

MidWestOne Financial Group, Inc.  
Form 10-Q  
October 31, 2013

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

FORM 10-Q

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

For the quarterly period ended September 30, 2013

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission file number 001-35968

MIDWESTONE FINANCIAL GROUP, INC.  
(Exact name of Registrant as specified in its charter)

Iowa	42-1206172
(State of Incorporation)	(I.R.S. Employer Identification No.)
102 South Clinton Street	
Iowa City, IA 52240	
(Address of principal executive offices, including zip code)	
319-356-5800	
(Registrant's telephone number, including area code)	

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

days. ☒ Yes ☐ No

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

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

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>
(Do not check if a smaller reporting company)			

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ☐ Yes ☒ No

As of October 30, 2013, there were 8,470,058 shares of common stock, \$1.00 par value per share, outstanding.

---

Table of Contents

MIDWESTONE FINANCIAL GROUP, INC.

Form 10-Q Quarterly Report

Table of Contents

	Page No.
PART I	
Item 1. <u>Financial Statements</u>	<u>1</u>
<u>Consolidated Balance Sheets</u>	<u>1</u>
<u>Consolidated Statements of Operations</u>	<u>2</u>
<u>Consolidated Statements of Comprehensive Income</u>	<u>3</u>
<u>Consolidated Statements of Shareholders' Equity</u>	<u>4</u>
<u>Consolidated Statements of Cash Flows</u>	<u>5</u>
<u>Notes to Consolidated Financial Statements</u>	<u>6</u>
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>32</u>
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	<u>54</u>
Item 4. <u>Controls and Procedures</u>	<u>57</u>
Part II	
Item 1. <u>Legal Proceedings</u>	<u>59</u>
Item 1A. <u>Risk Factors</u>	<u>59</u>
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	<u>59</u>
Item 3. <u>Defaults Upon Senior Securities</u>	<u>59</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>59</u>
Item 5. <u>Other Information</u>	<u>59</u>
Item 6. <u>Exhibits</u>	<u>60</u>
<u>Signatures</u>	<u>61</u>

Table of Contents

## PART I – FINANCIAL INFORMATION

## Item 1. Financial Statements.

MIDWESTONE FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS

	September 30, 2013 (unaudited)	December 31, 2012
(dollars in thousands)		
<b>ASSETS</b>		
Cash and due from banks	\$ 25,288	\$ 30,197
Interest-bearing deposits in banks	778	16,242
Federal funds sold	—	752
Cash and cash equivalents	26,066	47,191
Investment securities:		
Available for sale	490,148	557,541
Held to maturity (fair value of \$30,743 as of September 30, 2013 and \$32,920 as of December 31, 2012)	32,825	32,669
Loans held for sale	206	1,195
Loans	1,076,837	1,035,284
Allowance for loan losses	(16,505)	(15,957)
Net loans	1,060,332	1,019,327
Loan pool participations, net	28,071	35,650
Premises and equipment, net	26,535	25,609
Accrued interest receivable	10,554	10,292
Intangible assets, net	8,971	9,469
Bank-owned life insurance	29,367	28,676
Other real estate owned	1,917	3,278
Assets held for sale	—	764
Deferred income taxes	7,217	776
Other assets	16,316	20,382
Total assets	\$ 1,738,525	\$ 1,792,819
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Non-interest-bearing demand	\$ 201,886	\$ 190,491
Interest-bearing checking	576,318	582,283
Savings	94,043	91,603
Certificates of deposit under \$100,000	270,275	312,489
Certificates of deposit \$100,000 and over	179,129	222,867
Total deposits	1,321,651	1,399,733
Federal funds purchased	8,395	—
Securities sold under agreements to repurchase	58,663	68,823
Federal Home Loan Bank borrowings	145,187	120,120
Deferred compensation liability	3,492	3,555
Long-term debt	15,464	15,464
Accrued interest payable	1,267	1,475
Other liabilities	8,872	9,717
Total liabilities	1,562,991	1,618,887
Shareholders' equity:		

Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

Preferred stock, no par value; authorized 500,000 shares; no shares issued and outstanding at September 30, 2013 and December 31, 2012	\$ —	\$ —
Common stock, \$1.00 par value; authorized 15,000,000 shares at September 30, 2013 and December 31, 2012; issued 8,690,398 shares at September 30, 2013 and December 31, 2012; outstanding 8,470,058 shares at September 30, 2013 and 8,480,488 shares at December 31, 2012	8,690	8,690
Additional paid-in capital	80,314	80,383
Treasury stock at cost, 220,340 shares as of September 30, 2013 and 209,910 shares at December 31, 2012	(3,796 )	(3,316 )
Retained earnings	88,110	77,125
Accumulated other comprehensive income	2,216	11,050
Total shareholders' equity	175,534	173,932
Total liabilities and shareholders' equity	\$ 1,738,525	\$ 1,792,819

See accompanying notes to consolidated financial statements.

Table of ContentsMIDWESTONE FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS

(unaudited) (dollars in thousands, except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Interest income:				
Interest and fees on loans	\$12,215	\$12,760	\$36,606	\$38,639
Interest and discount on loan pool participations	226	886	1,916	1,741
Interest on bank deposits	2	7	8	29
Interest on federal funds sold	—	—	—	1
Interest on investment securities:				
Taxable securities	2,395	2,654	7,571	8,224
Tax-exempt securities	1,278	1,279	3,973	3,744
Total interest income	16,116	17,586	50,074	52,378
Interest expense:				
Interest on deposits:				
Interest-bearing checking	544	691	1,815	2,281
Savings	34	36	105	105
Certificates of deposit under \$100,000	987	1,433	3,347	4,519
Certificates of deposit \$100,000 and over	493	715	1,695	2,242
Total interest expense on deposits	2,058	2,875	6,962	9,147
Interest on federal funds purchased	10	6	37	11
Interest on securities sold under agreements to repurchase	31	43	96	145
Interest on Federal Home Loan Bank borrowings	671	767	2,068	2,353
Interest on notes payable	7	8	22	26
Interest on long-term debt	74	168	224	503
Total interest expense	2,851	3,867	9,409	12,185
Net interest income	13,265	13,719	40,665	40,193
Provision for loan losses	250	575	1,050	1,729
Net interest income after provision for loan losses	13,015	13,144	39,615	38,464
Noninterest income:				
Trust, investment, and insurance fees	1,297	1,294	4,069	3,767
Service charges and fees on deposit accounts	786	846	2,236	2,424
Mortgage origination and loan servicing fees	1,083	919	2,844	2,514
Other service charges, commissions and fees	406	303	1,574	1,636
Bank-owned life insurance income	230	225	691	676
Impairment losses on investment securities	—	(337)	—	(337)
Gain on sale or call of available for sale securities (Includes \$84 reclassified from accumulated other comprehensive income for net gains on available for sale securities for the nine months ended September 30, 2013)	—	8	84	741
Gain (loss) on sale of premises and equipment	(2)	—	(4)	4,205
Total noninterest income	3,800	3,258	11,494	15,626
Noninterest expense:				
Salaries and employee benefits	6,099	6,207	18,565	24,167
Net occupancy and equipment expense	1,580	1,537	4,806	4,741
Professional fees	615	612	2,016	2,137
Data processing expense	364	443	1,092	1,258

Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

FDIC insurance expense	255	326	845	929
Amortization of intangible assets	166	195	498	584
Other operating expense	1,204	1,393	4,040	4,280
Total noninterest expense	10,283	10,713	31,862	38,096
Income before income tax expense	6,532	5,689	19,247	15,994
Income tax expense (Includes \$32 income tax expense reclassified from accumulated other comprehensive income for the nine months ended September 30, 2013)	1,668	1,451	5,062	3,812
Net income	\$4,864	\$4,238	\$14,185	\$12,182
Share and Per share information:				
Ending number of shares outstanding	8,470,058	8,487,518	8,470,058	8,487,518
Average number of shares outstanding	8,468,755	8,483,918	8,478,928	8,484,404
Diluted average number of shares	8,517,645	8,534,908	8,524,451	8,526,161
Earnings per common share - basic	\$0.57	\$0.50	\$1.67	\$1.44
Earnings per common share - diluted	0.57	0.50	1.66	1.43
Dividends paid per common share	0.13	0.10	0.38	0.27
See accompanying notes to consolidated financial statements.				

Table of ContentsMIDWESTONE FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(unaudited) (dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	\$4,864	\$4,238	\$14,185	\$12,182
Other comprehensive income (loss), available for sale securities:				
Unrealized holding gains (losses) arising during period	(1,045 )	1,790	(14,013 )	4,205
Reclassification adjustment for gains included in net income	—	(8 )	(84 )	(741 )
Income tax (expense) benefit	387	(665 )	5,263	(1,295 )
Other comprehensive income (loss) on available for sale securities	(658 )	1,117	(8,834 )	2,169
Other comprehensive income, pension plan:				
Reclassification of pension plan expense due to plan settlement	—	—	—	5,968
Income tax benefit	—	—	—	(2,226 )
Defined benefit pension plans	—	—	—	3,742
Other comprehensive income (loss), net of tax	(658 )	1,117	(8,834 )	5,911
Comprehensive income	\$4,206	\$5,355	\$5,351	\$18,093
See accompanying notes to consolidated financial statements.				



