

HORIZON BANCORP /IN/
Form 10-Q
November 12, 2009

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HORIZON BANCORP
FORM 10-Q
United States
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
QUARTERLY REPORT UNDER SECTION 13 OR 15 (d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2009
Commission file number 0-10792
HORIZON BANCORP
(Exact name of registrant as specified in its charter)

Indiana

35-1562417

(State or other jurisdiction of incorporation or organization)

(I.R. S. Employer Identification No.)

515 Franklin Square, Michigan City, Indiana

46360

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: **(219) 879-0211**

Former name, former address and former fiscal year, if changed since last report: **N/A**

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

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 3,273,881 at November 12, 2009.

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(Dollar Amounts in Thousands)

	September 30 2009 (Unaudited)	December 31 2008
Assets		
Cash and due from banks	\$ 10,848	\$ 36,001
Interest-bearing deposits	4,464	2,679
Investment securities, available for sale	333,031	301,638
Investment securities, held to maturity	15,661	1,630
Loans held for sale	6,119	5,955
Loans, net of allowance for loan losses of \$13,924 and \$11,410	861,785	870,557
Premises and equipment	29,972	28,280
Federal Reserve and Federal Home Loan Bank stock	13,225	12,625
Goodwill	5,787	5,787
Other intangible assets	1,521	1,751
Interest receivable	6,222	5,708
Cash value life insurance	22,966	22,451
Other assets	9,623	11,795
Total assets	\$1,321,224	\$1,306,857
Liabilities		
Deposits		
Non-interest bearing	\$ 87,725	\$ 83,642
Interest bearing	770,272	757,527
Total deposits	857,997	841,169
Borrowings	311,884	324,383
Subordinated debentures	27,837	27,837
Interest payable	1,304	1,910
Other liabilities	8,369	8,208
Total liabilities	1,207,391	1,203,507
Commitments and contingent liabilities		
Stockholders Equity		
Preferred stock, no par value, \$1,000 liquidation value		
Authorized, 1,000,000 shares		
Issued 25,000 shares		
Common stock, \$.2222 stated value	24,267	24,154
Authorized, 22,500,000 shares		
Issued, 3,271,631 and 3,254,482 shares	1,118	1,114
Additional paid-in capital	9,974	9,650

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Retained earnings	72,255	67,804
Accumulated other comprehensive income	6,219	628
Total stockholders' equity	113,833	103,350
Total liabilities and stockholders' equity	\$1,321,224	\$1,306,857

See notes to condensed consolidated financial statements

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Table of Contents**HORIZON BANCORP AND SUBSIDIARIES****Condensed Consolidated Statements of Income**

(Dollar Amounts in Thousands, Except Per Share Data)

	Three Months Ended September 30		Nine Months Ended September 30	
	2009	2008	2009	2008
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Interest Income				
Loans receivable	\$13,797	\$14,202	\$43,793	\$ 43,763
Investment securities				
Taxable	2,673	2,172	8,333	6,934
Tax exempt	1,015	791	2,882	2,490
Total interest income	17,485	17,165	55,008	53,187
Interest Expense				
Deposits	3,528	4,261	11,517	15,552
Borrowed funds	2,897	3,108	9,011	8,782
Subordinated debentures	341	393	1,082	1,192
Total interest expense	6,766	7,762	21,610	25,526
Net Interest Income	10,719	9,403	33,398	27,661
Provision for loan losses	3,416	3,137	9,903	5,405
Net Interest Income after Provision for Loan Losses	7,303	6,266	23,495	22,256
Other Income				
Service charges on deposit accounts	972	1,065	2,880	2,975
Wire transfer fees	201	155	709	382
Interchange fees	514	216	1,358	618
Fiduciary activities	745	911	2,486	2,817
Gain (loss) on sale of securities	422		422	(15)
Gain on sale of mortgage loans	1,277	657	4,861	2,122
Mortgage servicing net of impairment	35	3	(131)	8
Increase in cash surrender value of bank owned life insurance	206	252	547	701
Death benefit on officer life insurance				538
Other income	170	92	420	316
Total other income	4,542	3,351	13,552	10,462

