

1ST SOURCE CORP  
Form 10-Q  
October 25, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

**For the quarterly period ended September 30, 2012**

**OR**

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

**For the transition period from                      to**

**Commission file number 0-6233**

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(Exact name of registrant as specified in its charter)

**INDIANA**

(State or other jurisdiction of  
incorporation or organization)

**35-1068133**

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

**100 North Michigan Street  
South Bend, IN**

(Address of principal executive  
offices)

**46601**

(Zip Code)

**(574) 235-2000**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

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 ☐  
(Do not check if a smaller reporting company)

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

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Number of shares of common stock outstanding as of October 12, 2012 24,279,271 shares

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	September 30, 2012	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$ 54,635	\$ 61,406
Federal funds sold and interest bearing deposits with other banks	17,179	52,921
Investment securities available-for-sale (amortized cost of \$832,951 and \$853,204 at September 30, 2012 and December 31, 2011, respectively)	868,312	883,000
Other investments	22,364	18,974
Trading account securities	145	132
Mortgages held for sale	22,853	12,644
Loans and leases - net of unearned discount		
Commercial and agricultural loans	584,996	545,570
Auto, light truck and environmental equipment	456,665	435,965
Medium and heavy duty truck	167,709	159,796
Aircraft financing	685,800	620,782
Construction equipment financing	276,270	261,204
Commercial real estate	548,921	545,457
Residential real estate	436,909	423,606
Consumer loans	111,143	98,163
Total loans and leases	3,268,413	3,090,543
Reserve for loan and lease losses	(83,499)	(81,644)
Net loans and leases	3,184,914	3,008,899
Equipment owned under operating leases, net	58,496	69,551
Net premises and equipment	43,172	39,857
Goodwill and intangible assets	87,796	87,675
Accrued income and other assets	128,353	139,012
Total assets	\$ 4,488,219	\$ 4,374,071
<b>LIABILITIES</b>		
Deposits:		
Noninterest bearing	\$ 634,795	\$ 580,101
Interest bearing	2,933,873	2,940,040
Total deposits	3,568,668	3,520,141
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	119,749	106,991
Other short-term borrowings	16,886	18,243
Total short-term borrowings	136,635	125,234
Long-term debt and mandatorily redeemable securities	66,964	37,156
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	72,592	77,930
Total liabilities	3,934,551	3,850,153
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock; no par value		
Authorized 10,000,000 shares; none issued or outstanding		
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,643,506 at September 30, 2012 and December 31, 2011	346,535	346,535

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Retained earnings	215,647	190,261
Cost of common stock in treasury (1,364,235 shares at September 30, 2012 and 1,429,484 shares at December 31, 2011)	(30,360)	(31,389)
Accumulated other comprehensive income	21,846	18,511
Total shareholders' equity	553,668	523,918
Total liabilities and shareholders' equity	\$ 4,488,219	\$ 4,374,071

The accompanying notes are a part of the consolidated financial statements.