Table of ContentsMIDWESTONE FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(unaudited) (dollars in thousands, except per share amounts)	Preferred Stock	Common Stock	Additional Paid-in Capital	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (loss)	Total
Balance at December 31, 2011	\$ —	\$ 8,690	\$ 80,333	\$(2,312 )	\$63,646	\$ 6,137	\$156,494
Net income	—	—	—	—	12,182	—	12,182
Dividends paid on common stock (\$0.265 per share)	—	—	—	—	(2,250 )	—	(2,250 )
Stock options exercised (38,204 shares)	—	—	(21 )	442	—	—	421
Release/lapse of restriction on RSUs (15,810 shares)	—	—	(201 )	213	—	—	12
Repurchase of common stock (86,083 shares)	—	—	—	(1,445 )	—	—	(1,445 )
Stock compensation	—	—	199	—	—	—	199
Other comprehensive income, net of tax	—	—	—	—	—	5,911	5,911
Balance at September 30, 2012	\$ —	\$ 8,690	\$ 80,310	\$(3,102 )	\$73,578	\$ 12,048	\$171,524
Balance at December 31, 2012	\$ —	\$ 8,690	\$ 80,383	\$(3,316 )	\$77,125	\$ 11,050	\$173,932
Net income	—	—	—	—	14,185	—	14,185
Dividends paid on common stock (\$0.375 per share)	—	—	—	—	(3,200 )	—	(3,200 )
Stock options exercised (30,678 shares)	—	—	(76 )	202	—	—	126
Release/lapse of restriction on RSUs (19,585 shares)	—	—	(267 )	285	—	—	18
Repurchase of common stock (40,713 shares)	—	—	—	(967 )	—	—	(967 )
Stock compensation	—	—	274	—	—	—	274
Other comprehensive loss, net of tax	—	—	—	—	—	(8,834 )	(8,834 )
Balance at September 30, 2013	\$ —	\$ 8,690	\$ 80,314	\$(3,796 )	\$88,110	\$ 2,216	\$175,534

See accompanying notes to consolidated financial statements.

Table of ContentsMIDWESTONE FINANCIAL GROUP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS

(unaudited) (dollars in thousands)	Nine Months Ended September 30,	
	2013	2012
Cash flows from operating activities:		
Net income	\$ 14,185	\$ 12,182
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,050	1,729
Depreciation, amortization and accretion	3,976	4,047
(Gain) loss on sale of premises and equipment	4	(4,205 )
Deferred income taxes	(1,178 )	503
Stock-based compensation	274	199
Net gain on sale or call of available for sale securities	(84 )	(741 )
Net (gain) loss on sale of other real estate owned	169	(95 )
Net gain on sale of loans held for sale	(1,123 )	(1,466 )
Writedown of other real estate owned	33	326
Other-than-temporary impairment of investment securities	—	337
Origination of loans held for sale	(73,405 )	(112,979 )
Proceeds from sales of loans held for sale	75,517	114,744
Recognition of previously deferred expense related to pension plan settlement	—	3,002
Pension plan contribution	—	(3,031 )
Increase in accrued interest receivable	(262 )	(770 )
Increase in cash surrender value of bank-owned life insurance	(691 )	(677 )
(Increase) decrease in other assets	4,066	(260 )
Decrease in deferred compensation liability	(63 )	(68 )
Decrease in accrued interest payable, accounts payable, accrued expenses, and other liabilities	(1,053 )	(263 )
Net cash provided by operating activities	21,415	12,514
Cash flows from investing activities:		
Proceeds from sales of available for sale securities	12,205	16,232
Proceeds from maturities and calls of available for sale securities	83,241	97,424
Purchases of available for sale securities	(43,637 )	(87,255 )
Proceeds from maturities and calls of held to maturity securities	1,029	556
Purchase of held to maturity securities	(1,185 )	(24,429 )
Increase in loans	(42,228 )	(28,258 )
Decrease in loan pool participations, net	7,579	12,150
Purchases of premises and equipment	(2,785 )	(2,777 )
Proceeds from sale of other real estate owned	1,332	2,274
Proceeds from sale of premises and equipment	15	5,220
Proceeds from sale of assets held for sale	764	—
Net cash provided by (used in) investing activities	16,330	(8,863 )
Cash flows from financing activities:		
Net increase (decrease) in deposits	(78,082 )	22,001
Increase (decrease) in federal funds purchased	8,395	(8,920 )
Increase (decrease) in securities sold under agreements to repurchase	(10,160 )	14,153
Proceeds from Federal Home Loan Bank borrowings	151,000	20,000
Repayment of Federal Home Loan Bank borrowings	(126,000 )	(30,000 )

Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

Stock options exercised	144	433	
Dividends paid	(3,200	) (2,250	)
Repurchase of common stock	(967	) (1,445	)
Net cash (used in) provided by financing activities	(58,870	) 13,972	
Net (decrease) increase in cash and cash equivalents	(21,125	) 17,623	
Cash and cash equivalents at beginning of period	47,191	32,623	
Cash and cash equivalents at end of period	\$26,066	\$50,246	
Supplemental disclosures of cash flow information:			
Cash paid during the period for interest	\$9,617	\$12,071	
Cash paid during the period for income taxes	\$6,070	\$4,455	
Supplemental schedule of non-cash investing activities:			
Transfer of loans to other real estate owned	\$173	\$1,589	
Transfer of property to assets held for sale	\$—	\$764	
See accompanying notes to consolidated financial statements.			

Table of Contents

MidWestOne Financial Group, Inc. and Subsidiaries  
Notes to Consolidated Financial Statements  
(Unaudited)

1.Principles of Consolidation and Presentation

MidWestOne Financial Group, Inc. (the “Company,” which is also referred to herein as “we,” “our” or “us”) is an Iowa corporation incorporated in 1983, a bank holding company under the Bank Holding Company Act of 1956 and a financial holding company under the Gramm-Leach-Bliley Act of 1999. Our principal executive offices are located at 102 South Clinton Street, Iowa City, Iowa 52240.

The Company owns 100% of the outstanding common stock of MidWestOne Bank, an Iowa state non-member bank chartered in 1934 with its main office in Iowa City, Iowa (the “Bank”), and 100% of the common stock of MidWestOne Insurance Services, Inc., Oskaloosa, Iowa. We operate primarily through our bank subsidiary, MidWestOne Bank, and MidWestOne Insurance Services, Inc., our wholly-owned subsidiary that operates an insurance agency business through three offices located in central and east-central Iowa.

The accompanying unaudited consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and, therefore, do not include all the information and notes necessary for complete financial statements in conformity with U.S. generally accepted accounting principles. The information in this Quarterly Report on Form 10-Q is written with the presumption that the users of the interim financial statements have read or have access to the most recent Annual Report on Form 10-K of the Company, which contains the latest audited financial statements and notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2012 and for the year then ended. Management believes that the disclosures are adequate to make the information presented not misleading. In the opinion of management, the accompanying consolidated financial statements contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position as of September 30, 2013, and the results of operations and cash flows for the three and nine months ended September 30, 2013 and 2012. All significant intercompany accounts and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amount of revenues and expenses during the reporting period. These estimates are based on information available to management at the time the estimates are made. Actual results could differ from those estimates. The results for the three and nine months ended September 30, 2013 may not be indicative of results for the year ending December 31, 2013, or for any other period.

During the quarter ended June 30, 2013, the Company identified an immaterial error in its accounting for other-than-temporary impairment on its portfolio of collateralized debt obligations. This error related to the identification of credit-related impairments subsequent to the Company's adoption of Financial Accounting Standards Board (FASB) Staff Position (FSP) No. FAS 115-2 and FAS 124-2, “Recognition and Presentation of Other-Than-Temporary Impairments” as of April 1, 2009.

As a result, the Company has adjusted prior period amounts for the immaterial error. Specifically, on the Company's consolidated statement of shareholders' equity the balance of retained earnings was reduced by \$2,653,000, from \$66,299,000 to \$63,646,000, and accumulated other comprehensive income was increased by \$2,653,000, from \$3,484,000 to \$6,137,000, as of December 31, 2011, to reflect the effect of the error in the years ended December 31, 2009, 2010, and 2011. On the Company's consolidated balance sheets, retained earnings and accumulated other comprehensive income as of December 31, 2012, were decreased and increased, respectively, by \$2,870,000. Of the adjustment amounts as of December 31, 2011 and 2012, \$2,322,000 relates to the after-tax effect of credit impairments that should have been recognized in the Company's consolidated statements of operations for the year ended December 31, 2009. Downward adjustments of \$212,000 to the Company's net income in the consolidated statements of operations for the three- and nine-month periods ended September 30, 2012 were necessary as a result of this correction.