Other Expenses

Salaries and employee benefits	4,539	4,203	14,264	12,698
Net occupancy expenses	941	944	2,872	2,834
Data processing	419	391	1,194	1,073
Professional fees	316	263	1,021	803
Outside services and consultants	366	328	1,043	940
Loan expense	631	593	1,841	1,603
FDIC insurance expense	400	146	1,751	404
Other (gains) losses	(25)	25	442	267
Other Expenses	1,342	1,390	3,826	3,927
Total other expenses	8,929	8,283	28,254	24,549
Income Before Income Tax	2,916	1,334	8,793	8,169
Income tax expense	559	2	1,737	1,319
Net Income	2,357	1,332	7,056	6,850
Preferred stock dividend and discount accretion	(351)		(1,051)	
Net Income Available to Common Shareholders	\$ 2,006	\$ 1,332	\$ 6,005	\$ 6,850
Basic Earnings Per Share	\$ 0.62	\$ 0.42	\$ 1.86	\$ 2.14
Diluted Earnings Per Share	\$ 0.61	\$ 0.41	\$ 1.84	\$ 2.11
See notes to condensed consolidated financial statements				

Table of Contents**Horizon Bancorp and Subsidiaries****Condensed Consolidated Statement of Stockholders Equity
(Unaudited)**

(Table Dollar Amounts in Thousands, Except Per Share Data)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Comprehensive Income	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balances, December 31, 2008	\$ 24,154	\$ 1,114	\$ 9,650		\$ 67,804	\$ 628	\$ 103,350
Net income				\$ 7,056	7,056		7,056
Amortization of discount on preferred stock	113				(113)		
Other comprehensive income (loss), net of tax:							
Unrealized gain on securities				5,523		5,523	5,523
Unrealized gain on derivative instruments				68		68	68
Comprehensive income				\$ 12,647			
Amortization of unearned compensation			147				147
Issuance of restricted shares		3	101				104
Exercise of stock options		1	31				32
Tax benefit related to stock options			16				16
Stock option expense			29				29
Cash dividends on preferred stock (5.00%)					(1,051)		(1,051)
Cash dividends on common stock (\$.51 per share)					(1,441)		(1,441)
Balances, September 30, 2009	\$ 24,267	\$ 1,118	\$ 9,974		\$ 72,255	\$ 6,219	\$ 113,833

See notes to condensed consolidated financial statements

Table of Contents**HORIZON BANCORP AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows**

(Dollar Amounts in Thousands)

	Nine Months Ended September 30	
	2009	2008
	(Unaudited)	(Unaudited)
Operating Activities		
Net income	\$ 7,056	\$ 6,850
Items not requiring (providing) cash		
Provision for loan losses	9,903	5,405
Depreciation and amortization	1,733	1,743
Share based compensation	29	28
Mortgage servicing rights impairment	124	5
Deferred income tax	(576)	(555)
Premium amortization on securities available for sale, net	491	239
(Gain) loss on sale of investment securities	(422)	15
Gain on sale of mortgage loans	(4,861)	(1,929)
Proceeds from sales of loans	270,354	108,659
Loans originated for sale	(267,847)	(103,152)
Increase in cash surrender value of life insurance	(515)	104
Loss on sale of other real estate owned	13	
Net change in		
Interest receivable	(514)	379
Interest payable	(606)	(490)
Other assets	961	(1,479)
Other liabilities	247	472
Net cash provided by operating activities	15,570	16,294
Investing Activities		
Net change in interest-bearing deposits	(1,785)	(937)
Purchases of securities available for sale	(89,034)	(38,751)
Proceeds from sales, maturities, calls, and principal repayments of securities available for sale	66,068	41,487
Purchase of securities held to maturity	(14,031)	(815)
Proceeds from maturities of securities held to maturity		85
Purchases of FRB Stock	(600)	
Net change in loans	(9,115)	(10,822)
Proceeds on sale of OREO and repossessed assets	8,833	
Recoveries on loans previously charged-off		799
Purchases of premises and equipment	(3,048)	(3,141)
Proceeds from sale of loans transferred to held for sale		37,695
Gain on sale of loans transferred to held for sale		(193)
Net cash provided by (used in) investing activities	(42,712)	25,407

