with respect to losses and eight years with respect to recoveries, while the term for loss sharing on residential real estate loans is ten years with respect to losses and recoveries. The reimbursable losses from the FDIC are based on the book value of the relevant loan as determined by the FDIC at the date of the transaction. New loans made after the acquisition are not covered by the loss share agreements.

The Elizabeth State Bank acquisition was accounted for under the acquisition method of accounting in accordance with ASC 805, "Business Combinations." Purchased loans acquired in a business combination, which include loans purchased in The Elizabeth State Bank acquisition, are recorded at estimated fair value on their purchase date, but the purchaser cannot carry over the related allowance for loan and lease losses. Purchased loans are accounted for under ASC 310-30, "Loans and Debt Securities with Deteriorated Credit Quality," when the loans have evidence of credit deterioration since origination and it is probable at the date of the acquisition that Heartland will not collect all contractually required principal and interest payments. Evidence of credit quality deterioration at the purchase date included statistics such as past due and nonaccrual status. Generally, acquired loans that meet Heartland's definition for nonaccrual status fall within the scope of ASC 310-30. The

difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference which is included in the carrying value of the loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan and lease losses. Subsequent increases in cash flows result in a reversal of the provision for loan and lease losses to the extent of prior charges, or a reclassification of the difference from nonaccretable to accretable with a positive impact on future interest income. Further, any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized into interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows.

The carrying amount of the loans covered by these loss share agreements at March 31, 2013, and December 31, 2012, consisted of purchased impaired and nonimpaired loans as summarized in the following table, in thousands:

| | March 31, 2013 | | | December 31, 2012 | | |
|---|--------------------------|------------------------------|---------------------|--------------------------|------------------------------|---------------------|
| | Impaired Purchased Loans | Non Impaired Purchased Loans | Total Covered Loans | Impaired Purchased Loans | Non Impaired Purchased Loans | Total Covered Loans |
| Commercial and commercial real estate | \$381 | \$2,357 | \$2,738 | \$598 | \$2,476 | \$3,074 |
| Agricultural and agricultural real estate | — | 453 | 453 | — | 748 | 748 |
| Residential real estate | — | 2,722 | 2,722 | — | 2,645 | 2,645 |
| Consumer loans | 383 | 445 | 828 | 89 | 697 | 786 |
| Total Covered Loans | \$764 | \$5,977 | \$6,741 | \$687 | \$6,566 | \$7,253 |

On the acquisition date, the preliminary estimate of the contractually required payments receivable for all loans with evidence of credit deterioration since origination acquired in the acquisition was \$13.8 million and the estimated fair value of the loans was \$9.0 million. At March 31, 2013, and December 31, 2012, a majority of these loans were valued based upon the liquidation value of the underlying collateral, because the expected cash flows are primarily based on the liquidation of underlying collateral and the timing and amount of the cash flows could not be reasonably estimated. There was no allowance for loan and lease losses related to these ASC 310-30 loans at March 31, 2013, and December 31, 2012.

On the acquisition date, the preliminary estimate of the contractually required payments receivable for all nonimpaired loans acquired in the acquisition was \$28.9 million and the estimated fair value of the loans was \$28.7 million.

NOTE 4: ALLOWANCE FOR LOAN AND LEASE LOSSES

Changes in the allowance for loan and lease losses for the three months ended March 31, 2013, and March 31, 2012, were as follows, in thousands:

| | Commercial | Commercial Real Estate | Agricultural | Residential Real Estate | Consumer | Leases | Unallocated | Total |
|------------------------------|------------|------------------------|--------------|-------------------------|----------|--------|-------------|----------|
| Balance at December 31, 2012 | \$11,388 | \$14,473 | \$2,138 | \$3,543 | \$7,173 | \$— | \$— | \$38,715 |
| Charge-offs | (538) | (1,243) | (23) | (265) | (995) | — | — | (3,064) |
| Recoveries | 781 | 186 | 12 | 7 | 254 | — | — | 1,240 |
| Provision | (2,332) | 1,774 | 68 | (19) | 1,146 | — | — | 637 |
| Balance at March 31, 2013 | \$9,299 | \$15,190 | \$2,195 | \$3,266 | \$7,578 | \$— | \$— | \$37,528 |
| | Commercial | Commercial | Agricultural | Residential | Consumer | Leases | Unallocated | Total |

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | Real Estate | | Real Estate | | | | |
|------------------------------------|----------|-------------|---------|-------------|---------|------|-----|----------|
| Balance at December 31, 2011 | \$10,547 | \$14,621 | \$1,763 | \$3,001 | \$6,874 | \$2 | \$— | \$36,808 |
| Charge-offs | (502) | (286) | — | (63) | (757) | — | — | (1,608) |
| Recoveries | 33 | 1,430 | 78 | 33 | 234 | — | — | 1,808 |
| Provision | 941 | (365) | 6 | 569 | 1,204 | (1) | — | 2,354 |
| Balance at March 31, 2012 | \$11,019 | \$15,400 | \$1,847 | \$3,540 | \$7,555 | \$1 | \$— | \$39,362 |

NOTE 5: GOODWILL, CORE DEPOSIT PREMIUM AND OTHER INTANGIBLE ASSETS

Heartland had goodwill of \$30.6 million at both March 31, 2013, and December 31, 2012.

Other intangible assets consist of core deposit intangibles, mortgage servicing rights and customer relationship intangible. The gross carrying amount of other intangible assets and the associated accumulated amortization at March 31, 2013, and December 31, 2012, are presented in the table below, in thousands:

| | March 31, 2013 | | Net Carrying Amount | December 31, 2012 | | Net Carrying Amount |
|----------------------------------|-----------------------------|-----------------------------|---------------------------|-----------------------------|-----------------------------|---------------------------|
| | Gross Carrying Amount | Accumulated Amortization | | Gross Carrying Amount | Accumulated Amortization | |
| Amortizing intangible assets: | | | | | | |
| Core deposit intangibles | \$11,668 | \$9,515 | \$2,153 | \$11,668 | \$9,327 | \$2,341 |
| Mortgage servicing rights | 24,959 | 7,326 | 17,633 | 22,892 | 7,239 | 15,653 |
| Customer relationship intangible | 1,177 | 697 | 480 | 1,177 | 685 | 492 |
| Total | \$37,804 | \$17,538 | \$20,266 | \$35,737 | \$17,251 | \$18,486 |

The following table shows the estimated future amortization expense for amortizable intangible assets, in thousands:

| | Core Deposit Intangibles | Mortgage Servicing Rights | Customer Relationship Intangible | Total |
|--------------------------------------|--------------------------------|---------------------------------|--|---------|
| Nine months ending December 31, 2013 | \$554 | \$5,473 | \$33 | \$6,060 |
| Year ending December 31, | | | | |
| 2014 | 468 | 4,053 | 43 | 4,564 |
| 2015 | 267 | 3,243 | 42 | 3,552 |
| 2016 | 238 | 2,432 | 41 | 2,711 |
| 2017 | 212 | 1,621 | 40 | 1,873 |
| 2018 | 187 | 811 | 39 | 1,037 |
| Thereafter | 227 | — | 242 | 469 |

Projections of amortization expense for mortgage servicing rights are based on existing asset balances and the existing interest rate environment as of March 31, 2013. Heartland's actual experience may be significantly different depending upon changes in mortgage interest rates and market conditions. Mortgage loans serviced for others were \$2.35 billion and \$2.20 billion as of March 31, 2013, and December 31, 2012, respectively. The fair value of Heartland's mortgage servicing rights was estimated at \$19.4 million and \$16.0 million at March 31, 2013, and December 31, 2012, respectively. Valuation allowances of \$0 and \$496,000, were required as of March 31, 2013, and December 31, 2012, respectively.

Heartland's mortgage servicing rights are separated into 15- and 30-year tranches. At March 31, 2013, the 30-year tranche had a fair value of \$15.7 million in comparison with the book value of \$14.5 million. At December 31, 2012, the 30-year tranche had a fair value of \$12.6 million in comparison with the book value of \$12.6 million, which was net of the related valuation allowance of \$496,000. At March 31, 2013, the 15-year tranche had a fair value of \$3.7 million in comparison with the book value of \$3.1 million. At December 31, 2012, the 15-year tranche had a fair value of \$3.3 million in comparison with the book value of \$3.0 million.

The following table summarizes, in thousands, the changes in capitalized mortgage servicing rights:

| | |
|------|------|
| 2013 | 2012 |
|------|------|

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | |
|----------------------|----------|----------|
| Balance at January 1 | \$15,653 | \$11,276 |
| Originations | 3,245 | 1,986 |
| Amortization | (1,761) | (1,719) |
| Valuation adjustment | 496 | 13 |
| Balance at March 31 | \$17,633 | \$11,556 |

NOTE 6: DERIVATIVE FINANCIAL INSTRUMENTS

Heartland uses derivative financial instruments as part of its interest rate risk management strategy, including interest rate swaps, caps, floors and collars and certain interest rate lock commitments and forward sales of securities related to mortgage banking activities. Heartland's objectives are to add stability to its net interest margin and to manage its exposure to movements in interest rates. The contract or notional amount of a derivative is used to determine, along with the other terms of the derivative, the amounts to be exchanged between the counterparties. Heartland is exposed to credit risk in the event of nonperformance by counterparties to financial instruments. Heartland minimizes this risk by entering into derivative contracts with large, stable financial institutions. Heartland has not experienced any losses from nonperformance by these counterparties. Heartland monitors counterparty risk in accordance with the provisions of ASC 815. In addition, interest rate-related derivative instruments generally contain language outlining collateral pledging requirements for each counterparty. Collateral must be posted when the market value exceeds certain threshold limits which are determined by credit ratings of each counterparty. Heartland was required to pledge \$6.4 million and \$6.7 million of cash as collateral at March 31, 2013, and December 31, 2012, respectively.

Heartland's derivative and hedging instruments are recorded at fair value on the consolidated balance sheets. See Note 7, "Fair Value," for additional fair value information and disclosures.

Cash Flow Hedges

Heartland has variable rate funding which creates exposure to variability in interest payments due to changes in interest rates. To manage the interest rate risk related to the variability of interest payments, Heartland has entered into various interest rate swap agreements. Amounts reported in accumulated other comprehensive income related to derivatives will be reclassified to interest expense as interest payments are received or made on Heartland's variable-rate liabilities. For the three months ended March 31, 2013, the change in net unrealized losses on cash flow hedges reflects changes in the fair value of the swaps and reclassification from accumulated other comprehensive income to interest expense totaling \$505,000. For the next twelve months, Heartland estimates that cash payments and reclassification from accumulated other comprehensive income to interest expense will total \$2.0 million.

Heartland executed an interest rate swap transaction on April 5, 2011, with an effective date of April 20, 2011, and an expiration date of April 20, 2016, to effectively convert \$15.0 million of its newly issued variable rate amortizing debt to fixed rate debt. For accounting purposes, this swap transaction is designated as a cash flow hedge of the changes in cash flows attributable to changes in one-month LIBOR, the benchmark interest rate being hedged, associated with the interest payments made on an amount of Heartland's debt principal equal to the then-outstanding swap notional amount. At inception, Heartland asserted that the underlying principal balance would remain outstanding throughout the hedge transaction making it probable that sufficient LIBOR-based interest payments would exist through the maturity date of the swap.

During the first quarter of 2009, Heartland entered into three forward-starting interest rate swap transactions to effectively convert \$65.0 million of its variable interest rate subordinated debentures (issued in connection with the trust preferred securities of Heartland Financial Statutory Trust IV, V and VII) to fixed interest rate debt. For accounting purposes, these three swap transactions are designated as cash flow hedges of the changes in cash flows attributable to changes in LIBOR, the benchmark interest rate being hedged, associated with the interest payments made on \$65.0 million of Heartland's subordinated debentures (issued in connection with the trust preferred securities of Heartland Financial Statutory Trust IV, V and VII) that reset quarterly on a specified reset date. At inception, Heartland asserted that the underlying principal balance would remain outstanding throughout the hedge transaction making it probable that sufficient LIBOR-based interest payments would exist through the maturity date of the swaps.