Table of Contents**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF INCOME****(Unaudited - Dollars in thousands, except per share amounts)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
<b>Interest income:</b>				
Loans and leases	\$ 40,610	\$ 40,741	\$ 120,824	\$ 123,750
Investment securities, taxable	3,913	4,694	12,574	14,088
Investment securities, tax-exempt	826	934	2,526	3,124
Other	231	217	688	707
<b>Total interest income</b>	<b>45,580</b>	<b>46,586</b>	<b>136,612</b>	<b>141,669</b>
<b>Interest expense:</b>				
Deposits	5,419	7,756	16,868	24,273
Short-term borrowings	36	77	136	240
Subordinated notes	1,647	1,647	4,942	4,942
Long-term debt and mandatorily redeemable securities	571	480	1,399	1,144
<b>Total interest expense</b>	<b>7,673</b>	<b>9,960</b>	<b>23,345</b>	<b>30,599</b>
<b>Net interest income</b>	<b>37,907</b>	<b>36,626</b>	<b>113,267</b>	<b>111,070</b>
Provision for loan and lease losses	650	1,260	4,959	3,525
<b>Net interest income after provision for loan and lease losses</b>	<b>37,257</b>	<b>35,366</b>	<b>108,308</b>	<b>107,545</b>
<b>Noninterest income:</b>				
Trust fees	4,055	3,902	12,407	12,305
Service charges on deposit accounts	4,708	4,748	14,028	13,622
Mortgage banking income	2,020	1,056	5,464	2,335
Insurance commissions	1,483	1,212	4,051	3,416
Equipment rental income	4,604	5,814	14,620	17,861
Other income	3,346	3,084	9,556	9,382
Investment securities and other investment gains	89	414	492	1,686
<b>Total noninterest income</b>	<b>20,305</b>	<b>20,230</b>	<b>60,618</b>	<b>60,607</b>
<b>Noninterest expense:</b>				
Salaries and employee benefits	20,982	19,476	61,668	57,249
Net occupancy expense	1,652	2,237	5,660	6,608
Furniture and equipment expense	3,817	3,519	11,155	10,429
Depreciation - leased equipment	3,795	4,650	11,909	14,250
Professional fees	1,385	1,326	4,232	3,502
Supplies and communication	1,387	1,312	4,165	4,022
FDIC and other insurance	913	874	2,716	3,508
Business development and marketing expense	1,008	968	2,925	2,454
Loan and lease collection and repossession expense	1,866	1,387	4,346	4,211
Other expense	388	1,399	3,043	5,334
<b>Total noninterest expense</b>	<b>37,193</b>	<b>37,148</b>	<b>111,819</b>	<b>111,567</b>
<b>Income before income taxes</b>	<b>20,369</b>	<b>18,448</b>	<b>57,107</b>	<b>56,585</b>
<b>Income tax expense</b>	<b>7,364</b>	<b>6,908</b>	<b>19,820</b>	<b>19,572</b>

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<b>Net income</b>	\$	13,005	\$	11,540	\$	37,287	\$	37,013
Per common share								
Basic net income per common share	\$	0.53	\$	0.47	\$	1.52	\$	1.51
Diluted net income per common share	\$	0.53	\$	0.47	\$	1.51	\$	1.51
Dividends	\$	0.17	\$	0.16	\$	0.49	\$	0.48
Basic weighted average common shares outstanding		24,279,178		24,213,063		24,267,535		24,246,041
Diluted weighted average common shares outstanding		24,289,495		24,223,432		24,278,160		24,255,357

The accompanying notes are a part of the consolidated financial statements.



Table of Contents**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(Unaudited - Dollars in thousands)**

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>	<b>2012</b>	<b>2011</b>
Net income	\$ 13,005	\$ 11,540	\$ 37,287	\$ 37,013
Other comprehensive income, net of tax:				
Change in unrealized appreciation of available-for-sale securities, net of tax	2,458	3,634	3,505	9,091
Reclassification adjustment for losses/(gains) included in net income, net of tax	1	(11)	(170)	(856)
Other comprehensive income	2,459	3,623	3,335	8,235
Comprehensive income	\$ 15,464	\$ 15,163	\$ 40,622	\$ 45,248

The accompanying notes are a part of the consolidated financial statements.

**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY****(Unaudited - Dollars in thousands, except per share amounts)**

	<b>Total</b>	<b>Preferred Stock</b>	<b>Common Stock</b>	<b>Retained Earnings</b>	<b>Cost of Common Stock in Treasury</b>	<b>Accumulated Other Comprehensive Income (Loss), Net</b>
Balance at January 1, 2011	\$ 486,383	\$	\$ 350,282	\$ 157,875	\$ (32,284)	\$ 10,510
Net income	37,013			37,013		
Other comprehensive income	8,235					8,235
Issuance of 149,731 common shares under stock based compensation awards, including related tax effects	2,853			(165)	3,018	
Cost of 109,525 shares of common stock acquired for treasury	(2,142)				(2,142)	
Repurchase of common stock warrant	(3,750)		(3,750)			
Common stock dividend (\$0.48 per share)	(11,716)			(11,716)		
Stock based compensation	3					

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Balance at September 30, 2011	\$	516,879	\$		\$	346,535	\$	183,007	\$	(31,408)	\$	18,745
Balance at January 1, 2012	\$	523,918	\$		\$	346,535	\$	190,261	\$	(31,389)	\$	18,511
Net income		37,287						37,287				
Other comprehensive income		3,335										3,335
Issuance of 169,720 common shares under stock based compensation awards, including related tax effects		3,743						97		3,646		
Cost of 104,471 shares of common stock acquired for treasury		(2,617)								(2,617)		
Common stock dividend (\$0.49 per share)		(11,998)						(11,998)				
Balance at September 30, 2012	\$	553,668	\$		\$	346,535	\$	215,647	\$	(30,360)	\$	21,846

The accompanying notes are a part of the consolidated financial statements.