Financing Activities

Net change in		
Deposits	16,828	(144,242)
Borrowings	(12,499)	69,590
Proceeds from issuance of stock	136	35
Tax benefit from issuance of stock	16	8
Dividends paid on preferred shares	(1,051)	
Dividends paid on common shares	(1,441)	(1,593)
Net cash provided by (used in) financing activities	1,989	(76,202)
Net Change in Cash and Cash Equivalent	(25,153)	(34,501)
Cash and Cash Equivalents, Beginning of Period	36,001	55,029
Cash and Cash Equivalents, End of Period	\$ 10,848	\$ 20,528
Additional Cash Flows Information		
Interest paid	\$ 22,216	\$ 26,016
Income taxes paid	2,005	1,405
Transfer of loans to other real estate owned	7,578	1,223
See notes to condensed consolidated financial statements		

Table of Contents**HORIZON BANCORP AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements**

(Table Dollar Amounts in Thousands, Except Per Share Data)

Note 1 Accounting Policies

The accompanying consolidated financial statements include the accounts of Horizon Bancorp (Horizon or the Company) and its wholly-owned subsidiaries, including Horizon Bank, N.A. (Bank). All inter-company balances and transactions have been eliminated. The results of operations for the periods ended September 30, 2009 and September 30, 2008 are not necessarily indicative of the operating results for the full year of 2009 or 2008. The accompanying unaudited condensed consolidated financial statements reflect all adjustments that are, in the opinion of Horizon's management, necessary to fairly present the financial position, results of operations and cash flows of Horizon for the periods presented. Those adjustments consist only of normal recurring adjustments.

Certain information and note disclosures normally included in Horizon's annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in Horizon's Annual Report on Form 10-K for 2008 filed with the Securities and Exchange Commission. The consolidated balance sheet of Horizon as of December 31, 2008 has been derived from the audited balance sheet of Horizon as of that date.

Basic earnings per share is computed by dividing net income available to common shareholders (net income less dividend requirements for preferred stock and accretion of preferred stock discount) by the weighted-average number of common shares outstanding. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. In August 2002, substantially all of the participants in Horizon's Stock Option and Stock Appreciation Rights Plans voluntarily entered into an agreement with Horizon to cap the value of their stock appreciation rights (SARS) at \$14.67 per share and cease any future vesting of the SARS. These agreements with option holders make it more advantageous to exercise an option rather than a SAR whenever Horizon's stock price exceeds \$14.67 per share, therefore the option becomes potentially dilutive at \$14.67 per share or higher. The following table shows computation of basic and diluted earnings per share.

	Three months ended September 30		Nine months ended September 30	
	2009	2008	2009	2008
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Basic earnings per share				
Net income	\$ 2,357	\$ 1,332	\$ 7,056	\$ 6,850
Less: Preferred stock dividends and accretion of discount	351		1,051	
Net income available to common shareholders	\$ 2,006	\$ 1,332	\$ 6,005	\$ 6,850
Weighted average common shares outstanding	3,245,505	3,209,482	3,221,622	3,208,362
Basic earnings per share	\$ 0.62	\$ 0.42	\$ 1.86	\$ 2.14
Diluted earnings per share	\$ 2,006	\$ 1,332	\$ 6,005	\$ 6,850

Net income available to common
shareholders

Weighted average common shares outstanding	3,245,505	3,209,482	3,221,622	3,208,362
Effect of dilutive securities:				
Restricted stock	20,572	34,257	41,895	26,903
Stock options	7,665	11,670	6,637	10,943
Weighted average shares outstanding	3,273,742	3,255,409	3,270,154	3,246,208
Diluted earnings per share	\$ 0.61	\$ 0.41	\$ 1.84	\$ 2.11

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(Table Dollar Amounts in Thousands, Except Per Share Data)

At September 30, 2009 and 2008 there were 30,800 shares and 28,000 shares that were not included in the computation of diluted earnings per share because they were non-dilutive. Warrants to purchase 212,104 shares at September 30, 2009 were not included in the computation of diluted earnings per share because the effect would be non-dilutive.

