GERMAN AMERICAN BANCORP, INC.
Form 10-Q
November 09, 2018
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

Quarterly Report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended September 30, 2018

Commission File Number 001-15877

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

| | |
|---|---|
| Indiana | 35-1547518 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

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

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

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

YES x NO ¨

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

YES x NO ¨

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

| Large accelerated filer | Accelerated filer | Non-accelerated filer | Smaller reporting company ¨ | Emerging growth company ¨ |
|---|---|---|---|---|
| x | ¨ | ¨ | | |

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.
¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):
YES ¨ NO x

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

| Class | Outstanding at November 1, 2018 |
|---|---|
| Common Shares, no par value | 24,959,106 |

CAUTION REGARDING FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS

Information included in or incorporated by reference in this Quarterly Report on Form 10-Q, our other filings with the Securities and Exchange Commission (the “SEC”) and our press releases or other public statements, contains or may contain “forward-looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995. Please refer to the discussions of our forward-looking statements and associated risks in our Annual Report on Form 10-K for the year ended December 31, 2017, in Item 1, “Business – Forward-Looking Statements and Associated Risks” and our discussion of risk factors in Item 1A, “Risk Factors” of that Annual Report on Form 10-K, as updated from time to time in our subsequent SEC filings, including by Item 2 of Part I of this Report (“Management’s Discussion and Analysis of Financial Condition and Results of Operations”) at the conclusion of that Item 2 under the heading “Forward-Looking Statements and Associated Risks.”

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

| | September 30, 2018 | December 31, 2017 |
|---|---|---|
| ASSETS | | |
| Cash and Due from Banks | $ 50,980 | $ 58,233 |
| Federal Funds Sold and Other Short-term Investments | 14,604 | 12,126 |
| Cash and Cash Equivalents | 65,584 | 70,359 |
| | | |
| Securities Available-for-Sale, at Fair Value | 739,627 | 740,641 |
| Other Investments | 353 | 353 |
| | | |
| Loans Held-for-Sale, at Fair Value | 9,178 | 6,719 |
| | | |
| Loans | 2,340,173 | 2,145,019 |
| Less: Unearned Income | (3,548) | (3,381) |
| Allowance for Loan Losses | (16,051) | (15,694) |
| Loans, Net | 2,320,574 | 2,125,944 |
| | | |
| Stock in FHLB of Indianapolis and Other Restricted Stock, at Cost | 13,048 | 13,048 |
| Premises, Furniture and Equipment, Net | 69,267 | 54,246 |
| Other Real Estate | 100 | 54 |
| Goodwill | 60,913 | 54,058 |
| Intangible Assets | 4,635 | 2,102 |
| Company Owned Life Insurance | 46,918 | 46,385 |
| Accrued Interest Receivable and Other Assets | 33,572 | 30,451 |
| TOTAL ASSETS | $ 3,363,769 | $ 3,144,360 |
| | | |
| LIABILITIES | | |
| Non-interest-bearing Demand Deposits | $ 634,421 | $ 606,134 |
| Interest-bearing Demand, Savings, and Money Market Accounts | 1,605,818 | 1,490,033 |
| Time Deposits | 400,608 | 387,885 |
| Total Deposits | 2,640,847 | 2,484,052 |
| | | |
| FHLB Advances and Other Borrowings | 327,039 | 275,216 |
| Accrued Interest Payable and Other Liabilities | 19,760 | 20,521 |
| TOTAL LIABILITIES | 2,987,646 | 2,779,789 |
| | | |
| SHAREHOLDERS’ EQUITY | | |
| Preferred Stock, no par value; 500,000 shares authorized, no shares issued | — | — |
| Common Stock, no par value, $1 stated value; 45,000,000 shares authorized | 22,968 | 22,934 |
| Additional Paid-in Capital | 166,227 | 165,288 |
| Retained Earnings | 204,188 | 178,969 |
| Accumulated Other Comprehensive Loss | (17,260) | (2,620) |
| TOTAL SHAREHOLDERS’ EQUITY | 376,123 | 364,571 |
| TOTAL LIABILITIES AND SHAREHOLDERS’ EQUITY | $ 3,363,769 | $ 3,144,360 |
| End of period shares issued and outstanding | 22,968,078 | 22,934,403 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| INTEREST INCOME | | |
| Interest and Fees on Loans | $28,148 | $23,182 |
| Interest on Federal Funds Sold and Other Short-term Investments | 101 | 46 |
| Interest and Dividends on Securities: | | |
| Taxable | 2,970 | 2,688 |
| Non-taxable | 2,256 | 2,070 |
| TOTAL INTEREST INCOME | 33,475 | 27,986 |
| | | |
| INTEREST EXPENSE | | |
| Interest on Deposits | 3,535 | 1,959 |
| Interest on FHLB Advances and Other Borrowings | 1,392 | 1,110 |
| TOTAL INTEREST EXPENSE | 4,927 | 3,069 |
| | | |
| NET INTEREST INCOME | 28,548 | 24,917 |
| Provision for Loan Losses | 500 | 250 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 28,048 | 24,667 |
| | | |
| NON-INTEREST INCOME | | |
| Trust and Investment Product Fees | 1,585 | 1,301 |
| Service Charges on Deposit Accounts | 1,858 | 1,608 |
| Insurance Revenues | 1,827 | 1,728 |
| Company Owned Life Insurance | 251 | 317 |
| Interchange Fee Income | 1,847 | 1,186 |
| Other Operating Income | 639 | 608 |
| Net Gains on Sales of Loans | 866 | 952 |
| Net Gains on Securities | 90 | 575 |
| TOTAL NON-INTEREST INCOME | 8,963 | 8,275 |
| | | |
| NON-INTEREST EXPENSE | | |
| Salaries and Employee Benefits | 12,134 | 11,570 |
| Occupancy Expense | 1,967 | 1,694 |
| Furniture and Equipment Expense | 771 | 678 |
| FDIC Premiums | 324 | 241 |
| Data Processing Fees | 1,309 | 1,067 |
| Professional Fees | 793 | 551 |
| Advertising and Promotion | 851 | 1,315 |
| Intangible Amortization | 430 | 230 |
| Other Operating Expenses | 2,997 | 2,425 |
| TOTAL NON-INTEREST EXPENSE | 21,576 | 19,771 |
| | | |
| Income before Income Taxes | 15,435 | 13,171 |
| Income Tax Expense | 2,796 | 3,511 |
| NET INCOME | $12,639 | $9,660 |

| | | |
|---|---|---|
| Basic Earnings per Share | $0.55 | $0.42 |
| Diluted Earnings per Share | $0.55 | $0.42 |
| | | |
| Dividends per Share | $0.15 | $0.13 |

See accompanying notes to consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| INTEREST INCOME | | |
| Interest and Fees on Loans | $78,406 | $68,046 |
| Interest on Federal Funds Sold and Other Short-term Investments | 211 | 100 |
| Interest and Dividends on Securities: | | |
| Taxable | 8,930 | 8,109 |
| Non-taxable | 6,606 | 6,165 |
| TOTAL INTEREST INCOME | 94,153 | 82,420 |
| | | |
| INTEREST EXPENSE | | |
| Interest on Deposits | 8,666 | 5,028 |
| Interest on FHLB Advances and Other Borrowings | 3,860 | 2,937 |
| TOTAL INTEREST EXPENSE | 12,526 | 7,965 |
| | | |
| NET INTEREST INCOME | 81,627 | 74,455 |
| Provision for Loan Losses | 2,070 | 1,100 |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES | 79,557 | 73,355 |
| | | |
| NON-INTEREST INCOME | | |
| Trust and Investment Product Fees | 5,035 | 3,894 |
| Service Charges on Deposit Accounts | 4,972 | 4,570 |
| Insurance Revenues | 6,453 | 6,112 |
| Company Owned Life Insurance | 823 | 1,051 |
| Interchange Fee Income | 5,043 | 3,365 |
| Other Operating Income | 2,156 | 2,095 |
| Net Gains on Sales of Loans | 2,421 | 2,598 |
| Net Gains on Securities | 434 | 575 |
| TOTAL NON-INTEREST INCOME | 27,337 | 24,260 |
| | | |
| NON-INTEREST EXPENSE | | |
| Salaries and Employee Benefits | 36,279 | 34,474 |
| Occupancy Expense | 5,522 | 4,813 |
| Furniture and Equipment Expense | 2,152 | 1,965 |
| FDIC Premiums | 799 | 712 |
| Data Processing Fees | 3,834 | 3,122 |
| Professional Fees | 3,025 | 2,267 |
| Advertising and Promotion | 2,409 | 2,723 |
| Intangible Amortization | 942 | 725 |
| Other Operating Expenses | 8,777 | 7,002 |
| TOTAL NON-INTEREST EXPENSE | 63,739 | 57,803 |
| | | |
| Income before Income Taxes | 43,155 | 39,812 |
| Income Tax Expense | 7,606 | 10,757 |
| NET INCOME | $35,549 | $29,055 |

| | | |
|---|---|---|
| Basic Earnings per Share | $1.55 | $1.27 |
| Diluted Earnings per Share | $1.55 | $1.27 |
| | | |
| Dividends per Share | $0.45 | $0.39 |

See accompanying notes to consolidated financial statements.

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

| | Three Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| NET INCOME | $12,639 | $9,660 |
| Other Comprehensive Income (Loss): | | |
| Unrealized Gains (Losses) on Securities: | | |
| Unrealized Holding Gain (Loss)Arising During the Period | (4,889) | (1,450) |
| Reclassification Adjustment for Gains Included in Net Income | (90) | (575) |
| Tax Effect | 1,058 | 714 |
| Net of Tax | (3,921) | (1,311) |
| Total Other Comprehensive Income (Loss) | (3,921) | (1,311) |
| COMPREHENSIVE INCOME | $8,718 | $8,349 |

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| NET INCOME | $35,549 | $29,055 |
| Other Comprehensive Income (Loss): | | |
| Unrealized Gains (Losses) on Securities: | | |
| Unrealized Holding Gain (Loss) Arising During the Period | (18,181) | 14,862 |
| Reclassification Adjustment for Gains Included in Net Income | (434) | (575) |
| Tax Effect | 3,975 | (5,034) |
| Net of Tax | (14,640) | 9,253 |
| Total Other Comprehensive Income (Loss) | (14,640) | 9,253 |
| COMPREHENSIVE INCOME | $20,909 | $38,308 |

See accompanying notes to consolidated financial statements.

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

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net Income | $35,549 | $29,055 |
| Adjustments to Reconcile Net Income to Net Cash from Operating Activities: | | |
| Net Amortization on Securities | 2,698 | 2,591 |
| Depreciation and Amortization | 4,226 | 3,496 |
| Loans Originated for Sale | (101,867) | (95,278) |
| Proceeds from Sales of Loans Held-for-Sale | 101,802 | 104,639 |
| Provision for Loan Losses | 2,070 | 1,100 |
| Gain on Sale of Loans, net | (2,421) | (2,598) |
| Gain on Securities, net | (434) | (575) |
| Gain on Sales of Other Real Estate and Repossessed Assets | (13) | (8) |
| Loss (Gain) on Disposition and Donation of Premises and Equipment | (36) | 873 |
| Increase in Cash Surrender Value of Company Owned Life Insurance | (784) | (1,089) |
| Equity Based Compensation | 835 | 941 |
| Change in Assets and Liabilities: | | |
| Interest Receivable and Other Assets | (2,314) | (1,985) |
| Interest Payable and Other Liabilities | 3,147 | 2,656 |
| Net Cash from Operating Activities | 42,458 | 43,818 |
| | | |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Proceeds from Maturity of Securities Available-for-Sale | 58,926 | 61,763 |
| Proceeds from Sales of Securities Available-for-Sale | 22,919 | 48,343 |
| Purchase of Securities Available-for-Sale | (101,712) | (129,760) |
| Purchase of Loans | — | (211) |
| Proceeds from Sales of Loans | 6,000 | — |
| Loans Made to Customers, net of Payments Received | (85,183) | (97,976) |
| Proceeds from Sales of Other Real Estate | 54 | 912 |
| Property and Equipment Expenditures | (12,692) | (7,277) |
| Proceeds from Sales of Property and Equipment | 40 | 2 |
| Proceeds from Life Insurance | 251 | — |
| Cash from Acquisition of Bank Branches | 41,392 | — |
| Net Cash from Investing Activities | (70,005) | (124,204) |
| | | |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Change in Deposits | (18,804) | 75,211 |
| Change in Short-term Borrowings | 86,890 | (20,354) |
| Advances in Long-term Debt | 35,000 | 75,000 |
| Repayments of Long-term Debt | (70,122) | (50,834) |
| Issuance (Retirement) of Common Stock | 138 | (29) |
| Dividends Paid | (10,330) | (8,862) |
| Net Cash from Financing Activities | 22,772 | 70,132 |
| | | |
| Net Change in Cash and Cash Equivalents | (4,775) | (10,254) |

| | | |
|---|---|---|
| Cash and Cash Equivalents at Beginning of Year | 70,359 | 64,816 |
| Cash and Cash Equivalents at End of Period | $65,584 | $54,562 |
| | | |
| Cash Paid During the Period for | | |
| Interest | $12,432 | $7,823 |
| Income Taxes | 3,710 | 10,661 |
| | | |
| Supplemental Non Cash Disclosures | | |
| Loans Transferred to Other Real Estate | $87 | $1,230 |
| Reclassification of Land to Other Assets | — | 330 |

See accompanying notes to consolidated financial statements.

GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2018
(unaudited, dollars in thousands except share and per share data)

NOTE 1 – Basis of Presentation

German American Bancorp, Inc. operates primarily in the banking industry. The accounting and reporting policies of German American Bancorp, Inc. and its subsidiaries (hereinafter collectively referred to as the "Company") conform to U.S. generally accepted accounting principles. Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. All adjustments which are, in the opinion of management, necessary for a fair presentation of the results for the periods reported have been included in the accompanying unaudited consolidated financial statements, and all such adjustments are of a normal recurring nature. It is suggested that these consolidated financial statements and notes be read in conjunction with the financial statements and notes thereto in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. Certain items included in the prior period financial statements were reclassified to conform to the current presentation. There was no effect on net income or total shareholders' equity based on these reclassifications.

NOTE 2 - Revenue Recognition

In May 2014, the Financial Accounting Standards Board (the "FASB") issued ASU No. 2014-09, Revenue from Contracts with Customers (Topic 606). On January 1, 2018, the Company adopted ASU 2014-09 and all subsequent amendments to the ASU that modified Topic 606. Topic 606 creates a single framework for recognizing revenue from contracts with customers that fall within its scope and revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets. Since the guidance does not apply to revenue associated with financial instruments, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The majority of the Company's revenues are from financial instruments and are not within the scope of Topic 606. The Company completed its overall assessment of revenue streams and related contracts, including service charges on deposit accounts, interchange income, and trust and investment brokerage fees. Based on the assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams. The Company also completed its evaluation of certain costs related to these revenue streams to determine whether certain revenue streams should be reported gross versus net of certain expenses. Based on its evaluation, the Company determined that the classification of certain debit card related costs should change and now be reported as expenses versus contra-revenue. This reclassification change resulted in an immaterial impact to both revenue and expense. The Company adopted ASU 2014-09 and its related amendments utilizing the modified retrospective approach. Since there was no net income impact upon adoption of this guidance, a cumulative adjustment to retained earnings was not deemed necessary. Consistent with the modified retrospective approach, the Company did not adjust prior period amounts for the debit card costs noted above.

A description of the Company's revenue streams accounted for under Topic 606 follows:

Service Charges on Deposit Accounts: The Company earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as stop payment charges and statement rendering, are recognized at the time the transaction is executed (the point in time the Company fills the customer's request). Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs.

Interchange Fee Income: The Company earns interchange fees from debit/credit cardholder transactions conducted through various payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

Trust and Investment Product Fees: The Company earns trust and investment brokerage fees from its contracts with trust and brokerage customers to manage assets for investment and/or to transact their accounts. These fees are primarily earned over time as the Company provides the contracted monthly or quarterly services and are generally assessed based on the market value of assets under management at month-end. Fees that are transaction based, including trade execution services, are recognized at the point in time that the transaction is executed (trade date).

Insurance Revenues: The Company earns insurance revenue from commissions derived from the sale of personal and corporate property and casualty insurance products. These commissions are primarily earned over time as the Company provides the contracted insurance product to customers.

GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2018
(unaudited, dollars in thousands except share and per share data)

NOTE 2 - Revenue Recognition (continued)

The following tables present non-interest income, segregated by revenue streams in-scope and out-of-scope of Topic 606, for the three and nine months ended September 30, 2018 and 2017. Trust and investment product fees are included in the trust and investment advisory services segment while insurance revenues are included in the insurance segment. All other revenue streams are primarily included in the banking segment.

| | Three Months Ended September 30, | |
|---|---|---|
| Non-interest Income | 2018 | 2017 |
| In-Scope of Topic 606: | | |
| Trust and Investment Product Fees | $1,585 | $1,301 |
| Service Charges on Deposit Accounts | 1,858 | 1,608 |
| Insurance Revenues | 1,827 | 1,728 |
| Interchange Fee Income | 1,847 | 1,186 |
| Other Operating Income | 432 | 383 |
| Non-interest Income (in-scope of Topic 606) | 7,549 | 6,206 |
| Non-interest Income (out-of-scope of Topic 606) | 1,414 | 2,069 |
| Total Non-interest Income | $8,963 | $8,275 |

| | Nine Months Ended September 30, | |
|---|---|---|
| Non-interest Income | 2018 | 2017 |
| In-Scope of Topic 606: | | |
| Trust and Investment Product Fees | $5,035 | $3,894 |
| Service Charges on Deposit Accounts | 4,972 | 4,570 |
| Insurance Revenues | 6,453 | 6,112 |
| Interchange Fee Income | 5,043 | 3,365 |
| Other Operating Income | 1,252 | 1,114 |
| Non-interest Income (in-scope of Topic 606) | 22,755 | 19,055 |
| Non-interest Income (out-of-scope of Topic 606) | 4,582 | 5,205 |
| Total Non-interest Income | $27,337 | $24,260 |

GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2018
(unaudited, dollars in thousands except share and per share data)

NOTE 3 – Per Share Data

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

| | Three Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| Basic Earnings per Share: | | |
| Net Income | $12,639 | $ 9,660 |
| Weighted Average Shares Outstanding | 22,968,047 | 22,929,864 |
| Basic Earnings per Share | $0.55 | $ 0.42 |
| | | |
| Diluted Earnings per Share: | | |
| Net Income | $12,639 | $ 9,660 |
| | | |
| Weighted Average Shares Outstanding | 22,968,047 | 22,929,864 |
| Potentially Dilutive Shares, Net | — | — |
| Diluted Weighted Average Shares Outstanding | 22,968,047 | 22,929,864 |
| Diluted Earnings per Share | $0.55 | $ 0.42 |

For the three months ended September 30, 2018 and 2017, there were no anti-dilutive shares.

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| Basic Earnings per Share: | | |
| Net Income | $35,549 | $ 29,055 |
| Weighted Average Shares Outstanding | 22,958,977 | 22,922,724 |
| Basic Earnings per Share | $1.55 | $ 1.27 |
| | | |
| Diluted Earnings per Share: | | |
| Net Income | $35,549 | $ 29,055 |
| | | |
| Weighted Average Shares Outstanding | 22,958,977 | 22,922,724 |
| Potentially Dilutive Shares, Net | — | — |
| Diluted Weighted Average Shares Outstanding | 22,958,977 | 22,922,724 |
| Diluted Earnings per Share | $1.55 | $ 1.27 |

For the nine months ended September 30, 2018 and 2017, there were no anti-dilutive shares.

GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2018
(unaudited, dollars in thousands except share and per share data)

NOTE 4 – Securities

The amortized cost, unrealized gross gains and losses recognized in accumulated other comprehensive income (loss), and fair value of Securities Available-for-Sale at September 30, 2018 and December 31, 2017, were as follows:

| Securities Available-for-Sale: | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| September 30, 2018 | | | | |
| Obligations of State and Political Subdivisions | $ 284,991 | $ 2,473 | $ (3,425 ) | $ 284,039 |
| MBS/CMO - Residential | 476,252 | 38 | (20,702 ) | 455,588 |
| Total | $ 761,243 | $ 2,511 | $ (24,127 ) | $ 739,627 |
| December 31, 2017 | | | | |
| Obligations of State and Political Subdivisions | $ 267,437 | $ 6,733 | $ (861 ) | $ 273,309 |
| MBS/CMO - Residential | 476,205 | 416 | (9,289 ) | 467,332 |
| Total | $ 743,642 | $ 7,149 | $ (10,150 ) | $ 740,641 |

All mortgage-backed securities in the above table (identified above and throughout this Note 4 as "MBS/CMO - Residential") are residential mortgage-backed securities and guaranteed by government sponsored entities.

The Company's equity securities are listed as Investment Securities on the Consolidated Balance Sheets and consist of one non-controlling investment in a single banking organization at September 30, 2018 and December 31, 2017. The original investment totaled $1,350 and other-than-temporary impairment was previously recorded totaling $997. Under ASU 2016-01 (Financial Instruments - Overall), equity securities are required to be measured at fair value with changes in fair value recognized in net income. No fair value adjustments were recognized during 2018.

The amortized cost and fair value of securities at September 30, 2018 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because some issuers have the right to call or prepay certain obligations with or without call or prepayment penalties. Mortgage-backed Securities are not due at a single maturity date and are shown separately in the table below.

| Securities Available-for-Sale: | Amortized Cost | Fair Value |
|---|---|---|
| Due in one year or less | $ 1,765 | $ 1,772 |
| Due after one year through five years | 21,474 | 21,838 |
| Due after five years through ten years | 80,362 | 81,129 |
| Due after ten years | 181,390 | 179,300 |
| MBS/CMO - Residential | 476,252 | 455,588 |
| Total | $ 761,243 | $ 739,627 |

Proceeds from the Sales of Securities are summarized below:

| | Three Months Ended September 30, 2018 | Three Months Ended September 30, 2017 |
|---|---|---|
| Proceeds from Sales | $ 5,404 | $ 48,343 |
| Gross Gains on Sales | 90 | 575 |
| Income Taxes on Gross Gains | 19 | 201 |

GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2018
(unaudited, dollars in thousands except share and per share data)

NOTE 4 - Securities (continued)

| | Nine Months Ended September 30, 2018 | Nine Months Ended September 30, 2017 |
|---|---|---|
| Proceeds from Sales | $ 22,919 | $ 48,343 |
| Gross Gains on Sales | 434 | 575 |
| Income Taxes on Gross Gains | 92 | 201 |

The carrying value of securities pledged to secure repurchase agreements, public and trust deposits, and for other purposes as required by law was $208,959 and $165,404 as of September 30, 2018 and December 31, 2017, respectively.

Below is a summary of securities with unrealized losses as of September 30, 2018 and December 31, 2017, presented by length of time the securities have been in a continuous unrealized loss position:

| September 30, 2018 | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Obligations of State and Political Subdivisions | $ 109,010 | $ (2,085 ) | $ 27,524 | $ (1,340 ) | $ 136,534 | $ (3,425 ) |
| MBS/CMO - Residential | 174,305 | (4,989 ) | 278,806 | (15,713 ) | 453,111 | (20,702 ) |
| Total | $ 283,315 | $ (7,074 ) | $ 306,330 | $ (17,053 ) | $ 589,645 | $ (24,127 ) |

| December 31, 2017 | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss | Fair Value | Unrealized Loss |
| Obligations of State and Political Subdivisions | $ 33,230 | $ (237 ) | $ 24,161 | $ (624 ) | $ 57,391 | $ (861 ) |
| MBS/CMO - Residential | 172,354 | (2,048 ) | 250,520 | (7,241 ) | 422,874 | (9,289 ) |
| Total | $ 205,584 | $ (2,285 ) | $ 274,681 | $ (7,865 ) | $ 480,265 | $ (10,150 ) |

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

NOTE 5 – Derivatives

The Company executes interest rate swaps with commercial banking customers to facilitate their respective risk management strategies. The notional amounts of these interest rate swaps and the offsetting counterparty derivative instruments were $86.2 million at September 30, 2018 and $87.8 million at December 31, 2017. These interest rate swaps are simultaneously hedged by offsetting interest rate swaps that the Company executes with a third party, such that the Company minimizes its net risk exposure resulting from such transactions with approved, reputable, independent counterparties with substantially matching terms. The agreements are considered stand alone derivatives and changes in the fair value of derivatives are reported in earnings as non-interest income.

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

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NOTE 5 - Derivatives (continued)

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

| | September 30, 2018 | | December 31, 2017 | |
|---|---|---|---|---|
| | Notional Amount | Fair Value | Notional Amount | Fair Value |
| Included in Other Assets: | | | | |
| Interest Rate Swaps | $86,180 | $ 3,490 | $87,788 | $ 1,564 |
| Included in Other Liabilities: | | | | |
| Interest Rate Swaps | $86,180 | $ 3,425 | $87,788 | $ 1,633 |

The following table presents the effect of derivative instruments on the Consolidated Statements of Income for the periods presented:

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Interest Rate Swaps: | | | | |
| Included in Other Operating Income | $17 | $101 | $133 | $449 |

NOTE 6 – Loans

Loans were comprised of the following classifications at September 30, 2018 and December 31, 2017:

| | September 30, 2018 | December 31, 2017 |
|---|---|---|
| Commercial: | | |
| Commercial and Industrial Loans and Leases | $ 527,938 | $486,668 |
| Commercial Real Estate Loans | 985,915 | 926,729 |
| Agricultural Loans | 358,543 | 333,227 |
| Retail: | | |
| Home Equity Loans | 175,008 | 152,187 |
| Consumer Loans | 72,853 | 67,475 |
| Residential Mortgage Loans | 219,916 | 178,733 |
| Subtotal | 2,340,173 | 2,145,019 |
| Less: Unearned Income | (3,548) | (3,381) |
| Allowance for Loan Losses | (16,051) | (15,694) |
| Loans, Net | $ 2,320,574 | $2,125,944 |

As further described in Note 14, during 2018 the Company acquired loans with a fair value of $117,604 as part of a branch acquisition. This was made up of loans with an acquired balance of $120,484, net of $2,880 of fair value discounts at date of acquisition. At September 30, 2018, the remaining carrying amount of such loans totaled

$112,873, which is included in the September 30, 2018 table above. This amount is made up of loans with a remaining balance of $115,523 net of remaining fair value discounts of $2,650. No loans with deteriorated credit quality were acquired as part of the branch acquisition described in Note 14.

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NOTE 6 - Loans (continued)

The following tables present the activity in the allowance for loan losses by portfolio class for the three months ended September 30, 2018 and 2017:

| September 30, 2018 | Commercial and Industrial Loans and Leases | Commercial Real Estate Loans | Agricultural Loans | Home Equity Loans | Consumer Loans | Residential Mortgage Loans | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Beginning Balance | $ 3,563 | $ 4,958 | $ 5,578 | $ 366 | $ 347 | $ 366 | $ 459 | $ 15,637 |
| Provision for Loan Losses | (444) | 138 | 618 | (80) | 195 | 67 | 6 | 500 |
| Recoveries | 69 | 7 | 20 | 1 | 82 | 3 | — | 182 |
| Loans Charged-off | — | (9) | — | (10) | (238) | (11) | — | (268) |
| Ending Balance | $ 3,188 | $ 5,094 | $ 6,216 | $ 277 | $ 386 | $ 425 | $ 465 | $ 16,051 |

| September 30, 2017 | Commercial and Industrial Loans and Leases | Commercial Real Estate Loans | Agricultural Loans | Home Equity Loans | Consumer Loans | Residential Mortgage Loans | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Beginning Balance | $ 3,672 | $ 5,316 | $ 4,829 | $ 300 | $ 254 | $ 353 | $ 596 | $ 15,320 |
| Provision for Loan Losses | 204 | (81) | (10) | 37 | 135 | 56 | (91) | 250 |
| Recoveries | 1 | 4 | 9 | 6 | 78 | 3 | — | 101 |
| Loans Charged-off | (140) | (6) | — | — | (204) | — | — | (350) |
| Ending Balance | $ 3,737 | $ 5,233 | $ 4,828 | $ 343 | $ 263 | $ 412 | $ 505 | $ 15,321 |

The following tables present the activity in the allowance for loan losses by portfolio class for the nine months ended September 30, 2018 and 2017:

| September 30, 2018 | Commercial and Industrial Loans and Leases | Commercial Real Estate Loans | Agricultural Loans | Home Equity Loans | Consumer Loans | Residential Mortgage Loans | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| Beginning Balance | $ 4,735 | $ 4,591 | $ 4,894 | $ 330 | $ 298 | $ 343 | $ 503 | $ 15,694 |
| Provision for Loan Losses | (121) | 498 | 1,302 | (38) | 399 | 68 | (38) | 2,070 |
| Recoveries | 74 | 18 | 20 | 11 | 239 | 34 | — | 396 |
| Loans Charged-off | (1,500) | (13) | — | (26) | (550) | (20) | — | (2,109) |
| Ending Balance | $ 3,188 | $ 5,094 | $ 6,216 | $ 277 | $ 386 | $ 425 | $ 465 | $ 16,051 |

| September 30, 2017 | Commercial and Industrial | Commercial Real Estate Loans | Agricultural Loans | Home Equity Loans | Consumer Loans | Residential Mortgage Loans | Unallocated | Total |
|---|---|---|---|---|---|---|---|---|

| | Loans and Leases | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Beginning Balance | $ 3,725 | $ 5,452 | $ 4,094 | $ 283 | $ 235 | $ 329 | $ 690 | $ 14,808 |
| Provision for Loan Losses | 151 | (62) | 725 | 70 | 307 | 94 | (185) | 1,100 |
| Recoveries | 10 | 43 | 9 | 8 | 205 | 38 | — | 313 |
| Loans Charged-off | (149) | (200) | — | (18) | (484) | (49) | — | (900) |
| Ending Balance | $ 3,737 | $ 5,233 | $ 4,828 | $ 343 | $ 263 | $ 412 | $ 505 | $ 15,321 |

In determining the adequacy of the allowance for loan loss, general allocations are made for pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on historical averages for loan losses for these portfolios, judgmentally adjusted for current economic factors and portfolio trends.

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NOTE 6 - Loans (continued)

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

Specific allocations on impaired loans are determined by comparing the loan balance to the present value of expected cash flows or expected collateral proceeds. Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be greater than historical averages, including non-performing consumer or residential real estate loans. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values.

The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio class and based on impairment method as of September 30, 2018 and December 31, 2017:

| September 30, 2018 | Total | Commercial and Industrial Loans and Leases | Commercial Real Estate Loans | Agricultural Loans | Home Equity Loans | Consumer Loans | Residential Mortgage Loans | Unallocated |
|---|---|---|---|---|---|---|---|---|
| Allowance for Loan Losses: | | | | | | | | |
| Ending Allowance Balance Attributable to Loans: | | | | | | | | |
| Individually Evaluated for Impairment | $ 1,594 | $ 208 | $ 1,386 | $ — | $— | $ — | $— | $ — |
| Collectively Evaluated for Impairment | 14,422 | 2,980 | 3,678 | 6,216 | 277 | 386 | 420 | 465 |
| Acquired with Deteriorated Credit Quality | 35 | — | 30 | — | — | — | 5 | — |
| Total Ending Allowance Balance | $ 16,051 | $ 3,188 | $ 5,094 | $ 6,216 | $ 277 | $ 386 | $ 425 | $ 465 |
| | | | | | | | | |
| Loans: | | | | | | | | |
| Loans Individually Evaluated for Impairment | $ 9,394 | $ 3,521 | $ 5,873 | $ — | $— | $ — | $— | n/m(2) |
| | 2,334,284 | 524,754 | 978,124 | 362,982 | 175,800 | 73,050 | 219,574 | n/m(2) |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Loans Collectively Evaluated for Impairment | | | | | | | | |
| Loans Acquired with Deteriorated Credit Quality | 7,599 | 1,189 | 4,578 | 972 | — | — | 860 | n/m[2] |
| Total Ending Loans Balance[1] | $2,351,277 | $529,464 | $988,575 | $363,954 | $175,800 | $73,050 | $220,434 | n/m[2] |

[1]Total recorded investment in loans includes $11,104 in accrued interest.
[2]n/m = not meaningful

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NOTE 6 - Loans (continued)

| December 31, 2017 | Total | Commercial and Industrial Loans and Leases | Commercial Real Estate Loans | Agricultural Loans | Home Equity Loans | Consumer Loans | Residential Mortgage Loans | Unallocated |
|---|---|---|---|---|---|---|---|---|
| Allowance for Loan Losses: | | | | | | | | |
| Ending Allowance Balance Attributable to Loans: | | | | | | | | |
| Individually Evaluated for Impairment | $ 2,228 | $ 1,399 | $ 829 | $ — | $ — | $ — | $ — | $ — |
| Collectively Evaluated for Impairment | 13,455 | 3,333 | 3,759 | 4,894 | 330 | 298 | 338 | 503 |
| Acquired with Deteriorated Credit Quality | 11 | 3 | 3 | — | — | — | 5 | — |
| Total Ending Allowance Balance | $ 15,694 | $ 4,735 | $ 4,591 | $ 4,894 | $ 330 | $ 298 | $ 343 | $ 503 |
| | | | | | | | | |
| Loans: | | | | | | | | |
| Loans Individually Evaluated for Impairment | $ 11,633 | $ 5,918 | $ 5,552 | $ 163 | $ — | $ — | $ — | n/m[2] |
| Loans Collectively Evaluated for Impairment | 2,133,752 | 481,152 | 917,036 | 336,849 | 152,757 | 67,647 | 178,311 | n/m[2] |
| Loans Acquired with Deteriorated Credit Quality | 9,117 | 988 | 6,452 | 789 | — | — | 888 | n/m[2] |
| Total Ending Loans Balance[1] | $ 2,154,502 | $ 488,058 | $ 929,040 | $ 337,801 | $ 152,757 | $ 67,647 | $ 179,199 | n/m[2] |

[1]Total recorded investment in loans includes $9,483 in accrued interest.
[2]n/m = not meaningful

The following tables present loans individually evaluated for impairment by class of loans as of September 30, 2018 and December 31, 2017:

| September 30, 2018 | Unpaid Principal Balance[1] | Recorded Investment | Allowance for Loan Losses Allocated |
|---|---|---|---|
| With No Related Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | $ 1,117 | $ 1,120 | $ — |
| Commercial Real Estate Loans | 2,102 | 1,974 | — |

| | | | |
|---|---|---|---|
| Agricultural Loans | 659 | 552 | — |
| Subtotal | 3,878 | 3,646 | — |
| With An Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | 2,400 | 2,400 | 208 |
| Commercial Real Estate Loans | 4,713 | 4,546 | 1,416 |
| Agricultural Loans | — | — | — |
| Subtotal | 7,113 | 6,946 | 1,624 |
| Total | $ 10,991 | $ 10,592 | $ 1,624 |
| | | | |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above) | $ 1,194 | $ 1,003 | $ — |
| Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above) | $ 363 | $ 195 | $ 30 |

(1) Unpaid Principal Balance is the remaining contractual principal payments gross of partial charge-offs and discounts.