The table below identifies the balance sheet category and fair values of Heartland's derivative instruments designated as cash flow hedges at March 31, 2013, and December 31, 2012, in thousands:

| | Notional Amount | Fair Value | Balance Sheet Category | Receive Rate | Weighted Average Pay Rate | Maturity |
|--------------------|-----------------|------------|------------------------|--------------|---------------------------|--------------|
| March 31, 2013 | | | | | | |
| Interest rate swap | \$ 12,688 | \$(645) |) Other Liabilities | 2.953 | % 5.140 | % 04/20/2016 |
| Interest rate swap | 25,000 | (565) |) Other Liabilities | 0.280 | % 2.580 | % 03/17/2014 |
| Interest rate swap | 20,000 | (2,055) |) Other Liabilities | 0.287 | % 3.220 | % 03/01/2017 |
| Interest rate swap | 20,000 | (2,773) |) Other Liabilities | 0.305 | % 3.355 | % 01/07/2020 |
| December 31, 2012 | | | | | | |
| Interest rate swap | \$ 13,002 | \$(711) |) Other Liabilities | 2.961 | % 5.140 | % 04/20/2016 |
| Interest rate swap | 25,000 | (708) |) Other Liabilities | 0.308 | % 2.580 | % 03/17/2014 |
| Interest rate swap | 20,000 | (2,186) |) Other Liabilities | 0.311 | % 3.220 | % 03/01/2017 |
| Interest rate swap | 20,000 | (3,020) |) Other Liabilities | 0.351 | % 3.355 | % 01/07/2020 |

The table below identifies the gains and losses recognized on Heartland's derivative instruments designated as cash flow hedges for the three months ended March 31, 2013, and March 31, 2012, in thousands:

| | Effective Portion | | Ineffective Portion | | |
|--------------------|----------------------|------------------------------------|----------------------|------------------------------------|-------------------------------------|
| | Recognized in OCI | Reclassified from AOCI into Income | Recognized in OCI | Reclassified from AOCI into Income | Recognized in Income on Derivatives |
| | Amount of Gain(Loss) | Category | Amount of Gain(Loss) | Category | Amount of Gain(Loss) |
| March 31, 2013 | | | | | |
| Interest rate swap | \$66 | Interest Expense | \$(71) |) Other Income | \$— |
| Interest rate swap | 143 | Interest Expense | (142) |) Other Income | — |
| Interest rate swap | 131 | Interest Expense | (142) |) Other Income | — |
| Interest rate swap | 247 | Interest Expense | (150) |) Other Income | — |
| March 31, 2012 | | | | | |
| Interest rate swap | \$22 | Interest Expense | \$(75) |) Other Income | \$— |
| Interest rate swap | 29 | Interest Expense | (128) |) Other Income | — |
| Interest rate swap | 88 | Interest Expense | (136) |) Other Income | — |
| Interest rate swap | 282 | Interest Expense | (155) |) Other Income | — |

Economic Hedges

Heartland has certain derivative contracts which are accounted for as economic hedges. These contracts do not qualify for hedge accounting. These contracts are carried on the consolidated balance sheets at fair value with changes in fair value recorded as a component of other noninterest expense on the consolidated statements of income.

To reduce the potentially negative impact an upward movement in interest rates would have on its net interest income, Heartland entered into a cap transaction. For accounting purposes, the cap transaction was designated as a cash flow hedge of the changes in cash flows attributable to changes in LIBOR, the benchmark interest rate being hedged, above the cap strike rate associated with the hedged interest payments made on \$20 million of Heartland's subordinated debentures that reset quarterly on a specified reset date. This transaction, executed on January 15, 2008, was a fifty-five month interest rate cap on a notional amount of \$20.0 million. The cap had an effective date of January 15, 2008, and matured on September 1, 2012. When 3-month LIBOR exceeded 5.12% on a reset date, the counterparty paid Heartland the amount of interest that exceeded the amount owed on the debt at the cap LIBOR rate of 5.12%. The floating rate subordinated debentures contain an interest rate deferral feature that was mirrored in the cap transaction.

Heartland executed an interest rate swap transaction on February 4, 2009, and converted this cap transaction into an economic hedge and hedge accounting for the cap transaction was ceased.

Mortgage Derivatives

Heartland also has entered into interest rate lock commitments to originate residential mortgage loans held for sale and forward commitments to sell residential mortgage loans and mortgage backed securities that are considered derivative instruments. The fair value of these commitments is recorded on the consolidated balance sheets with the changes in fair value recorded in the consolidated statements of income as a component of gains on sale of loans held for sale. These derivative contracts are designated as free standing derivative contracts and are not designated against specific assets and liabilities on the consolidated balance sheet or forecasted transactions and therefore do not qualify for hedge accounting treatment.

The table below identifies the balance sheet category and fair values of Heartland's derivative instruments not designated as hedging instruments at March 31, 2013, and December 31, 2012, in thousands:

| | Balance Sheet Category | Notional Amount | Fair Value |
|---|------------------------|-----------------|------------|
| March 31, 2013 | | | |
| Interest rate lock commitments (mortgage) | Other Assets | \$193,522 | \$6,683 |
| Forward commitments | Other Assets | 146,444 | 636 |
| Forward commitments | Other Liabilities | 227,118 | (1,024) |
| December 31, 2012 | | | |
| Interest rate lock commitments (mortgage) | Other Assets | \$267,397 | \$9,353 |
| Forward commitments | Other Assets | 168,910 | 462 |
| Forward commitments | Other Liabilities | 351,996 | (1,221) |

The table below identifies the income statement category of the gains and losses recognized in income on Heartland's derivative instruments not designated as hedging instruments for the three months ended March 31, 2013, and March 31, 2012, in thousands:

| | Income Statement Category | Year-to-Date Gain(Loss) Recognized |
|---|---------------------------|------------------------------------|
| March 31, 2013 | | |
| Interest rate lock commitments (mortgage) | Gains on sale of loans | \$(3,161) |
| Forward commitments | Gains on sale of loans | 372 |
| March 31, 2012 | | |
| Interest rate lock commitments (mortgage) | Gains on sale of loans | 2,795 |
| Forward commitments | Gains on sale of loans | 909 |

NOTE 7: FAIR VALUE

Heartland utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Securities available for sale, trading securities and derivatives are recorded in the consolidated balance sheets at fair value on a recurring basis. Additionally, from time to time, Heartland may be required to record at fair value other assets on a nonrecurring basis such as loans held for sale, loans held to maturity and certain other assets including, but not limited to, mortgage servicing rights and other real estate owned. These nonrecurring fair value adjustments typically involve application of lower of cost or fair value accounting or write-downs of individual assets.

Fair Value Hierarchy

Under ASC 820, assets and liabilities are grouped at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 — Valuation is based upon quoted prices for identical instruments in active markets.

Level 2 — Valuation is based upon quoted prices for similar instruments in active markets, or similar instruments in markets that are not active, and model-based valuation techniques for all significant assumptions are observable in the market.

Level 3 — Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value on a recurring or non-recurring basis.

Assets

Securities Available for Sale and Held to Maturity

Securities available for sale are recorded at fair value on a recurring basis. Securities held to maturity are generally recorded at cost and are recorded at fair value only to the extent a decline in fair value is determined to be other-than-temporary. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, as well as U.S. Treasury securities. Level 2 securities include U.S. government and agency securities, mortgage-backed securities and private collateralized mortgage obligations, municipal bonds and corporate debt securities. The Level 3 securities consist primarily of Z tranche mortgage-backed securities. On a quarterly basis, a secondary independent pricing service is used for a sample of securities to validate the pricing from Heartland's primary pricing service.

Trading Assets

Trading assets are recorded at fair value and consist of securities held for trading purposes. The valuation method for trading securities is the same as the methodology used for securities classified as available for sale.

Loans Held for Sale

Loans held for sale are carried at the lower of cost or fair value on an aggregate basis. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, Heartland classifies loans held for sale subjected to nonrecurring fair value adjustments as Level 2.

Loans Held to Maturity

Heartland does not record loans held to maturity at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment in accordance with ASC 310. Loan impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, except where more practical, at the observable market price of the loan or the fair value of the collateral if the loan is collateral dependent. At March 31, 2013, all impaired loans were measured based on the fair value of the collateral. In accordance with ASC 820, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. Heartland classifies impaired loans as nonrecurring Level 3.

Mortgage Servicing Rights

Mortgage servicing rights assets represent the value associated with servicing residential real estate loans that have been sold to outside investors with servicing retained. The fair value for servicing assets is determined through discounted cash flow analysis and utilizes discount rates, prepayment speeds and delinquency rate assumptions as inputs. All of these assumptions require a significant degree of management estimation and judgment. Mortgage

servicing rights are subject to impairment testing. The carrying values of these rights are reviewed quarterly for impairment based upon the calculation of fair value as performed by an outside third party. For purposes of measuring impairment, the rights are stratified into certain risk characteristics including note type, note rate, prepayment trends and external market factors. If the valuation model reflects a value less than the carrying value, mortgage servicing rights are adjusted to fair value through a valuation allowance. Heartland classifies mortgage servicing rights as nonrecurring with Level 3 measurement inputs.

Derivative Financial Instruments

Currently, Heartland uses interest rate swaps, caps, floors, collars and certain interest rate lock commitments and forward sales of securities related to mortgage banking activities to manage its interest rate risk. The valuation of these instruments is determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities. The fair values of interest rate options

are determined using the market standard methodology of discounting the future expected cash receipts that would occur if variable interest rates fell below (rise above) the strike rate of the floors (caps). The variable interest rates used in the calculation of projected receipts on the floor (cap) are based on an expectation of future interest rates derived from observable market interest rate curves and volatilities. To comply with the provisions of ASC 820, Heartland incorporates credit valuation adjustments to appropriately reflect both its own nonperformance risk and the respective counterparty's nonperformance risk in the fair value measurements. In adjusting the fair value of its derivative contracts for the effect of nonperformance risk, Heartland has considered the impact of netting any applicable credit enhancements, such as collateral postings, thresholds, mutual puts, and guarantees.

Although Heartland has determined that the majority of the inputs used to value its derivatives fall within Level 2 of the fair value hierarchy, the credit valuation adjustments associated with its derivatives utilize Level 3 inputs, such as estimates of current credit spreads to evaluate the likelihood of default by itself and its counterparties. However, as of March 31, 2013, and December 31, 2012, Heartland has assessed the significance of the impact of the credit valuation adjustments on the overall valuation of its derivative positions and has determined that the credit valuation adjustments are not significant to the overall valuation of its derivatives. As a result, Heartland has determined that its derivative valuations in their entirety are classified in Level 2 of the fair value hierarchy.

Mortgage Derivatives

Mortgage derivatives include interest rate lock commitments to originate held for sale residential mortgage loans for individual customers and forward commitments to sell residential mortgage loans and mortgage backed securities to various investors. The fair value of these derivative instruments is primarily based on quoted prices for similar assets in active markets that Heartland has the ability to access and are classified in Level 2 of the fair value hierarchy.

Other Real Estate Owned

Other real estate owned ("OREO") represents property acquired through foreclosures and settlements of loans. Property acquired is carried at the lower of the principal amount of the loan outstanding at the time of acquisition, plus any acquisition costs, or the estimated fair value of the property, less disposal costs. Heartland considers third party appraisals, as well as independent fair value assessments from realtors or persons involved in selling OREO, in determining the fair value of particular properties. Accordingly, the valuation of OREO is subject to significant external and internal judgment. Heartland also periodically reviews OREO to determine if the fair value of the property, less disposal costs, has declined below its recorded book value and records any adjustments accordingly. OREO is classified as nonrecurring Level 3.

The table below presents Heartland's assets and liabilities that are measured at fair value on a recurring basis as of March 31, 2013, and December 31, 2012, in thousands, aggregated by the level in the fair value hierarchy within which those measurements fall:

| | Total Fair Value | Level 1 | Level 2 | Level 3 |
|---------------------------------|------------------|----------|-------------|---------|
| March 31, 2013 | | | | |
| Trading securities | \$694 | \$694 | \$— | \$— |
| Securities available for sale | 1,524,569 | 8,174 | 1,512,225 | 4,170 |
| Derivative assets | 7,319 | — | 7,319 | — |
| Total assets at fair value | \$1,532,582 | \$8,868 | \$1,519,544 | \$4,170 |
| Derivative liabilities | \$7,062 | \$— | \$7,062 | \$— |
| Total liabilities at fair value | \$7,062 | \$— | \$7,062 | \$— |
| December 31, 2012 | | | | |
| Trading securities | \$380 | \$380 | \$— | \$— |
| Securities available for sale | 1,506,075 | 12,811 | 1,488,924 | 4,340 |
| Derivative assets | 9,815 | — | 9,815 | — |
| Total assets at fair value | \$1,516,270 | \$13,191 | \$1,498,739 | \$4,340 |

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | | | |
|---------------------------------|---------|-----|---------|-----|
| Derivative liabilities | \$7,846 | \$— | \$7,846 | \$— |
| Total liabilities at fair value | \$7,846 | \$— | \$7,846 | \$— |

There were no transfers between Levels 1, 2, or 3 during the three-month period ended March 31, 2013.