Horizon has share-based employee compensation plans, which are described in the notes to the financial statements included in the December 31, 2008 Annual Report on Form 10-K.

Reclassifications

Certain reclassifications have been made to the 2008 consolidated financial statements to be comparable to 2009.

These reclassifications had no effect on net income.

Note 2 Securities

The fair value of securities is as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2009 (Unaudited)				
Available for sale				
U.S. Treasury and federal agencies	\$ 19,722	\$ 571	\$	\$ 20,293
State and municipal	96,371	4,585	(233)	100,723
Federal agency collateralized mortgage obligations	49,608	625	(299)	49,934
Federal agency mortgage-backed pools	156,300	5,328	(1)	161,627
Corporate notes	710	6	(262)	454
Total available for sale investment securities	\$322,711	\$11,115	\$ (795)	\$333,031
Held to maturity, State and Municipal	\$ 15,661	\$ 4	\$ (1)	\$ 15,664
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2008				
Available for sale				
U.S. Treasury and federal agencies	\$ 23,661	\$ 1,253	\$	\$ 24,914
State and municipal	88,282	804	(2,101)	86,985
Federal agency collateralized mortgage obligations	13,063	223	(335)	12,951
Federal agency mortgage-backed pools	174,227	2,374	(212)	176,389
Corporate notes	587		(188)	399
Total available for sale investment securities	\$299,820	\$ 4,654	\$(2,836)	\$301,638
Held to maturity, State and Municipal	\$ 1,630	\$ 4	\$	\$ 1,634

Based on evaluation of available evidence, including recent changes in market interest rates, credit rating information, and information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary. While these securities are held in the available for sale portfolio, Horizon intends and has the ability to

hold them until the earlier of a recovery in fair value or maturity.

Should the impairment of any of these securities become other than temporary, the cost basis of the investment will be reduced and the resulting loss recognized in net income in the period the other-than-

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(Table Dollar Amounts in Thousands, Except Per Share Data)

temporary impairment is identified. At September 30, 2009, no individual investment security had an unrealized loss that was determined to be other-than-temporary.

The unrealized losses on the Company's investments in securities of state and municipal, federal agency collateralized mortgage obligations, and federal agency mortgage-backed pools were caused by interest rate increases and not a decline in credit quality. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments or the Company expects to recover the amortized cost basis over the term of the securities. Because the Company does not intend to sell the investments and it is not likely that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company did not consider those investments to be other-than-temporarily impaired at September 30, 2009.

The amortized cost and fair value of securities available for sale and held to maturity at September 30, 2009 and December 31, 2008, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	September 30, 2009 (Unaudited)		December 31, 2008	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Available for sale				
Within one year	\$ 2,642	\$ 2,696	\$ 1,182	\$ 1,190
One to five years	21,067	21,815	10,569	10,926
Five to ten years	37,779	39,192	28,701	28,664
After ten years	55,315	57,767	72,078	71,518
	116,803	121,470	112,530	112,298
Federal agency collateralized mortgage obligations	49,608	49,934	13,063	12,951
Federal agency mortgage-backed pools	156,300	161,627	174,227	176,389
Total available for sale investment securities	\$ 322,711	\$ 333,031	\$ 299,820	\$ 301,638
Held to maturity				
Within one year	\$ 15,371	\$ 15,372	\$ 90	\$ 91
One to five years	290	292	1,540	1,543
Total held to maturity investment securities	\$ 15,661	\$ 15,664	\$ 1,630	\$ 1,634

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(Table Dollar Amounts in Thousands, Except Per Share Data)

The following table shows investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position.