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	<b>Nine Months Ended September 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating activities:</b>		
Net income	\$ 37,287	\$ 37,013
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	4,959	3,525
Depreciation of premises and equipment	3,151	2,698
Depreciation of equipment owned and leased to others	11,909	14,250
Amortization of investment security premiums and accretion of discounts, net	3,140	1,610
Amortization of mortgage servicing rights	2,267	2,125
Mortgage servicing asset impairment	230	230
Deferred income taxes	(4,817)	3,015
Investment securities and other investment gains	(492)	(1,686)
Originations of loans held for sale, net of principal collected	(165,577)	(67,655)
Proceeds from the sales of loans held for sale	160,301	88,372
Net gain on sale of loans held for sale	(4,933)	(1,337)
Change in trading account securities	(13)	19
Change in interest receivable	(634)	1,002
Change in interest payable	(529)	424
Change in other assets	10,993	1,251
Change in other liabilities	404	(331)
Other	990	2,901
Net change in operating activities	58,636	87,426
<b>Investing activities:</b>		
Proceeds from sales of investment securities	40,736	133,241
Proceeds from maturities of investment securities	203,436	269,416
Purchases of investment securities	(226,567)	(270,817)
Net change in other investments	(3,390)	2,370
Loans sold or participated to others	22,968	15,039
Net change in loans and leases	(206,261)	(33,899)
Net change in equipment owned under operating leases	(854)	(11,208)
Purchases of premises and equipment	(6,521)	(10,587)
Net change in investing activities	(176,453)	93,555
<b>Financing activities:</b>		
Net change in demand deposits, NOW accounts and savings accounts	119,128	(129,250)
Net change in certificates of deposit	(70,601)	(45,910)
Net change in short-term borrowings	11,401	(15,051)
Proceeds from issuance of long-term debt	26,873	10,710
Payments on long-term debt	(360)	(328)
Net proceeds from issuance of treasury stock	3,743	2,853
Acquisition of treasury stock	(2,617)	(2,142)
Repurchase of common stock warrant		(3,750)
Cash dividends paid on common stock	(12,263)	(11,935)
Net change in financing activities	75,304	(194,803)
Net change in cash and cash equivalents	(42,513)	(13,822)

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Cash and cash equivalents, beginning of year	114,327	96,872
Cash and cash equivalents, end of period	\$ 71,814	\$ 83,050
<u>Non-cash transactions:</u>		
Loans transferred to other real estate and repossessed assets	\$ 2,319	\$ 11,993
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan	2,643	2,420

The accompanying notes are a part of the consolidated financial statements.

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**1ST SOURCE CORPORATION**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1. Basis of Presentation**

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as 1st Source or the Company), a broad array of financial products and services. The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in shareholders' equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted.

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K (2011 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The balance sheet at December 31, 2011 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current year presentation.

**Note 2. Recent Accounting Pronouncements**

Offsetting Assets and Liabilities: In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11 *Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities*. ASU 2011-11 requires an entity to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Retrospective disclosure is required for all comparative periods presented. The Company is assessing the impact of ASU 2011-11 on its disclosures.

Goodwill: In September 2011, the FASB issued ASU No. 2011-08 *Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment*. ASU 2011-08 allows an entity the option to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of the reporting unit. ASU 2011-08 was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption was permitted. The Company does not expect an impact on its financial condition or results of operations.

Comprehensive Income: In June 2011, the FASB issued ASU No. 2011-05 *Comprehensive Income (Topic 220) - Presentation of Comprehensive Income*. ASU 2011-05 requires that all nonowner changes in stockholders' equity be presented either in a single continuous

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statement of comprehensive income or in two separate but consecutive statements. In both cases, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. In December 2011, FASB issued ASU No. 2011-12 which defers the effective date of the requirement in ASU 2011-05 to present items that are

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reclassified from accumulated other comprehensive income to net income alongside their respective components of net income and other comprehensive income. ASU 2011-05 was effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. The effect of applying this standard is reflected in the Consolidated Statements of Comprehensive Income and Consolidated Statements of Shareholders' Equity.