As of December 31, 2012, Heartland revised the classification of government sponsored agency securities from previous filings. In previous filings, government sponsored agency securities were classified as Level 1 under ASC 820. Heartland

revised the classifications to Level 2 as of December 31, 2012 as the determination of fair value requires model based pricing or pricing based on similar securities. The resulting change in presentation does not have a material impact on the financial statements and did not affect the method by which Heartland estimates fair value, nor the resulting fair values.

The tables below present Heartland's assets that are measured at fair value on a nonrecurring basis, in thousands:

Fair Value Measurements at March 31, 2013

| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Losses |
|---|----------|--|---|--|---------|
| Collateral dependent impaired loans: | | | | | |
| Commercial | \$7,431 | \$— | \$— | \$7,431 | \$538 |
| Commercial real estate | 36,230 | — | — | 36,230 | 1,243 |
| Agricultural and agricultural real estate | 13,046 | — | — | 13,046 | 23 |
| Residential real estate | 6,509 | — | — | 6,509 | 265 |
| Consumer | 3,525 | — | — | 3,525 | 995 |
| Total collateral dependent impaired loans | \$66,741 | \$— | \$— | \$66,741 | \$3,064 |
| Other real estate owned | \$36,704 | \$— | \$— | \$36,704 | \$502 |

Fair Value Measurements at December 31, 2012

| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Losses |
|---|----------|--|---|--|----------|
| Collateral dependent impaired loans | | | | | |
| Commercial | \$7,681 | \$— | \$— | \$7,681 | \$1,799 |
| Commercial real estate | 44,471 | — | — | 44,471 | 6,898 |
| Agricultural and agricultural real estate | 16,019 | — | — | 16,019 | 1 |
| Residential real estate | 6,660 | — | — | 6,660 | 988 |
| Consumer | 4,121 | — | — | 4,121 | 4,818 |
| Total collateral dependent impaired loans | \$78,952 | \$— | \$— | \$78,952 | \$14,504 |
| Other real estate owned | \$35,822 | \$— | \$— | \$35,822 | \$6,953 |
| Mortgage servicing rights | \$15,956 | \$— | \$— | \$15,956 | \$477 |

The following tables present additional quantitative information about assets measured at fair value and for which Heartland has utilized Level 3 inputs to determine fair value, in thousands:

| | Quantitative Information About Level 3 Fair Value Measurements | | | |
|---|--|--------------------------|---|---|
| | Fair Value at 3/31/13 | Valuation Technique | Unobservable Input | Range (Weighted Average) |
| Z-Tranche Securities | \$4,170 | Discounted cash flows | Pretax discount rate Actual defaults Actual deferrals | 6 - 8% 13.94-20.94% (15.52%) 6.30-23.71% (11.32%) |
| Collateral dependent impaired loans: | | | | |
| Commercial | 7,431 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Commercial real estate | 36,230 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Agricultural and agricultural real estate | 13,046 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Residential real estate | 6,509 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Consumer | 3,525 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Other real estate owned | 36,704 | Modified appraised value | Disposal costs | NM* |

* Not Meaningful. Third party appraisals are obtained as to the value of the underlying asset, but disclosure of this information would not provide meaningful information, as the range will vary widely from loan to loan. Types of discounts considered included age of the appraisal, local market conditions, current condition of the property, and estimated sales costs. These discounts will also vary from loan to loan, thus providing range would not be meaningful.

| | Quantitative Information About Level 3 Fair Value Measurements | | | |
|---|--|--------------------------|---|--|
| | Fair Value at 12/31/12 | Valuation Technique | Unobservable Input | Range (Weighted Average) |
| Z-Tranche Securities | \$4,340 | Discounted cash flows | Pretax discount rate Actual defaults Actual deferrals | 8 - 10% 13.94-20.94% (15.52%) 6.30-23.71% (11.32%) |
| Collateral dependent impaired loans: | | | | |
| Commercial | 7,681 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Commercial real estate | 44,471 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Agricultural and agricultural real estate | 16,019 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Residential real estate | 6,660 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Consumer | 4,121 | Modified appraised value | Third party appraisal Appraisal discount | NM* NM* |
| Other real estate owned | 35,822 | Modified appraised value | Disposal costs | NM* |
| Mortgage servicing rights | 15,956 | Discounted cash flows | Prepayment speeds, servicing costs and escrow analysis | Average CPR Life 12.99 - 18.71% (18.05%) |

* Not Meaningful. Third party appraisals are obtained as to the value of the underlying asset, but disclosure of this information would not provide meaningful information, as the range will vary widely from loan to loan. Types of discounts considered included age of the appraisal, local market conditions, current condition of the property, and estimated sales costs. These discounts will also vary from loan to loan, thus providing range would not be meaningful.

The changes in fair value of Level 3 assets that are measured on a recurring basis are summarized in the following table, in thousands:

| | For the Three Months Ended March 31, 2013 | For the Year Ended December 31, 2012 |
|--|--|---|
| Balance at January 1, | \$4,340 | \$3,243 |
| Total gains (losses): | | |
| Included in earnings | — | — |
| Included in other comprehensive income | (155 |) 938 |
| Purchases, issuances, sales and settlements: | | |

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | | |
|-----------------------|---------|---------|---|
| Purchases | — | 195 | |
| Sales | — | — | |
| Settlements | (15 |) (36 |) |
| Balance at period end | \$4,170 | \$4,340 | |

The tables below summarize the estimated fair value of Heartland's financial instruments as defined by ASC 825 as of March 31, 2013, and December 31, 2012, in thousands. The carrying amounts in the following table are recorded in the consolidated balance sheets under the indicated captions. In accordance with ASC 825, the assets and liabilities that are not financial instruments are not included in the disclosure, such as the value of the mortgage servicing rights, premises, furniture and equipment, goodwill and other intangibles and other liabilities.

Heartland does not believe that the estimated information presented herein is representative of the earnings power or value of Heartland. The following analysis, which is inherently limited in depicting fair value, also does not consider any value associated with either existing customer relationships or the ability of Heartland to create value through loan origination, deposit gathering or fee generating activities. Many of the estimates presented herein are based upon the use of highly subjective information and assumptions and, accordingly, the results may not be precise. Management believes that fair value estimates may not be comparable between financial institutions due to the wide range of permitted valuation techniques and numerous estimates which must be made. Furthermore, because the disclosed fair value amounts were estimated as of the balance sheet date, the amounts actually realized or paid upon maturity or settlement of the various financial instruments could be significantly different.

| | Carrying Amount | Estimated Fair Value | Fair Value Measurements at March 31, 2013 | | |
|---|-----------------|----------------------|--|---|---|
| | | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$74,587 | \$74,587 | \$74,587 | \$— | \$— |
| Time deposits in other financial institutions | 3,605 | 3,605 | 3,605 | — | — |
| Securities: | | | | | |
| Trading | 694 | 694 | 694 | — | — |
| Available for sale | 1,524,569 | 1,524,569 | 8,174 | 1,512,225 | 4,170 |
| Held to maturity | 55,456 | 55,846 | — | 55,846 | — |
| Total securities | 1,580,719 | 1,581,109 | 8,868 | 1,568,071 | 4,170 |
| Loans held for sale | 91,708 | 91,762 | — | 91,762 | — |
| Loans, net: | | | | | |
| Commercial | 683,160 | 677,353 | — | 669,922 | 7,431 |
| Commercial real estate | 1,283,290 | 1,283,763 | — | 1,247,533 | 36,230 |
| Agricultural and agricultural real estate | 312,810 | 313,954 | — | 300,908 | 13,046 |
| Residential real estate | 240,080 | 229,433 | — | 222,924 | 6,509 |
| Consumer | 239,766 | 242,962 | — | 239,437 | 3,525 |
| Total Loans, net | 2,759,106 | 2,747,465 | — | 2,680,724 | 66,741 |
| Derivatives | 7,319 | 7,319 | — | 7,319 | — |
| Financial liabilities: | | | | | |
| Deposits | | | | | |
| Demand deposits | 971,142 | 971,142 | — | 971,142 | — |
| Savings deposits | 2,022,625 | 2,022,625 | — | 2,022,625 | — |
| Time deposits | 848,689 | 848,689 | — | 848,689 | — |
| Short term borrowings | 202,694 | 202,694 | — | 202,694 | — |
| Other borrowings | 336,577 | 329,318 | — | 329,318 | — |

| | | | | | |
|-------------|-------|-------|---|-------|---|
| Derivatives | 7,062 | 7,062 | — | 7,062 | — |
|-------------|-------|-------|---|-------|---|

| | Fair Value Measurements at December 31, 2012 | | | | |
|---|---|----------------------------|---|---|--|
| | Carrying Amount | Estimated Fair Value | Quoted Prices in | | |
| | | | Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial assets: | | | | | |
| Cash and cash equivalents | \$ 168,054 | \$ 168,054 | \$ 168,054 | \$— | \$— |
| Securities: | | | | | |
| Trading | 380 | 380 | 380 | — | — |
| Available for sale | 1,506,075 | 1,506,075 | 12,811 | 1,488,924 | 4,340 |
| Held to maturity | 55,502 | 55,982 | — | 55,982 | — |
| Total securities | 1,561,957 | 1,562,437 | 13,191 | 1,544,906 | 4,340 |
| Loans held for sale | 96,165 | 96,165 | — | 96,165 | — |
| Loans, net: | | | | | |
| Commercial | 700,225 | 691,605 | — | 683,924 | 7,681 |
| Commercial real estate | 1,275,770 | 1,281,031 | — | 1,236,560 | 44,471 |
| Agricultural and agricultural real estate | 326,867 | 329,443 | — | 313,424 | 16,019 |
| Residential real estate | 248,608 | 237,050 | — | 230,390 | 6,660 |
| Consumer | 238,617 | 241,978 | — | 237,857 | 4,121 |
| Total Loans, net | 2,790,087 | 2,781,107 | — | 2,702,155 | 78,952 |
| Mortgage derivatives | 9,815 | 9,815 | — | 9,815 | — |
| Financial liabilities: | | | | | |
| Deposits | | | | | |
| Demand deposits | 974,232 | 974,232 | — | 974,232 | — |
| Savings deposits | 2,004,438 | 2,004,438 | — | 2,004,438 | — |
| Time deposits | 866,990 | 866,990 | — | 866,990 | — |
| Short term borrowings | 224,626 | 224,626 | — | 224,626 | — |
| Other borrowings | 389,025 | 376,422 | — | 376,422 | — |
| Derivatives | 7,846 | 7,846 | — | 7,846 | — |

Cash and Cash Equivalents — The carrying amount is a reasonable estimate of fair value due to the short-term nature of these instruments.

Time Deposits in Other Financial Institutions — The carrying amount is a reasonable estimate of fair value due to the short-term nature of these instruments.

Securities — For securities either held to maturity, available for sale or trading, fair value equals quoted market price if available. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities. For Level 3 securities, Heartland utilizes independent pricing provided by third party vendors or brokers.

Loans and Leases — The fair value of loans is estimated using an entrance price concept by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The fair value of impaired loans is measured using the fair value of the underlying collateral. The fair value of loans held for sale is estimated using quoted market prices.

Mortgage Derivatives — The fair value of these instruments is determined using widely accepted valuation techniques, including discounted cash flow analysis of the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities

Derivatives — The fair value of all derivatives is estimated based on the amount that Heartland would pay or would be paid to terminate the contract or agreement, using current rates and, when appropriate, the current creditworthiness of the counter-party.

Deposits — The fair value of demand deposits, savings accounts and certain money market deposits is the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. If the fair value of the fixed maturity certificates of deposit is calculated at less than the carrying amount, the carrying value of these deposits is reported as the fair value.