The correction will also result in the following adjustments to historical amounts which will be part of comparative amounts in future filings: (i) on the Company's consolidated statement of shareholders' equity, the balance of retained earnings will be reduced by \$2,647,000, from \$55,619,000 to \$52,972,000, and accumulated other comprehensive income will be increased by \$2,647,000, from \$(1,826,000) to \$821,000, as of December 31, 2010, to reflect the effect of the error in the years ended December 31, 2009 and 2010; (ii) on the Company's consolidated statements of operations, net income for the year ended December 31, 2011 will be reduced \$6,000, from \$13,317,000 to \$13,311,000, with no change in the reported basic or diluted earnings per share for such time period; (iii) on the Company's consolidated statements of operations, net income for the year ended December 31, 2012 will be reduced \$217,000, from \$16,751,000 to

Table of Contents

\$16,534,000, with basic earnings per share decreasing from \$1.97 to \$1.95 and diluted earnings per share decreasing from \$1.96 to \$1.94 during such period; (iv) corresponding adjustments to the Company's comprehensive income will be made for the years ended December 31, 2012 and 2011; and (v) amounts in relevant footnotes for all periods to be presented will be corrected for the effects of this immaterial error.

All significant accounting policies followed in the preparation of the quarterly financial statements are disclosed in the December 31, 2012 Annual Report on Form 10-K. In the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks, interest-bearing deposits in banks, and federal funds sold.

## 2.Shareholders' Equity

**Preferred Stock:** The number of authorized shares of preferred stock for the Company is 500,000. As of September 30, 2013, none were issued or outstanding.

**Common Stock:** As of September 30, 2013, the number of authorized shares of common stock for the Company was 15,000,000.

On October 18, 2011, our Board of Directors amended the Company's existing \$1.0 million share repurchase program, originally authorized on July 26, 2011, by increasing the remaining amount of authorized repurchases to \$5.0 million, and extending the expiration of the program to December 31, 2012.

On January 15, 2013, the Company's board of directors announced the renewal of the Company's share repurchase program, extending the expiration of the program to December 31, 2014 and increasing the remaining amount of authorized repurchases under the program to \$5.0 million from the approximately \$2.4 million of authorized repurchases that had previously remained. Pursuant to the program, the Company may continue to repurchase shares from time to time in the open market, and the method, timing and amounts of repurchase will be solely in the discretion of the Company's management. The repurchase program does not require the Company to acquire a specific number of shares. Therefore, the amount of shares repurchased pursuant to the program will depend on several factors, including market conditions, capital and liquidity requirements, and alternative uses for cash available. As of September 30, 2013 the remaining amount available for share repurchases under the program was \$4.0 million.

## 3.Earnings per Common Share

Basic earnings per common share computations are based on the weighted average number of shares of common stock actually outstanding during the period. Diluted earnings per share amounts are computed by dividing net income by the weighted average number of shares outstanding and all dilutive potential shares outstanding during the period.

The following table presents the computation of earnings per common share for the respective periods:

	Three Months Ended September 30,		Nine Months Ended September 30,	
(dollars in thousands, except per share amounts)	2013	2012	2013	2012
Basic earnings per common share computation				
Numerator:				
Net income	\$4,864	\$4,238	\$14,185	\$12,182
Denominator:				
Weighted average shares outstanding	8,468,755	8,483,918	8,478,928	8,484,404
Basic earnings per common share	\$0.57	\$0.50	\$1.67	\$1.44
Diluted earnings per common share computation				
Numerator:				
Net income	\$4,864	\$4,238	\$14,185	\$12,182
Denominator:				
	8,517,645	8,534,908	8,524,451	8,526,161

Weighted average shares outstanding, included all  
dilutive potential shares

Diluted earnings per common share	\$0.57	\$0.50	\$1.66	\$1.43
-----------------------------------	--------	--------	--------	--------

## Table of Contents

### 4. Investment Securities

A summary of investment securities available for sale is as follows:

	As of September 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(in thousands)				
U.S. Government agencies and corporations	\$51,202	\$587	\$778	\$51,011
State and political subdivisions	200,133	6,143	2,486	203,790
Mortgage-backed securities and collateralized mortgage obligations	203,679	3,247	2,384	204,542
Corporate debt securities	28,925	276	1,291	27,910
Total debt securities	483,939	10,253	6,939	487,253
Other equity securities	2,652	282	39	2,895
Total	\$486,591	\$10,535	\$6,978	\$490,148

	As of December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(in thousands)				
U.S. Government agencies and corporations	\$68,707	\$1,132	\$56	\$69,783
State and political subdivisions	206,392	11,752	125	218,019
Mortgage-backed securities and collateralized mortgage obligations	236,713	6,433	28	243,118
Corporate debt securities	26,438	360	1,858	24,940
Total debt securities	538,250	19,677	2,067	555,860
Other equity securities	1,637	109	65	1,681
Total	\$539,887	\$19,786	\$2,132	\$557,541

A summary of investment securities held to maturity is as follows:

	As of September 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(in thousands)				
State and political subdivisions	\$19,894	\$—	\$1,278	\$18,616
Mortgage-backed securities	9,670	3	752	8,921
Corporate debt securities	3,261	—	55	3,206
Total	\$32,825	\$3	\$2,085	\$30,743

	As of December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(in thousands)				
State and political subdivisions	\$19,278	\$199	\$57	\$19,420
Mortgage-backed securities	10,133	121	—	10,254
Corporate debt securities	3,258	—	12	3,246



Total	\$32,669	\$320	\$69	\$32,920
-------	----------	-------	------	----------

The summary of investment securities shows that some of the securities in the available for sale and held to maturity investment portfolios had unrealized losses, or were temporarily impaired, as of September 30, 2013 and December 31, 2012. This temporary impairment represents the estimated amount of loss that would be realized if the securities were sold on the valuation date.

Table of Contents

The following presents information pertaining to securities with gross unrealized losses as of September 30, 2013 and December 31, 2012, aggregated by investment category and length of time that individual securities have been in a continuous loss position:

Available for Sale	As of September 30, 2013						Unrealized
	Number of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	
(in thousands, except number of securities)							
U.S. Government agencies and corporations	3	\$22,083	\$ 778	\$—	\$ —	\$22,083	\$ 778
State and political subdivisions	134	43,345	2,486	—	—	43,345	2,486
Mortgage-backed securities and collateralized mortgage obligations	14	95,204	2,384	—	—	95,204	2,384
Corporate debt securities	8	14,266	180	1,260	1,111	15,526	1,291
Other equity securities	1	960	39	—	—	960	39
Total	160	\$175,858	\$ 5,867	\$1,260	\$ 1,111	\$177,118	\$ 6,978

	As of December 31, 2012						Unrealized
	Number of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	
(in thousands, except number of securities)							
U.S. Government agencies and corporations	2	\$15,359	\$ 56	\$—	\$ —	\$15,359	\$ 56
State and political subdivisions	27	7,221	125	—	—	7,221	125
Mortgage-backed securities and collateralized mortgage obligations	2	10,919	28	—	—	10,919	28
Corporate debt securities	9	14,672	242	755	1,616	15,427	1,858
Other equity securities	1	754	65	—	—	754	65
Total	41	\$48,925	\$ 516	\$755	\$ 1,616	\$49,680	\$ 2,132

Held to Maturity	As of September 30, 2013						Unrealized
	Number of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	
(in thousands, except number of securities)							
State and political subdivisions	30	\$18,616	\$ 1,278	\$—	\$ —	\$18,616	\$ 1,278
Mortgage-backed securities and collateralized mortgage obligations	1	8,883	752	—	—	8,883	752
Corporate debt securities	1	2,329	55	—	—	2,329	55
Total	32	\$29,828	\$ 2,085	\$—	\$ —	\$29,828	\$ 2,085

	As of December 31, 2012						Unrealized
	Number of Securities	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	

(in thousands, except number of securities)

State and political subdivisions	11	\$3,672	\$ 57	\$—	\$ —	\$3,672	\$ 57
Corporate debt securities	1	2,371	12	—	—	2,371	12
Total	12	\$6,043	\$ 69	\$—	\$ —	\$6,043	\$ 69

The Company's assessment of other-than-temporary impairment ("OTTI") is based on its reasonable judgment of the specific facts and circumstances impacting each individual security at the time such assessments are made. The Company reviews and considers factual information, including expected cash flows, the structure of the security, the creditworthiness of the issuer, the type of underlying assets and the current and anticipated market conditions. At September 30, 2013, approximately 60% of the municipal bonds held by the Company were Iowa based. The Company does not intend to sell these municipal obligations, and it is not more likely than not that the Company will be required to sell them before the recovery of its cost. Due to the issuers' continued satisfaction of their obligations under the securities

Table of Contents

in accordance with their contractual terms and the expectation that they will continue to do so, management's intent and ability to hold these securities for a period of time sufficient to allow for any anticipated recovery in fair value, as well as the evaluation of the fundamentals of the issuers' financial condition and other objective evidence, the Company believes that the municipal obligations identified in the tables above were temporarily depressed as of September 30, 2013 and December 31, 2012.

At September 30, 2013 and December 31, 2012, the Company's mortgage-backed securities portfolio consisted of securities predominantly backed by one- to four- family mortgage loans and underwritten to the standards of and guaranteed by the following government-sponsored agencies: FHLMC, FNMA and GNMA. The receipt of principal, at par, and interest on mortgage-backed securities is guaranteed by the respective government-sponsored agency guarantor, such that the Company believes that its mortgage-backed securities do not expose the Company to credit-related losses.