**Fair Value Measurements:** In May 2011, the FASB issued ASU No. 2011-04 *Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. ASU 2011-04 changed the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs (International Financial Reporting Standards). ASU 2011-04 was effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early application by public entities was not permitted. The effect of applying this standard is reflected in Note 12 Fair Value Measurements.

**Transfers and Servicing:** In April 2011, the FASB issued ASU No. 2011-03 *Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement*. ASU 2011-03 removed from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 was effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date. Early adoption was not permitted. ASU 2011-03 did not have an impact on the Company's financial condition, results of operations, or disclosures.

## **Note 3. Investment Securities**

Investment securities available-for-sale were as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2012				
U.S. Treasury and Federal agencies securities	\$ 370,394	\$ 12,002	\$ (52)	\$ 382,344
U.S. States and political subdivisions securities	100,702	6,454	(443)	106,713
Mortgage-backed securities - Federal agencies	318,775	13,381	(1)	332,155
Corporate debt securities	36,010	471	(234)	36,247
Foreign government and other securities	4,703	33		4,736
Total debt securities	830,584	32,341	(730)	862,195
Marketable equity securities	2,367	3,753	(3)	6,117
Total investment securities available-for-sale	\$ 832,951	\$ 36,094	\$ (733)	\$ 868,312
December 31, 2011				
U.S. Treasury and Federal agencies securities	\$ 390,819	\$ 10,356	\$ (50)	\$ 401,125
U.S. States and political subdivisions securities	101,587	6,433	(660)	107,360
Mortgage-backed securities - Federal agencies	317,392	11,565	(9)	328,948
Corporate debt securities	36,349	325	(364)	36,310
Foreign government and other securities	4,690	24	(1)	4,713
Total debt securities	850,837	28,703	(1,084)	878,456
Marketable equity securities	2,367	2,673	(496)	4,544

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Total investment securities available-for-sale	\$	853,204	\$	31,376	\$	(1,580)	\$	883,000
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At September 30, 2012 and December 31, 2011, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).



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The contractual maturities of debt securities available-for-sale at September 30, 2012 are shown below. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	\$ 50,631	\$ 50,940
Due after one year through five years	349,881	360,131
Due after five years through ten years	104,113	112,138
Due after ten years	7,184	6,831
Mortgage-backed securities	318,775	332,155
Total debt securities available-for-sale	\$ 830,584	\$ 862,195

The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. There were no other-than-temporary-impairment (OTTI) write-downs in 2012 or 2011.

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Gross realized gains	\$ 63	\$ 275	\$ 1,662	
Gross realized losses	(46)		(284)	
Net realized gains (losses)	\$ 17	\$ 275	\$ 1,378	

The following table summarizes gross unrealized losses and fair value by investment category and age:

(Dollars in thousands)	Less than 12 Months		12 months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2012						
U.S. Treasury and Federal agencies securities	\$ 15,236	\$ (52)	\$ 15,236	\$ (52)		
U.S. States and political subdivisions securities	2,963	(14)	3,371	(429)	6,334	(443)
Mortgage-backed securities - Federal agencies			63	(1)	63	(1)
Corporate debt securities	5,144	(8)	4,299	(226)	9,443	(234)
Foreign government and other securities	200				200	
Total debt securities	23,543	(74)	7,733	(656)	31,276	(730)
Marketable equity securities			5	(3)	5	(3)
Total investment securities available-for-sale	\$ 23,543	\$ (74)	\$ 7,738	\$ (659)	\$ 31,281	\$ (733)
December 31, 2011						
U.S. Treasury and Federal agencies securities	\$ 42,536	\$ (50)	\$ 42,536	\$ (50)		
U.S. States and political subdivisions securities	423	(9)	5,149	(651)	5,572	(660)
Mortgage-backed securities - Federal agencies	5,071	(1)	13,099	(8)	18,170	(9)
Corporate debt securities	4,858	(142)	8,579	(222)	13,437	(364)
Foreign government and other securities	1,011	(1)			1,011	(1)
Total debt securities	53,899	(203)	26,827	(881)	80,726	(1,084)
Marketable equity securities	622	(492)	4	(4)	626	(496)
Total investment securities available-for-sale	\$ 54,521	\$ (695)	\$ 26,831	\$ (885)	\$ 81,352	\$ (1,580)