Short-term and Other Borrowings — Rates currently available to Heartland for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

Commitments to Extend Credit, Unused Lines of Credit and Standby Letters of Credit — Based upon management's analysis of the off balance sheet financial instruments, there are no significant unrealized gains or losses associated with these financial instruments based upon review of the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties.

NOTE 8: SEGMENT REPORTING

Heartland has identified two operating segments for purposes of financial reporting: community and other banking and retail mortgage banking. These segments were determined based on the products and services provided or the type of customers served and is consistent with the information used by Heartland's key decision makers to make operating decisions and to assess Heartland's performance.

The following table presents financial information from Heartland's operating segments for March 31, 2013 and 2012, in thousands.

| | Three Months Ended March 31, 2013 | | | Three Months Ended March 31, 2012 | | |
|---------------------------|--------------------------------------|-------------------------------|-------------|--------------------------------------|-------------------------------|-------------|
| | Community and Other Banking | Retail Mortgage Banking | Total | Community and Other Banking | Retail Mortgage Banking | Total |
| Net interest income | \$38,333 | \$334 | \$38,667 | \$37,787 | \$406 | \$38,193 |
| Provision for loan losses | 637 | — | 637 | 2,354 | — | 2,354 |
| Total noninterest income | 13,400 | 13,068 | 26,468 | 13,900 | 9,488 | 23,388 |
| Total noninterest expense | 34,905 | 11,842 | 46,747 | 31,903 | 8,237 | 40,140 |
| Income before taxes | \$16,191 | \$1,560 | \$17,751 | \$17,430 | \$1,657 | \$19,087 |
| Segment Assets | \$4,783,247 | \$117,311 | \$4,900,558 | \$4,191,870 | \$120,981 | \$4,312,851 |
| Average Loans | \$2,784,785 | \$92,175 | \$2,876,960 | \$2,495,962 | \$81,467 | \$2,577,429 |

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

SAFE HARBOR STATEMENT

This document (including information incorporated by reference) contains, and future oral and written statements of Heartland and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of Heartland. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of Heartland's management and on information currently available to management, are generally identifiable by the use of words such as "believe", "expect", "anticipate", "plan", "intend", "estimate", "may", "will", "would", "could", "should" or other similar expressions. Although Heartland has made these statements based on management's experience and best estimate of future events, there may be events or factors that management has not anticipated, and the accuracy and achievement of such forward-looking statements and estimates are subject to a number of risks, including those identified in our Annual Report on Form 10-K for the year ended December 31, 2012. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and Heartland undertakes no obligation to update any statement in light of new information or future events.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, income and expenses. These estimates are based upon historical experience and on various other assumptions that management believes are reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The estimates and judgments that management believes have the most effect on Heartland's reported financial position and results of operations are described as critical accounting policies in Heartland's Annual Report on Form 10-K for the year ended December 31, 2012. There have been no significant changes in the critical accounting policies or the assumptions and judgments utilized in applying these policies since the year ended December 31, 2012.

OVERVIEW

Heartland's results of operations depend primarily on net interest income, which is the difference between interest income from interest earning assets and interest expense on interest bearing liabilities. Noninterest income, which includes service charges and fees, loan servicing income, trust income, brokerage and insurance commissions, securities gains and gains on sale of loans, also affects Heartland's results of operations. Heartland's principal operating expenses, aside from interest expense, consist of the provision for loan and lease losses, salaries and employee benefits, occupancy and equipment costs, professional fees, FDIC insurance premiums and net losses on repossessed assets.

Net income was \$12.6 million for the quarter ended March 31, 2013, which was a slight decrease from the \$12.8 million recorded for the first quarter of 2012. Net income available to common stockholders was \$12.1 million, or \$0.70 per diluted common share, for the quarter ended March 31, 2013, compared to \$11.8 million, or \$0.71 per diluted common share, for the first quarter of 2012. Return on average common equity was 15.18% and return on average assets was 1.00% for the first quarter of 2013, compared to 17.27% and 1.12%, respectively, for the same quarter in 2012.

Earnings for the first quarter of 2013, in comparison to the first quarter of 2012, were positively affected by a lower provision for loan and lease losses, an increase in loan servicing income and gains on sale of loans attributable to the continued expansion of our mortgage operations and a reduction in net losses on repossessed assets. The first quarter of 2012 included \$2.0 million in equity earnings from the sale of two low-income housing projects within partnerships in which Dubuque Bank and Trust Company was a member. The absence of comparable other noninterest income during the first quarter of 2013, combined with a significant increase in salaries and employee benefits, offset the improvements discussed above.

Total assets were \$4.90 billion at March 31, 2013, a decrease of \$90.0 million since December 31, 2012, reflecting the decreased loan and leases balances discussed below. Securities represented 32% of total assets at March 31, 2013, compared to 31% at year-end 2012.

Total loans and leases held to maturity were \$2.79 billion at March 31, 2013, compared to \$2.82 billion at year-end 2012, a decrease of \$31.7 million or 4% annualized, a large portion of which was attributable to seasonal paydowns on agricultural and

commercial lines of credit. Additionally, payoffs were received on loans to borrowers who obtained lower rates and more liberal terms from competitors, including some we chose to exit due to increased credit risk evidenced in the relationship.

Total deposits were \$3.84 billion at March 31, 2013, compared to \$3.85 billion at year-end 2012, a decrease of \$3.2 million or less than 1% annualized. The composition of Heartland's deposits continued its positive trend as no-cost demand deposits as a percentage of total deposits was 25% at both March 31, 2013, and December 31, 2012, while higher-cost certificates of deposit as a percentage of total deposits was 22% at March 31, 2013, compared to 23% at December 31, 2012.

RESULTS OF OPERATIONS

Net Interest Income

Net interest margin, expressed as a percentage of average earning assets, was 3.77% during the first quarter of 2013 compared to 3.81% during the fourth quarter of 2012 and 4.23% during the first quarter of 2012. These declines are a result of the sustained low interest rate environment where yields on the securities and loan portfolios are declining at a greater pace than rates paid on deposits and other borrowings. Because deposit rates have been set at close to the bottom of their manageable range, and because the reinvestment rates on maturing securities have fallen dramatically and loan rates are presently impacted by competition for new loans, management anticipates net interest margin as a percentage will continue to decline, but believes net interest margin in dollars will increase as the amount of earning assets grows.

On a tax-equivalent basis, interest income in the first quarter of 2013 was \$50.0 million compared to \$49.9 million in the first quarter of 2012. The small increase in interest income in the first quarter of 2013, as compared to the first quarter of 2012, was due to an increase in average earning assets, as the interest rate earned on those assets continued to decline throughout 2012 and the first quarter of 2013 due to the sustained low interest rate environment. The average interest rate earned on total earning assets was 4.60% during the first quarter of 2013 compared to 5.30% during the first quarter of 2012. The most significant contributor to these declines was the overall yield earned on the securities portfolio, which decreased 109 basis points during the quarter ended March 31, 2013, compared to the same quarter in 2012. Average earning assets increased \$619.4 million or 16% during the first quarter of 2013 compared to the first quarter of 2012, with approximately \$180.0 million attributable to the three acquisitions completed during the third and fourth quarters of 2012.

Interest expense for the first quarter of 2013 was \$9.0 million, a decrease of \$1.0 million or 10% from \$10.0 million in the first quarter of 2012. Even though average interest bearing liabilities increased \$331.3 million or 11% for the quarter ended March 31, 2013, as compared to the same quarter in 2012, the average interest rate paid on Heartland's interest bearing deposits and borrowings declined 24 basis points decreasing from 1.31% in the first quarter of 2012 to 1.07% in the first quarter of 2013. Contributing to this improvement in interest expense was a continued change in the mix of deposits. Average savings balances, the lowest cost interest-bearing deposits, as a percentage of total average interest bearing deposits was 69% during the first quarter of 2013, compared to 68% for the first quarter of 2012. Additionally, the average interest rate paid on savings deposits was 0.34% during the first quarter of 2013 compared to 0.40% during the first quarter of 2012 and the average interest rate paid on time deposits was 1.61% during the first quarter of 2013 compared to 2.12% during the first quarter of 2012. Management continues to look for opportunities to reduce Heartland's funding costs, including the early payoff of its Federal Home Loan Bank "FHLB" advances, wholesale repurchase agreements and trust preferred securities. Certificates of deposit maturing within the next six months total \$221.0 million at an average interest rate of 1.11% and an additional \$170.0 million mature within the following six months at an average interest rate of 1.97%. For the past several months, the average renewal interest rate on maturing certificates of deposit has been ranging between 0.50% and 0.70%.

Net interest income on a tax-equivalent basis totaled \$40.9 million during the first quarter of 2013, an increase of \$1.1 million or 3% from the \$39.8 million recorded during the first quarter of 2012.

Heartland attempts to manage its balance sheet to minimize the effect that a change in interest rates has on its net interest margin. Heartland plans to continue to work toward improving both its earning assets and funding mix through targeted organic growth strategies, which management believes will result in additional net interest income. Heartland believes its net interest income simulations reflect a well-balanced and manageable interest rate posture. Management supports a pricing discipline in which the focus is less on price and more on the unique value provided to business and retail clients. Approximately 40% of Heartland's commercial and agricultural loan portfolios consist of floating rate loans that reprice based upon a change in the national prime or LIBOR interest rate. Since nearly 70% of these floating rate loans have interest rate floors that are currently in effect, an upward movement in the national prime interest rate would not have an immediate positive effect on Heartland's interest income. Item 3 of this Form 10-Q contains additional information about the results of Heartland's most recent net interest income simulations. Note 6 to the quarterly financial statements contains a detailed discussion of the derivative instruments Heartland has utilized to manage its interest rate risk.

The table below sets forth certain information relating to Heartland's average consolidated balance sheets and reflects the yield on average earning assets and the cost of average interest bearing liabilities for the periods indicated, in thousands. Dividing income or expense by the average balance of assets or liabilities derives such yields and costs. Average balances are derived from daily balances, and nonaccrual loans and loans held for sale are included in each respective loan category. Interest income is measured on a tax equivalent basis using a 35% tax rate.

ANALYSIS OF AVERAGE BALANCES, TAX EQUIVALENT YIELDS AND RATES⁽¹⁾

For the Quarters Ended March 31, 2013, and 2012

| | 2013 | | | 2012 | | | |
|--|-----------------|----------|------|-----------------|----------|------|---|
| | Average Balance | Interest | Rate | Average Balance | Interest | Rate | |
| EARNING ASSETS | | | | | | | |
| Securities: | | | | | | | |
| Taxable | \$1,184,567 | \$4,659 | 1.60 | % \$1,021,228 | \$7,572 | 2.98 | % |
| Nontaxable ⁽¹⁾ | 370,872 | 4,920 | 5.38 | 219,283 | 3,494 | 6.41 | |
| Total securities | 1,555,439 | 9,579 | 2.50 | 1,240,511 | 11,066 | 3.59 | |
| Interest bearing deposits | 8,985 | 4 | 0.18 | 3,823 | — | — | |
| Federal funds sold | 1,634 | — | — | 148 | — | — | |
| Loans and leases: | | | | | | | |
| Commercial and commercial real estate ⁽¹⁾ | 1,982,456 | 25,560 | 5.23 | 1,827,733 | 24,995 | 5.50 | |
| Residential mortgage | 333,742 | 3,439 | 4.18 | 264,596 | 3,116 | 4.74 | |
| Agricultural and agricultural real estate ⁽¹⁾ | 315,176 | 4,364 | 5.62 | 266,763 | 3,933 | 5.93 | |
| Consumer | 245,586 | 5,824 | 9.62 | 218,337 | 5,377 | 9.90 | |
| Fees on loans | — | 1,194 | — | — | 1,395 | — | |
| Less: allowance for loan and lease losses | (38,899) | — | — | (37,202) | — | — | |
| Net loans and leases | 2,838,061 | 40,381 | 5.77 | 2,540,227 | 38,816 | 6.15 | |
| Total earning assets | 4,404,119 | \$49,964 | 4.60 | % 3,784,709 | \$49,882 | 5.30 | % |
| NONEARNING ASSETS | 485,904 | | | 441,106 | | | |
| TOTAL ASSETS | \$4,890,023 | | | \$4,225,815 | | | |
| INTEREST BEARING LIABILITIES | | | | | | | |
| Savings | \$1,961,438 | \$1,633 | 0.34 | % \$1,679,651 | \$1,663 | 0.40 | % |
| Time, \$100,000 and over | 315,761 | 1,170 | 1.50 | 247,396 | 1,228 | 2.00 | |
| Other time deposits | 550,633 | 2,273 | 1.67 | 533,153 | 2,884 | 2.18 | |
| Short-term borrowings | 229,752 | 148 | 0.26 | 247,090 | 213 | 0.35 | |
| Other borrowings | 355,057 | 3,797 | 4.34 | 374,050 | 4,061 | 4.37 | |
| Total interest bearing liabilities | 3,412,641 | 9,021 | 1.07 | % 3,081,340 | 10,049 | 1.31 | % |
| NONINTEREST BEARING LIABILITIES | | | | | | | |
| Noninterest bearing deposits | 973,293 | | | 740,873 | | | |
| Accrued interest and other liabilities | 96,807 | | | 43,958 | | | |
| Total noninterest bearing liabilities | 1,070,100 | | | 784,831 | | | |
| STOCKHOLDERS' EQUITY | 407,282 | | | 359,644 | | | |
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$4,890,023 | | | \$4,225,815 | | | |
| Net interest income ⁽¹⁾ | | \$40,943 | | | \$39,833 | | |
| Net interest spread ⁽¹⁾ | | | 3.53 | % | | 3.99 | % |