At September 30, 2013, the Company owned six collateralized debt obligations backed by pools of trust preferred securities with an original cost basis of \$9.8 million. The book value of these securities as of September 30, 2013 totaled \$2.4 million, after OTTI charges have been recognized. All of the Company's trust preferred collateralized debt obligations are in mezzanine tranches and are currently rated less than investment grade by Moody's Investor Services. They are secured by trust preferred securities of banks and insurance companies throughout the United States, and were rated as investment grade securities when purchased between March 2006 and December 2007. However, as the banking climate eroded during 2008, the securities experienced cash flow problems. Due to continued market deterioration in these securities, additional pre-tax charges to earnings were recorded from 2009 to 2012. The market for these securities is considered to be inactive according to the guidance issued in ASC Topic 820, "Fair Value Measurements and Disclosures." The Company uses a discounted cash flow model to determine the estimated fair value of its pooled trust preferred collateralized debt obligations and to assess OTTI. The discounted cash flow analysis was performed in accordance with ASC Topic 325. The assumptions used in preparing the discounted cash flow model include the following: estimated discount rates (using yields of comparable traded instruments adjusted for illiquidity and other risk factors), estimated deferral and default rates on collateral, and estimated cash flows. The Company also reviewed a stress test of these securities to determine the additional deferrals or defaults in the collateral pool in excess of what the Company believes is probable, before the payments on the individual securities are negatively impacted.

As of September 30, 2013, the Company also owned \$1.9 million of equity securities in banks and financial service-related companies, and \$1.0 million of mutual funds invested in debt securities and other debt instruments that will cause units of the fund to be deemed to be qualified under the Community Reinvestment Act (the "CRA"). Equity securities are considered to have OTTI whenever they have been in a loss position, compared to current book value, for twelve consecutive months, and the Company does not expect them to recover to their original cost basis. For the first nine months of 2013 and the full year of 2012, no impairment charges were recorded, as the affected equity securities were not deemed impaired due to stabilized market prices in relation to the Company's original purchase price.

The following table provides a roll forward of credit losses on fixed maturity securities recognized in net income:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2013	2012	2013	2012
(in thousands)				
Beginning balance	\$7,379	\$7,034	\$7,379	\$7,034
Additional credit losses:				
Securities with no previous other than temporary impairment	—	—	—	—
Securities with previous other than temporary impairments	—	337	—	337
Ending balance	\$7,379	\$7,371	\$7,379	\$7,371

It is reasonably possible that the fair values of the Company's investment securities could decline in the future if the overall economy or the financial condition of the issuers deteriorate or the liquidity of certain securities remains depressed. As a result, there is a risk that OTTI's may occur in the future and any such amounts could be material to the Company's consolidated statements of operations.

Table of Contents

A summary of the contractual maturity distribution of debt investment securities at September 30, 2013 is as follows:

	Available For Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(in thousands)				
Due in one year or less	\$15,706	\$15,910	\$185	\$184
Due after one year through five years	105,380	108,449	2,574	2,517
Due after five years through ten years	104,048	105,438	7,587	7,370
Due after ten years	55,126	52,914	12,809	11,751
Mortgage-backed securities and collateralized mortgage obligations	203,679	204,542	9,670	8,921
Total	\$483,939	\$487,253	\$32,825	\$30,743

Mortgage-backed and collateralized mortgage obligations are collateralized by mortgage loans guaranteed by U.S. government agencies. Experience has indicated that principal payments will be collected sooner than scheduled because of prepayments. Therefore, these securities are not scheduled in the maturity categories indicated above. Equity securities available for sale with an amortized cost of \$2.7 million and a fair value of \$2.9 million are also excluded from this table.

Other investment securities include investments in Federal Home Loan Bank ("FHLB") stock. The carrying value of the FHLB stock at September 30, 2013 and December 31, 2012 was \$10.8 million and \$11.1 million, respectively, which is included in the Other Assets line of the consolidated balance sheets. This security is not readily marketable and ownership of FHLB stock is a requirement for membership in the FHLB Des Moines. The amount of FHLB stock the Bank is required to hold is directly related to the amount of FHLB advances borrowed. Because there are no available market values, this security is carried at cost and evaluated for potential impairment each quarter. Redemption of this investment is at the option of the FHLB.

Realized gains and losses on sales are determined on the basis of specific identification of investments based on the trade date. Realized gains on investments for the three and nine months ended September 30, 2013 and 2012 are as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
(in thousands)				
Available for sale fixed maturity securities:				
Gross realized gains	\$—	\$8	\$144	\$360
Gross realized losses	—	—	(60	) —
Other-than-temporary impairment	—	(337	) —	(337
		(329	) 84	23
Equity securities:				
Gross realized gains	—	—	—	381
Gross realized losses	—	—	—	—
Other-than-temporary impairment	—	—	—	—
	—	—	—	381
	\$—	\$(329	) \$84	\$404

Table of Contents

## 5.Loans Receivable and the Allowance for Loan Losses

The composition of loans and loan pool participations by portfolio segment are as follows:

Allowance for Loan Losses and Recorded Investment in Loan Receivables  
As of September 30, 2013 and December 31, 2012

(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
September 30, 2013							
Allowance for loan losses:							
Individually evaluated for impairment	\$ 140	\$ 217	\$ 653	\$ 214	\$ 18	\$ —	\$ 1,242
Collectively evaluated for impairment	918	4,462	5,334	3,178	321	1,050	15,263
Total	\$ 1,058	\$ 4,679	\$ 5,987	\$ 3,392	\$ 339	\$ 1,050	\$ 16,505
Loans acquired with deteriorated credit quality (loan pool participations)	\$ 3	\$ 66	\$ 700	\$ 124	\$ 5	\$ 1,236	\$ 2,134
Loans receivable							
Individually evaluated for impairment	\$ 3,164	\$ 2,078	\$ 5,008	\$ 1,569	\$ 72	\$ —	\$ 11,891
Collectively evaluated for impairment	87,858	261,206	428,628	268,355	18,899	—	1,064,946
Total	\$ 91,022	\$ 263,284	\$ 433,636	\$ 269,924	\$ 18,971	\$ —	\$ 1,076,837
Loans acquired with deteriorated credit quality (loan pool participations)	\$ 53	\$ 1,563	\$ 19,912	\$ 4,013	\$ 60	\$ 4,604	\$ 30,205
(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
December 31, 2012							
Allowance for loan losses:							
Individually evaluated for impairment	\$ 159	\$ 295	\$ 293	\$ 136	\$ 6	\$ —	\$ 889
Collectively evaluated for impairment	867	4,304	5,474	2,871	350	1,202	15,068
Total	\$ 1,026	\$ 4,599	\$ 5,767	\$ 3,007	\$ 356	\$ 1,202	\$ 15,957
Loans acquired with deteriorated credit quality (loan pool participations)	\$ 4	\$ 77	\$ 673	\$ 240	\$ 15	\$ 1,125	\$ 2,134
Loans receivable							
Individually evaluated for impairment	\$ 3,323	\$ 1,806	\$ 5,342	\$ 886	\$ 37	\$ —	\$ 11,394
Collectively evaluated for impairment	81,403	236,810	434,642	251,990	19,045	—	1,023,890

Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

Total	\$ 84,726	\$ 238,616	\$ 439,984	\$ 252,876	\$ 19,082	\$ —	\$ 1,035,284
Loans acquired with deteriorated credit quality (loan pool participations)	\$ 76	\$ 2,379	\$ 24,346	\$ 4,788	\$ 67	\$ 6,128	\$ 37,784

The changes in the allowance for loan losses by portfolio segment are as follows:

(in thousands)	Allowance for Loan Loss Activity For the Three Months Ended September 30, 2013 and 2012						Total
	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	
2013							
Beginning balance	\$995	\$4,774	\$ 5,664	\$3,334	\$279	\$ 1,532	\$16,578
Charge-offs	—	(99	) (115	) (87	) (47	) —	(348
Recoveries	—	20	—	2	3	—	25
Provision	63	(16	) 438	143	104	(482	) 250
Ending balance	\$1,058	\$4,679	\$ 5,987	\$3,392	\$339	\$ 1,050	\$16,505
2012							
Beginning balance	\$954	\$4,946	\$ 4,602	\$2,894	\$365	\$ 1,976	\$15,737
Charge-offs	—	(607	) (23	) (168	) (9	) —	(807
Recoveries	—	310	11	—	1	—	322
Provision	59	118	1,264	154	(101	) (919	) 575
Ending balance	\$1,013	\$4,767	\$ 5,854	\$2,880	\$256	\$ 1,057	\$15,827



Table of Contents

Allowance for Loan Loss Activity For the Nine Months Ended September 30, 2013 and 2012							
(in thousands)	Agricultural	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
2013							
Beginning balance	\$ 1,026	\$ 4,599	\$ 5,767	\$ 3,007	\$ 356	\$ 1,202	\$ 15,957
Charge-offs	(39 )	(475 )	(203 )	(267 )	(118 )	—	(1,102 )
Recoveries	36	59	462	25	18	—	600
Provision	35	496	(39 )	627	83	(152 )	1,050
Ending balance	\$ 1,058	\$ 4,679	\$ 5,987	\$ 3,392	\$ 339	\$ 1,050	\$ 16,505
2012							
Beginning balance	\$ 1,209	\$ 5,380	\$ 5,171	\$ 3,501	\$ 167	\$ 248	\$ 15,676
Charge-offs	—	(1,891 )	(129 )	(481 )	(43 )	—	(2,544 )
Recoveries	507	407	24	12	16	—	966
Provision	(703 )	871	788	(152 )	116	809	1,729
Ending balance	\$ 1,013	\$ 4,767	\$ 5,854	\$ 2,880	\$ 256	\$ 1,057	\$ 15,827