September 30, 2009 (Unaudited)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
State and municipal	\$2,416	\$ (33)	\$3,430	\$ (201)	\$ 5,846	\$ (234)
Federal agency collateralized mortgage obligations	5,745	(163)	3,104	(136)	8,849	(299)
Federal agency mortgage-backed pools			44	(1)	44	(1)
Corporate notes			325	(262)	325	(262)
Total temporarily impaired securities	\$8,161	\$ (196)	\$6,903	\$ (600)	\$15,064	\$ (796)

December 31, 2008	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
State and municipal	\$47,215	\$ (1,973)	\$ 2,342	\$ (128)	\$49,557	\$ (2,101)
Federal agency collateralized mortgage obligations	4,026	(335)			4,026	(335)
Federal agency mortgage-backed pools	24,753	(161)	6,145	(51)	30,898	(212)
Corporate notes	399	(188)			399	(188)
Total temporarily impaired securities	\$76,393	\$ (2,657)	\$ 8,487	\$ (179)	\$ 84,880	\$ (2,836)

Information regarding security proceeds, gross gains and gross losses are presented below.

	Three months ended September 30		
	2009	2008	
Sales of securities available for sale (Unaudited)			
Proceeds	\$ 12,880	\$	
Gross gains	422		
Gross losses			
		Nine months ended September 30	
		2009	2008

Sales of securities available for sale (Unaudited)

Proceeds		\$ 12,880	\$ 30
Gross gains		422	
Gross losses			(15)

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HORIZON BANCORP AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
(Table Dollar Amounts in Thousands, Except Per Share Data)

Note 3 Loans

	September 30, 2009 (Unaudited)	December 31 2008
Commercial	\$ 312,573	\$ 310,842
Residential mortgage	142,568	167,766
Mortgage warehouse	145,270	123,287
Installment	275,299	280,072
	875,709	881,967
Allowance for loan losses	(13,924)	(11,410)
Total loans	\$ 861,785	\$ 870,557

Note 4 Allowance for Loan Losses

	September 30, 2009 (Unaudited)	September 30, 2008 (Unaudited)
Balances, beginning of period	\$ 11,410	\$ 9,791
Provision for losses	9,903	5,405
Recoveries on loans	952	799
Loans charged off	(8,341)	(5,470)
Balances, end of period	\$ 13,924	\$ 10,525

Note 5 Non-performing Assets

	September 30, 2009 (Unaudited)	December 31 2008
Non-performing loans		
Commercial	\$ 9,235	\$ 5,167
Residential mortgage	4,926	1,904
Mortgage warehouse		
Installment	2,312	792
Total non-performing loans	16,473	7,863
Other real estate owned and repossessed collateral		
Commercial		
Residential mortgage	1,671	2,874

Mortgage warehouse Installment	142	207
Total other real estate owned and repossessed collateral	1,813	3,081
Total non-performing assets	\$ 18,286	\$ 10,944

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HORIZON BANCORP AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
(Table Dollar Amounts in Thousands, Except Per Share Data)

Note 6 Derivative financial instruments

Cash Flow Hedges

As a strategy to maintain acceptable levels of exposure to the risk of changes in future cash flow due to interest rate fluctuations, the Company entered into interest rate swap agreements for a portion of its floating rate debt. The agreements provide for the Company to receive interest from the counterparty at three month LIBOR and to pay interest to the counterparty at a weighted average fixed rate of 5.38% on a notional amount of \$22.0 million at September 30, 2009. Under the agreements, the Company pays or receives the net interest amount monthly, with the monthly settlements included in interest expense.

Management has designated the interest rate swap agreement as a cash flow hedging instrument. For derivative instruments that are designated and qualify as a cash flow hedge, the effective portion of the gain or loss on the derivative is reported as a component of the other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings. At September 30, 2009 the Company's cash flow hedge was effective and is not expected to have a significant impact the Company's net income over the next 12 months.

Fair Value Hedges

Fair value hedges are intended to reduce the interest rate risk associated with the underlying hedged item. The Company enters into fixed rate loan agreements as part of its lending policy. To mitigate the risk of changes in fair value based on fluctuations in interest rates, the Company has entered into interest rate swap agreements on individual loans, converting the fixed rate loans to a variable rate. For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative as well as the offsetting gain or loss on the hedged item attributable to the hedged risk are recognized in current earnings. At September 30, 2009 the Company's fair value hedges were effective and are not expected to have a significant impact the Company's net income over the next 12 months. The change in fair value of both the hedge instruments and the underlying loan agreements are recorded as gains or losses in interest income. The fair value hedges are considered to be highly effective and any hedge ineffectiveness was deemed not material. The notional amounts of the loan agreements being hedged were \$25.7 million at September 30, 2009.