Edgar Filing: HEARTLAND FINANCIAL USA INC - Form 10-Q

| | | | | | | | | |
|--|-------|---|------|---|-------|---|------|---|
| Net interest income to total earning assets ⁽¹⁾ | | | 3.77 | % | | | 4.23 | % |
| Interest bearing liabilities to earning assets | 77.49 | % | | | 81.42 | % | | |

(1) Tax equivalent basis is calculated using an effective tax rate of 35%.

Provision For Loan And Lease Losses

The allowance for loan and lease losses is established through a provision charged to expense to provide, in Heartland management's opinion, an adequate allowance for loan and lease losses. The provision for loan and lease losses was \$637,000 for the first quarter of 2013 compared to \$2.4 million for the first quarter of 2012, a \$1.7 million or 73% decrease.

The adequacy of the allowance for loan and lease losses is determined by management using factors that include the overall composition of the loan portfolio, general economic conditions, types of loans, loan collateral values, past loss experience, loan delinquencies, substandard credits, and doubtful credits. For additional details on the specific factors considered, refer to the critical accounting policies and allowance for loan and lease losses sections of this report. Heartland believes the allowance for loan and lease losses as of March 31, 2013, was at a level commensurate with the overall risk exposure of the loan portfolio. However, if economic conditions should become more unfavorable, certain borrowers may experience difficulty and the level of nonperforming loans, charge-offs and delinquencies could rise and require further increases in the provision for loan and lease losses.

Noninterest Income

The table below shows Heartland's noninterest income for the three-month periods indicated, in thousands:

| | Three Months Ended | | | |
|---|--------------------|----------------|---------|----------|
| | March 31, 2013 | March 31, 2012 | Change | % Change |
| Noninterest Income: | | | | |
| Service charges and fees | \$4,008 | \$3,584 | \$424 | 12 % |
| Loan servicing income | 3,371 | 1,760 | 1,611 | 92 |
| Trust fees | 2,904 | 2,613 | 291 | 11 |
| Brokerage and insurance commissions | 951 | 910 | 41 | 5 |
| Securities gains, net | 3,427 | 3,943 | (516) | (13) |
| Gain (loss) on trading account securities, net | 314 | (3) | 317 | 10,567 |
| Impairment loss on securities | — | (981) | 981 | 100 |
| Gains on sale of loans | 9,912 | 8,502 | 1,410 | 17 |
| Valuation adjustment on mortgage servicing rights | 496 | 13 | 483 | 3,715 |
| Income on bank owned life insurance | 405 | 482 | (77) | (16) |
| Other noninterest income | 680 | 2,565 | (1,885) | (73) |
| Total noninterest income | \$26,468 | \$23,388 | \$3,080 | 13 % |

Noninterest income was \$26.5 million during the first quarter of 2013 compared to \$23.4 million during the first quarter of 2012, an increase of \$3.1 million or 13%. The categories contributing most significantly to the improvement in noninterest income in the first quarter of 2013 compared to the first quarter of 2012 were loan servicing income and gains on sale of loans.

Service charges and fees increased \$424,000 or 12% during the quarters under comparison. Service charges on checking and savings accounts recorded during the first quarter of 2013 were \$1.1 million compared to \$918,000 during the first quarter of 2012, an increase of \$194,000 or 21%. Overdraft fees were \$1.3 million during both the first quarter of 2013 and 2012. Interchange revenue from activity on bank debit cards, along with surcharges on ATM activity, resulted in service charges and fees of \$1.4 million during the first quarter of 2013 compared to \$1.2 million during the first quarter of 2012, an increase of \$112,000 or 9%.

Loan servicing income increased \$1.6 million or 92% for the first quarter of 2013 as compared to the first quarter of 2012 as mortgage servicing rights income, which is influenced by market interest rates for home mortgage loans and the level of loans Heartland originates and sells into the secondary market, increased significantly. Loan servicing income also includes the fees collected for the servicing of mortgage loans for others, which is dependent upon the aggregate outstanding balance of these loans, rather than quarterly production and sale of mortgage loans. Fees collected for the servicing of mortgage loans for others were \$1.4 million during the first quarter of 2013 compared to \$967,000 during the first quarter of 2012. The portfolio of mortgage loans serviced for others by Heartland totaled \$2.35 billion at March 31, 2013, compared to \$1.63 billion at March 31, 2012.

Gains on sale of loans, which result primarily from the sale of mortgage loans into the secondary market, totaled \$9.9 million during the first quarter of 2013 compared to \$8.5 million during the first quarter of 2012, an increase of \$1.4 million or 17%. The volume of mortgage loans sold totaled \$424.9 million during the first quarter of 2013, a 74% increase over the \$243.8 million sold during the first quarter of 2012.

The following table summarizes Heartland's residential mortgage loan activity during the most recent five quarters, in thousands:

| | As Of and For the Quarter Ended | | | | |
|---|---------------------------------|-------------|-------------|-------------|-------------|
| | 3/31/2013 | 12/31/2012 | 9/30/2012 | 6/30/2012 | 3/31/2012 |
| Mortgage Servicing Fees | \$1,430 | \$1,304 | \$1,123 | \$1,037 | \$967 |
| Mortgage Servicing Rights Income | 3,245 | 3,535 | 3,316 | 2,614 | 1,986 |
| Mortgage Servicing Rights Amortization | (1,761) | (1,871) | (1,896) | (1,112) | (1,718) |
| Total Residential Mortgage Loan Servicing Income | \$2,914 | \$2,968 | \$2,543 | \$2,539 | \$1,235 |
| Valuation Adjustment on Mortgage Servicing Rights | \$496 | \$197 | \$(493) | \$(194) | \$13 |
| Gains On Sale of Residential Mortgage Loans | \$9,641 | \$13,966 | \$13,750 | \$12,689 | \$8,502 |
| Total Residential Mortgage Loan Applications | \$556,890 | \$645,603 | \$672,382 | \$638,595 | \$549,315 |
| Residential Mortgage Loans Originated | \$432,974 | \$490,525 | \$488,658 | \$374,743 | \$293,724 |
| Residential Mortgage Loans Sold | \$424,931 | \$478,280 | \$448,704 | \$360,743 | \$243,836 |
| Residential Mortgage Loan Servicing Portfolio | \$2,349,596 | \$2,199,486 | \$1,963,567 | \$1,776,912 | \$1,626,129 |

As reflected in the table above, on a sequential quarterly basis, residential mortgage loan originations and the gains on sale of residential mortgage loans and the mortgage servicing rights income they create, decreased in the first quarter of 2013 as compared to the last quarter of 2012. These decreases resulted primarily from the seasonality typically experienced in mortgage loan activity during the first quarter of the year, coupled with a slight increase in residential mortgage loan interest rates and reduced spread on loan volume. Heartland believes long term success in the mortgage banking business depends on its ability to shift toward the origination of loans for the purchase of new homes versus the refinance of mortgages on existing homes. For the first quarter of 2013, refinancing activity represented 70% of total mortgage loan originations compared to 71% during the fourth quarter of 2012, 64% during the third quarter of 2012 and 58% during the second quarter of 2012. With continued expansion of its mortgage origination operations, Heartland expects to originate and sell into the secondary market over \$2.00 billion residential mortgage loans during 2013.

Trust fees increased \$291,000 or 11% during the first quarter of 2013 compared to the same quarter in 2012. A large portion of trust fees are based upon the market value of the trust assets under management, which was \$1.46 billion at March 31, 2013, compared to \$1.44 billion at March 31, 2012. Those values fluctuate throughout the year as market conditions improve or decline.

Securities gains totaled \$3.4 million during the first quarter of 2013 compared to \$3.9 million during the first quarter of 2012, as volatility in the bond market continued to provide opportunities to swap securities from one sector of the portfolio to another without significantly changing the duration of the portfolio.

During the first quarter of 2012, an impairment loss on three private-label mortgage-backed securities totaling \$981,000 was recorded. The charge related to a decline in the credit quality of these securities. Management does not anticipate further declines on these or any other securities within the portfolio due to credit quality, but will continue to monitor the portfolio for any further declines. Based on their analysis, management believes it is prudent to continue to hold these securities as their economic value exceeds their market value.

Trading securities contributed a net gain of \$314,000 during the first quarter of 2013 compared to a net loss of \$3,000 during the first quarter of 2012. The net gain during the first quarter of 2013 was primarily attributable to shares of Fannie Mae preferred stock Heartland has held in its trading securities portfolio since 2008.

Income on bank owned life insurance decreased \$77,000 or 16% during the first quarter of 2013 compared to the same quarter of 2012. A large portion of Heartland's bank owned life insurance is held in a separate account product, upon which the cash surrender value varies based upon the returns of the underlying policy assets.

Other noninterest income totaled \$680,000 during the first quarter of 2013 compared to \$2.6 million during the first quarter of 2012. Included in the other noninterest income during the first quarter of 2012 was \$2.0 million in equity earnings which resulted from the sale of two low-income housing projects within partnerships in which Dubuque Bank and Trust Company was a member.

Noninterest Expenses

The table below shows Heartland's noninterest expenses for the three-month periods indicated, in thousands:

| | Three Months Ended | | Change | % Change | |
|--------------------------------|--------------------|----------------|---------|----------|---|
| | March 31, 2013 | March 31, 2012 | | | |
| Noninterest Expenses: | | | | | |
| Salaries and employee benefits | \$29,740 | \$23,996 | \$5,744 | 24 | % |
| Occupancy | 3,185 | 2,482 | 703 | 28 | |
| Furniture and equipment | 2,051 | 1,446 | 605 | 42 | |
| Professional fees | 3,543 | 2,760 | 783 | 28 | |
| FDIC insurance assessments | 902 | 864 | 38 | 4 | |
| Advertising | 1,228 | 1,071 | 157 | 15 | |
| Intangible assets amortization | 200 | 131 | 69 | 53 | |
| Net loss on repossessed assets | 1,340 | 2,904 | (1,564) | (54) |) |
| Other noninterest expenses | 4,558 | 4,486 | 72 | 2 | |
| Total Noninterest Expenses | \$46,747 | \$40,140 | \$6,607 | 16 | % |

For the first quarter of 2013, noninterest expenses totaled \$46.7 million, an increase of \$6.6 million or 16% from the same quarter of 2012. The primary contributors to this increase were salaries and employee benefits, occupancy, furniture and equipment and professional fees.

The largest component of noninterest expense, salaries and employee benefits, increased \$5.7 million or 24% during the first quarter of 2013 compared to the first quarter of 2012, a large portion of which resulted from the expansion of Heartland's residential loan origination operations, with a smaller portion attributable to the additional employees joining Heartland through the acquisitions completed during the last two quarters of 2012. Full-time equivalent employees increased from 1,253 on March 31, 2012, to 1,532 on March 31, 2013, approximately 35 of which were from the acquisitions.