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NOTE 6 - Loans (continued)

| December 31, 2017 | Unpaid Principal Balance[(1)] | Recorded Investment | Allowance for Loan Losses Allocated |
|---|---|---|---|
| With No Related Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | $ 1,205 | $ 1,166 | $ — |
| Commercial Real Estate Loans | 1,812 | 1,495 | — |
| Agricultural Loans | 919 | 749 | — |
| Subtotal | 3,936 | 3,410 | — |
| With An Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | 4,804 | 4,763 | 1,402 |
| Commercial Real Estate Loans | 4,489 | 4,465 | 832 |
| Agricultural Loans | — | — | — |
| Subtotal | 9,293 | 9,228 | 2,234 |
| Total | $ 13,229 | $ 12,638 | $ 2,234 |
| | | | |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above) | $ 1,255 | $ 797 | $ — |
| Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above) | $ 252 | $ 208 | $ 6 |

(1) Unpaid Principal Balance is the remaining contractual payments gross of partial charge-offs and discounts.

The following tables present the average balance and related interest income of loans individually evaluated for impairment by class of loans for the three month period ended September 30, 2018 and 2017:

| September 30, 2018 | Average Recorded Investment | Interest Income Recognized | Cash Basis Recognized |
|---|---|---|---|
| With No Related Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | $ 1,130 | $ 14 | $ 2 |
| Commercial Real Estate Loans | 1,988 | 26 | — |
| Agricultural Loans | 537 | — | — |
| Subtotal | 3,655 | 40 | 2 |
| With An Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | 2,594 | 1 | 9 |
| Commercial Real Estate Loans | 4,693 | 4 | — |
| Agricultural Loans | — | — | — |
| Subtotal | 7,287 | 5 | 9 |
| Total | $ 10,942 | $ 45 | $ 11 |
| | | | |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above) | $ 995 | $ 11 | $ — |
| | $ 197 | $ 5 | $ — |

Loans Acquired With Deteriorated Credit Quality With An Additional Allowance
Recorded (Included in the Total Above)

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NOTE 6 - Loans (continued)

| September 30, 2017 | Average Recorded Investment | Interest Income Recognized | Cash Basis Recognized |
|---|---|---|---|
| With No Related Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | $ 1,202 | $ 13 | $ — |
| Commercial Real Estate Loans | 1,554 | 13 | — |
| Agricultural Loans | 735 | — | — |
| Subtotal | 3,491 | 26 | — |
| With An Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | 2,865 | 2 | 1 |
| Commercial Real Estate Loans | 3,654 | 3 | — |
| Agricultural Loans | 228 | — | — |
| Subtotal | 6,747 | 5 | 1 |
| Total | $ 10,238 | $ 31 | $ 1 |
| | | | |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above) | $ 771 | $ — | $ — |
| Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above) | $ 215 | $ 4 | $ — |

The following tables present the average balance and related interest income of loans individually evaluated for impairment by class of loans for the nine month period ended September 30, 2018 and 2017:

| September 30, 2018 | Average Recorded Investment | Interest Income Recognized | Cash Basis Recognized |
|---|---|---|---|
| With No Related Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | $ 1,152 | $ 40 | $ 2 |
| Commercial Real Estate Loans | 1,525 | 52 | 7 |
| Agricultural Loans | 594 | — | — |
| Subtotal | 3,271 | 92 | 9 |
| With An Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | 3,189 | 2 | 9 |
| Commercial Real Estate Loans | 4,816 | 14 | — |
| Agricultural Loans | — | — | — |
| Subtotal | 8,005 | 16 | 9 |
| Total | $ 11,276 | $ 108 | $ 18 |
| | | | |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above) | $ 697 | $ 11 | $ — |
| Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above) | $ 200 | $ 16 | $ — |

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NOTE 6 - Loans (continued)

| September 30, 2017 | Average Recorded Investment | Interest Income Recognized | Cash Basis Recognized |
|---|---|---|---|
| With No Related Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | $ 456 | $ 15 | $ 2 |
| Commercial Real Estate Loans | 1,067 | 43 | 29 |
| Agricultural Loans | 650 | 24 | 16 |
| Subtotal | 2,173 | 82 | 47 |
| With An Allowance Recorded: | | | |
| Commercial and Industrial Loans and Leases | 1,011 | 4 | 2 |
| Commercial Real Estate Loans | 2,290 | 13 | 6 |
| Agricultural Loans | 484 | — | — |
| Subtotal | 3,785 | 17 | 8 |
| Total | $ 5,958 | $ 99 | $ 55 |
| | | | |
| Loans Acquired With Deteriorated Credit Quality With No Related Allowance Recorded (Included in the Total Above) | $ 826 | $ 25 | $ 25 |
| Loans Acquired With Deteriorated Credit Quality With An Additional Allowance Recorded (Included in the Total Above) | $ 255 | $ 15 | $ 7 |

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

The following tables present the recorded investment in non-accrual loans and loans past due 90 days or more still on accrual by class of loans as of September 30, 2018 and December 31, 2017:

| | Non-Accrual Loans | | Loans Past Due 90 Days or More & Still Accruing | |
|---|---|---|---|---|
| | September 30, 2018 | December 31, 2017 | September 30, 2018 | December 31, 2017 |
| Commercial and Industrial Loans and Leases | $ 2,400 | $ 4,753 | $ — | $ — |
| Commercial Real Estate Loans | 4,667 | 4,618 | 70 | 474 |
| Agricultural Loans | 552 | 748 | — | 268 |

| | | | | |
|---|---|---|---|---|
| Home Equity Loans | 59 | 199 | — | — |
| Consumer Loans | 148 | 286 | — | — |
| Residential Mortgage Loans | 602 | 487 | — | — |
| Total | $8,428 | $ 11,091 | $ 70 | $ 742 |
| Loans Acquired With Deteriorated Credit Quality (Included in the Total Above) | $609 | $ 866 | $ 70 | $ — |

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NOTE 6 - Loans (continued)

The following tables present the aging of the recorded investment in past due loans by class of loans as of September 30, 2018 and December 31, 2017:

| September 30, 2018 | Total | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Loans Not Past Due |
|---|---|---|---|---|---|---|
| Commercial and Industrial Loans and Leases | $529,464 | $ 3,172 | $ 4,519 | $ 25 | $7,716 | $521,748 |
| Commercial Real Estate Loans | 988,575 | 997 | 594 | 2,044 | 3,635 | 984,940 |
| Agricultural Loans | 363,954 | 333 | — | — | 333 | 363,621 |
| Home Equity Loans | 175,800 | 757 | 111 | 59 | 927 | 174,873 |
| Consumer Loans | 73,050 | 667 | 26 | 149 | 842 | 72,208 |
| Residential Mortgage Loans | 220,434 | 3,415 | 858 | 408 | 4,681 | 215,753 |
| Total(1) | $2,351,277 | $ 9,341 | $ 6,108 | $ 2,685 | $18,134 | $2,333,143 |
| Loans Acquired With Deteriorated Credit Quality (Included in the Total Above) | $7,599 | $ 170 | $ 138 | $ 95 | $403 | $7,196 |
| Loans Acquired in Current Year (Included in the Total Above) | $113,173 | $ 33 | $ 111 | $ — | $144 | $113,029 |

(1)Total recorded investment in loans includes $11,104 in accrued interest.

| December 31, 2017 | Total | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due | Total Past Due | Loans Not Past Due |
|---|---|---|---|---|---|---|
| Commercial and Industrial Loans and Leases | $488,058 | $ 209 | $ 1,365 | $ 905 | $2,479 | $485,579 |
| Commercial Real Estate Loans | 929,040 | 1,229 | 1,650 | 677 | 3,556 | 925,484 |
| Agricultural Loans | 337,801 | 27 | — | 268 | 295 | 337,506 |
| Home Equity Loans | 152,757 | 366 | 93 | 199 | 658 | 152,099 |
| Consumer Loans | 67,647 | 246 | 97 | 286 | 629 | 67,018 |
| Residential Mortgage Loans | 179,199 | 2,850 | 1,247 | 261 | 4,358 | 174,841 |
| Total(1) | $2,154,502 | $ 4,927 | $ 4,452 | $ 2,596 | $11,975 | $2,142,527 |
| Loans Acquired With Deteriorated Credit Quality (Included in the Total Above) | $9,117 | $ 342 | $ 74 | $ 27 | $443 | $8,674 |

(1)Total recorded investment in loans includes $9,483 in accrued interest.

Troubled Debt Restructurings:

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

During the three and nine months ended September 30, 2018, there were no loans modified as a troubled debt restructuring. During the three months ended September 30, 2017, there were no loans modified as a troubled debt restructuring. During the nine months ended September 30, 2017, there were two loans modified as troubled debt restructurings.

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NOTE 6 - Loans (continued)

The following tables present the recorded investment of troubled debt restructurings by class of loans as of September 30, 2018 and December 31, 2017:

| September 30, 2018 | Total | Performing | Non-Accrual[1] |
|---|---|---|---|
| Commercial and Industrial Loans and Leases | $177 | $ 122 | $ 55 |
| Commercial Real Estate Loans | — | — | — |
| Total | $177 | $ 122 | $ 55 |
| December 31, 2017 | Total | Performing | Non-Accrual[1] |
| Commercial and Industrial Loans and Leases | $258 | $ 125 | $ 133 |
| Commercial Real Estate Loans | 24 | 24 | — |
| Total | $282 | $ 149 | $ 133 |

[1]The non-accrual troubled debt restructurings are included in the Non-Accrual Loan table presented on a previous page.

The Company had not committed to lending any additional amounts as of September 30, 2018 and December 31, 2017 to customers with outstanding loans that are classified as troubled debt restructurings.

The Company had no loans modified as troubled debt restructurings during the three months ended September 30, 2018 and 2017. The following tables present loans by class modified as troubled debt restructurings that occurred during the nine months ending September 30, 2018 and 2017:

| September 30, 2018 | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Commercial and Industrial Loans and Leases | — | $ — | $ — |
| Commercial Real Estate Loans | — | — | — |
| Total | — | $ — | $ — |

The troubled debt restructurings described above increased the allowance for loan losses by $0 and resulted in charge-offs of $0 during the nine months ending September 30, 2018.

| September 30, 2017 | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| Commercial and Industrial Loans and Leases | 1 | $ 127 | $ 127 |
| Commercial Real Estate Loans | 1 | 28 | 28 |
| Total | 2 | $ 155 | $ 155 |

The troubled debt restructurings described above increased the allowance for loan losses by $10 and resulted in charge-offs of $0 during the nine months ending September 30, 2017.

Additionally, there were no loans modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three and nine months ending September 30, 2018 and 2017.

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

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NOTE 6 - Loans (continued)

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company classifies loans as to credit risk by individually analyzing loans. This analysis includes commercial and industrial loans, commercial real estate loans, and agricultural loans with an outstanding balance greater than $250. This analysis is typically performed on at least an annual basis. The Company uses the following definitions for risk ratings:

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

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

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

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

| September 30, 2018 | Pass | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| Commercial and Industrial Loans and Leases | $506,547 | $5,901 | $ 17,016 | $ — | $529,464 |
| Commercial Real Estate Loans | 960,077 | 17,807 | 10,691 | — | 988,575 |
| Agricultural Loans | 304,138 | 40,441 | 19,375 | — | 363,954 |
| Total | $1,770,762 | $64,149 | $ 47,082 | $ — | $1,881,993 |
| Loans Acquired With Deteriorated Credit Quality (Included in the Total Above) | $2,745 | $1,802 | $ 2,192 | $ — | $6,739 |
| Loans Acquired in Current Year (Included in the Total Above) | $52,105 | $— | $ — | $ — | $52,105 |

| December 31, 2017 | Pass | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| Commercial and Industrial Loans and Leases | $462,212 | $7,901 | $ 17,945 | $ — | $488,058 |
| Commercial Real Estate Loans | 894,027 | 18,037 | 16,976 | — | 929,040 |
| Agricultural Loans | 304,032 | 27,288 | 6,481 | — | 337,801 |
| Total | $1,660,271 | $53,226 | $ 41,402 | $ — | $1,754,899 |
| Loans Acquired With Deteriorated Credit Quality | $2,604 | $1,647 | $ 3,978 | $ — | $8,229 |

(Included in the Total Above)

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NOTE 6 - Loans (continued)

The Company considers the performance of the loan portfolio and its impact on the allowance for loan losses. For home equity, consumer and residential mortgage loan classes, the Company also evaluates credit quality based on the aging status of the loan, which was previously presented, and by payment activity. The following table presents the recorded investment in home equity, consumer and residential mortgage loans based on payment activity as of September 30, 2018 and December 31, 2017:

| September 30, 2018 | Home Equity Loans | Consumer Loans | Residential Mortgage Loans |
|---|---|---|---|
| Performing | $175,741 | $ 72,901 | $ 219,832 |
| Nonperforming | 59 | 149 | 602 |
| Total | $175,800 | $ 73,050 | $ 220,434 |
| Loans Acquired With Deteriorated Credit Quality (Included in the Total Above) | $— | $ — | $ 860 |

| December 31, 2017 | Home Equity Loans | Consumer Loans | Residential Mortgage Loans |
|---|---|---|---|
| Performing | $152,558 | $ 67,361 | $ 178,712 |
| Nonperforming | 199 | 286 | 487 |
| Total | $152,757 | $ 67,647 | $ 179,199 |
| Loans Acquired With Deteriorated Credit Quality (Included in the Total Above) | $— | $ — | $ 888 |

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

| | September 30, 2018 | December 31, 2017 |
|---|---|---|
| Commercial and Industrial Loans | $ 1,189 | $ 988 |
| Commercial Real Estate Loans | 4,578 | 6,452 |
| Agricultural Loans | 972 | 789 |
| Residential Mortgage Loans | 860 | 888 |
| Total | $ 7,599 | $ 9,117 |
| | | |
| Carrying Amount, Net of Allowance | $ 7,564 | $ 9,106 |

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

| | 2018 | 2017 |
|---|---|---|
| Balance at July 1 | $2,567 | $2,705 |
| New Loans Purchased | — | — |

| | | |
|---|---|---|
| Accretion of Income | (553 ) | (43 ) |
| Reclassifications from Non-accretable Difference | 63 | 146 |
| Charge-off of Accretable Yield | — | — |
| Balance at September 30 | $2,077 | $2,808 |

For those purchased loans disclosed above, the Company did not increase the allowance for loan losses during the three months ended September 30, 2018 and 2017. The Company reversed allowance for loan losses of $3 and $54 during the three months ended September 30, 2018 and 2017.

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NOTE 6 - Loans (continued)

| | 2018 | 2017 |
|---|---|---|
| Balance at January 1 | $2,734 | $2,521 |
| New Loans Purchased | — | — |
| Accretion of Income | (774 ) | (325 ) |
| Reclassifications from Non-accretable Difference | 214 | 612 |
| Charge-off of Accretable Yield | (97 ) | — |
| Balance at September 30 | $2,077 | $2,808 |

For those purchased loans disclosed above, the Company increased the allowance for loan losses by $30 and $11 during the nine months ended September 30, 2018 and 2017. The Company reversed allowance for loan losses of $6 and $110 during the nine months ended September 30, 2018 and 2017.

The carrying amount of consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to local requirements of the applicable jurisdiction totaled $60 as of September 30, 2018 and $14 as of December 31, 2017.

NOTE 7 – Repurchase Agreements Accounted for as Secured Borrowings

Repurchase agreements are short-term borrowings included in FHLB Advances and Other Borrowings and mature overnight and continuously. Repurchase agreements, which were secured by mortgage-backed securities, totaled $35,889 and $41,499 as of September 30, 2018 and December 31, 2017, respectively. Risk could arise when the collateral pledged to a repurchase agreement declines in fair value. The Company minimizes risk by consistently monitoring the value of the collateral pledged. At the point in time where the collateral has declined in fair value, the Company is required to provide additional collateral based on the value of the underlying securities.

NOTE 8 – Segment Information

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

The core banking segment is comprised by the Company’s banking subsidiary, German American Bank, which operated through 58 banking offices at September 30, 2018. Net interest income from loans and investments funded by deposits and borrowings is the primary revenue for the core-banking segment. The trust and investment advisory services segment’s revenues are comprised primarily of fees generated by the trust operations of the Company's banking subsidiary and by German American Investment Services, Inc. These fees are derived by providing trust, investment advisory, and brokerage services to its customers. The insurance segment primarily consists of German

American Insurance, Inc., which provides a full line of personal and corporate insurance products. Commissions derived from the sale of insurance products are the primary source of revenue for the insurance segment.