**Loan Portfolio Segment Risk Characteristics**

**Agricultural** - Agricultural loans, most of which are secured by crops, livestock, and machinery, are provided to finance capital improvements and farm operations as well as acquisitions of livestock and machinery. The ability of the borrower to repay may be affected by many factors outside of the borrower's control including adverse weather conditions, loss of livestock due to disease or other factors, declines in market prices for agricultural products and the impact of government regulations. The ultimate repayment of agricultural loans is dependent upon the profitable operation or management of the agricultural entity. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

**Commercial and Industrial** - Commercial and industrial loans are primarily made based on the reported cash flow of the borrower and secondarily on the underlying collateral provided by the borrower. The collateral support provided by the borrower for most of these loans and the probability of repayment are based on the liquidation of the pledged collateral and enforcement of a personal guarantee, if any exists. The primary repayment risks of commercial and industrial loans are that the cash flows of the borrower may be unpredictable, and the collateral securing these loans may fluctuate in value. The size of the loans the Company can offer to commercial customers is less than the size of the loans that competitors with larger lending limits can offer. This may limit the Company's ability to establish relationships with the area's largest businesses. As a result, the Company may assume greater lending risks than financial institutions that have a lesser concentration of such loans and tend to make loans to larger businesses. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. In addition, if the United States economy does not meaningfully improve, this could harm or continue to harm the businesses of our commercial and industrial customers and reduce the value of the collateral securing these loans.

**Commercial Real Estate** - The Company offers mortgage loans to commercial and agricultural customers for the acquisition of real estate used in their businesses, such as offices, warehouses and production facilities, and to real estate investors for the acquisition of apartment buildings, retail centers, office buildings and other commercial buildings. The market value of real estate securing commercial real estate loans can fluctuate significantly in a short period of time as a result of market conditions in the geographic area in which the real estate is located. Adverse

developments affecting real estate values in one or more of the Company's markets could increase the credit risk associated with its loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts and the repayment of the loans generally is dependent, in large part, on sufficient income from the properties securing the loans to cover operating expenses and debt service. Economic events or governmental regulations outside of the control of the borrower or lender could negatively impact the future cash flow and market values of the affected properties.

Residential Real Estate - The Company generally retains short-term residential mortgage loans that are originated for its own portfolio but sells most long-term loans to other parties while retaining servicing rights on the majority of those loans. The market value of real estate securing residential real estate loans can fluctuate as a result of market conditions in the geographic area in which the real estate is located. Adverse developments affecting real estate values in one or more of the Company's markets could increase the credit risk associated with its loan portfolio. Additionally, real estate lending typically involves higher loan principal amounts and the repayment of the loans generally is dependent, in large

## Table of Contents

part, on the borrower's continuing financial stability, and is therefore more likely to be affected by adverse personal circumstances.

Consumer - Consumer loans typically have shorter terms, lower balances, higher yields and higher risks of default. Consumer loan collections are dependent on the borrower's continuing financial stability, and are therefore more likely to be affected by adverse personal circumstances. Collateral for these loans generally includes automobiles, boats, recreational vehicles, mobile homes, and real estate. However, depending on the overall financial condition of the borrower, some loans are made on an unsecured basis. The collateral securing these loans may depreciate over time, may be difficult to recover and may fluctuate in value based on condition. In addition, a decline in the United States economy could result in reduced employment, impacting the ability of customers to repay their obligations.

Loans acquired with deteriorated credit quality (loan pool participations) - The underlying loans in the loan pool participations include both fixed-rate and variable-rate instruments. No amounts for interest due are reflected in the carrying value of the loan pool participations. Based on historical experience, the average period of collectibility for loans underlying loan pool participations, many of which have exceeded contractual maturity dates, is approximately three to five years. Loan pool balances are affected by the payment and refinancing activities of the borrowers resulting in pay-offs of the underlying loans and reduction in the balances. Collections from the individual borrowers are managed by the loan pool servicer and are affected by the borrower's financial ability and willingness to pay, foreclosure and legal action, collateral value, and the economy in general.

### Charge-off Policy

The Company requires a loan to be charged-off as soon as it becomes apparent that some loss will be incurred, or when its collectability is sufficiently questionable that it no longer is considered a bankable asset. The primary considerations when determining if and how much of a loan should be charged-off are as follows: (1) the potential for future cash flows; (2) the value of any collateral; and (3) the strength of any co-makers or guarantors.

When it is determined that a loan requires partial or full charge-off, a request for approval of a charge-off is submitted to the Bank's President, Executive Vice President and Chief Credit Officer, and the Senior Regional Loan officer. The Bank's Board of Directors formally approves all loan charge-offs. Once a loan is charged-off, it cannot be restructured and returned to the Bank's books.

### The Allowance for Loan and Lease Losses - Bank Loans

The Company requires the maintenance of an adequate allowance for loan and lease losses ("ALLL") in order to cover estimated probable losses without eroding the Company's capital base. Calculations are done at each quarter end, or more frequently if warranted, to analyze the collectability of loans and to ensure the adequacy of the allowance. In line with FDIC directives, the ALLL calculation does not include consideration of loans held for sale or off-balance-sheet credit exposures (such as unfunded letters of credit). Determining the appropriate level for the ALLL relies on the informed judgment of management, and as such, is subject to inaccuracy. Given the inherently imprecise nature of calculating the necessary ALLL, the Company's policy permits an "unallocated" allowance between 15% above and 5% below the "indicated reserve." These unallocated amounts are due to those overall factors impacting the ALLL that are not captured in detailed loan category calculations.

### Loans Reviewed Individually for Impairment

The Company identifies loans to be reviewed and evaluated individually for impairment, based on current information and events, and the probability that the borrower will be unable to repay all amounts due according to the contractual terms of the loan agreement. Specific areas of consideration include: size of credit exposure, risk rating, delinquency, nonaccrual status, and loan classification.

The level of individual impairment is measured using one of the following methods: (1) the fair value of the collateral less costs to sell; (2) the present value of expected future cash flows, discounted at the loan's effective interest rate; or (3) the loan's observable market price. Loans that are deemed fully collateralized or have been charged down to a level

corresponding with any three of the measurements require no assignment of reserves from the ALLL.

All loans deemed troubled debt restructure or “TDR” are considered impaired. A loan is considered a TDR when the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that the Bank would not otherwise consider. All of the following factors are indicators that the Bank has granted a concession (one or multiple items may be present):

Table of Contents

- The borrower receives a reduction of the stated interest rate for the remaining original life of the debt.
- The borrower receives an extension of the maturity date or dates at a stated interest rate lower than the current market interest rate for new debt with similar risk characteristics.
- The borrower receives a reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement.
- The borrower receives a deferral of required payments (principal and/or interest).
- The borrower receives a reduction of the accrued interest.

The following tables set forth information on the Company's TDRs<sup>(1)</sup> by class of financing receivable occurring during the stated periods:

	Three Months Ended September 30, 2013			2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
(dollars in thousands)						
Troubled Debt						
Restructurings:						
Residential real estate:						
One- to four- family first						
liens						
Amortization or maturity	1	66	69	0	—	—
date change						
Total	1	\$ 66	\$ 69	0	\$ —	\$ —
	Nine Months Ended September 30, 2013			2012		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
(dollars in thousands)						
Troubled Debt						
Restructurings:						
Commercial and						
industrial						
Amortization or maturity	1	158	158	0	—	—
date change						
Commercial real estate:						
Farmland						
Interest rate reduction	0	—	—	2	2,475	2,475
Commercial real						
estate-other						
Amortization or maturity	2	165	136	0	—	—
date change						
Residential real estate:						
One- to four- family first						
liens						
Interest rate reduction	2	164	169	0	—	—

Amortization or maturity date change	1	66	69	0	—	—
One- to four- family junior liens						
Interest rate reduction	1	8	13	0	—	—
Total	7	\$ 561	\$ 545	2	\$ 2,475	\$ 2,475

(1) - TDRs may include multiple concessions and the disclosure classifications are based on the primary concession provided to the borrower.

Loans by class of financing receivable modified as TDRs<sup>(1)</sup> within the previous 12 months and for which there was a payment default during the stated periods were:

	Three Months Ended September 30, 2013		September 30, 2012		Nine Months Ended September 30, 2013		September 30, 2012	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
(dollars in thousands)								
Troubled Debt Restructurings That Subsequently Defaulted:								
Total	0	\$ —	0	\$ —	0	\$ —	0	\$ —

(1) - TDRs may include multiple concessions and the disclosure classifications are based on the primary concession provided to the borrower.

## Table of Contents

### Loans Reviewed Collectively for Impairment

All loans not evaluated individually for impairment are grouped together by type (i.e. commercial, agricultural, consumer, etc.) and further segmented within each subset by risk classification (i.e. pass, special mention, and substandard). Homogeneous loans past due 60-89 days and 90+ days, are classified special mention and substandard, respectively, for allocation purposes.