During the first quarter of 2013, occupancy expense increased \$703,000 or 28% and furniture and equipment expense increased \$605,000 or 42% when compared to the first quarter of 2012, primarily as a result of the residential loan origination operations expansion and the acquisitions completed during the last two quarters of 2012.

Professional fees increased \$783,000 or 28% during the first quarter of 2013 compared to the first quarter of 2012. These increases were primarily attributable to Heartland's expansion of its mortgage loan origination operations and Heartland's use of third-party providers.

Net losses on repossessed assets, the only noninterest expense category to experience a decrease during the first quarter of 2013 in comparison to the first quarter 2012, decreased by \$1.6 million or 54%, as real estate values have stabilized.

Other noninterest expenses increased \$72,000 or 2% during the first quarter of 2013 compared to the first quarter of 2012, a portion of which was attributable to the continued expansion of our mortgage origination operations. Included in noninterest expenses during the first quarter of 2012 was a \$300,000 provision to a reserve for the potential buyback of residential mortgage loans and a \$302,000 charge for an early payment obligation (\$238,000) and

remaining unamortized issuance costs (\$64,000) due to the early redemption of \$5.0 million of trust preferred securities.

Income Taxes

Heartland's effective tax rate was 29.39% for the first quarter of 2013 compared to 32.82% for the first quarter of 2012. Federal low-income housing tax credits included in Heartland's effective tax rate totaled \$200,000 during both the first quarter of 2013 and 2012. Heartland's effective tax rate is also affected by the level of tax-exempt interest income which, as a percentage of pre-tax income, was 23.81% during the first quarter of 2013 compared to 15.93% during the first quarter of 2012. The tax-

equivalent adjustment for this tax-exempt interest income was \$2.3 million during the first quarter of 2013 compared to \$1.6 million during the first quarter of 2012.

Segment Reporting

Heartland has two reportable segments: community and other banking and retail mortgage banking. Revenues from community and other banking operations consist primarily of interest earned on loans and investment securities and fees from deposit services. Retail mortgage banking operating revenues consist of interest earned on mortgage loans held for sale, gains on sales of loans into the secondary market, the servicing of mortgage loans for various investors and loan origination fee income. See Note 8 to our consolidated financial statements for further information regarding our segment reporting.

Net income for the community and other banking segment for the first quarter of 2013 was \$16.2 million compared to \$17.4 million for the first quarter of 2012, a \$1.2 million or 7% decrease. Net interest income of \$38.3 million for the first quarter of 2013 was \$546,000 or 1% percent more than the net interest income of \$37.8 million for the first quarter of 2012. Provision for loan and lease losses was \$637,000 for the first quarter of 2013, a decrease of \$1.7 million or 73% from the \$2.4 million recorded during the first quarter of 2012. Noninterest income totaled \$13.4 million during the first quarter of 2013 compared to \$13.9 million during the first quarter of 2012, a \$542,000 or 4% decrease. Noninterest expense was \$34.9 million during the first quarter of 2013 compared to \$31.9 million during the first quarter of 2012, an increase of \$3.0 million or 9%.

Net income for the retail mortgage banking segment for the first quarter of 2013 was \$1.6 million compared to \$1.7 million for the first quarter of 2012, a \$97,000 or 6% decrease. Net interest income of \$334,000 for the first quarter of 2013 was \$72,000 or 18% percent less than the net interest income of \$406,000 for the first quarter of 2012. Noninterest income totaled \$13.1 million during the first quarter of 2013 compared to \$9.5 million during the first quarter of 2012, a \$3.6 million or 38% decrease. Noninterest expense was \$11.8 million during the first quarter of 2013 compared to \$8.2 million during the first quarter of 2012, an increase of \$3.60 million or 44%.

FINANCIAL CONDITION

Total assets were \$4.90 billion at March 31, 2013, a decrease of \$90.0 million since December 31, 2012. Securities represented 32% of total assets at March 31, 2013, compared to 31% at year-end 2012.

Lending Activities

Total loans and leases held to maturity were \$2.79 billion at March 31, 2013, compared to \$2.82 billion at year-end 2012, a decrease of \$31.7 million or 4% annualized, a large portion of which was attributable to seasonal paydowns on agricultural and commercial lines of credit. Additionally, payoffs were received on loans to borrowers who obtained lower rates and more liberal terms from competitors, including some relationships we chose to exit due to increased credit risk evidenced in the relationship. Commercial and commercial real estate loans, which totaled \$1.99 billion at March 31, 2013, decreased \$10.7 million or 2% annualized since year-end 2012. Residential mortgage loans, which totaled \$240.5 million at March 31, 2013, decreased \$9.2 million or 15% annualized since year-end 2012. Agricultural and agricultural real estate loans, which totaled \$314.6 million at March 31, 2013, decreased \$13.7 million or 17% annualized since year-end 2012. Consumer loans, which totaled \$247.0 million at March 31, 2013, increased \$1.3 million or 2% annualized since year-end 2012.

The initial 5.00% dividend rate payable on the preferred stock issued to the U.S. Treasury under the SBLF is subject to reduction during the second through ninth quarter after issuance (through September 30, 2013, for Heartland) based upon increases in qualified small business lending ("QSBL") over a baseline amount, and may be reduced to as low as

1.00% if QSBL increases by ten percent or more over that period. Heartland's baseline amount was initially determined to be \$923.0 million, which would require growth in QSBL of \$92.3 million to have the dividend rate paid to the U.S. Treasury reduced to 1.00%. As a result of the acquisitions, Heartland's baseline amount was adjusted to \$1.02 billion, which would require growth in QSBL of \$102.0 million to have the dividend rate reduced to 1.00%. Through December 31, 2012, Heartland's QSBL had grown by \$123.0 million or 12.1%, but slipped backwards to \$96.2 million or 9.5% at March 31, 2013. The dividend rate on Heartland's \$81.7 million preferred stock issued to the U.S. Treasury was 2.00% for the first quarter of 2013, and will be 1.00% for the second quarter of 2013 and 2.00% for the third quarter of 2013.

The table below presents the composition of the loan portfolio as of March 31, 2013, and December 31, 2012, in thousands:

LOAN PORTFOLIO

| | March 31, 2013 | | December 31, 2012 | | |
|--|----------------|---------|-------------------|---------|---|
| | Amount | Percent | Amount | Percent | |
| Loans and leases receivable held to maturity: | | | | | |
| Commercial | \$ 693,235 | 24.82 | % \$ 712,308 | 25.21 | % |
| Commercial real estate | 1,297,583 | 46.46 | 1,289,184 | 45.63 | |
| Agricultural and agricultural real estate | 314,606 | 11.26 | 328,311 | 11.62 | |
| Residential mortgage | 240,453 | 8.62 | 249,689 | 8.84 | |
| Consumer | 246,996 | 8.84 | 245,678 | 8.70 | |
| Gross loans and leases receivable held to maturity | 2,792,873 | 100.00 | % 2,825,170 | 100.00 | % |
| Unearned discount | (479) | | (676) | | |
| Deferred loan fees | (2,501) | | (2,945) | | |
| Total net loans and leases receivable held to maturity | 2,789,893 | | 2,821,549 | | |
| Loans covered under loss share agreements: | | | | | |
| Commercial and commercial real estate | \$ 2,738 | 40.62 | % \$ 3,074 | 42.38 | % |
| Agricultural and agricultural real estate | 453 | 6.72 | 748 | 10.31 | |
| Residential mortgage | 2,722 | 40.38 | 2,645 | 36.47 | |
| Consumer | 828 | 12.28 | 786 | 10.84 | |
| Total loans covered under loss share agreements | 6,741 | 100.00 | % 7,253 | 100.00 | % |
| Allowance for loan and lease losses | (37,528) | | (38,715) | | |
| Loans and leases receivable, net | \$ 2,759,106 | | \$ 2,790,087 | | |

Loans and leases secured by real estate, either fully or partially, totaled \$1.94 billion or 69% of total loans and leases at March 31, 2013. Of the non-farm, nonresidential loans, 60% are owner occupied. The largest categories within Heartland's real estate secured loans at March 31, 2013, and December 31, 2012, are listed below, in thousands:

LOANS SECURED BY REAL ESTATE

| | March 31, 2013 | December 31, 2012 |
|---|----------------|-------------------|
| Residential real estate, excluding residential construction and residential lot loans | \$ 518,161 | \$ 523,071 |
| Industrial, manufacturing, business and commercial | 264,841 | 241,369 |
| Agriculture | 199,842 | 211,823 |
| Retail | 171,975 | 171,974 |
| Office | 166,863 | 154,681 |
| Land development and lots | 104,355 | 104,716 |
| Hotel, resort and hospitality | 99,017 | 96,928 |
| Multi-family | 76,907 | 76,606 |
| Food and beverage | 78,668 | 79,222 |
| Warehousing | 72,831 | 74,634 |
| Health services | 53,317 | 45,469 |
| Residential construction | 34,455 | 31,351 |
| All other | 96,431 | 101,866 |
| Total loans secured by real estate | \$ 1,937,663 | \$ 1,913,710 |

The process utilized by Heartland to determine the adequacy of the allowance for loan and lease losses is considered a critical accounting practice for Heartland. The allowance for loan and lease losses represents management's estimate of identified and unidentified probable losses in the existing loan portfolio. For additional details on the specific factors considered, refer to the critical accounting policies section of our Annual Report on Form 10-K for the year

ended December 31, 2012.

Exclusive of loans covered under loss sharing agreements, the allowance for loan and lease losses at March 31, 2013, was 1.35% of loans and leases and 114.38% of nonperforming loans compared to 1.37% of loans and leases and 89.71% of nonperforming loans at December 31, 2012.

Nonperforming loans, exclusive of those covered under the loss sharing agreements, were \$32.8 million or 1.18% of total loans and leases at March 31, 2013, compared to \$43.2 million or 1.53% of total loans and leases at December 31, 2012. Approximately 42%, or \$13.7 million, of Heartland's nonperforming loans have individual loan balances exceeding \$1.0 million. These nonperforming loans, to an aggregate of 7 borrowers, are primarily concentrated in Heartland's banks serving the Western states, with \$4.4 million originated by New Mexico Bank & Trust, \$4.1 million originated by Rocky Mountain Bank, \$1.7 million originated by Galena State Bank & Trust Co., \$1.3 million originated by Riverside Community Bank, \$1.2 million originated by Arizona Bank & Trust and \$1.0 million originated by Wisconsin Bank & Trust. The portion of Heartland's nonperforming loans covered by government guarantees was \$454,000 at March 31, 2013. The industry breakdown for nonperforming loans with individual balances exceeding \$1.0 million, as identified using the North American Industry Classification System (NAICS), was \$8.4 million for lot and land development. The remaining \$5.3 million was distributed among four other industry categories.

Other real estate owned was \$36.7 million at March 31, 2013, compared to \$35.8 million at December 31, 2012. Liquidation strategies have been identified for all the assets held in other real estate owned. Management continues to market these properties through an orderly liquidation process instead of a quick liquidation process in order to avoid discounts greater than the projected carrying costs. During the first quarter of 2013, \$3.3 million of other real estate owned was sold.

Net charge-offs on loans during the first quarter of 2013 were \$1.8 million compared to net recoveries of \$200,000 during the first quarter of 2012.

Delinquencies in each of the loan portfolios continue to be well-managed and no significant adverse trends were identified during the first quarter of 2013. Loans delinquent 30 to 89 days as a percent of total loans were 0.48% at March 31, 2013, compared to 0.32% at December 31, 2012, 0.53% at September 30, 2012, 0.46% at June 30, 2012, and 0.55% at March 31, 2012.