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

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NOTE 8 - Segment Information (continued)

| | Core Banking | Trust and Investment Advisory Services | Insurance | Other | Consolidated Totals |
|---|---|---|---|---|---|
| Three Months Ended September 30, 2018 | | | | | |
| Net Interest Income | $ 28,755 | $ 2 | $ 3 | $ (212 ) | $ 28,548 |
| Net Gains on Sales of Loans | 866 | — | — | — | 866 |
| Net Gains on Securities | 90 | — | — | — | 90 |
| Trust and Investment Product Fees | 1 | 1,584 | — | — | 1,585 |
| Insurance Revenues | 9 | 31 | 1,787 | — | 1,827 |
| Noncash Items: | | | | | |
| Provision for Loan Losses | 500 | — | — | — | 500 |
| Depreciation and Amortization | 1,540 | 2 | 19 | 64 | 1,625 |
| Income Tax Expense (Benefit) | 2,825 | 109 | 52 | (190 ) | 2,796 |
| Segment Profit (Loss) | 12,462 | 298 | 147 | (268 ) | 12,639 |
| Segment Assets at September 30, 2018 | 3,365,394 | 2,700 | 11,185 | (15,510) | 3,363,769 |

| | Core Banking | Trust and Investment Advisory Services | Insurance | Other | Consolidated Totals |
|---|---|---|---|---|---|
| Three Months Ended September 30, 2017 | | | | | |
| Net Interest Income | $ 25,109 | $ 2 | $ 2 | $ (196) | $ 24,917 |
| Net Gains on Sales of Loans | 952 | — | — | — | 952 |
| Net Gains on Securities | 572 | — | — | 3 | 575 |
| Trust and Investment Product Fees | — | 1,300 | — | 1 | 1,301 |
| Insurance Revenues | 11 | 2 | 1,715 | — | 1,728 |
| Noncash Items: | | | | | |
| Provision for Loan Losses | 250 | — | — | — | 250 |
| Depreciation and Amortization | 1,091 | 5 | 19 | 64 | 1,179 |
| Income Tax Expense (Benefit) | 3,669 | 31 | 67 | (256 ) | 3,511 |
| Segment Profit (Loss) | 9,621 | 41 | 102 | (104 ) | 9,660 |
| Segment Assets at December 31, 2017 | 3,142,096 | 1,987 | 10,078 | (9,801) | 3,144,360 |

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NOTE 8 - Segment Information (continued)

| | Core Banking | Trust and Investment Advisory Services | Insurance | Other | Consolidated Totals |
|---|---|---|---|---|---|
| Nine Months Ended September 30, 2018 | | | | | |
| Net Interest Income | $ 82,217 | $ 4 | $ 8 | $ (602 ) | $ 81,627 |
| Net Gains on Sales of Loans | 2,421 | — | — | — | 2,421 |
| Net Gains on Securities | 434 | — | — | — | 434 |
| Trust and Investment Product Fees | 3 | 5,032 | — | — | 5,035 |
| Insurance Revenues | 15 | 35 | 6,403 | — | 6,453 |
| Noncash Items: | | | | | |
| Provision for Loan Losses | 2,070 | — | — | — | 2,070 |
| Depreciation and Amortization | 3,971 | 4 | 59 | 192 | 4,226 |
| Income Tax Expense (Benefit) | 7,556 | 341 | 386 | (677 ) | 7,606 |
| Segment Profit (Loss) | 34,702 | 952 | 1,116 | (1,221 ) | 35,549 |
| Segment Assets at September 30, 2018 | 3,365,394 | 2,700 | 11,185 | (15,510) | 3,363,769 |

| | Core Banking | Trust and Investment Advisory Services | Insurance | Other | Consolidated Totals |
|---|---|---|---|---|---|
| Nine Months Ended September 30, 2017 | | | | | |
| Net Interest Income | $ 75,017 | $ 4 | $ 6 | $ (572) | $ 74,455 |
| Net Gains on Sales of Loans | 2,598 | — | — | — | 2,598 |
| Net Gains on Securities | 572 | — | — | 3 | 575 |
| Trust and Investment Product Fees | 2 | 3,894 | — | (2 ) | 3,894 |
| Insurance Revenues | 25 | 15 | 6,072 | — | 6,112 |
| Noncash Items: | | | | | |
| Provision for Loan Losses | 1,100 | — | — | — | 1,100 |
| Depreciation and Amortization | 3,235 | 12 | 57 | 192 | 3,496 |
| Income Tax Expense (Benefit) | 10,906 | 114 | 542 | (805 ) | 10,757 |
| Segment Profit (Loss) | 28,377 | 151 | 849 | (322 ) | 29,055 |
| Segment Assets at December 31, 2017 | 3,142,096 | 1,987 | 10,078 | (9,801) | 3,144,360 |

NOTE 9 – Stock Repurchase Plan

On April 26, 2001, the Company announced that its Board of Directors approved a stock repurchase program for up to 911,631 of the outstanding shares of common stock of the Company. Shares may be purchased from time to time in the open market and in large block privately negotiated transactions. The Company is not obligated to purchase any shares under the program, and the program may be discontinued at any time before the maximum number of shares specified by the program are purchased. The Board of Directors established no expiration date for this program. As of

September 30, 2018, the Company had purchased 502,447 shares under the program. No shares were purchased under the program during the three or nine months ended September 30, 2018 and 2017.

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NOTE 10 – Equity Plans and Equity Based Compensation

The Company maintains three equity incentive plans under which stock options, restricted stock, and other equity incentive awards can be granted. At September 30, 2018, the Company has reserved 386,754 shares of common stock for the purpose of issuance pursuant to outstanding and future grants of options, restricted stock, and other equity awards to officers, directors and other employees of the Company.

For the three and nine months ended September 30, 2018 and 2017, the Company granted no options. The Company recorded no stock compensation expense applicable to options during the three and nine months ended September 30, 2018 and 2017 because all outstanding options were fully vested prior to 2007. In addition, there was no unrecognized option expense.

During the periods presented, awards of long-term incentives were granted in the form of restricted stock. Awards that were granted to management under a management incentive plan were granted in tandem with cash credit entitlements (typically in the form of 60% restricted stock grants and 40% cash credit entitlements). The management and employee restricted stock grants and tandem cash credit entitlements awarded will vest in three equal installments of 33.3% with the first annual vesting on December 5th of the year of the grant and on December 5th of the next two succeeding years. Awards that were granted to directors as additional retainer for their services do not include any cash credit entitlement. These director restricted stock grants are subject to forfeiture in the event that the recipient of the grant does not continue in service as a director of the Company through December 5th of the year after grant or does not satisfy certain meeting attendance requirements, at which time they generally vest 100 percent. For measuring compensation costs, restricted stock awards are valued based upon the market value of the common shares on the date of grant. During the three months ended September 30, 2018 and 2017, the Company granted awards of 180 and 390 shares of restricted stock, respectively. During the nine months ended September 30, 2018 and 2017, the Company granted awards of 35,490 and 38,490 shares of restricted stock, respectively. Total unvested restricted stock awards at September 30, 2018 and December 31, 2017 were 79,981 and 46,306, respectively.

The following tables present expense recorded for restricted stock and cash entitlements as well as the related tax information for the periods presented:

| | Three Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |
| Restricted Stock Expense | $311 | $303 |
| Cash Entitlement Expense | 167 | 155 |
| Tax Effect | (124 ) | (180 ) |
| Net of Tax | $354 | $278 |

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2018 | 2017 |

| | | |
|---|---|---|
| Restricted Stock Expense | $972 | $952 |
| Cash Entitlement Expense | 509 | 495 |
| Tax Effect | (386 ) | (568 ) |
| Net of Tax | $1,095 | $879 |

Unrecognized expense associated with the restricted stock grants and cash entitlements totaled $2,356 and $2,277 as of September 30, 2018 and 2017, respectively.

The Company maintains an Employee Stock Purchase Plan whereby eligible employees have the option to purchase the Company's common stock at a discount. The purchase price of the shares under this Plan has been set at 95% of the fair market value of the Company's common stock as of the last day of the plan year. The plan provided for the purchase of up to 750,000 shares of common stock, which the Company may obtain by purchases on the open market or from private sources, or by issuing authorized but unissued common shares. At September 30, 2018, there were 557,203 shares available for future issuance under this plan. Funding for the purchase of common stock is from employee and Company contributions.

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NOTE 10 - Equity Plans and Equity Based Compensation (continued)

There was $39 of expense recorded for the employee stock purchase plan during the three and nine months ended September 30, 2018. There was $32 of expense recorded for the employee stock purchase plan during the three and nine months ended September 30, 2017. There was no unrecognized compensation expense as of September 30, 2018 and 2017 for the Employee Stock Purchase Plan.

NOTE 11 – Fair Value

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

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

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

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

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

Investment Securities and Other Investments: The fair values for investment securities and other investments are determined by quoted market prices, if available (Level 1). For investment securities and other investments where quoted prices are not available, fair values are calculated based on market prices of similar investment securities and other investments (Level 2). For investment securities and other investments where quoted prices or market prices of similar investment securities and other investments are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). Level 3 pricing is obtained from a third-party based upon similar trades that are not traded frequently without adjustment by the Company. At September 30, 2018, the Company held $5.0 million in Level 3 securities which consist of $4.7 million of non-rated Obligations of State and Political Subdivisions and $353 thousand of equity securities that are not actively traded. Absent the credit rating, significant assumptions must be made such that the credit risk input becomes an unobservable input and thus these investment securities and other investments are reported by the Company in a Level 3 classification.

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

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

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

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NOTE 11 - Fair Value (continued)

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

Loan Servicing Rights: On a quarterly basis, loan servicing rights are evaluated for impairment based upon the fair value of the rights as compared to carrying amount resulting in a Level 2 classification. The valuation model utilizes interest rate, prepayment speed, and default rate assumptions that market participants would use in estimating future net servicing income and that can be validated against available market data.

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

Assets and Liabilities Measured on a Recurring Basis

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

| | Fair Value Measurements at September 30, 2018 Using | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| Obligations of State and Political Subdivisions | $ — | $ 279,376 | $ 4,663 | $ 284,039 |
| MBS/CMO - Residential | — | 455,588 | — | 455,588 |
| Equity Securities | — | — | 353 | 353 |
| Total Securities and Other Investments | $ — | $ 734,964 | $ 5,016 | $ 739,980 |
| Loans Held-for-Sale | $ — | $ 9,178 | $ — | $ 9,178 |
| Derivative Assets | $ — | $ 3,490 | $ — | $ 3,490 |
| Mortgage Servicing Rights | $ — | $ 1,023 | $ — | $ 1,023 |
| Derivative Liabilities | $ — | $ 3,425 | $ — | $ 3,425 |

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NOTE 11 - Fair Value (continued)

| | Fair Value Measurements at December 31, 2017 Using | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| Obligations of State and Political Subdivisions | $ — | $ 267,660 | $ 5,649 | $ 273,309 |
| MBS/CMO - Residential | — | 467,332 | — | 467,332 |
| Equity Securities | — | — | 353 | 353 |
| Total Securities and Other Investments | $ — | $ 734,992 | $ 6,002 | $ 740,994 |
| Loans Held-for-Sale | $ — | $ 6,719 | $ — | $ 6,719 |
| Derivative Assets | $ — | $ 1,564 | $ — | $ 1,564 |
| Mortgage Servicing Rights | $ — | $ 547 | $ — | $ 547 |
| Derivative Liabilities | $ — | $ 1,633 | $ — | $ 1,633 |

There were no transfers between Level 1 and Level 2 for the periods ended September 30, 2018 and December 31, 2017.

At September 30, 2018, the aggregate fair value of the Loans Held-for-Sale was $9,178. Aggregate contractual principal balance was $9,019 with a difference of $159.  At December 31, 2017, the aggregate fair value of the Loans Held-for-Sale was $6,719. Aggregate contractual principal balance was $6,576 with a difference of $143.

The tables below present a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2018 and 2017:

| | Obligations of State and Political Subdivisions | | Equity Securities | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Balance of Recurring Level 3 Assets at July 1 | $ 5,167 | $ 6,464 | $ 353 | $ 353 |
| Total Gains or Losses Included in Other Comprehensive Income | (44) | — | — | — |
| Maturities / Calls | (460) | (450) | — | — |
| Purchases | — | — | — | — |
| Balance of Recurring Level 3 Assets at September 30 | $ 4,663 | $ 6,014 | $ 353 | $ 353 |

| | Obligations of State and Political | Equity Securities |
|---|---|---|

| | Subdivisions | | | |
|---|---|---|---|---|
| | 2018 | 2017 | 2018 | 2017 |
| Balance of Recurring Level 3 Assets at January 1 | $ 5,649 | $ 7,295 | $ 353 | $ 353 |
| Total Gains or Losses Included in Other Comprehensive Income | (66 ) | 34 | — | — |
| Maturities / Calls | (920 ) | (1,315 ) | — | — |
| Purchases | — | — | — | — |
| Balance of Recurring Level 3 Assets at September 30 | $ 4,663 | $ 6,014 | $ 353 | $ 353 |

Of the total gain/loss for the three and nine months ended September 30, 2018, ($44) and ($66) was attributable to other changes in fair value, respectively. Of the total gain/loss for the three and nine months ended September 30, 2017, $0 and $34 was attributable to other changes in fair value, respectively.

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NOTE 11 - Fair Value (continued)

Assets and Liabilities Measured on a Non-Recurring Basis

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

| | Fair Value Measurements at September 30, 2018 Using | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| Assets: | | | | |
| Impaired Loans | | | | |
| Commercial and Industrial Loans | $ — | $ — | $ 2,192 | $ 2,192 |
| Commercial Real Estate Loans | — | — | 2,965 | 2,965 |

| | Fair Value Measurements at December 31, 2017 Using | | | |
|---|---|---|---|---|
| | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | Total |
| Assets: | | | | |
| Impaired Loans | | | | |
| Commercial and Industrial Loans | $ — | $ — | $ 3,354 | $ 3,354 |
| Commercial Real Estate Loans | — | — | 3,438 | 3,438 |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $6,751 with a valuation allowance of $1,594, resulting in an increase to the provision for loan losses of $190 for the three months ended September 30, 2018 and a decrease to the provision for loan losses of $640 for the nine months ended September 30, 2018. For the three and nine months ended September 30, 2017, impaired loans resulted in an increase to the provision for loan losses of $1,583 and $1,587, respectively. Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $9,020 with a valuation allowance of $2,228, resulting in an increase to the provision for loan losses of $1,973 for the year ended December 31, 2017.

There was no Other Real Estate carried at fair value less costs to sell at September 30, 2018. No charge to earnings was included in the three and nine months ended September 30, 2018 and 2017. There was no Other Real Estate carried at fair value less costs to sell at December 31, 2017. No charge to earnings was included in the year ended December 31, 2017.