The Company's historical loss experience for each loan type is calculated using the fiscal quarter-end data for the most recent 20 quarters as a starting point for estimating losses. In addition, other prevailing qualitative or environmental factors likely to cause probable losses to vary from historical data are incorporated in the form of adjustments to increase or decrease the loss rate applied to each group. These adjustments are documented, and fully explain how the current information, events, circumstances, and conditions impact the historical loss measurement assumptions.

Although not a comprehensive list, the following are considered key factors and are evaluated with each calculation of the ALLL to determine if adjustments to historical loss rates are warranted:

- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses.
- Changes in international, national, regional, and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments.
- Changes in the nature and volume of the portfolio and in the terms of loans.
- Changes in the experience, ability and depth of lending management and other relevant staff.
- Changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans.
- Changes in the quality of our loan review system.
- Changes in the value of underlying collateral for collateral-dependent loans.
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
- The effect of other external factors, such as competition and legal and regulatory requirements, on the level of estimated credit losses in the Bank's existing portfolio.

The items listed above are used to determine the pass percentage for loans evaluated collectively and, as such, are applied to the loans risk rated pass. Due to the inherent risks associated with special mention risk rated loans (i.e. early stages of financial deterioration, technical exceptions, etc.), this subset is reserved at two times the pass allocation factor to reflect this increased risk exposure. In addition, non-impaired loans classified as substandard loans carry greater risk than special mention loans, and as such, this subset is reserved at six times the pass allocation. Further, non-impaired loans less than \$0.2 million that are past due 60 - 89 days or 90 days and over, are respectively classified as special mention or substandard. They are given an increased loan loss allocation of 25% or 50%, respectively, above the five year historical loss rate of the specific loan type.

### The Allowance for Loan and Lease Losses - Loan Pool Participations

The Company requires that the loan pool participation ALLL will be at least sufficient to cover the next quarter's estimated charge-offs as presented by the servicer. Currently, charge-offs are netted against the income the Company receives, thus the balance in the loan pool participation reserve is not affected and remains stable. In essence, a provision for loan losses is made that is equal to the quarterly charge-offs, which is deducted from income received from the loan pool participations. By maintaining a sufficient reserve to cover the next quarter's charge-offs, the Company will have sufficient reserves in place should no income be collected from the loan pool participations during the quarter. In the event the estimated charge-offs provided by the servicer are greater than the loan pool participation ALLL, an additional provision is made to cover the difference between the current ALLL and the estimated charge-offs provided by the servicer.

### Loans Reviewed Individually for Impairment

The loan servicer reviews the portfolio quarterly on a loan-by-loan basis, and loans that are deemed to be impaired are charged-down to their estimated value. All loans that are to be charged-down are reserved against in the ALLL adequacy calculation. Loans that continue to have an investment basis that have been charged-down are monitored, and if additional impairment is noted the reserve requirement is increased on the individual loan.

#### Loans Reviewed Collectively for Impairment

The Company utilizes the annualized average of portfolio loan (not loan pool) historical loss per risk category over a two-year period of time. Supporting documentation for the technique used to develop the historical loss rate for each group of loans is required to be maintained. It is management's assessment that the two-year rate is most reflective of the probable credit losses in the current loan pool portfolio.



Table of Contents

The following table sets forth the composition of each class of the Company's loans by internally assigned credit quality indicators at September 30, 2013 and December 31, 2012:

	Pass	Special Mention/ Watch	Substandard	Doubtful	Loss	Total
(in thousands)						
September 30, 2013						
Agricultural	\$87,008	\$429	\$3,585	\$—	\$—	\$91,022
Commercial and industrial	239,934	9,578	12,461	—	—	261,973
Credit cards	1,107	54	1	—	—	1,162
Overdrafts	450	134	71	—	—	655
Commercial real estate:						
Construction and development	55,137	10,507	2,195	—	—	67,839
Farmland	79,986	3,547	2,346	—	—	85,879
Multifamily	53,492	196	—	—	—	53,688
Commercial real estate-other	211,061	12,865	2,304	—	—	226,230
Total commercial real estate	399,676	27,115	6,845	—	—	433,636
Residential real estate:						
One- to four- family first liens	210,589	4,564	2,161	—	—	217,314
One- to four- family junior liens	52,288	111	211	—	—	52,610
Total residential real estate	262,877	4,675	2,372	—	—	269,924
Consumer	18,308	72	85	—	—	18,465
Total	\$1,009,360	\$42,057	\$25,420	\$—	\$—	\$1,076,837
Loans acquired with deteriorated credit quality (loan pool participations)						
	\$15,382	\$—	\$14,819	\$—	\$4	\$30,205
	Pass	Special Mention/ Watch	Substandard	Doubtful	Loss	Total
(in thousands)						
December 31, 2012						
Agricultural	\$80,657	\$579	\$3,490	\$—	\$—	\$84,726
Commercial and industrial	211,344	12,473	13,376	—	—	237,193
Credit cards	967	4	30	—	—	1,001
Overdrafts	452	181	126	—	—	759
Commercial real estate:						
Construction and development	72,916	9,493	4,385	—	—	86,794
Farmland	76,023	2,684	2,356	—	—	81,063
Multifamily	46,272	1,486	—	—	—	47,758
Commercial real estate-other	209,143	13,745	1,481	—	—	224,369
Total commercial real estate	404,354	27,408	8,222	—	—	439,984
Residential real estate:						
One- to four- family first liens	191,712	4,478	1,552	—	—	197,742
One- to four- family junior liens	54,606	229	299	—	—	55,134
Total residential real estate	246,318	4,707	1,851	—	—	252,876
Consumer	18,604	70	71	—	—	18,745

Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

Total	\$962,696	\$45,422	\$27,166	\$—	\$—	\$1,035,284
Loans acquired with deteriorated credit quality (loan pool participations)	\$21,251	\$—	\$16,518	\$—	\$15	\$37,784

Special Mention/Watch - A special mention/watch asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Company's credit position at some future date. Special mention/watch assets are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard - Substandard loans 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 Company will sustain some loss if the

Table of Contents

deficiencies are not corrected.

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

Loss - Loans classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Table of Contents

The following table sets forth the amounts and categories of the Company's impaired loans as of September 30, 2013 and December 31, 2012:

	September 30, 2013			December 31, 2012		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
(in thousands)						
With no related allowance recorded:						
Agricultural	\$1,482	\$1,982	\$—	\$1,600	\$2,100	\$—
Commercial and industrial	956	1,057	—	775	1,524	—
Credit cards	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—
Commercial real estate:						
Construction and development	49	176	—	149	299	—
Farmland	97	110	—	75	88	—
Multifamily	—	—	—	—	—	—
Commercial real estate-other	1,125	1,354	—	1,722	1,887	—
Total commercial real estate	1,271	1,640	—	1,946	2,274	—
Residential real estate:						
One- to four- family first liens	416	551	—	136	203	—
One- to four- family junior liens	121	121	—	41	41	—
Total residential real estate	537	672	—	177	244	—
Consumer	1	1	—	14	30	—
Total	\$4,247	\$5,352	\$—	\$4,512	\$6,172	\$—
With an allowance recorded:						
Agricultural	\$1,682	\$1,682	\$140	\$1,723	\$1,723	\$159
Commercial and industrial	1,122	1,177	217	1,031	1,031	295
Credit cards	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—
Commercial real estate:						
Construction and development	447	447	342	525	525	105
Farmland	2,316	2,466	160	2,316	2,466	47
Multifamily	—	—	—	—	—	—
Commercial real estate-other	974	1,074	151	555	555	141
Total commercial real estate	3,737	3,987	653	3,396	3,546	293
Residential real estate:						
One- to four- family first liens	955	963	174	642	642	89
One- to four- family junior liens	77	77	40	67	67	47
Total residential real estate	1,032	1,040	214	709	709	136
Consumer	71	87	18	23	23	6
Total	\$7,644	\$7,973	\$1,242	\$6,882	\$7,032	\$889
Total:						
Agricultural	\$3,164	\$3,664	\$140	\$3,323	\$3,823	\$159
Commercial and industrial	2,078	2,234	217	1,806	2,555	295
Credit cards	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—

Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

Commercial real estate:						
Construction and development	496	623	342	674	824	105
Farmland	2,413	2,576	160	2,391	2,554	47
Multifamily	—	—	—	—	—	—
Commercial real estate-other	2,099	2,428	151	2,277	2,442	141
Total commercial real estate	5,008	5,627	653	5,342	5,820	293
Residential real estate:						
One- to four- family first liens	1,371	1,514	174	778	845	89
One- to four- family junior liens	198	198	40	108	108	47
Total residential real estate	1,569	1,712	214	886	953	136
Consumer	72	88	18	37	53	6
Total	\$11,891	\$13,325	\$1,242	\$11,394	\$13,204	\$889

Table of Contents

The following table sets forth the average recorded investment and interest income recognized for each category of the Company's impaired loans during the stated periods:

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013	Average Interest	2012	Average Interest	2013	Average Interest	2012	Average Interest
	Recorded Investment	Income Recognized	Recorded Investment	Income Recognized	Recorded Investment	Income Recognized	Recorded Investment	Income Recognized
(in thousands)								
With no related allowance recorded:								
Agricultural	\$1,482	\$ 13	\$1,600	\$ 16	\$1,555	\$ 45	\$1,600	\$ 44
Commercial and industrial	966	3	736	6	1,079	27	852	46
Credit cards	—	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—	—
Commercial real estate:								
Construction and development	49	—	288	—	49	—	358	—
Farmland	99	2	79	2	103	6	85	6
Multifamily	—	—	—	—	—	—	—	—
Commercial real estate-other	1,104	(5 )	1,755	13	1,094	19	1,782	59
Total commercial real estate	1,252	(3 )	2,122	15	1,246	25	2,225	65
Residential real estate:								
One- to four- family first liens	451	1	285	1	475	7	289	2
One- to four- family junior liens	122	(1 )	55	1	123	3	57	2
Total residential real estate	573	—	340	2	598	10	346	4
Consumer	1	—	15	—	1	—	16	—
Total	\$4,274	\$ 13	\$4,813	\$ 39	\$4,479	\$ 107	\$5,039	\$ 159
With an allowance recorded:								
Agricultural	\$1,682	\$ 13	1,723	13	\$1,695	\$ 37	2,433	36
Commercial and industrial	1,132	10	1,685	24	1,152	35	1,376	30
Credit cards	—	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—	—
Commercial real estate:								
Construction and development	447	6	525	7	447	20	335	22
Farmland	2,466	28	2,517	28	2,466	82	280	85
Multifamily	—	—	—	—	—	—	—	—
Commercial real estate-other	972	7	1,326	15	974	21	2,989	46

Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

Total commercial real estate	3,885	41	4,368	50	3,887	123	3,604	153
Residential real estate:								
One- to four- family first liens	957	9	626	8	960	27	973	25
One- to four- family junior liens	78	—	68	1	79	—	19	2
Total residential real estate	1,035	9	694	9	1,039	27	992	27
Consumer	72	1	24	1	74	2	120	2
Total	\$7,806	\$ 74	\$8,494	\$ 97	\$7,847	\$ 224	\$8,525	\$ 248
Total:								
Agricultural	\$3,164	\$ 26	3,323	29	\$3,250	\$ 82	4,033	80
Commercial and industrial	2,098	13	2,421	30	2,231	62	2,228	76
Credit cards	—	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—	—
Commercial real estate:								
Construction and development	496	6	813	7	496	20	693	22
Farmland	2,565	30	2,596	30	2,569	88	365	91
Multifamily	—	—	—	—	—	—	—	—
Commercial real estate-other	2,076	2	3,081	28	2,068	40	4,771	105
Total commercial real estate	5,137	38	6,490	65	5,133	148	5,829	218
Residential real estate:								
One- to four- family first liens	1,408	10	911	9	1,435	34	1,262	27
One- to four- family junior liens	200	(1 )	123	2	202	3	76	4
Total residential real estate	1,608	9	1,034	11	1,637	37	1,338	31
Consumer	73	1	39	1	75	2	136	2
Total	\$12,080	\$ 87	\$13,307	\$ 136	\$12,326	\$ 331	\$13,564	\$ 407

Table of Contents

The following table sets forth the composition and past due and nonaccrual status of the Company's loans at September 30, 2013 and December 31, 2012:

	30 - 59 Days Past Due	60 - 89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans Receivable	Recorded Investment > 90 Days Past Due and Accruing
(in thousands)							
September 30, 2013							
Agricultural	\$17	\$59	\$11	\$87	\$90,935	\$91,022	\$—
Commercial and industrial	510	999	596	2,105	259,868	261,973	243
Credit cards	22	32	1	55	1,107	1,162	1
Overdrafts	63	5	5	73	582	655	—
Commercial real estate:							
Construction and development	—	67	49	116	67,723	67,839	—
Farmland	—	—	—	—	85,879	85,879	—
Multifamily	—	—	—	—	53,688	53,688	—
Commercial real estate-other	832	90	1,639	2,561	223,669	226,230	216
Total commercial real estate	832	157	1,688	2,677	430,959	433,636	216
Residential real estate:							
One- to four- family first liens	1,544	1,658	669	3,871	213,443	217,314	390
One- to four- family junior liens	325	73	198	596	52,014	52,610	50
Total residential real estate	1,869	1,731	867	4,467	265,457	269,924	440
Consumer	38	72	58	168	18,297	18,465	8
Total	\$3,351	\$3,055	\$3,226	\$9,632	\$1,067,205	\$1,076,837	\$908
December 31, 2012							
Agricultural	\$96	\$—	\$—	\$96	\$84,630	\$84,726	\$—
Commercial and industrial	289	70	85	444	236,749	237,193	85
Credit cards	4	—	30	34	967	1,001	30
Overdrafts	82	6	39	127	632	759	—
Commercial real estate:							
Construction and development	448	—	—	448	86,346	86,794	—
Farmland	—	—	—	—	81,063	81,063	—
Multifamily	—	—	—	—	47,758	47,758	—
Commercial real estate-other	892	295	67	1,254	223,115	224,369	67
Total commercial real estate	1,340	295	67	1,702	438,282	439,984	67
Residential real estate:							



Edgar Filing: MidWestOne Financial Group, Inc. - Form 10-Q

One- to four- family first liens	2,210	1,185	311	3,706	194,036	197,742	311
One- to four- family junior liens	233	189	75	497	54,637	55,134	75
Total residential real estate	2,443	1,374	386	4,203	248,673	252,876	386
Consumer	70	72	4	146	18,599	18,745	4
Total	\$4,324	\$1,817	\$611	\$6,752	\$1,028,532	\$1,035,284	\$572

#### Non-accrual and Delinquent Loans

Loans are placed on non-accrual when (1) payment in full of principal and interest is no longer expected or (2) principal or interest has been in default for 90 days or more (unless the loan is both well secured with marketable collateral and in the process of collection). All loans rated doubtful or worse, and certain loans rated substandard, are placed on non-accrual.

A non-accrual asset may be restored to an accrual status when (1) all past due principal and interest has been paid (excluding renewals and modifications that involve the capitalizing of interest) or (2) the loan becomes well secured and is in the process of collection. An established track record of performance is also considered when determining accrual status.

Delinquency status of a loan is determined by the number of days that have elapsed past the loan's payment due date, using the following classification groupings: 30-59 days, 60-89 days and 90 days or more. Loans shown in the 30-59 days and 60-89 days columns in the table above reflect contractual delinquency status of loans not considered nonperforming due to classification as a TDR or being placed on non-accrual.

Table of Contents

The following table sets forth the composition of the Company's recorded investment in loans on nonaccrual status as of September 30, 2013 and December 31, 2012:

	September 30, 2013	December 31, 2012
(in thousands)		
Agricultural	\$70	\$64
Commercial and industrial	756	757
Credit cards	—	—
Overdrafts	—	—
Commercial real estate:		
Construction and development	49	149
Farmland	30	33
Multifamily	—	—
Commercial real estate-other	1,552	1,128
Total commercial real estate	1,631	1,310
Residential real estate:		
One- to four- family first liens	386	550
One- to four- family junior liens	148	223
Total residential real estate	534	773
Consumer	50	34
Total	\$3,041	\$2,938

As of September 30, 2013, the Company had no commitments to lend additional funds to any borrowers who have had a troubled debt restructure.

**Loan Pool Participations**

ASC Topic 310 addresses accounting for differences between contractual cash flows and cash flows expected to be collected from an investor's initial investment in loans or debt securities acquired in a transfer if those differences are attributable, at least in part, to credit quality. The loans underlying the loan pool participations were evaluated individually when purchased for application of ASC Topic 310, utilizing various criteria including: past-due status, late payments, legal status of the loan (not in foreclosure, judgment against the borrower, or referred to legal counsel), frequency of payments made, collateral adequacy and the borrower's financial condition. If all the criteria were met, the individual loan utilized the accounting treatment required by ASC Topic 310 with the accretable yield difference between the expected cash flows and the purchased basis accreted into income on the level yield basis over the anticipated life of the loan. If any of the six criteria were not met at the time of purchase, the loan was accounted for on the cash basis of accounting.

The loan servicer reviews the portfolio quarterly on a loan-by-loan basis, and loans that are deemed to be impaired are charged down to their estimated value. As of September 30, 2013, approximately 64% of the loans were contractually current or less than 90 days past due, while 36% were contractually past due 90 days or more. Many of the loans were acquired in a contractually past due status, which was reflected in the discounted purchase price of the loans.

Performance status is monitored on a monthly basis. The 36% contractually past due includes loans in litigation and foreclosed property.

**6.Income Taxes**

Federal income tax expense for the three and nine months ended September 30, 2013 and 2012 was computed using the consolidated effective federal tax rate. The Company also recognized income tax expense pertaining to state franchise taxes payable by the subsidiary bank.