Other Derivative Instruments

The Company enters into non-hedging derivatives in the form of mortgage loan forward sale commitments with investors and commitments to originate mortgage loans as part of its mortgage banking business. At September 30, 2009 the Company's fair value of these derivatives were recorded and over the next 12 months are not expected to have a significant impact the Company's net income.

The change in fair value of both the forward sale commitments and commitments to originate mortgage loans were recorded and the net gains or losses included in the Company's gain on sale of loans.

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HORIZON BANCORP AND SUBSIDIARIES
Notes to Condensed Consolidated Financial Statements
(Table Dollar Amounts in Thousands, Except Per Share Data)

The following tables summarize the fair value of derivative financial instruments utilized by Horizon Bancorp:

Derivatives designated as hedging instruments	Asset Derivative September 30, 2009 (Unaudited)		Liability Derivatives September 30, 2009 (Unaudited)	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate contracts	Loans	\$ 1,287	Other liabilities	\$ 1,287
Interest rate contracts			Other liabilities	746
Total derivatives designated as hedging instruments		1,287		2,033
 Derivatives not designated as hedging instruments				
Mortgage loan contracts	Other assets	366	Other liabilities	(42)
Total derivatives not designated as hedging instruments		366		(42)
Total derivatives		\$ 1,653		\$ 1,991

The effect of the derivative instruments on the consolidated statement of income for the three and nine-month periods ended is as follows:

Derivative in cash flow hedging relationship	Amount of Gain Recognized in Other Comprehensive Income on Derivative (Effective Portion)	
	Three Months Ended September 30, 2009 (Unaudited)	Nine Months Ended September 30, 2009 (Unaudited)
Interest rate contracts	\$ (564)	\$ 68
Total	\$ (564)	\$ 68

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(Table Dollar Amounts in Thousands, Except Per Share Data)

FASB Accounting Standards Codification (ASC) Topic 820-10-20 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 at the measurement date. Topic 820-10-55 establishes a fair value hierarchy that emphasizes the use of observable inputs and minimizes the use of unobservable inputs when measuring fair value.

Derivative in fair value hedging relationship	Location of Gain (Loss) Recognized on Derivative	Amount of Gain (Loss) Recognized on Derivative	
		Three Months Ended Sept. 30, 2009 (Unaudited)	Nine Months Ended Sept 30, 2009 (Unaudited)
Interest rate contracts	Interest income loans	\$ 1,847	\$ (419)
Interest rate contracts	Interest income loans	(1,847)	419
Total		\$	\$

Derivative in fair value hedging	Location of Gain (Loss) Recognized on Derivative	Amount of Gain (Loss) Recognized on Derivative	
		Three Months Ended Sept 30, 2009 (Unaudited)	Nine Months Ended Sept 30, 2009 (Unaudited)
Mortgage contracts	Other income gain on sale of loans	\$ 553	\$ 177
Total		\$ 553	\$ 177

Note 7 Disclosures about fair value of assets and liabilities

The Fair Value Measurements topic of the FASB ASC defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. There are three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities

Level 2

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 for substantially the full term of the assets or liabilities

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis and recognized in the accompanying financial statements, as well as the general classification of such instruments pursuant to the valuation hierarchy.

Available for sale securities

When quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated by using pricing

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models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include, U.S. Treasury and federal agency securities, state and municipal securities, federal agency mortgage obligations and mortgage-backed pools, and corporate notes. Level 2 securities are valued by a third party pricing service commonly used in the banking industry utilizing observable inputs. Observable inputs include dealer quotes, market spreads, cash flow analysis, the U.S. Treasury yield curve, trade execution data, market consensus prepayment spreads and available credit information and the bond's terms and conditions. The pricing provider utilizes evaluated pricing models that vary based on asset class. These models incorporate available market information including quoted prices of securities with similar characteristics and, because many fixed-income securities do not trade on a daily basis, apply available information through processes such as benchmark curves, benchmarking of like securities, sector grouping, and matrix pricing. In addition, model processes, such as an option adjusted spread model is used to develop prepayment and interest rate scenarios for securities with prepayment features.