The following table presents quantitative information about Level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2018 and December 31, 2017:

| September 30, 2018 | Fair Value | Valuation Technique(s) | Unobservable Input(s) | Range (Weighted Average) |
|---|---|---|---|---|
| Impaired Loans - Commercial and Industrial Loans | $ 2,192 | Sales comparison approach | Adjustment for physical condition of comparable properties sold | 0%-100% (100%) |
| Impaired Loans - Commercial Real Estate Loans | $ 2,965 | Sales comparison approach | Adjustment for physical condition of comparable properties sold | 18%-76% (54%) |

GERMAN AMERICAN BANCORP, INC.
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NOTE 11 - Fair Value (continued)

| December 31, 2017 | Fair Value | Valuation Technique(s) | Unobservable Input(s) | Range (Weighted Average) |
|---|---|---|---|---|
| Impaired Loans - Commercial and Industrial Loans | $ 3,354 | Sales comparison approach | Adjustment for physical condition of comparable properties sold | 0%-95% (84%) |
| Impaired Loans - Commercial Real Estate Loans | $ 3,438 | Sales comparison approach | Adjustment for physical condition of comparable properties sold | 30%-76% (47%) |

The carrying amounts and estimated fair values of the Company's financial instruments not previously presented are provided in the tables below for the periods ending September 30, 2018 and December 31, 2017. Not all of the Company's assets and liabilities are considered financial instruments, and therefore are not included in the tables. Because no active market exists for a significant portion of the Company's financial instruments, fair value estimates were based on subjective judgments, and therefore cannot be determined with precision. In accordance with the adoption of ASU 2016-01, the table below for September 30, 2018, presents the fair values measured using an exit price notion. The fair value of loans as of December 31, 2017 was measured using an entrance price notion.

| | | Fair Value Measurements at September 30, 2018 Using | | | |
|---|---|---|---|---|---|
| | Carrying Value | Level 1 | Level 2 | Level 3 | Total |
| Financial Assets: | | | | | |
| Cash and Short-term Investments | $ 65,584 | $50,980 | $14,604 | $ — | $65,584 |
| Loans, Net | 2,315,417 | — | — | 2,274,223 | 2,274,223 |
| FHLB Stock and Other Restricted Stock | 13,048 | N/A | N/A | N/A | N/A |
| Accrued Interest Receivable | 15,218 | — | 3,972 | 11,246 | 15,218 |
| Financial Liabilities: | | | | | |
| Demand, Savings, and Money Market Deposits | (2,240,239) | (2,240,239) | — | — | (2,240,239) |
| Time Deposits | (400,608) | — | (399,625) | — | (399,625) |
| Short-term Borrowings | (220,389) | — | (220,389) | — | (220,389) |
| Long-term Debt | (106,650) | — | (93,587) | (11,250) | (104,837) |
| Accrued Interest Payable | (1,152) | — | (1,075) | (77) | (1,152) |

| | | Fair Value Measurements at December 31, 2017 Using | | | |
|---|---|---|---|---|---|
| | Carrying Value | Level 1 | Level 2 | Level 3 | Total |
| Financial Assets: | | | | | |
| Cash and Short-term Investments | $ 70,359 | $48,467 | $16,349 | $ — | $64,816 |
| Loans, Net | 2,119,152 | — | — | 2,120,154 | 2,120,154 |
| FHLB Stock and Other Restricted Stock | 13,048 | N/A | N/A | N/A | N/A |
| Accrued Interest Receivable | 13,258 | — | 3,574 | 9,684 | 13,258 |
| Financial Liabilities: | | | | | |
| Demand, Savings, and Money Market Deposits | (2,096,167) | (1,096,167) | — | — | (1,096,167) |
| Time Deposits | (387,885) | — | (388,640) | — | (388,640) |

| | | | | | |
|---|---|---|---|---|---|
| Short-term Borrowings | (133,499) | — | (133,499) | — | (133,499) |
| Long-term Debt | (141,717) | — | (129,366) | (11,052) | (140,418) |
| Accrued Interest Payable | (1,058) | — | (1,042) | (16) | (1,058) |

GERMAN AMERICAN BANCORP, INC.
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NOTE 12 - Other Comprehensive Income (Loss)

The tables below summarize the changes in accumulated other comprehensive income (loss) by component for the three and nine months ended September 30, 2018 and 2017, net of tax:

| September 30, 2018 | Unrealized Gains and Losses on Available-for-Sale Securities | Postretirement Benefit Items | Total |
|---|---|---|---|
| Beginning Balance at July 1, 2018 | $ (13,054) | $ (285) | $ (13,339) |
| Other Comprehensive Income (Loss) Before Reclassification | (3,850) | — | (3,850) |
| Amounts Reclassified from Accumulated Other Comprehensive Income (Loss) | (71) | — | (71) |
| Net Current Period Other Comprehensive Income (Loss) | (3,921) | — | (3,921) |
| Ending Balance at September 30, 2018 | $ (16,975) | $ (285) | $ (17,260) |

| September 30, 2018 | Unrealized Gains and Losses on Available-for-Sale Securities | Postretirement Benefit Items | Total |
|---|---|---|---|
| Beginning Balance at January 1, 2018 | $ (2,335) | $ (285) | $ (2,620) |
| Other Comprehensive Income (Loss) Before Reclassification | (14,298) | — | (14,298) |
| Amounts Reclassified from Accumulated Other Comprehensive Income (Loss) | (342) | — | (342) |
| Net Current Period Other Comprehensive Income (Loss) | (14,640) | — | (14,640) |
| Ending Balance at September 30, 2018 | $ (16,975) | $ (285) | $ (17,260) |

| September 30, 2017 | Unrealized Gains and Losses on Available-for-Sale Securities | Postretirement Benefit Items | Total |
|---|---|---|---|
| Beginning Balance at July 1, 2017 | $ 4,252 | $ (92) | $ 4,160 |
| Other Comprehensive Income (Loss) Before Reclassification | (937) | — | (937) |
| Amounts Reclassified from Accumulated Other Comprehensive Income (Loss) | (374) | — | (374) |
| Net Current Period Other Comprehensive Income (Loss) | (1,311) | — | (1,311) |
| Ending Balance at September 30, 2017 | $ 2,941 | $ (92) | $ 2,849 |

GERMAN AMERICAN BANCORP, INC.
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NOTE 12 - Other Comprehensive Income (Loss) (continued)

| September 30, 2017 | Unrealized Gains and Losses on Available-for-Sale Securities | Postretirement Benefit Items | Total |
|---|---|---|---|
| Beginning Balance at January 1, 2017 | $ (6,312) | $ (92) | $ (6,404) |
| Other Comprehensive Income (Loss) Before Reclassification | 9,627 | — | 9,627 |
| Amounts Reclassified from Accumulated Other Comprehensive Income (Loss) | (374) | — | (374) |
| Net Current Period Other Comprehensive Income (Loss) | 9,253 | — | 9,253 |
| Ending Balance at September 30, 2017 | $ 2,941 | $ (92) | $ 2,849 |

The tables below summarize the classifications out of accumulated other comprehensive income (loss) by component for the three and nine months ended September 30, 2018 and 2017:

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified From Accumulated Other Comprehensive Income (Loss) | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|
| Unrealized Gains and Losses on Available-for-Sale Securities | $ 90 | Net Gains on Securities |
| | (19) | Income Tax Expense |
| | 71 | Net of Tax |
| Total Reclassifications for the Three Months Ended September 30, 2018 | $ 71 | |

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified From Accumulated Other Comprehensive Income (Loss) | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|
| Unrealized Gains and Losses on Available-for-Sale Securities | $ 434 | Net Gains on Securities |
| | (92) | Income Tax Expense |
| | 342 | Net of Tax |
| Total Reclassifications for the Nine Months Ended September 30, 2018 | $ 342 | |

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified From Accumulated Other Comprehensive Income (Loss) | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|
| Unrealized Gains and Losses on Available-for-Sale Securities | $ 575 | Net Gains on Securities |

| | | | | |
|---|---|---|---|---|
| | | (201 | ) | Income Tax Expense |
| | | 374 | | Net of Tax |
| Total Reclassifications for the Three Months Ended September 30, 2017 | $ | 374 | | |

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GERMAN AMERICAN BANCORP, INC.
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NOTE 12 - Other Comprehensive Income (Loss) (continued)

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified From Accumulated Other Comprehensive Income (Loss) | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|
| Unrealized Gains and Losses on Available-for-Sale Securities | $ 575 | Net Gains on Securities |
| | (201 ) | Income Tax Expense |
| | 374 | Net of Tax |
| Total Reclassifications for the Nine Months Ended September 30, 2017 | $ 374 | |

NOTE 13 - Newly Issued Accounting Pronouncements

In January 2016, the FASB amended existing guidance (ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities) that requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. Also, it requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. It requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). It eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost. These amendments are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within that reporting period. The Company notes that the impact of adoption is to carry the equity security at fair value or at cost, less impairment when fair value is not readily determinable, with observable price changes being recognized in earnings. The Company adopted ASU 2016-01 on January 1, 2018 and no adjustment to the single equity security was performed upon adoption. Also, upon adoption of ASU 2016-01, this equity security is no longer classified as available-for-sale. For additional information on this equity security, see Note 4 - Securities. Per ASU 2016-01 guidance, the Company reported the fair value of financial instruments based upon an exit price notion for September 30, 2018. For additional information, see Note 11 - Fair Value.

In August 2016, the FASB issued ASU (ASU No. 2016-15, Statement of Cash Flows (Topic 320): Classification of Certain Cash Receipts and Cash Payments) to address the diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows including the following:

- Debt Prepayment or Debt Extinguishment Costs;
- Settlement of Zero-Coupon Bonds or Debt with Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate;
- Contingent Consideration payments Made Soon After a Business Combination;
- Proceeds From the Settlement of Insurance Claims;
- Proceeds From the Settlement of BOLI and COLI Policies;
- Distributions Received From Equity Method Investees;

- Beneficial Interests in Securitization Transactions; and
- Application of the Predominance Principle.

These amendments are effective for public business entities beginning January 1, 2018. The Company adopted ASU 2016-15 on January 1, 2018 and there was no material impact on the Company's Consolidated Statements of Cash Flows.

In March 2017, the FASB amended existing guidance (ASU No. 2017-07, Compensation - Retirement Benefits (Topic 715)) to improve the presentation of net periodic pension cost and net periodic postretirement benefit cost. The amendments require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit costs are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. The amendments are effective for public business entities beginning January 1, 2018. The Company adopted ASU 2017-07 on January 1, 2018 and there was no material impact on the Company's Consolidated Statements of Income.

GERMAN AMERICAN BANCORP, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 13 - Newly Issued Accounting Pronouncements (continued)

In February 2016, the FASB amended existing guidance (ASU No. 2016-02, Leases (Topic 842)) that requires lessees recognize the following for all leases (with the exception of short-term leases) at the commencement date (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. These amendments are effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within that reporting period. Based on our leases outstanding as of September 30, 2018, the Company does not expect this new guidance to have a material impact on the consolidated results of operation. However as a result of this new guidance, the Company anticipates an estimated increase in its Consolidated Balance Sheet of approximately $6,000. This impact will vary based on the Company's future decisions to enter into new lease agreements or exit/renew current lease agreements prior to the date of implementation.

In June 2016, the FASB issued guidance (ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326)) to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to-maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. This standard will be effective for public business entities for fiscal years beginning after December 15, 2019, including interim periods within that reporting period.

The transition to the new standard will be applied as follows:

- For debt securities with other-than-temporary impairment (OTTI), the guidance will be applied prospectively.
- Existing purchased credit impaired (PCI) assets will be grandfathered and classified as purchased credit deteriorated (PCD) assets at the date of adoption. The asset will be grossed up for the allowance for expected credit losses for all PCD assets at the date of adoption and will continue to recognize the noncredit discount in interest income based on the yield of such assets as of the adoption date. Subsequent changes in expected credit losses will be recorded through the allowance.
- For all other assets within the scope of CECL, a cumulative-effect adjustment will be recognized in retained earnings as of the beginning of the first reporting period in which the guidance is effective.

The Company has formed a cross-functional committee that has assessed data and system needs, selected a vendor to provide modeling needs and is currently implementing new software with the plan to run parallel processing of our existing allowance for loan loss model with the CECL model in the first quarter of 2019. The Company expects to recognize a one-time cumulative adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot estimate the amount at this time.

NOTE 14 – Business Combinations

Branch Acquisition

On May 18, 2018, German American Bank completed the acquisition of five branch locations of First Financial Bancorp (formerly branch locations of Mainsource Financial Group, Inc. prior to its merger with First Financial Bancorp on April 1, 2018) and certain related assets, and the assumption by German American Bank of certain related liabilities. Four of the branches are located in Columbus, Indiana, and one in Greensburg, Indiana. At the time of closing, German American Bank acquired approximately $175.3 million in deposits and approximately $117.6 million in loans associated with the five bank branches. The premium paid on deposits by German American Bank was approximately $7.4 million. The premium is subject to adjustment to reflect increases or decreases in the deposit balances during the six month period following the closing date. German American Bank also has the ability, under certain circumstances, to put loans back to First Financial Bancorp's bank subsidiary during such six month period. The Company accounted for the transaction under the acquisition method of accounting, which means that the acquired assets and liabilities were recorded at fair value at the date of acquisition. The fair value estimates included in these financial statements are based on preliminary valuations. There have been no adjustments to the premium paid for deposits nor have any loans been put back to date. The Company expects that final valuation estimates will be completed during the fourth quarter of 2018.

GERMAN AMERICAN BANCORP, INC.
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NOTE 14 - Business Combinations (continued)

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

In accordance with ASC 805, the Company has expensed approximately $632 of direct acquisition costs and recorded $6.9 million of goodwill and $3.5 million of intangible assets. The intangible assets are related to core deposits and are being amortized over 8 years. For tax purposes, goodwill totaling $6.9 million is tax deductible and will be amortized over 15 years. The following table summarizes the fair value of the total cash received as part of the branch acquisition as well as the fair value of identifiable assets acquired and liabilities assumed as of the effective date of the transaction.

| | |
|---|---|
| Total Cash Received from First Financial | $40,637 |
| | |
| Recognized Amounts of Identifiable Assets Acquired and Liabilities Assumed: | |
| Cash | $755 |
| Loans | 117,604 |
| Premises, Furniture & Equipment | 5,666 |
| Intangible Assets | 3,475 |
| Accrued Interest Receivable and Other Assets | 780 |
| Deposits - Non-interest Bearing | (39,607) |
| Deposits - Interest Bearing | (136,096) |
| Accrued Interest Payable and Other Liabilities | (69) |
| | |
| Total Identifiable Net Assets | $(47,492) |
| | |
| Goodwill | $6,855 |

NOTE 15 – Subsequent Event

Effective October 15, 2018, the Company completed the acquisition of First Security, Inc. ("First Security") through the merger of First Security with and into the Company (the "Merger"). Immediately following completion of the Merger, First Security’s subsidiary bank, First Security Bank, Inc., was merged with and into the Company’s subsidiary bank, German American Bank. First Security, based in Owensboro, Kentucky, operated 11 retail banking offices through First Security Bank, Inc., in Owensboro, Bowling Green, Franklin and Lexington, Kentucky and in Evansville and Newburgh, Indiana. At September 30, 2018, First Security had total assets of approximately $572 million, total loans of approximately $406 million, and total deposits of approximately $432 million.

Under terms of the definitive agreement, the Company issued approximately 2.0 million shares of its common stock, and paid approximately $31.2 million in cash, in exchange for all of the issued and outstanding shares of common stock of First Security and in cancellation of all outstanding options to acquire First Security common stock.

The acquired assets and liabilities will be recorded at fair value at the date of acquisition and will be reflected in the December 31, 2018 financial statements as such; however, at the time of these financial statements, the appraisals and valuations are incomplete. The Company expects to record goodwill and a core deposit intangible in regards to this transaction based on earlier estimates, but the amount is not known as the initial fair value accounting is incomplete. The goodwill will not be deductible for tax purposes.

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

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

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

German American Bancorp, Inc., is a NASDAQ-traded (symbol: GABC) financial services holding company based in Jasper, Indiana. German American Bancorp, Inc., through its banking subsidiary German American Bank, operates 66 banking offices in 20 contiguous southern Indiana counties and five Kentucky counties. Prior to April 1, 2018, German American Bank was known as German American Bancorp. The Company also owns an investment brokerage subsidiary (German American Investment Services, Inc.) and a full line property and casualty insurance agency (German American Insurance, Inc.).

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

This section presents an analysis of the consolidated financial condition of the Company as of September 30, 2018 and December 31, 2017 and the consolidated results of operations for the three and nine months ended September 30, 2018 and 2017. This discussion should be read in conjunction with the consolidated financial statements and other financial data presented elsewhere herein and with the financial statements and other financial data, as well as the Management's Discussion and Analysis of Financial Condition and Results of Operations, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

MANAGEMENT OVERVIEW

This updated discussion should be read in conjunction with the Management Overview that was included in our Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Net income for the quarter ended September 30, 2018 totaled $12,639,000, or $0.55 per diluted share, an improvement on a per share basis of 31%, compared to net income of $9,660,000, or $0.42 per diluted share for the quarter ended September 30, 2017. Net income for the first nine months of 2018 totaled $35,549,000, or $1.55 per diluted share, an increase of 22% on a per share basis, compared to net income of $29,055,000, or $1.27 per diluted share for the nine months ended September 30, 2017.

The third quarter and first nine months of 2018 net income was positively impacted by lower federal income tax rates that became effective January 1, 2018 as a result of the Tax Act (as discussed and defined below). The lower federal income tax rates had a positive impact of approximately $0.07 per share during the third quarter of 2018 and $0.20 per share for the first nine months of 2018.

On December 22, 2017, the U.S. government enacted comprehensive tax reform legislation commonly referred to as the Tax Cuts and Jobs Act of 2017 (the "Tax Act"). Among other things, the Tax Act includes significant changes to the U.S. corporate income tax system, including: reducing the federal corporate rate from 35% to 21%; modifying the rules regarding limitations on certain deductions for executive compensation; introducing a capital investment deduction in certain circumstances; placing certain limitations on the interest deduction; and modifying the rules regarding the usability of net operating losses.

On May 18, 2018, German American Bank completed the acquisition of five branch locations of First Financial Bancorp (formerly branch locations of Mainsource Financial Group, Inc. prior to its merger with First Financial Bancorp on April 1, 2018) and certain related assets, and the assumption by German American Bank of certain related liabilities. Four of the branches are located in Columbus, Indiana, and one in Greensburg, Indiana. At the time of closing, German American Bank acquired approximately $175.3 million in deposits and approximately $117.6 million in loans associated with the five bank branches. The premium paid on deposits by German American Bank was approximately $7.4 million. The premium is subject to adjustment to reflect increases or decreases in the deposit balances during the six month period following the closing date. German American Bank also has the ability, under certain circumstances, to put loans back to First Financial Bancorp's bank subsidiary during such six month period. There have been no adjustments to the premium paid for deposits nor have any loans been put back to date.