**7.Defined Benefit Pension Plan**

Prior to the Company's merger with the Former MidWestOne, the Bank sponsored a noncontributory defined benefit pension plan for substantially all its employees. Effective December 31, 2007, the Bank elected to curtail the plan by limiting this employee benefit to those employees vested as of December 31, 2007. During the second quarter of 2012, the Company completed the liquidation of plan assets and full termination of the plan, including full benefit payout to plan participants. The total amount of the Company's required contribution to fully fund the plan for liquidation was \$6.1 million, pre-tax, which is included in Salaries and Employee Benefits on the consolidated statements of operations.

## Table of Contents

### 8. Fair Value Measurements

ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability is not adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

ASC Topic 820 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs – Unadjusted quoted prices for identical assets or liabilities in active markets that the reporting entity has the ability to access at the measurement date.

Level 2 Inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 Inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

It is the Company's policy to maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements. Recent market conditions have led to diminished, and in some cases, non-existent trading in certain of the financial asset classes. The Company is required to use observable inputs, to the extent available, in the fair value estimation process unless that data results from forced liquidations or distressed sales. Despite the Company's best efforts to maximize the use of relevant observable inputs, the current market environment has diminished the observability of trades and assumptions that have historically been available. A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Valuation methods for instruments measured at fair value on a recurring basis.

**Securities Available for Sale** - The Company's investment securities classified as available for sale include: debt securities issued by the U.S. Treasury and other U.S. government corporations and agencies, debt securities issued by state and political subdivisions, mortgage-backed securities, collateralized mortgage obligations, corporate debt securities, and equity securities. Quoted exchange prices are available for equity securities, which are classified as Level 1. The Company utilizes an independent pricing service to obtain the fair value of debt securities. On a quarterly basis, the Company selects a sample of 30 securities from its primary pricing service and compares them to a secondary independent pricing service to validate value. In addition, the Company periodically reviews the pricing methodology utilized by the primary independent service for reasonableness. Debt securities issued by the U.S.

Treasury and other U.S. government corporations and agencies and mortgage-backed obligations are priced utilizing industry-standard models that consider various assumptions, including time value, yield curves, volatility factors, prepayment speeds, default rates, loss severity, current market and contractual prices for the underlying financial instruments, as well as other relevant economic measures. Substantially all of these assumptions are observable in the marketplace, can be derived from observable data, or are supported by observable levels at which transactions are executed in the marketplace and are classified as Level 2. Municipal securities are valued using a type of matrix or grid pricing, in which securities are benchmarked against the

Table of Contents

treasury rate based on credit characteristics. These model and matrix measurements are classified as Level 2 in the fair value hierarchy. On an annual basis, a group of selected municipal securities are priced by a securities dealer and that price is used to verify the primary independent service's valuation.

The Company classifies its pooled trust preferred collateralized debt obligations as Level 3. The portfolio consists of six investments in collateralized debt obligations backed by pools of trust preferred securities issued by financial institutions and insurance companies. The Company has determined that the observable market data associated with these assets do not represent orderly transactions in accordance with ASC Topic 820 and reflect forced liquidations or distressed sales. Based on the lack of observable market data, the Company estimated fair value based on the observable data available and reasonable unobservable market data. The Company estimated fair value based on a discounted cash flow model which used appropriately adjusted discount rates reflecting credit and liquidity risks.

**Mortgage Servicing Rights** - The Company recognizes the rights to service mortgage loans for others on residential real estate loans internally originated and then sold. Mortgage servicing rights are recorded at fair value based on assumptions through a third-party valuation service. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the servicing cost per loan, the discount rate, the escrow float rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. Because many of these inputs are unobservable, the valuations are classified as Level 3.

The following table summarizes assets measured at fair value on a recurring basis as of September 30, 2013 and December 31, 2012. There were no liabilities subject to fair value measurement as of these dates. The assets are segregated by the level of valuation inputs within the fair value hierarchy utilized to measure fair value:

Fair Value Measurement at September 30, 2013 Using				
(in thousands)	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Assets:</b>				
<b>Available for sale debt securities:</b>				
U.S. Government agencies and corporations	\$51,011	\$ —	\$51,011	\$ —
State and political subdivisions	203,790	—	203,790	—
Mortgage-backed securities and collateralized mortgage obligations	204,542	—	204,542	—
Corporate debt securities	26,649	—	26,649	—
Collateralized debt obligations	1,261	—	—	1,261
Total available for sale debt securities	487,253	—	485,992	1,261
<b>Available for sale equity securities:</b>				
Other equity securities	2,895	2,895	—	—
Total available for sale equity securities	2,895	2,895	—	—
Total securities available for sale	\$490,148	\$ 2,895	\$485,992	\$ 1,261
 Mortgage servicing rights	 \$2,324	 \$ —	 \$—	 \$ 2,324

Table of Contents

(in thousands)	Fair Value Measurement at December 31, 2012 Using			
	Total	Quoted Prices in	Significant Other	Significant
		Active Markets for Identical Assets (Level 1)	Observable Inputs (Level 2)	Unobservable Inputs (Level 3)
Assets:				
Available for sale debt securities:				
U.S. Government agencies and corporations	\$69,783	\$ —	\$ 69,783	\$ —
State and political subdivisions	218,019	—	218,019	—
Mortgage-backed securities and collateralized mortgage obligations	243,118	—	243,118	—
Corporate debt securities	24,185	—	24,185	—
Collateralized debt obligations	755	—	—	755
Total available for sale debt securities	555,860	—	555,105	755
Available for sale equity securities:				
Other equity securities	1,681	1,681	—	—
Total available for sale equity securities	1,681	1,681	—	—
Total securities available for sale	\$557,541	\$ 1,681	\$ 555,105	\$ 755
Mortgage servicing rights	\$1,484	\$ —	\$ —	\$ 1,484

There were no transfers of assets between levels of the fair value hierarchy during the three and nine months ended September 30, 2013 and 2012.

The following table presents additional information about assets measured at fair market value on a recurring basis for which the Company has utilized Level 3 inputs to determine fair value for the nine months ended September 30, 2013 and 2012:

(in thousands)	2013		2012	
	Collateralized Debt Obligations	Mortgage Servicing Rights	Collateralized Debt Obligations	Mortgage Servicing Rights
Beginning balance	\$755	\$1,484	\$806	\$1,265
Transfers into Level 3	—	—	—	—
Transfers out of Level 3	—	—	—	—
Total gains (losses):				
Included in earnings	—	378	—	(373 )
Included in other comprehensive income	506	—	(1 )	—
Purchases, issuances, sales, and settlements:				
Purchases	—	—	—	—
Issuances	—	462	—	543
Sales	—	—	—	—
Settlements	—	—	—	—
Ending balance	\$1,261	\$2,324	\$805	\$1,435

Table of Contents

The following table presents the amount of gains and losses included in earnings and other comprehensive income for the nine months ended September 30, 2013 and 2012 that are attributable to the change in unrealized gains and losses relating to those assets still held, and the line item in the consolidated financial statements in which they are included:

	2013		2012	
	Collateralized Debt Obligations	Mortgage Servicing Rights	Collateralized Debt Obligations	Mortgage Servicing Rights
(in thousands)				
Total gains for the period in earnings*	\$—	\$ 840	\$—	\$ 170
Change in unrealized gains (losses) for the period included in other comprehensive income	506	—	(1	) —

\* included in mortgage origination and loan servicing fees in the consolidated statements of operations.

Changes in the fair value of available for sale securities are included in other comprehensive income to the extent the changes are not considered OTTI's. OTTI tests are performed on a quarterly basis and any decline in the fair value of an individual security below its cost that is deemed to be other-than-temporary results in a write-down that is reflected directly in the Company's consolidated statements of operations.

Valuation methods for instruments measured at fair value on a nonrecurring basis

Collateral Dependent Impaired Loans - From time to time, a loan is considered impaired and an allowance for credit losses is established. The specific reserves for collateral dependent impaired loans are based on the fair value of the collateral less estimated costs to sell. The fair value of collateral is determined based on appraisals. In some cases, adjustments are made to the appraised values due to various factors, including age of the appraisal, age of comparables included in the appraisal, and known changes in the market and in the collateral. Because many of these inputs are unobservable, the valuations are classified as Level 3.

Other Real Estate Owned ("OREO") - OREO represents property acquired through foreclosures and settlements of loans. Property acquired is carried at the lower of the carrying amount of the loan at the time of acquisition, or the estimated fair value of the property, less disposal costs. The Company considers third party appraisals as well as independent fair value assessments from real estate brokers or persons involved in selling OREO in determining the fair value of particular properties. Accordingly, the valuation of OREO is subject to significant external and internal judgment. The Company also periodically reviews OREO to determine whether the property continues to be carried at the lower of its recorded book value or fair value of the property, less disposal costs. Because many of these inputs are unobservable, the valuations are classified as Level 3.



Table of Contents

The following table discloses the Company's estimated fair value amounts of its assets recorded at fair value on a nonrecurring basis. It is management's belief that the fair values presented below are reasonable based on the valuation techniques and data available to the Company as of September 30, 2013 and December 31, 2012, as more fully described previously.

(in thousands)	Total	Fair Value Measurement at September 30, 2013 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Collateral dependent impaired loans:				
Agricultural	\$65	\$ —	\$—	\$ 65
Commercial and industrial	1,528	—	—	1,528
Commercial real estate:				
Construction and development	154	—	—	154
Farmland	97	—	—	