The table below presents the changes in the allowance for loan and lease losses during the periods indicated, in thousands:

ANALYSIS OF ALLOWANCE FOR LOAN AND LEASE LOSSES

| | Three Months Ended | |
|--|--------------------|----------------|
| | March 31, 2013 | March 31, 2012 |
| Balance at beginning of period | \$38,715 | \$36,808 |
| Provision for loan and lease losses | 637 | 2,354 |
| Recoveries on loans and leases previously charged off | 1,240 | 1,808 |
| Charge-offs on loans and leases not covered by loss share agreements | (3,041 |) (1,608 |
| Charge-offs on loans and leases covered by loss share agreements | (23 |) — |
| Balance at end of period | \$37,528 | \$39,362 |
| Annualized ratio of net charge offs to average loans and leases | 0.26 | % (0.03 |
| | |)% |

The table below presents the amounts of nonperforming loans and leases and other nonperforming assets on the dates indicated, in thousands:

NONPERFORMING ASSETS

| | March 31, 2013 | 2012 | December 31, 2012 | 2011 | |
|--|-------------------|----------|----------------------|-----------|---|
| Not covered under loss share agreements: | | | | | |
| Nonaccrual loans and leases | \$32,356 | \$49,940 | \$43,156 | \$57,435 | |
| Loan and leases contractually past due 90 days or more | 454 | — | — | — | |
| Total nonperforming loans and leases | 32,810 | 49,940 | 43,156 | 57,435 | |
| Other real estate | 35,697 | 38,693 | 35,470 | 43,506 | |
| Other repossessed assets | 1,059 | 710 | 542 | 648 | |
| Total nonperforming assets not covered under loss share agreements | \$69,566 | \$89,343 | \$79,168 | \$101,589 | |
| Covered under loss share agreements: | | | | | |
| Nonaccrual loans and leases | \$636 | \$3,189 | \$1,259 | \$3,345 | |
| Loan and leases contractually past due 90 days or more | — | — | — | — | |
| Total nonperforming loans and leases | 636 | 3,189 | 1,259 | 3,345 | |
| Other real estate | 1,007 | 241 | 352 | 881 | |
| Other repossessed assets | — | — | — | — | |
| Total nonperforming assets covered under loss share agreements | \$1,643 | \$3,430 | \$1,611 | 4,226 | |
| Performing troubled debt restructured loans ⁽¹⁾ | \$24,473 | \$21,379 | \$21,121 | \$25,704 | |
| Nonperforming loans and leases not covered under loss share agreements to total loans and leases | 1.18 | % 1.97 | % 1.53 | % 2.31 | % |
| Nonperforming assets not covered under loss share agreements to total loans and leases plus repossessed property | 2.46 | % 3.47 | % 2.77 | % 4.02 | % |
| Nonperforming assets not covered under loss share agreements to total assets | 1.42 | % 2.07 | % 1.59 | % 2.39 | % |

(1) Represents accruing troubled debt restructured loans performing according to their restructured terms.

The schedules below summarize the changes in Heartland's nonperforming assets, including those covered by loss share agreements, during the first quarter of 2013, in thousands:

| | Nonperforming Loans | Other Real Estate Owned | Other Repossessed Assets | Total Nonperforming Assets | |
|---|------------------------|-------------------------------|--------------------------------|----------------------------------|---|
| December 31, 2012 | \$44,415 | \$35,822 | \$542 | \$80,779 | |
| Loan foreclosures | (5,330) |) 4,843 | 487 | — | |
| Net loan recoveries | (1,824) |) — | — | (1,824) |) |
| New nonperforming loans | 3,362 | — | — | 3,362 | |
| Reduction of nonperforming loans ⁽¹⁾ | (7,177) |) — | — | (7,177) |) |
| OREO/Repossessed assets sales proceeds | — | (3,292) |) (31) | (3,323) |) |
| OREO/Repossessed assets writedowns, net | — | (669) |) (23) | (692) |) |
| Net activity at Citizens Finance Co. | — | — | 84 | 84 | |
| March 31, 2013 | \$33,446 | \$36,704 | \$1,059 | \$71,209 | |

(1) Includes principal reductions and transfers to performing status.

Securities

The composition of Heartland's securities portfolio is managed to maximize the return on the portfolio while considering the impact it has on Heartland's asset/liability position and liquidity needs. Securities represented 32% of total assets at March 31, 2013, compared to 31% at year-end 2012. Total available for sale securities as of March 31, 2013, were \$1.52 billion, an increase of \$18.5 million or 1% from \$1.51 billion at December 31, 2012.

The composition of the securities portfolio changed slightly as a larger portion of the securities sales were in the lower-yielding U.S. government corporations and agency securities versus the mortgage-backed and municipal securities. The percentage of mortgage-backed securities was 67% at both March 31, 2013, and December 31, 2012. Approximately 82% of Heartland's mortgage-backed securities were issuances of government-sponsored enterprises at March 31, 2013. Heartland's securities portfolio had an expected duration of 4.05 years as of March 31, 2013.

The table below presents the composition of the securities portfolio, including trading, available for sale and held to maturity, by major category, as of March 31, 2013, and December 31, 2012, in thousands:

SECURITIES PORTFOLIO COMPOSITION

| | March 31, 2013 | | December 31, 2012 | | |
|---|----------------|---------|-------------------|---------|---|
| | Amount | Percent | Amount | Percent | |
| U.S. government corporations and agencies | \$8,174 | 0.52 | % \$21,444 | 1.37 | % |
| Mortgage-backed securities | 1,066,908 | 67.49 | 1,043,241 | 66.79 | |
| Obligation of states and political subdivisions | 483,833 | 30.61 | 474,907 | 30.41 | |
| Other securities | 21,804 | 1.38 | 22,365 | 1.43 | |
| Total securities | \$1,580,719 | 100.00 | % \$1,561,957 | 100.00 | % |

Deposits And Borrowed Funds

Total deposits were \$3.84 billion at March 31, 2013, compared to \$3.85 billion at year-end 2012, a decrease of \$3.2 million or less than 1% annualized. Demand deposits totaled \$971.1 million at March 31, 2013, a decrease of \$3.1 million or 1% annualized since year-end 2012. Also experiencing a decrease during the quarter, certificates of deposit totaled \$848.7 million at March 31, 2013, a decrease of \$18.3 million or 8% annualized. Savings deposits experienced an increase during the quarter, growing to \$2.02 billion at March 31, 2013, an increase of \$18.2 million or 4% annualized. The composition of Heartland's deposits continued its positive trend as no-cost demand deposits as a percentage of total deposits was 25% at both March 31, 2013, and December 31, 2012, while higher-cost certificates of deposit as a percentage of total deposits was 22% at March 31, 2013, compared to 23% at December 31, 2012.

Short-term borrowings generally include federal funds purchased, treasury tax and loan note options, securities sold under agreements to repurchase, short-term FHLB advances and discount window borrowings from the Federal Reserve Bank. These funding alternatives are utilized in varying degrees depending on their pricing and availability. All of Heartland's bank subsidiaries own FHLB stock in either the Chicago, Dallas, Des Moines, Seattle, San Francisco or Topeka FHLB, enabling them to borrow funds from their respective FHLB for short- or long-term purposes under a variety of programs. The amount of short-term borrowings was \$202.7 million at March 31, 2013, compared to \$224.6 million at year-end 2012, a decrease of \$21.9 million or 10%, resulting primarily from a \$47.5 million decline in retail repurchase agreement balances, which was partially offset by a \$35.6 million increase in federal funds purchased. Also contributing to the decrease during the first quarter of 2013 was the maturity of the only short-term FHLB advance outstanding at year-end 2012 in the amount of \$10.0 million.

All of the bank subsidiaries provide retail repurchase agreements to their customers as a cash management tool, sweeping excess funds from demand deposit accounts into these agreements. This source of funding does not increase the bank's reserve requirements. Although the aggregate balance of these retail repurchase agreements is subject to

variation, the account relationships represented by these balances are principally local. The balances of retail repurchase agreements were \$155.8 million at March 31, 2013, compared to \$203.3 million at December 31, 2012, a decrease of \$47.5 million or 23%, primarily driven by seasonal activity.

Also included in short-term borrowings are the revolving credit lines Heartland has with two unaffiliated banks, primarily to provide liquidity to Heartland. These credit lines may also be used to fund the operations of Heartland Community Development Inc., a wholly-owned subsidiary of Heartland formed to hold and manage certain nonperforming loans and assets and to allow the liquidation of those assets at a time that is more economically advantageous. Under these unsecured revolving

credit lines, Heartland may borrow up to \$10.0 million at any one time. There was no balance outstanding on these revolving credit lines at both March 31, 2013, and December 31, 2012.

As of March 31, 2013, the amount of other borrowings was \$336.6 million, a decrease of \$52.4 million or 13% since year-end 2012, primarily due to the maturity of \$27.0 million in long-term FHLB advances and \$15.0 million in structured wholesale repurchase agreements. At March 31, 2013, long-term FHLB borrowings with an original term beyond one year totaled \$116.1 million compared to \$143.2 million at December 31, 2012, a decrease of \$27.1 million or 19%. Total long-term FHLB borrowings at March 31, 2013, had an average rate of 3.31% and an average maturity date of April 2015. When considering the earliest possible call date on these advances, the average maturity date is shortened to December 2013. Structured wholesale repurchase agreements totaled \$60.0 million at March 31, 2013, compared to \$85.0 million at December 31, 2012, a decrease of \$25.0 million or 29%.

The balances outstanding on trust preferred capital securities issued by Heartland are also included in other borrowings. A schedule of Heartland's trust preferred offerings outstanding as of March 31, 2013, is as follows, in thousands:

| Amount Issued | Issuance Date | Interest Rate | Interest Rate as of March 31, 2013 ⁽¹⁾ | Maturity Date | Callable Date |
|---------------|---------------|------------------|---|---------------|---------------|
| \$20,619 | 10/10/2003 | 8.25% | 8.25% | 10/10/2033 | 06/30/2013 |
| 25,774 | 03/17/2004 | 2.75% over LIBOR | 3.03% ⁽²⁾ | 03/17/2034 | 06/17/2013 |
| 20,619 | 01/31/2006 | 1.33% over LIBOR | 1.63% ⁽³⁾ | 04/07/2036 | 07/07/2013 |
| 20,619 | 06/21/2007 | 6.75% | 6.75% ⁽⁴⁾ | 09/15/2037 | 06/15/2013 |
| 20,619 | 06/26/2007 | 1.48% over LIBOR | 1.77% ⁽⁵⁾ | 09/01/2037 | 06/01/2013 |
| \$108,250 | | | | | |

(1) Effective weighted average interest rate as of March 31, 2013, was 5.91% due to interest rate swap transactions on the variable rate securities as discussed in Note 6 to Heartland's consolidated financial statements.

(2) Effective interest rate as of March 31, 2013, was 5.33% due to an interest rate swap transaction as discussed in Note 6 to Heartland's consolidated financial statements.

(3) Effective interest rate as of March 31, 2013, was 4.69% due to an interest rate swap transaction as discussed in Note 6 to Heartland's consolidated financial statements.

(4) Interest rate is fixed at 6.75% through June 15, 2017 then resets to 1.48% over LIBOR for the remainder of the term.

(5) Effective interest rate as of March 31, 2013, was 4.70% due to an interest rate swap transaction as discussed in Note 6 to Heartland's consolidated financial statements.

Other borrowings also include all debt arrangements Heartland and its subsidiaries have entered into with original maturities that extend beyond one year. The outstanding balance on Heartland's amortizing term loan with an unaffiliated bank was \$12.7 million at March 31, 2013, compared to \$13.0 million at December 31, 2012. Heartland also had senior notes totaling \$37.5 million outstanding at both March 31, 2013, and December 31, 2012.

COMMITMENTS AND CONTRACTUAL OBLIGATIONS

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Heartland banks evaluate each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Heartland banks upon extension of credit, is based upon management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment and

income-producing commercial properties. Standby letters of credit and financial guarantees written are conditional commitments issued by the Heartland banks to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. At March 31, 2013, and December 31, 2012, commitments to extend credit aggregated \$926.8 million and \$844.6 million, and standby letters of credit aggregated \$33.7 million and \$29.5 million, respectively.

Contractual obligations and other commitments were presented in Heartland's Annual Report on Form 10-K for the year ended December 31, 2012. There have been no material changes in Heartland's contractual obligations and other commitments since that report was filed.

CAPITAL RESOURCES

Bank regulatory agencies have adopted capital standards by which all bank holding companies will be evaluated. Under the risk-based method of measurement, the resulting ratio is dependent upon not only the level of capital and assets, but also the composition of assets and capital and the amount of off-balance sheet commitments. Heartland and its bank subsidiaries have been, and will continue to be, managed so they meet the well-capitalized requirements under the regulatory framework for prompt corrective action. To be categorized as well capitalized under the regulatory framework, bank holding companies and banks must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios of 10%, 6% and 4%, respectively. The most recent notification from the FDIC categorized Heartland and each of its bank subsidiaries as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed each institution's category.