On October 15, 2018, the Company completed the acquisition of First Security, Inc. ("First Security") through the merger of First Security with and into the Company (the "Merger"). Immediately following completion of the Merger, First Security's subsidiary bank, First Security Bank, Inc., was merged with and into the Company's subsidiary bank, German American Bank. First Security, based in Owensboro, Kentucky, operated 11 retail banking offices, through First Security Bank, Inc., in Owensboro, Bowling Green, Franklin and Lexington, Kentucky and in Evansville and Newburgh, Indiana. As of September 30, 2018, First Security had total assets of approximately $572 million, total loans of approximately $406 million, and total deposits of approximately $432 million.

The Company issued approximately 2.0 million shares of its common stock, and paid approximately $31.2 million in cash, in exchange for all of the issued and outstanding shares of common stock of First Security and in cancellation of all outstanding options to acquire First Security common stock.

For further information regarding this pending acquisition, see Note 14 (Business Combinations) in the Notes to the Consolidated Financial Statements included in Item 1 of this Report.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

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

Allowance for Loan Losses

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

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

Commercial and agricultural loans are subject to a standardized grading process administered by an internal loan review function. The need for specific reserves is considered for credits identified as impaired when: (a) the customer’s cash flow or net worth appears insufficient to repay the loan; (b) the loan has been criticized in a regulatory examination; (c) the loan is on non-accrual; or (d) other reasons where the ultimate collectability of the loan is in question, or the loan characteristics require special monitoring. Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individual credit that we believe indicates the loan is impaired.

Specific allocations on impaired loans are determined by comparing the loan balance to the present value of expected cash flows or expected collateral proceeds. Allocations are also applied to categories of loans not considered individually impaired but for which the rate of loss is expected to be greater than historical averages, including non-performing consumer or residential real estate loans. Such allocations are based on past loss experience and information about specific borrower situations and estimated collateral values.

General allocations are made for commercial and agricultural loans that are graded as substandard based on migration analysis techniques to determine historical average losses for similar types of loans. General allocations are also made for other pools of loans, including non-classified loans, homogeneous portfolios of consumer and residential real estate loans, and loans within certain industry categories believed to present unique risk of loss. General allocations of the allowance are primarily made based on historical averages for loan losses for these portfolios, judgmentally adjusted for economic, external and internal factors and portfolio trends. Economic factors include evaluating changes in international, national, regional and local economic and business conditions that affect the collectability of the loan portfolio. Internal factors include evaluating changes in lending policies and procedures; changes in the nature and volume of the loan portfolio; and changes in experience, ability and depth of lending management and staff. In setting our external and internal factors we also consider the overall level of the allowance for loan losses to total loans; our allowance coverage as compared to similar size bank holding companies; and regulatory requirements.

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

Securities Valuation

Securities available-for-sale are carried at fair value, with unrealized holding gains and losses reported separately in accumulated other comprehensive income (loss), net of tax. The Company obtains market values from a third party on a monthly basis in order to adjust the securities to fair value. Equity securities that do not have readily determinable fair values are carried at cost, less impairment with observable price changes being recognized in earnings. Additionally, when securities are deemed to be other than temporarily impaired, a charge will be recorded through earnings; therefore, future changes in the fair value of securities could have a significant impact on the Company's operating results. In determining whether a market value decline is other than temporary, management considers the reason for the decline, the extent of the decline, the duration of the decline and whether the Company intends to sell or believes it will be required to sell the securities prior to recovery. As of September 30, 2018, gross unrealized gains on the securities available-for-sale portfolio totaled approximately $2,511,000 and gross unrealized losses totaled approximately $24,127,000.

Income Tax Expense

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

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

Goodwill and Other Intangible Assets

Goodwill resulting from business combinations represents the excess of the purchase price over the fair value of the net assets of businesses acquired. Goodwill resulting from business combinations is generally determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected December 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on the Company's balance sheet.

Other intangible assets consist of core deposit and acquired customer relationship intangible assets. They are initially measured at fair value and then are amortized over their estimated useful lives, which range from 6 to 10 years.

RESULTS OF OPERATIONS

Net Income:

Net income for the quarter ended September 30, 2018 totaled $12,639,000, or $0.55 per share, an increase of 31% on a per share basis compared with the third quarter 2017 net income of $9,660,000, or $0.42 per share. The third quarter of 2018 net income was positively impacted by lower federal income tax rates that became effective January 1, 2018, as a result of the Tax Act. The lower federal income tax rates had a positive impact of approximately $0.07 per share during the third quarter of 2018.

Net income for the nine months ended September 30, 2018 totaled $35,549,000, or $1.55 per share, an increase of 22% on a per share basis compared with the first nine months of 2017 net income of $29,055,000, or $1.27 per share. The first nine months of 2018 net income was positively impacted by approximately $0.20 per share due to the lower federal income tax rates.

Net Interest Income:

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

The following table summarizes net interest income (on a tax-equivalent basis) for the three months ended September 30, 2018 and 2017. For tax-equivalent adjustments, an effective tax rate of 21% was used for the three months ended September 30, 2018 and 35% was used for the three months ended September 30, 2017[(1)].

| | Average Balance Sheet (Tax-equivalent basis / dollars in thousands) | | | | | |
|---|---|---|---|---|---|---|
| | Three Months Ended September 30, 2018 | | | Three Months Ended September 30, 2017 | | |
| | Principal Balance | Income / Expense | Yield / Rate | Principal Balance | Income / Expense | Yield / Rate |
| ASSETS | | | | | | |
| Federal Funds Sold and Other Short-term Investments | $20,745 | $101 | 1.94% | $13,543 | $46 | 1.38% |
| Securities: | | | | | | |
| Taxable | 473,914 | 2,971 | 2.51% | 482,269 | 2,688 | 2.23% |
| Non-taxable | 281,879 | 2,855 | 4.05% | 266,485 | 3,184 | 4.78% |
| Total Loans and Leases[(2)] | 2,318,657 | 28,240 | 4.84% | 2,058,453 | 23,358 | 4.51% |
| TOTAL INTEREST EARNING ASSETS | 3,095,195 | 34,167 | 4.39% | 2,820,750 | 29,276 | 4.13% |
| Other Assets | 253,739 | | | 227,813 | | |
| Less: Allowance for Loan Losses | (15,929) | | | (15,508) | | |
| TOTAL ASSETS | $3,333,005 | | | $3,033,055 | | |
| | | | | | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | |
| Interest-bearing Demand, Savings and Money Market Deposits | $1,617,768 | $2,028 | 0.50% | $1,447,693 | $1,117 | 0.31% |
| Time Deposits | 425,783 | 1,507 | 1.40% | 382,827 | 842 | 0.87% |
| FHLB Advances and Other Borrowings | 257,460 | 1,392 | 2.14% | 246,698 | 1,110 | 1.79% |
| TOTAL INTEREST-BEARING LIABILITIES | 2,301,011 | 4,927 | 0.85% | 2,077,218 | 3,069 | 0.59% |
| Demand Deposit Accounts | 636,989 | | | 572,204 | | |
| Other Liabilities | 19,750 | | | 25,334 | | |
| TOTAL LIABILITIES | 2,957,750 | | | 2,674,756 | | |
| Shareholders' Equity | 375,255 | | | 358,299 | | |
| TOTAL LIBABILITIES AND SHAREHOLDERS' EQUITY | $3,333,005 | | | $3,033,055 | | |

| | | |
|---|---|---|
| COST OF FUNDS | 0.63 % | 0.43 % |
| NET INTEREST INCOME | $ 29,240 | $ 26,207 |
| NET INTEREST MARGIN | 3.76 % | 3.70 % |

(1) Effective tax rates were determined as though interest earned on the Company's investments in municipal bonds and loans was fully taxable.
(2) Loans held-for-sale and non-accruing loans have been included in average loans.

Net interest income increased $3,631,000, or 15%, for the quarter ended September 30, 2018 compared with the same quarter of 2017. The net interest margin represents tax-equivalent net interest income expressed as a percentage of average earning assets. The tax equivalent net interest margin was 3.76% for the third quarter of 2018 compared to 3.70% during the third quarter of 2017. The tax equivalent yield on earning assets totaled 4.39% during the quarter ended September 30, 2018 compared to 4.13% in the same period of 2017, while the cost of funds (expressed as a percentage of average earning assets) totaled 0.63% during the quarter ended September 30, 2018 compared to 0.43% in the same period of 2017.

The increased level of net interest income during the third quarter of 2018 compared with the third quarter of 2017 was driven primarily by a higher level of average earning assets and an improved net interest margin. The increased level of average earning assets in the third quarter of 2018 was driven by organic loan growth from the Company's existing branch footprint combined with growth related to the branch acquisition completed during the second quarter of 2018.

The net interest margin during the third quarter of 2018 when compared with the third quarter of 2017 was positively impacted by an improvement in loan yields driven by higher short-term market interest rates and an increase in the amount of accretion on loan discounts on acquired loans while an increase in the cost of funds and the decline in federal income tax rates in 2018 compared with 2017 negatively impacted the net interest margin. Accretion of loan discounts on acquired loans contributed approximately 8 basis points to the net interest margin on an annualized basis in the third quarter of 2018 compared with 5 basis points in the third quarter of 2017. The Company's cost of funds increased approximately 20 basis points in the third quarter of 2018 compared with the third quarter of 2017. The higher cost of funds was largely attributable to an increase in short-term market interest rates over the past several quarters. The lower federal income tax rates during the second quarter of 2018 had an approximately 9 basis point negative impact on the Company's net interest margin and earning asset yield.

The following table summarizes net interest income (on a tax-equivalent basis) for the nine months ended September 30, 2018 and 2017. For tax-equivalent adjustments, an effective tax rate of 21% was used for the nine months ended September 30, 2018 and 35% was used for the nine months ended September 30, 2017(1).

| | Average Balance Sheet (Tax-equivalent basis / dollars in thousands) | | | | | |
|---|---|---|---|---|---|---|
| | Nine Months Ended September 30, 2018 | | | Nine Months Ended September 30, 2017 | | |
| | Principal Balance | Income / Expense | Yield / Rate | Principal Balance | Income / Expense | Yield / Rate |
| ASSETS | | | | | | |
| Federal Funds Sold and Other Short-term Investments | $18,852 | $211 | 1.50% | $13,125 | $100 | 1.02% |
| Securities: | | | | | | |
| Taxable | 476,647 | 8,930 | 2.50% | 481,242 | 8,109 | 2.25% |
| Non-taxable | 276,944 | 8,362 | 4.03% | 260,146 | 9,485 | 4.86% |
| Total Loans and Leases(2) | 2,230,100 | 78,666 | 4.72% | 2,015,245 | 68,577 | 4.55% |
| TOTAL INTEREST EARNING ASSETS | 3,002,543 | 96,169 | 4.28% | 2,769,758 | 86,271 | 4.16% |
| Other Assets | 240,450 | | | 222,582 | | |
| Less: Allowance for Loan Losses | (15,527) | | | (15,317) | | |
| TOTAL ASSETS | $3,227,466 | | | $2,977,023 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | |
| Interest-bearing Demand, Savings and Money Market Deposits | $1,556,460 | $4,901 | 0.42% | $1,426,906 | $2,794 | 0.26% |
| Time Deposits | 414,022 | 3,766 | 1.22% | 381,573 | 2,234 | 0.78% |
| FHLB Advances and Other Borrowings | 252,987 | 3,859 | 2.04% | 235,633 | 2,937 | 1.67% |
| TOTAL INTEREST-BEARING LIABILITIES | 2,223,469 | 12,526 | 0.75% | 2,044,112 | 7,965 | 0.52% |
| Demand Deposit Accounts | 616,048 | | | 563,679 | | |
| Other Liabilities | 19,896 | | | 22,176 | | |

| | | | | |
|---|---|---|---|---|
| TOTAL LIABILITIES | 2,859,413 | | 2,629,967 | |
| Shareholders’ Equity | 368,053 | | 347,056 | |
| TOTAL LIBABILITIES AND SHAREHOLDERS' EQUITY | $3,227,466 | | $2,977,023 | |
| | | | | |
| COST OF FUNDS | | 0.56% | | 0.38% |
| NET INTEREST INCOME | $83,643 | | $78,306 | |
| NET INTEREST MARGIN | | 3.72% | | 3.78% |

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

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

Net interest income increased $7,172,000, or 10%, for the nine months ended September 30, 2018 compared with the same period of 2017. The increased level of net interest income during the first nine months of 2018 compared with the nine months ended September 30, 2017 was driven primarily by a higher level of average earning assets and an improved net interest margin (excluding the impact of lower federal tax rates on the net interest margin). The increased level of average earning assets during 2018 was largely driven by organic loan growth from the Company's existing branch footprint and to a lesser degree from growth related to the branch acquisition completed during the second quarter of 2018.

The tax equivalent net interest margin was 3.72% for the first nine months of 2018 compared to 3.78% during the same period of 2017. The tax equivalent yield on earning assets totaled 4.28% during the nine months ended September 30, 2018 compared to 4.16% in the same period of 2017, while the cost of funds (expressed as a percentage of average earning assets) totaled 0.56% during the nine months ended September 30, 2018 compared to 0.38% in the same period of 2017. The increased yield on earning assets and the increase in the cost of funds during 2018 were both impacted by increased short-term market interest rates.

Accretion of loan discounts on acquired loans contributed approximately 6 basis points to the net interest margin on an annualized basis in the nine months of 2018 and 11 basis points in the same period of 2017. The lower federal income tax rates during the first nine months of 2018 had an approximately 9 basis point negative impact on the Company's net interest margin and earning asset yield.

Provision for Loan Losses:

The Company provides for loan losses through regular provisions to the allowance for loan losses. The provision is affected by net charge-offs on loans and changes in specific and general allocations of the allowance. During the quarter ended September 30, 2018, the provision for loan losses totaled $500,000 compared with a $250,000 provision for loan losses during the third quarter of 2017. The provision for loan losses represented approximately 9 basis points and 5 basis points of average loans on an annualized basis in the third quarter of 2018 and 2017, respectively.

The provision for loan losses totaled $2,070,000 for the nine months ended September 30, 2018, an increase of $970,000, or 88%, compared to the provision of $1,100,000 during the nine months ended September 30, 2017. During the first nine months of 2018, the provision for loan loss represented approximately 12 basis points of average loans on an annualized basis compared with 7 basis points of average loans on an annualized basis during the nine months ended September 30, 2017. The level of provision during all periods presented was done in accordance with the Company's standard methodology for determining the adequacy of its allowance for loan loss.

Net charge-offs totaled $86,000 or 1 basis point on an annualized basis of average loans outstanding during the three months ended September 30, 2018, compared with $249,000 or 5 basis points on an annualized basis of average loans outstanding during the same period of 2017. The Company realized net charge-offs of $1,713,000 or 10 basis points on an annualized basis of average loans outstanding during the nine months ended September 30, 2018, compared with net charge-offs of $587,000 or 4 basis points on an annualized basis of average loans outstanding during the same period of 2017. The increase in net charge-offs during the first nine months of 2018 was primarily attributable to a partial charge-off on a single commercial lending relationship in the first quarter of 2018 that was downgraded and largely reserved for during the fourth quarter of 2017.

The provision for loan losses made during each of the three and nine month periods ended September 30, 2018 was made at a level deemed necessary by management to absorb changes in estimated, probable incurred losses in the loan portfolio. A detailed evaluation of the adequacy of the allowance for loan losses is completed quarterly by management, the results of which are used to determine provision for loan losses. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors.

Non-interest Income:

During the quarter ended September 30, 2018, non-interest income totaled $8,963,000, an increase of $688,000, or 8%, compared with the third quarter of 2017.

| Non-interest Income (dollars in thousands) | Three Months Ended September 30, | | Change From Prior Period | |
|---|---|---|---|---|
| | 2018 | 2017 | Amount Change | Percent Change |
| Trust and Investment Product Fees | $1,585 | $1,301 | $284 | 22 % |
| Service Charges on Deposit Accounts | 1,858 | 1,608 | 250 | 16 |
| Insurance Revenues | 1,827 | 1,728 | 99 | 6 |
| Company Owned Life Insurance | 251 | 317 | (66 ) | (21 ) |
| Interchange Fee Income | 1,847 | 1,186 | 661 | 56 |
| Other Operating Income | 639 | 608 | 31 | 5 |
| Subtotal | 8,007 | 6,748 | 1,259 | 19 |
| Net Gains on Sales of Loans | 866 | 952 | (86 ) | (9 ) |
| Net Gains on Securities | 90 | 575 | (485 ) | (84 ) |
| Total Non-interest Income | $8,963 | $8,275 | $688 | 8 |

Trust and investment product fees increased $284,000, or 22%, during the third quarter of 2018 compared with the third quarter of 2017. Increased assets under management in the Company's wealth advisory group contributed to this increase in trust and investment product fees.

Service charges on deposit accounts increased $250,000, or 16%, during the third quarter of 2018 compared with the third quarter of 2017. The increase was largely attributable to the branch acquisition that was completed during the second quarter of 2018.

Interchange fees increased $661,000, or 56%, during the third quarter of 2018 compared with the third quarter of 2017. The increase during the third quarter of 2018 compared with the same period of 2017 was attributable to increased card utilization by customers and to the adoption of the new revenue recognition standard effective January 1, 2018. While the adoption of the standard did not have a significant impact on the Company's financial results, the recording of revenue gross versus net of certain expenses, in accordance with the standard, did result in the reclassification of some expenses associated with the interchange fee revenue during the third quarter of 2018. The reclassification of this expense for the third quarter of 2018 totaled $399,000.