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The initial indication of OTTI for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, the impaired securities are analyzed on a qualitative and quantitative basis in determining OTTI. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-

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temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In estimating OTTI impairment losses, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

At September 30, 2012, the Company does not have the intent to sell any of the available-for-sale securities in the table above and believes that it is more likely than not that it will not have to sell any such securities before an anticipated recovery of cost. The unrealized losses on debt securities are due to increases in market interest rates over the yields available at the time the underlying securities were purchased and market illiquidity on auction rate securities which are reflected in U.S. States and Political subdivisions securities. The fair value is expected to recover on all debt securities as they approach their maturity date or repricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

At September 30, 2012 and December 31, 2011, investment securities with carrying values of \$246.05 million and \$250.36 million, respectively, were pledged as collateral to secure government deposits, security repurchase agreements, and for other purposes.

**Note 4. Loan and Lease Financings**

The Company evaluates loans and leases for credit quality at least annually but more frequently if certain circumstances occur (such as material new information which becomes available and indicates a potential change in credit risk). The Company uses two methods to assess credit risk: loan or lease credit quality grades and credit risk classifications. The purpose of the loan or lease credit quality grade is to document the degree of risk associated with individual credits as well as inform management of the degree of risk in the portfolio taken as a whole. Credit risk classifications are used to categorize loans by degree of risk and to designate individual or committee approval authorities for higher risk credits at the time of origination. Credit risk classifications include categories for: Acceptable, Marginal, Special Attention, Special Risk, Restricted by Policy, Regulated and Prohibited by Law.

All loans and leases, except residential real estate loans and consumer loans, are assigned credit quality grades on a scale from 1 to 12 with grade 1 representing superior credit quality. The criteria used to assign grades to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on the Company's safety and soundness. Loans or leases graded 7 or weaker are considered special attention credits and, as such, relationships in excess of \$100,000 are reviewed quarterly as part of management's evaluation of the appropriateness of the reserve for loan and lease losses. Grade 7 credits are defined as watch and contain greater than average credit risk and are monitored to limit the exposure to increased risk; grade 8 credits are special mention and, following regulatory guidelines, are defined as having potential weaknesses that deserve management's close attention. Credits that exhibit well-defined weaknesses and a distinct possibility of loss are considered classified and are graded 9 through 12 corresponding to the regulatory definitions of substandard (grades 9 and 10) and the more severe doubtful (grade 11) and loss (grade 12).

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The table below presents the credit quality grades of the recorded investment in loans and leases, segregated by class.

(Dollars in thousands)	Credit Quality Grades		
	1-6	7-12	Total
September 30, 2012			
Commercial and agricultural loans	\$ 552,188	\$ 32,808	\$ 584,996
Auto, light truck and environmental equipment	443,163	13,502	456,665
Medium and heavy duty truck	165,196	2,513	167,709
Aircraft financing	654,971	30,829	685,800
Construction equipment financing	259,822	16,448	276,270
Commercial real estate	495,987	52,934	548,921
Total	\$ 2,571,327	\$ 149,034	\$ 2,720,361
December 31, 2011			
Commercial and agricultural loans	\$ 513,011	\$ 32,559	\$ 545,570
Auto, light truck and environmental equipment	432,288	3,677	435,965
Medium and heavy duty truck	154,261	5,535	159,796
Aircraft financing	580,004	40,778	620,782
Construction equipment financing	239,643	21,561	261,204
Commercial real estate	487,576	57,881	545,457
Total	\$ 2,406,783	\$ 161,991	\$ 2,568,774

For residential real estate and consumer loans, credit quality is based on the aging status of the loan and by payment activity. The table below presents the recorded investment in residential real estate and consumer loans by performing or nonperforming status. Nonperforming loans are those loans which are on nonaccrual status or are 90 days or more past due.

(Dollars in thousands)	Performing		Nonperforming		Total
September 30, 2012					
Residential real estate	\$	434,005	\$	2,904	\$ 436,909
Consumer		109,389		1,754	111,143
Total	\$	543,394	\$	4,658	\$ 548,052
December 31, 2011					
Residential real estate	\$	418,810	\$	4,796	\$ 423,606
Consumer		97,857		306	98,163
Total	\$	516,667	\$	5,102	\$ 521,769

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The table below presents the recorded investment of loans and leases, segregated by class, with delinquency aging and nonaccrual status.