Hedged loans

Certain fixed rate loans have been converted to variable rate loans through entering into interest rate swap agreements. Fair value of those fixed rate loans is based on discounting estimated cash flows using interest rates determined by a respective interest rate swap agreement. Loans are classified within Level 3 of the valuation hierarchy based on the unobservable inputs used.

Interest rate swap agreements

The fair value is estimated by a third party using inputs that are primarily unobservable and cannot be corroborated by observable market data and, therefore, are classified within Level 3 of the valuation hierarchy.

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The following table presents the fair value measurements of assets and liabilities recognized in the accompanying financial statements measured at fair value on a recurring basis and the level within the FASB ASC fair value hierarchy in which the fair value measurements fall at the following:

	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
September 30, 2009 (Unaudited)				
Available-for-sale securities				
U.S. Treasury and federal agencies	\$ 20,293	\$	\$ 20,293	\$
State and municipal	100,723		100,723	
Federal agency collateralized mortgage obligations	49,934		49,934	
Federal agency mortgage-backed pools	161,627		161,627	
Corporate notes	454		454	
Total available-for-sale securities	333,031		333,031	
Hedged loans	26,971			26,971
Forward sale commitments	366			366
Interest rate swap agreements	(2,033)			(2,033)
Commitments to originate loans	42			42
December 31, 2008				
Available-for-sale securities	\$ 301,638	\$	\$ 301,638	\$
Hedged loans	25,033			25,033
Forward sale commitments	670			670
Interest rate swap agreements	(2,557)			(2,557)
Commitments to originate loans	(438)			(438)
September 30, 2008 (Unaudited)				
Available-for-sale securities	\$ 230,107	\$ 1,418	\$ 228,689	\$
Hedged loans	18,814			18,814
Interest rate swap agreements	(35)			(35)

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The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the accompanying condensed consolidated balance sheet using significant unobservable (level 3) inputs (Unaudited):

	Hedged Loans	Forward Sale Commitments	Interest Rate Swaps	Commitments to Originate Loans
Beginning balance December 31, 2008	\$ 25,033	\$ 670	\$ (2,557)	\$ (438)
Total realized and unrealized gains and losses				
Included in net income	24	(226)	(24)	258
Included in other comprehensive income, gross			(73)	
Purchases, issuances, and settlements	2,901			
Principal payments	(167)			
Ending balance March 31, 2009	27,791	444	(2,654)	(180)
Total realized and unrealized gains and losses				
Included in net income	(584)	(214)	584	37
Included in other comprehensive income, gross			194	
Principal payments	(190)			
Ending balance June 30, 2009	27,017	230	(1,876)	(143)
Total realized and unrealized gains and losses				
Included in net income	141	136	(141)	185
Included in other comprehensive income, gross			(16)	
Principal payments	(187)			
Ending balance September 30, 2009	\$ 26,971	\$ 366	\$ (2,033)	\$ 42
	Hedged Loans	Forward Sale Commitments	Interest Rate Swaps	Commitments to Originate Loans
Beginning balance December 31, 2007	\$	\$	\$	\$
Total realized and unrealized gains and losses				
Included in net income	195		(195)	
Included in other comprehensive income, gross			(584)	
Purchases, issuances, and settlements	11,437			
Principal payments	(31)			
Ending balance March 31, 2008	11,601		(779)	

Total realized and unrealized gains and losses				
Included in net income	(436)		436	
Included in other comprehensive income, gross			601	
Purchases, issuances, and settlements	5,166			
Principal payments	(62)			
Ending balance June 30, 2008	16,269		258	
Total realized and unrealized gains and losses				
Included in net income	198		(198)	
Included in other comprehensive income, gross			(95)	
Purchases, issuances, and settlements	2,506			
Principal payments	(159)			
Ending balance September 30, 2008	\$ 18,814	\$	\$ (35)	\$

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