During the quarter ended September 30, 2018, the Company realized a net gain on the sale of securities of $90,000 related to the sale of $5.3 million of securities compared with a net gain on sales of securities of $575,000 related to the sale of $47.8 million of securities during the third quarter of 2017.

During the nine months ended September 30, 2018, non-interest income totaled $27,337,000, an increase of $3,077,000, or 13%, compared with the first nine months of 2017.

| Non-interest Income (dollars in thousands) | Nine Months Ended September 30, | | Change From Prior Period | |
|---|---|---|---|---|
| | 2018 | 2017 | Amount Change | Percent Change |
| Trust and Investment Product Fees | $5,035 | $3,894 | $1,141 | 29 % |
| Service Charges on Deposit Accounts | 4,972 | 4,570 | 402 | 9 |

| | | | | |
|---|---|---|---|---|
| Insurance Revenues | 6,453 | 6,112 | 341 | 6 |
| Company Owned Life Insurance | 823 | 1,051 | (228 ) | (22 ) |
| Interchange Fee Income | 5,043 | 3,365 | 1,678 | 50 |
| Other Operating Income | 2,156 | 2,095 | 61 | 3 |
| Subtotal | 24,482 | 21,087 | 3,395 | 16 |
| Net Gains on Sales of Loans | 2,421 | 2,598 | (177 ) | (7 ) |
| Net Gains on Securities | 434 | 575 | (141 ) | (25 ) |
| Total Non-interest Income | $27,337 | $24,260 | $3,077 | 13 |

Trust and investment product fees increased $1,141,000, or 29%, during the nine months ended September 30, 2018 compared with the same period of 2017. The increase was primarily attributable to fees generated from increased assets under management in the Company's wealth advisory group.

Service charges on deposit accounts increased $402,000, or 9%, during the nine months ended September 30, 2018 compared with the same period of 2017. The increase was largely attributable to the branch acquisition that was completed during the second quarter of 2018.

Insurance revenues increased $341,000, or 6%, during the first nine months of 2018 compared with the first nine months of 2017. The increase during 2018 was primarily due to increased contingency revenue. Contingency revenue during 2018 totaled $1,218,000 compared with $992,000 during 2017. The fluctuation in contingency revenue is a normal course of business variance and is reflective of claims and loss experience with insurance carriers that the Company represents through its property and casualty insurance agency. Typically, the majority of contingency revenue is recognized during the first quarter of the year.

Company owned life insurance revenue declined $228,000, or 22%, during the nine months ended September 30, 2018, compared with the same period of 2017. The decline was largely related to death benefits received from life insurance policies during 2017.

Interchange fees increased $1,678,000, or 50%, during the first nine months of 2018 compared with 2017. The increase during 2018 compared with 2017 was attributable to increased card utilization by customers and to the adoption of the new revenue recognition standard effective January 1, 2018. While the adoption of the standard did not have a significant impact on the Company's financial results, the recording of revenue gross versus net of certain expenses, in accordance with the standard, did result in the reclassification of some expenses associated with the interchange fee revenue during 2018. The reclassification of this expense for the nine months ended September 30, 2018 totaled $1,099,000.

Non-interest Expense:

During the quarter ended September 30, 2018, non-interest expense totaled $21,576,000, an increase of $1,805,000, or 9%, compared with the third quarter of 2017. The third quarter of 2018 included a full quarter of operating expenses for the five-branch acquisition completed during the second quarter of 2018. The third quarter of 2018 included acquisition-related expenses of approximately $396,000 (approximately $317,000 or $0.01 per share, on an after tax basis) for the five-branch acquisition that closed on May 18, 2018 and the acquisition of First Security, Inc. that closed on October 15, 2018.

| Non-interest Expense (dollars in thousands) | Three Months Ended September 30, | | Change From Prior Period | |
|---|---|---|---|---|
| | | | Amount | Percent |
| | 2018 | 2017 | Change | Change |
| Salaries and Employee Benefits | $12,134 | $11,570 | $564 | 5 % |
| Occupancy, Furniture and Equipment Expense | 2,738 | 2,372 | 366 | 15 |
| FDIC Premiums | 324 | 241 | 83 | 34 |
| Data Processing Fees | 1,309 | 1,067 | 242 | 23 |
| Professional Fees | 793 | 551 | 242 | 44 |
| Advertising and Promotion | 851 | 1,315 | (464 ) | (35 ) |
| Intangible Amortization | 430 | 230 | 200 | 87 |
| Other Operating Expenses | 2,997 | 2,425 | 572 | 24 |
| Total Non-interest Expense | $21,576 | $19,771 | $1,805 | 9 |

Salaries and benefits increased $564,000, or 5%, during the quarter ended September 30, 2018 compared with the third quarter of 2017. The increase in salaries and benefits during the third quarter of 2018 compared with the third quarter of 2017 was primarily attributable to an increased number of full-time equivalent employees.

Occupany, furniture and equipment expense increased $366,000, or 15%, during the third quarter of 2018 compared with the third quarter of 2017. The increase during the third quarter of 2018 compared to the third quarter of 2017 was primarily due to operating costs related to the acquisition of the five banking branches in the Columbus and Greensburg, Indiana markets as well as other facilities the Company has placed into service over the past several quarters.

Data processing fees increased $242,000, or 23%, during the third quarter of 2018 compared to the second quarter of 2017. The increase during the third quarter of 2018 was largely related to costs associated with merger and acquisition activities.

Professional fees increased $242,000, or 44%, during the third quarter of 2018 compared with the third quarter of 2017. The increase during the third quarter of 2018 compared with the third quarter of 2017 was due to professional fees related to merger and acquisition activity during 2018.

Advertising and promotion expense declined $464,000, or 35%, during the third quarter of 2018 compared with the third quarter of 2017. The decline in the third quarter of 2018 compared to the third quarter of 2017 was primarily related to the donation of a former branch facility to a municipality in one of the Company's market areas during the third quarter of 2017.

Intangible amortization increased $200,000, or 87%, during the quarter ended September 30, 2018 compared with the third quarter of 2017. The increase in intangible amortization was attributable to the previously discussed branch acquisition completed during the second quarter of 2018.

Other operating expenses increased $572,000, or 24%, during the third quarter of 2018 compared with the third quarter of 2017. The increase in the third quarter of 2018 compared with the third quarter of 2017 was largely attributable to the adoption of the revenue recognition standard effective January 1, 2018 and the reclassification of expense as previously discussed. The reclassification of expense in accordance with the standard for the third quarter of 2018 totaled $399,000.

During the nine months ended September 30, 2018, non-interest expense totaled $63,739,000, an increase of $5,936,000, or 10%, compared with the first nine months of 2017. The first nine months of 2018 included acquisition-related expenses of approximately $1,486,000 (approximately $1,183,000 or $0.05 per share, on an after tax basis) for the five-branch acquisition that closed on May 18, 2018 and the acquisition of First Security, Inc. that closed on October 15, 2018.

| Non-interest Expense (dollars in thousands) | Nine Months Ended September 30, | | Change From Prior Period | |
|---|---|---|---|---|
| | 2018 | 2017 | Amount Change | Percent Change |
| Salaries and Employee Benefits | $36,279 | $34,474 | $1,805 | 5 % |
| Occupancy, Furniture and Equipment Expense | 7,674 | 6,778 | 896 | 13 |
| FDIC Premiums | 799 | 712 | 87 | 12 |
| Data Processing Fees | 3,834 | 3,122 | 712 | 23 |
| Professional Fees | 3,025 | 2,267 | 758 | 33 |
| Advertising and Promotion | 2,409 | 2,723 | (314 ) | (12 ) |
| Intangible Amortization | 942 | 725 | 217 | 30 |
| Other Operating Expenses | 8,777 | 7,002 | 1,775 | 25 |
| Total Non-interest Expense | $63,739 | $57,803 | $5,936 | 10 |

Salaries and benefits increased $1,805,000, or 5%, during the nine months ended September 30, 2018 compared with the same period of 2017. The increase in salaries and benefits during 2018 compared with 2017 was primarily attributable to an increased number of full-time equivalent employees.

Occupancy, furniture and equipment expense increased $896,000, or 13%, during the nine months ended September 30, 2018 compared with the same period of 2017. The increase during 2018 compared with 2017 was primarily due to operating costs related to facilities the Company has placed into service over the past several quarters and to the acquisition of the five banking branches in the Columbus and Greensburg, Indiana markets.

Data processing fees increased $712,000, or 23%, during the first nine months of 2018 compared with 2017. The increase during the first nine months of 2018 was largely related to costs associated with merger and acquisition activities.

Professional fees increased $758,000, or 33%, during the first nine months of 2018 compared with 2017. The increase during 2018 was related to professional fees associated with the the five-branch acquisition that closed on May 18, 2018 and the acquisition of First Security, Inc. that closed on October 15, 2018.

Advertising and promotion expense declined $314,000, or 12%, during the nine months ended September 30, 2018 compared with the same period of 2017. The decline in 2018 compared with 2017 was primarily related to the donation of a former branch facility to a municipality in one of the Company's market areas during the third quarter of 2017.

Intangible amortization increased $217,000, or 30%, during the nine months ended September 30, 2018 compared with the same period of 2017. The increase in intangible amortization was attributable to the previously discussed branch acquisition completed during the second quarter of 2018.

Other operating expenses increased $1,775,000, or 25%, during the first nine months of 2018 compared with 2017. The increase in 2018 was largely attributable to the adoption of the revenue recognition standard effective January 1, 2018, The reclassification of expense in accordance with the standard for the nine months ended September 30, 2018, totaled $1,099,000.

Income Taxes:

The Company's effective income tax rate was 18.1% and 26.7%, respectively, during the three months ended September 30, 2018 and 2017. The Company's effective income tax rate was 17.6% and 27.0%, respectively, during the nine months ended September 30, 2018 and 2017. The effective tax rate in all periods presented was lower than the blended statutory rate resulting primarily from the Company's tax-exempt investment income on securities, loans and company-owned life insurance, income tax credits generated from affordable housing projects, and income generated by subsidiaries domiciled in a state with no state or local income tax.

During the quarter ended September 30, 2018, the Company recorded a provision for income tax expense of $2,796,000 compared with a provision for income tax expense of $3,511,000 in the third quarter of 2017. During the nine months ended September 30, 2018, the Company recorded a provision for income tax expense of $7,606,000 compared with a provision for income tax expense of $10,757,000 in the first nine months of 2017. The provision for income tax and the effective tax rate was positively impacted during the third quarter and first nine months of 2018 by the reduction of federal income tax rates from a statutory rate of 35% to 21% effective January 1, 2018 related to the federal tax reform legislation enacted during the fourth quarter of 2017.

FINANCIAL CONDITION

Total assets for the Company increased to $3.364 billion at September 30, 2018, representing an increase of $219.4 million, or 9% on an annualized basis, compared with December 31, 2017. The increase in total assets was driven by the acquisition of the five-branch network in the Columbus and Greensburg, Indiana markets, as well as organic loan growth.

At September 30, 2018, total loans increased $195.2 million, or 12% on an annualized basis, compared with December 31, 2017. At September 30, 2018, the loans acquired as a part of the branch acquisition, which closed on May 18, 2018, totaled $112.9 million. At September 30, 2018, total loans, excluding those acquired as a part of the branch acquisition, increased $82.3 million, or approximately 5% on an annualized basis, compared with December 31, 2017.

The increase in total loans during the first nine months of 2018, excluding those acquired as a part of the branch acquisition, was driven by an increase of approximately $16.8 million, or 5% on an annualized basis, of commercial and industrial loans, an increase of $34.0 million, or 5% on an annualized basis, of commercial real estate loans, an increase of $23.0 million, or 9% on an annualized basis, of agricultural loans and an increase of $8.5 million, or 3% on annualized basis, of retail loans.

| End of Period Loan Balances: (dollars in thousands) | September 30, 2018 | December 31, 2017 | Current Period Change |
|---|---|---|---|
| Commercial and Industrial Loans and Leases | $527,938 | $486,668 | $41,270 |
| Commercial Real Estate Loans | 985,915 | 926,729 | 59,186 |
| Agricultural Loans | 358,543 | 333,227 | 25,316 |
| Home Equity and Consumer Loans | 247,861 | 219,662 | 28,199 |
| Residential Mortgage Loans | 219,916 | 178,733 | 41,183 |
| Total Loans | $2,340,173 | $2,145,019 | $195,154 |

The following table indicates the breakdown of the allowance for loan losses for the periods indicated (dollars in thousands):

| | September 30, 2018 | December 31, 2017 |
|---|---|---|
| Commercial and Industrial Loans and Leases | $ 3,188 | $ 4,735 |
| Commercial Real Estate Loans | 5,094 | 4,591 |
| Agricultural Loans | 6,216 | 4,894 |
| Home Equity and Consumer Loans | 663 | 628 |
| Residential Mortgage Loans | 425 | 343 |
| Unallocated | 465 | 503 |
| Total Allowance for Loan Loss | $ 16,051 | $ 15,694 |

The Company's allowance for loan losses totaled $16.1 million at September 30, 2018 compared to $15.7 million at December 31, 2017. The allowance for loan losses represented 0.69% of period-end loans at September 30, 2018 compared with 0.73% of period-end loans at December 31, 2017. From time to time, the Company has acquired loans through bank and branch acquisitions with the most recent being a branch acquisition in the second quarter of 2018. Under acquisition accounting treatment, loans acquired are recorded at fair value which includes a credit risk component, and therefore the allowance on loans acquired is not carried over from the seller. The Company held a net discount on acquired loans of $9.0 million as of September 30, 2018 and $7.6 million at December 31, 2017.

The following is an analysis of the Company's non-performing assets at September 30, 2018 and December 31, 2017:

| Non-performing Assets: (dollars in thousands) | September 30, 2018 | December 31, 2017 |
|---|---|---|
| Non-accrual Loans | $ 8,428 | $ 11,091 |
| Past Due Loans (90 days or more) | 69 | 719 |
| Total Non-performing Loans | 8,497 | 11,810 |
| Other Real Estate | 100 | 54 |
| Total Non-performing Assets | $ 8,597 | $ 11,864 |
| | | |
| Restructured Loans | $ 122 | $ 149 |
| | | |
| Non-performing Loans to Total Loans | 0.36 % | 0.55 % |
| Allowance for Loan Loss to Non-performing Loans | 188.90 % | 132.89 % |

The following tables present non-accrual loans and loans past due 90 days or more still on accrual by class of loans:

| | Non-Accrual Loans | | Loans Past Due 90 Days or More & Still Accruing | |
|---|---|---|---|---|
| | September 30, 2018 | December 31, 2017 | September 30, 2018 | December 31, 2017 |
| Commercial and Industrial Loans and Leases | $ 2,400 | $ 4,753 | $ — | $ — |
| Commercial Real Estate Loans | 4,667 | 4,618 | 69 | 471 |
| Agricultural Loans | 552 | 748 | — | 248 |
| Home Equity Loans | 59 | 199 | — | — |
| Consumer Loans | 148 | 286 | — | — |
| Residential Mortgage Loans | 602 | 487 | — | — |
| Total | $ 8,428 | $ 11,091 | $ 69 | $ 719 |

Non-performing assets totaled $8.6 million at September 30, 2018 compared to $11.9 million of non-performing assets at December 31, 2017. Non-performing assets represented 0.26% of total assets at September 30, 2018 compared to 0.38% of total assets at December 31, 2017. Non-performing loans totaled $8.5 million at September 30, 2018 compared to $11.8 million at December 31, 2017. Non-performing loans represented 0.36% of total loans at September 30, 2018 compared to 0.55% at December 31, 2017. The decline in non-performing assets during the first nine months of 2018 was largely attributable to a partial charge-off on a single commercial lending relationship that was downgraded during the fourth quarter of 2017.

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

Total deposits increased $156.8 million, or 8% on an annualized basis, as of September 30, 2018 compared with December 31, 2017. The increase in total deposits during the first nine months of 2018 compared with year-end 2017 was largely driven by the previously discussed branch acquisition. At September 30, 2018, the deposits acquired as a part of the branch acquisition totaled approximately $132.1 million.

| End of Period Deposit Balances: (dollars in thousands) | September 30, 2018 | December 31, 2017 | Current Period Change |
|---|---|---|---|
| Non-interest-bearing Demand Deposits | $634,421 | $606,134 | $28,287 |
| Interest-bearing Demand, Savings, & Money Market Accounts | 1,605,818 | 1,490,033 | 115,785 |
| Time Deposits < $100,000 | 189,405 | 198,646 | (9,241 ) |
| Time Deposits of $100,000 or more | 211,203 | 189,239 | 21,964 |
| Total Deposits | $2,640,847 | $2,484,052 | $156,795 |

Capital Resources:

As of September 30, 2018, shareholders' equity increased by $11.5 million to $376.1 million compared with $364.6 million at year-end 2017. The increase in shareholders' equity was primarily attributable to an increase of $25.2 million in retained earnings partially offset by a decline in accumulated other comprehensive income primarily related to the decrease in value of the Company's available-for-sale securities portfolio. Shareholders' equity represented 11.1% of total assets at September 30, 2018 and 11.6% of total assets at December 31, 2017. Shareholders' equity included $65.5 million of goodwill and other intangible assets at September 30, 2018 compared to $56.2 million of goodwill and other intangible assets at December 31, 2017. The increase in goodwill and other intangible assets resulted from the previously discussed branch acquisition.