Heartland's capital ratios were as follows for the dates indicated, in thousands:

CAPITAL RATIOS

| | March 31, 2013 | | December 31, 2012 | | |
|---|----------------|-------|-------------------|-------|---|
| | Amount | Ratio | Amount | Ratio | |
| Risk-Based Capital Ratios ⁽¹⁾ | | | | | |
| Tier 1 capital | \$477,476 | 13.93 | % \$463,371 | 13.36 | % |
| Tier 1 capital minimum requirement | 137,150 | 4.00 | % 138,743 | 4.00 | % |
| Excess | \$340,326 | 9.93 | % \$324,628 | 9.36 | % |
| Total capital | \$538,232 | 15.70 | % \$532,502 | 15.35 | % |
| Total capital minimum requirement | 274,300 | 8.00 | % 277,485 | 8.00 | % |
| Excess | \$263,932 | 7.70 | % \$255,017 | 7.35 | % |
| Total risk-adjusted assets | \$3,428,751 | | \$3,468,565 | | |
| Leverage Capital Ratios ⁽²⁾ | | | | | |
| Tier 1 capital | \$477,476 | 9.83 | % \$463,371 | 9.84 | % |
| Tier 1 capital minimum requirement ⁽³⁾ | 194,363 | 4.00 | % 188,284 | 4.00 | % |
| Excess | \$283,113 | 5.83 | % \$275,087 | 5.84 | % |
| Average adjusted assets (less goodwill and other intangible assets) | \$4,859,082 | | \$4,707,110 | | |

(1) Based on the risk-based capital guidelines of the Federal Reserve, a bank holding company is required to maintain a Tier 1 capital to risk-adjusted assets ratio of 4.00% and total capital to risk-adjusted assets ratio of 8.00%.

(2) The leverage ratio is defined as the ratio of Tier 1 capital to average adjusted assets.

(3) Management of Heartland has established a minimum target leverage ratio of 4.00%. Based on Federal Reserve guidelines, a bank holding company generally is required to maintain a leverage ratio of 3.00% plus additional capital of at least 100 basis points.

Minnesota Bank & Trust, Heartland's tenth bank, began operations on April 15, 2008, in Edina, Minnesota. Heartland's initial investment in this de novo bank was \$13.2 million, or 80%, of the \$16.5 million initial capital. All minority stockholders entered into a stock transfer agreement that imposed certain restrictions on the sale, transfer or other disposition of their shares in Minnesota Bank & Trust and allowed, but did not require, Heartland to repurchase the shares from investors after five years of operations. As of April 15, 2013, Heartland completed the repurchase of all minority shares of Minnesota Bank & Trust. The shareholders were offered the option to receive Heartland common stock for the portion of the repurchase price that represented their original investment and to also receive the appreciation in their original investment in the form of Heartland common stock. The stock transfer agreement also contained provisions for the valuation of Minnesota Bank & Trust by Sheshunoff & Co. as of the repurchase date, and for that valuation to be completed within 30 days after the repurchase date. Sheshunoff advised Heartland that it

would not be possible to complete the valuation within 30 days. As such, Heartland offered to pay the minimum repurchase price to which the shareholders were entitled as of April 15, 2013, and agreed to pay any higher amount per share if determined appropriate, when Sheshunoff completes its valuation. Six shareholders elected to receive 51,015 shares of Heartland common stock for all or a portion of their investment and the remaining shareholders elected to receive cash totaling \$3.2 million.

LIQUIDITY

Liquidity refers to Heartland's ability to maintain a cash flow that is adequate to meet maturing obligations and existing commitments, to withstand fluctuations in deposit levels, to fund operations and to provide for customers' credit needs. The liquidity of Heartland principally depends on cash flows from operating activities, investment in and maturity of assets, changes in balances of deposits and borrowings and its ability to borrow funds in the money or capital markets.

Operating activities provided \$12.4 million of cash during the first three months of 2013 compared to using \$27.9 million of cash during the first three months of 2012. The biggest contributor to this change was activity associated with the origination of loans for sale which provided \$4.5 million of cash for the first three months of 2013 compared to using \$49.9 million of cash during the first three months of 2012.

Investing activities used cash of \$27.0 million during the first three months of 2013 compared to providing \$21.3 million during the first three months of 2012. Cash used for the purchase of securities totaled \$207.5 million during the first quarter of 2013 compared to \$124.2 million during the first three months of 2012. The proceeds from securities sales, paydowns and maturities was \$158.4 million during the first three months of 2013 compared to \$201.2 million during the first three months of 2012. A net decrease in loans and leases provided \$25.0 million of cash during the first three months of 2013 compared to a net increase in loans and leases using cash of \$57.7 million during the first three months of 2012.

Financing activities used cash of \$78.9 million during the first three months of 2013 compared to providing \$26.9 million during the first three months of 2012. A net decrease in deposit accounts used \$3.2 million of cash during the first three months of 2013 compared to providing cash of \$65.6 million during the first three months of 2012. Activity in short-term borrowings used cash of \$21.9 million during the first three months of 2013 compared to \$40.5 million during the first three months of 2012. There were no cash proceeds from other borrowings during the first three months of 2013 compared to proceeds of \$10.1 million during the first three months of 2012. Repayment of other borrowings used cash of \$52.4 million during the first three months of 2013 compared to \$5.6 million during the first three months of 2012.

Management of investing and financing activities, and market conditions, determine the level and the stability of net interest cash flows. Management attempts to mitigate the impact of changes in market interest rates to the extent possible, so that balance sheet growth is the principal determinant of growth in net interest cash flows.

In the event of short-term liquidity needs, the bank subsidiaries may purchase federal funds from each other or from correspondent banks and may also borrow from the Federal Reserve Bank. Additionally, the subsidiary banks' FHLB memberships give them the ability to borrow funds for short- and long-term purposes under a variety of programs.

At March 31, 2013, Heartland's revolving credit agreements with two unaffiliated banks provided a maximum borrowing capacity of \$10.0 million, of which nothing had been borrowed. These credit agreements contain specific covenants, with which Heartland was in compliance on March 31, 2013.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk is the risk of loss arising from adverse changes in market prices and rates. Heartland's market risk is comprised primarily of interest rate risk resulting from its core banking activities of lending and deposit gathering. Interest rate risk measures the impact on earnings from changes in interest rates and the effect on current fair market values of Heartland's assets, liabilities and off-balance sheet contracts. The objective is to measure this risk and manage the balance sheet to avoid unacceptable potential for economic loss.

Management continually develops and applies strategies to mitigate market risk. Exposure to market risk is reviewed on a regular basis by the asset/liability committees of the banks and, on a consolidated basis, by Heartland's executive management and board of directors. Darling Consulting Group, Inc. has been engaged to provide asset/liability management position assessment and strategy formulation services to Heartland and its bank subsidiaries. At least quarterly, a detailed review of the balance sheet risk profile is performed for Heartland and each of its bank subsidiaries. Included in these reviews are interest rate sensitivity analyses, which simulate changes in net interest income in response to various interest rate scenarios. These analyses consider current portfolio rates, existing maturities, repricing opportunities and market interest rates, in addition to prepayments and growth under different interest rate assumptions. Selected strategies are modeled prior to implementation to determine their effect on Heartland's interest rate risk profile and net interest income. Management does not believe that Heartland's primary market risk exposures have changed significantly in the first three months of 2013.

The core interest rate risk analysis utilized by Heartland examines the balance sheet under increasing and decreasing interest scenarios that are neither too modest nor too extreme. All rate changes are ramped over a 12-month horizon based upon a parallel shift in the yield curve and then maintained at those levels over the remainder of the simulation horizon. Using this approach, management is able to see the effect that both a gradual change of rates (year 1) and a rate shock (year 2 and beyond) could have on Heartland's net interest income. Starting balances in the model reflect actual balances on the "as of" date, adjusted for material and significant transactions. Pro-forma balances remain static. This enables interest rate risk embedded within the existing balance sheet structure to be isolated from the interest rate risk often caused by growth in assets and liabilities. Due to the low interest rate environment, the simulations under a decreasing interest rate scenario were prepared using a 100 basis point shift in rates. The most recent reviews at March 31, 2013, and March 31, 2012, provided the following results, in thousands:

| | 2013 | | 2012 | |
|-----------------------|---------------------|--------------------|---------------------|--------------------|
| | Net Interest Margin | % Change From Base | Net Interest Margin | % Change From Base |
| Year 1 | | | | |
| Down 100 Basis Points | \$ 146,669 | (0.95 |)% \$ 145,641 | (0.06 |
| Base | \$ 148,074 | | \$ 145,724 |)% |
| Up 200 Basis Points | \$ 150,200 | 1.44 | % \$ 142,990 | (1.88 |
| Year 2 | | | |)% |
| Down 100 Basis Points | \$ 141,730 | (4.28 |)% \$ 141,729 | (2.74 |
| Base | \$ 147,374 | (0.47 |)% \$ 145,160 | (0.39 |
| Up 200 Basis Points | \$ 157,820 | 6.58 | % \$ 146,965 | 0.85 |
| | | | | % |

Heartland uses derivative financial instruments to manage the impact of changes in interest rates on its future interest income or interest expense. Heartland is exposed to credit-related losses in the event of nonperformance by the counterparties to these derivative instruments, but believes it has minimized the risk of these losses by entering into the contracts with large, stable financial institutions. The estimated fair market values of these derivative instruments are presented in Note 6 to the consolidated financial statements.

Heartland 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 commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates and may require collateral from the borrower. Standby letters of credit are conditional commitments issued by Heartland to guarantee the performance of a customer to a third party up to a stated amount and with specified terms and conditions. These commitments to extend credit and standby letters of credit are not recorded on the balance sheet until the instrument is exercised.

Heartland holds a securities trading portfolio that would also be subject to elements of market risk. These securities are carried on the balance sheet at fair value. These securities had a carrying value of \$694,000 at March 31, 2013, and \$380,000 at December 31, 2012, and in both cases was less than 2% of total assets.

ITEM 4. CONTROLS AND PROCEDURES

Under the direction of our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) promulgated under the Securities and Exchange Act of 1934, as amended) as of March 31, 2013. Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in applicable rules and forms and that such information is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, in a manner that allows timely decisions regarding required disclosure.

There were no significant changes to Heartland's disclosure controls or internal controls over financial reporting during the first three months of 2013 that have materially affected or are reasonably likely to materially affect Heartland's internal control over financial reporting.

PART II

ITEM 1. LEGAL PROCEEDINGS

There are no material pending legal proceedings to which Heartland or its subsidiaries are a party other than ordinary routine litigation incidental to their respective businesses. While the ultimate outcome of current legal proceedings cannot be predicted with certainty, it is the opinion of management that the resolution of these legal actions should not have a material effect on Heartland's consolidated financial position or results of operations.

ITEM 1A. RISK FACTORS

There have been no material changes in the risk factors applicable to Heartland from those disclosed in Part I, Item 1A. "Risk Factors" in Heartland's 2012 Annual Report on Form 10-K. Please refer to that section of Heartland's Form 10-K for disclosures regarding the risks and uncertainties related to Heartland's business.

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

Effective January 24, 2008, Heartland's board of directors authorized management to acquire and hold up to 500,000 shares of common stock as treasury shares at any one time. During participation in the Treasury's Capital Purchase Program, which was terminated on September 15, 2011, Heartland was prohibited from any repurchase, redemption, or acquisition of its common stock, except for certain repurchases to the extent of increases in shares outstanding because of issuances under existing benefit plans. Heartland and its affiliated purchasers made no purchases of its common stock during the quarter ended March 31, 2013.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

In April 2013, Arizona Bank & Trust was released from the informal agreements it had entered with the FDIC in the spring of 2009.

ITEM 6. EXHIBITS

Exhibits

- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a)/15d-14(a).
- 32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Financial statement formatted in Extensible Business Reporting Language: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows, (v) the Consolidated Statements of Changes in Equity, and (vi) the Notes to Consolidated Financial Statements.

SIGNATURES

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

HEARTLAND FINANCIAL USA, INC.
(Registrant)

Principal Executive Officer

/s/ Lynn B. Fuller
By: Lynn B. Fuller
President and Chief Executive Officer

Principal Financial and Accounting Officer

/s/ John K. Schmidt
John K. Schmidt
Executive Vice President and Chief Financial
Officer

Dated: May 9, 2013