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

As of January 1, 2015, the Company and its subsidiary bank adopted the new Basel III regulatory capital framework. The adoption of this new framework modified the regulatory capital calculations, minimum capital levels and well-capitalized thresholds and added the new Common Equity Tier 1 capital ratio. Additionally, under the new rules, in order to avoid limitations on capital distributions, including dividend payments, the Company is required to maintain a capital conservation buffer above the adequately capitalized regulatory capital ratios. The capital conservation buffer is being phased in from 0.00% in 2015 to 2.50% in 2019. For September 30, 2018, the capital conservation buffer was 1.875% and for December 31, 2017, the capital conservation buffer was 1.25%. At September 30, 2018, the capital levels for the Company and its subsidiary bank remained well in excess of of the minimum amounts needed for capital adequacy purposes and the bank's capital levels met the necessary requirements to be considered well-capitalized.

The table below presents the Company’s consolidated and the subsidiary bank's capital ratios under regulatory guidelines:

| | 9/30/2018 Ratio | | 12/31/2017 Ratio | | Minimum for Capital Adequacy Purposes | | Well-Capitalized Guidelines | |
|---|---|---|---|---|---|---|---|---|
| Total Capital (to Risk Weighted Assets) | | | | | | | | |
| Consolidated | 13.23 | % | 13.62 | % | 8.00 | % | N/A | |
| Bank | 12.11 | % | 12.29 | % | 8.00 | % | 10.00 | % |
| Tier 1 (Core) Capital (to Risk Weighted Assets) | | | | | | | | |
| Consolidated | 12.63 | % | 12.99 | % | 6.00 | % | N/A | |
| Bank | 11.52 | % | 11.66 | % | 6.00 | % | 8.00 | % |
| Common Tier 1, (CET 1) Capital Ratio (to Risk Weighted Assets) | | | | | | | | |
| Consolidated | 12.21 | % | 12.55 | % | 4.50 | % | N/A | |
| Bank | 11.52 | % | 11.66 | % | 4.50 | % | 6.50 | % |
| Tier 1 Capital (to Average Assets) | | | | | | | | |
| Consolidated | 10.34 | % | 10.71 | % | 4.00 | % | N/A | |
| Bank | 9.44 | % | 9.63 | % | 4.00 | % | 5.00 | % |

Under the the final rules provided for by Basel III, accumulated other comprehensive income ("AOCI") was to be included in a banking organization's Common Equity Tier 1 capital. The final rules allowed community banks to make a one-time election not to include the additional components of AOCI in regulatory capital and instead use the existing treatment under the general risk-based capital rules that excludes most AOCI components from regulatory capital. The Company elected, in its March 31, 2015 regulatory filings (Call Report and FR Y-9), to opt-out and continue the existing treatment of AOCI for regulatory capital purposes.

Liquidity:

The Consolidated Statement of Cash Flows details the elements of changes in the Company’s consolidated cash and cash equivalents. Total cash and cash equivalents decreased $4,775,000 during the nine months ended September 30, 2018 ending at $65.6 million.  During the nine months ended September 30, 2018, operating activities resulted in net cash inflows of $42.7 million. Investing activities resulted in net cash outflows of $70.2 million during the nine months ended September 30, 2018.  Financing activities resulted in net cash inflows for the nine months ended September 30, 2018 of $22.8 million.

The parent company is a corporation separate and distinct from its bank and other subsidiaries. The Company uses funds at the parent-company level to pay dividends to its shareholders, to acquire or make other investments in other businesses or their securities or assets, to repurchase its stock from time to time, and for other general corporate purposes including debt service. The parent company does not have access at the parent-company level to the deposits and certain other sources of funds that are available to its bank subsidiary to support its operations. Instead, the parent company has historically derived most of its revenues from dividends paid to the parent company by its bank subsidiary. The Company’s banking subsidiary is subject to statutory restrictions on its ability to pay dividends to the parent company. The parent company has in recent years supplemented the dividends received from its subsidiaries with borrowings. As of September 30, 2018, the parent company had approximately $21.8 million of cash and cash equivalents available to meet its cash flow needs.

On October 11, 2018, the Company entered into a Loan Agreement with U.S. Bank National Association, providing the Company with a term loan in the principal amount of $25,000,000 (the “Term Loan”), and with a revolving credit loan in the principal amount of up to $15,000,000 (the “Revolving Credit Loan” and, collectively with the Term Loan, the “Loans”). The Term Loan was advanced in its entirety on October 11, 2018, for purposes of funding a portion of the cash payment required to be paid by the Company in connection with the acquisition of the outstanding capital stock of First Security, Inc., which closed effective October 15, 2018. The Revolving Credit Loan will be used for general corporate needs, operating expenditures and capital injections incurred in the ordinary course of business.

The Term Loan, as evidenced by a term loan promissory note (the “Term Note”), bears interest at an annual rate of 5.24%. The Revolving Credit Loan, as evidenced by a revolving credit promissory note (the “Revolving Credit Note”), bears interest at an annual rate equal to 1.75% plus the greater of (a) zero percent (0.00%) or (b) the one month LIBOR rate in effect two New York banking days prior to the beginning of each calendar month, adjusted for any reserve requirement and any subsequent costs arising from a change in government regulation, as reset each month.

The Company will pay quarterly payments of accrued interest on the Loans beginning on December 31, 2018. The balance of all outstanding principal and accrued interest under the Term Note will become due and payable on September 30, 2021. The balance of all outstanding principal and accrued interest under the Revolving Credit Note will become due and payable on September 30, 2019. As of the date hereof, there have been no borrowings under the Revolving Credit Note.

FORWARD-LOOKING STATEMENTS AND ASSOCIATED RISKS

The Company from time to time in its oral and written communications makes statements relating to its expectations regarding the future. These types of statements are considered "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The Company may include forward-looking statements in filings with the Securities and Exchange Commission ("SEC"), such as this Form 10-Q, in other written materials, and in oral statements made by senior management to analysts, investors, representatives of the media, and others. Such forward looking statements can include statements about the Company's net interest income or net interest margin; its adequacy of allowance for loan losses, levels of provisions for loan losses, and the quality of the Company's loans, investment securities and other assets; simulations of changes in interest rates; expected results from mergers with or acquisitions of other businesses; litigation results; tax estimates and recognition; dividend policy; parent company cash resources and cash requirements, and parent company capital resources; estimated cost savings, plans and objectives for future operations; and expectations about the Company's financial and business performance and other business matters as well as economic and market conditions and trends. They often can be identified by the use of words like "plan," "expect," "can," "might," "may," "will," "would," "could," "should," "intend," "project," "estimate," "believe" or "anticipate," or simila

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

Readers are cautioned that, by their nature, all forward-looking statements are based on assumptions and are subject to risks, uncertainties, and other factors. Actual results may differ materially and adversely from the expectations of the Company that are expressed or implied by any forward-looking statement. The discussions in this Item 2 list some of the factors that could cause the Company's actual results to vary materially from those expressed or implied by any forward-looking statements. Other risks, uncertainties, and factors that could cause the Company's actual results to vary materially from those expressed or implied by any forward-looking statement include the unknown future direction of interest rates and the timing and magnitude of any changes in interest rates; changes in competitive conditions; the introduction, withdrawal, success and timing of asset/liability management strategies or of mergers and acquisitions and other business initiatives and strategies; changes in customer borrowing, repayment, investment and deposit practices; changes in fiscal, monetary and tax policies; changes in financial and capital markets; deterioration in general economic conditions, either nationally or locally, resulting in, among other things, credit quality deterioration; capital management activities, including possible future sales of new securities, or possible repurchases or redemptions by the Company of outstanding debt or equity securities; risks of expansion through acquisitions and mergers, such as unexpected credit quality problems of the acquired loans or other assets, unexpected attrition of the customer base of the acquired institution or branches, and difficulties in integration of the acquired operations; factors driving impairment charges on investments; the impact, extent and timing of technological changes; potential cyber-attacks, information security breaches and other criminal activities; litigation liabilities, including related costs, expenses, settlements and judgments, or the outcome of matters before regulatory agencies, whether pending or commencing in the future; actions of the Federal Reserve Board; changes in accounting principles and interpretations; the expected impact of U.S. tax regulations passed in December 2017; potential increases of federal deposit insurance premium expense, and possible future special assessments of FDIC premiums, either industry wide or specific to the Company's banking subsidiary; actions of the regulatory authorities under the Dodd-Frank Wall Street Reform and

Consumer Protection Act (the "Dodd-Frank Act") and the Federal Deposit Insurance Act and other possible legislative and regulatory actions and reforms; impacts resulting from possible amendments or revisions to the Dodd-Frank Act and the regulations promulgated thereunder, or to Consumer Financial Protection Bureau rules and regulations; and the continued availability of earnings and excess capital sufficient for the lawful and prudent declaration and payment of cash dividends. Such statements reflect our views with respect to future events and are subject to these and other risks, uncertainties and assumptions relating to the operations, results of operations, growth strategy and liquidity of the Company. Readers are cautioned not to place undue reliance on these forward-looking statements.

Investors should consider these risks, uncertainties, and other factors, in addition to those mentioned by the Company in its Annual Report on Form 10-K for its fiscal year ended December 31, 2017, and other SEC filings from time to time, when considering any forward-looking statement.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

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

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

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

The table below provides an assessment of the risk to net interest income over the next 12 months in the event of a sudden and sustained 1% and 2% increase and decrease in prevailing interest rates (dollars in thousands).

Interest Rate Sensitivity as of September 30, 2018 - Net Interest Income

| | Net Interest Income | |
|---|---|---|
| Changes in Rates | Amount | % Change |
| +2% | $114,925 | (3.19 )% |
| +1% | 116,842 | (1.58 )% |
| Base | 118,712 | — |
| -1% | 117,819 | (0.75 )% |
| -2% | 109,643 | (7.64 )% |

The above table is a measurement of the Company's net interest income at risk, assuming a static balance sheet as of September 30, 2018 and instantaneous parallel changes in interest rates. The Company also monitors interest rate risk under other scenarios including a more gradual movement in market interest rates. This type of scenario can at times produce different modeling results in measuring interest rate risk sensitivity.

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The table below provides an assessment of the risk to NPV in the event of a sudden and sustained 1% and 2% increase and decrease in prevailing interest rates (dollars in thousands).

Interest Rate Sensitivity as of September 30, 2018 - Net Portfolio Value

| | Net Portfolio Value | | Net Portfolio Value as a % of Present Value of Assets | |
|---|---|---|---|---|
| Changes in Rates | Amount | % Change | NPV Ratio | Change |
| +2% | $443,821 | (9.61)% | 14.26% | (73) b.p. |
| +1% | 469,098 | (4.46)% | 14.69% | (30) b.p. |
| Base | 490,981 | — | 14.99% | — |
| -1% | 490,114 | (0.18)% | 14.65% | (34) b.p. |
| -2% | 452,891 | (7.76)% | 13.29% | (170) b.p. |

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

## Item 4. Controls and Procedures

As of September 30, 2018, the Company carried out an evaluation, under the supervision and with the participation of its principal executive officer and principal financial officer, of the effectiveness of the design and operation of its disclosure controls and procedures. Based on this evaluation, the Company’s principal executive officer and principal financial officer concluded that the Company’s disclosure controls and procedures were, as of that date, effective in timely alerting them to material information required to be included in the Company’s periodic reports filed with the Securities and Exchange Commission. There are inherent limitations to the effectiveness of systems of disclosure controls and procedures, including the possibility of human error and the circumvention or overriding of the controls and procedures. Accordingly, even effective systems of disclosure controls and procedures can provide only reasonable assurances of achieving their control objectives.

There was no change in the Company’s internal control over financial reporting that occurred during the Company’s third fiscal quarter of 2018 that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

There are no pending legal proceedings, other than litigation incidental to the ordinary business of the Company, of a material nature to which the Company is a party or of which any of its properties are subject.

Item 1A. Risk Factors

There have been no material changes to the risk factors previously disclosed in German American Bancorp, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2017.

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

Issuer Purchases of Equity Securities
The following table sets forth information regarding the Company's purchases of its common shares during each of the three months ended September 30, 2018.

| Period | Total Number of Shares (or Units) Purchased | Average Price Paid Per Share (or Unit) | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased under the Plans or Programs [1] |
|---|---|---|---|---|
| July 2018 | — | — | — | 409,184 |
| August 2018 | — | — | — | 409,184 |
| September 2018 | — | — | — | 409,184 |

[1] On April 26, 2001, the Company announced that its Board of Directors had approved a stock repurchase program for up to 911,631 of its outstanding common shares, of which the Company had purchased 502,447 common shares through September 30, 2018 (both such numbers adjusted for subsequent stock dividends). The Board of Directors established no expiration date for this program. The Company purchased no shares under this program during the quarter ended September 30, 2018.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

None.

Item 6. Exhibits

The following exhibits are included with this Report or incorporated herein by reference.

| Exhibit No. | Description |
|---|---|
| 2.1 | Purchase and Assumption Agreement by and between German American Bancorp and MainSource Bank, dated February 12, 2018, is incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K filed February 13, 2018 (SEC File No. 001-15877). |
| 2.2 | Agreement and Plan of Reorganization by and among German American Bancorp, Inc., First Security, Inc., First Security Bank, Inc., and German American Bank, dated May 22, 2018, is incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K filed May 22, 2018 (SEC File No. 001-15877). |
| 3.1 | Restatement of the Articles of Incorporation of German American Bancorp, Inc., as amended, is incorporated by reference to Exhibit 3.1 of the Registrant’s Quarterly Report on Form 10-Q for the quarter ended March 31, 2017 filed on May 9, 2017 (SEC File No. 001-15877). |
| 3.2 | Restated Bylaws of German American Bancorp, Inc., as amended and restated July 27, 2009, is incorporated by reference to Exhibit 3.2 of the Registrant's Annual Report on Form 10-K filed March 9, 2015 (SEC File No. 001-15877). |
| 4.1 | Terms of Common Shares and Preferred Shares of the Registrant (included in Restatement of Articles of Incorporation) are incorporated by reference to Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2017 filed on May 9, 2017 (SEC File No. 001-15877). |
| 4.2 | Specimen stock certificate for Common Shares of the Registrant is incorporated by reference to Exhibit 99.1 to the Registrant's Current Report on Form 8-K filed October 21, 2010 (SEC File No. 001-15877). |
| 4.3 | Loan Agreement, dated as of October 11, 2018, by and between German American Bancorp, Inc. and U.S. Bank National Association is incorporated by reference to Exhibit 4.1 to the Registrant’s Current Report on Form 8-K filed October 15, 2018 (SEC File No. 001-15877). |
| 4.4 | Negative Pledge Agreement, dated October 11, 2018, by German American Bancorp, Inc. and in favor of U.S. Bank National Association is incorporated by reference to Exhibit 4.2 to the Registrant’s Current Report on Form 8-K filed October 15, 2018 (SEC File No. 001-15877). |
| 4.5 | Term Note, in the principal sum of $25,000,000, issued by German American Bancorp, Inc. on October 11, 2018, to U.S. Bank National Association is incorporated by reference to Exhibit 4.3 to the Registrant’s Current Report on Form 8-K filed October 15, 2018 (SEC File No. 001-15877). |
| 4.6 | Revolving Credit Note, in the principal sum of $15,000,000, issued by German American Bancorp, Inc. on October 11, 2018, to U.S. Bank National Association is incorporated by reference to Exhibit 4.4 to the Registrant’s Current Report on Form 8-K filed October 15, 2018 (SEC File No. 001-15877). |
| 31.1* | Sarbanes-Oxley Act of 2002, Section 302 Certification for Chairman of the Board and Chief Executive Officer. |
| 31.2* | Sarbanes-Oxley Act of 2002, Section 302 Certification for Executive Vice President and Chief Financial Officer. |
| 32.1* | Sarbanes-Oxley Act of 2002, Section 906 Certification for Chairman of the Board and Chief Executive Officer. |
| 32.2* | Sarbanes-Oxley Act of 2002, Section 906 Certification for Executive Vice President and Chief Financial Officer. |
| 101+ | The following materials from German American Bancorp, Inc.’s Form 10-Q Report for the quarterly period ended September 30, 2018, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Consolidated Statements of Cash Flows, and (v) the Notes to Consolidated Financial Statements. |

Note: No long-term debt instrument issued by the Registrant exceeds 10% of consolidated total assets or is registered. In accordance with paragraph 4 (iii) of Item 601(b) of Regulation S-K, the Registrant will furnish the Securities and Exchange Commission copies of long-term debt instruments and related agreements upon request.

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

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

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

| | |
|---|---|
| | GERMAN AMERICAN BANCORP, INC. |
| Date: November 9, 2018 | By: /s/Mark A. Schroeder<br>Mark A. Schroeder<br>Chairman and Chief Executive Officer<br>(Principal Executive Officer) |
| Date: November 9, 2018 | By: /s/Bradley M. Rust<br>Bradley M. Rust<br>Executive Vice President and Chief Financial Officer<br>(Principal Financial and Accounting Officer) |