(Dollars in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Accruing Loans	Nonaccrual	Total Financing Receivables
September 30, 2012							
Commercial and agricultural loans	\$ 573,728	\$ 849	\$ 181	\$	\$ 574,758	\$ 10,238	\$ 584,996
Auto, light truck and environmental equipment	453,348	489	41		453,878	2,787	456,665
Medium and heavy duty truck	166,916	452			167,368	341	167,709
Aircraft financing	672,947	7,012			679,959	5,841	685,800
Construction equipment financing	269,871	1,773			271,644	4,626	276,270
Commercial real estate	533,612	567			534,179	14,742	548,921
Residential real estate	429,365	3,762	878	212	434,217	2,692	436,909
Consumer	108,375	683	331	265	109,654	1,489	111,143
Total	\$ 3,208,162	\$ 15,587	\$ 1,431	\$ 477	\$ 3,225,657	\$ 42,756	\$ 3,268,413
December 31, 2011							
Commercial and agricultural loans	\$ 534,053	\$ 550	\$ 1	\$	\$ 534,604	\$ 10,966	\$ 545,570
Auto, light truck and environmental equipment	433,048	674	241		433,963	2,002	435,965
Medium and heavy duty truck	158,192	5			158,197	1,599	159,796
Aircraft financing	608,032	224			608,256	12,526	620,782
Construction equipment financing	256,691	376			257,067	4,137	261,204
Commercial real estate	522,883	2,005			524,888	20,569	545,457
Residential real estate	415,177	2,894	739	416	419,226	4,380	423,606
Consumer	96,824	762	271	45	97,902	261	98,163
Total	\$ 3,024,900	\$ 7,490	\$ 1,252	\$ 461	\$ 3,034,103	\$ 56,440	\$ 3,090,543

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The table below presents impaired loans and leases, segregated by class, and the corresponding reserve for impaired loan and lease losses.

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
September 30, 2012			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 3,112	\$ 3,112	\$
Auto, light truck and environmental equipment	740	740	
Medium and heavy duty truck	322	322	
Aircraft financing	3,544	3,544	
Construction equipment financing	4,355	4,355	
Commercial real estate	20,020	20,019	
Residential real estate	103	103	
Consumer loans			
Total with no related allowance recorded	32,196	32,195	
With an allowance recorded:			
Commercial and agricultural loans	6,036	6,036	878
Auto, light truck and environmental equipment	1,493	1,493	500
Medium and heavy duty truck			
Aircraft financing	2,190	2,190	886
Construction equipment financing			
Commercial real estate	2,504	2,504	49
Residential real estate			
Consumer loans			
Total with an allowance recorded	12,223	12,223	2,313
Total impaired loans	\$ 44,419	\$ 44,418	\$ 2,313
December 31, 2011			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 2,002	\$ 2,002	\$
Auto, light truck and environmental equipment	770	770	
Medium and heavy duty truck	959	959	
Aircraft financing	11,206	11,206	
Construction equipment financing	3,949	3,949	
Commercial real estate	17,088	17,091	
Residential real estate			
Consumer loans	211	210	
Total with no related allowance recorded	36,185	36,187	
With an allowance recorded:			
Commercial and agricultural loans	8,406	8,406	1,461
Auto, light truck and environmental equipment	113	113	35
Medium and heavy duty truck	645	645	165
Aircraft financing	1,118	1,118	534
Construction equipment financing			
Commercial real estate	6,029	6,029	294
Residential real estate			
Consumer loans			
Total with an allowance recorded	16,311	16,311	2,489
Total impaired loans	\$ 52,496	\$ 52,498	\$ 2,489

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Average recorded investment and interest income recognized on impaired loans and leases, segregated by class, is shown in the table below.

(Dollars in thousands)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural loans	\$ 9,111	\$ 2	\$ 10,437	\$ 101	\$ 9,441	\$ 12	\$ 11,583	\$ 331
Auto, light truck and environmental equipment	2,578		1,378		2,474	7	1,796	1
Medium and heavy duty truck	434	1	3,770	15	917	2	4,310	18
Aircraft financing	6,100		14,882		8,831		16,076	15
Construction equipment financing	4,512		3,922	7	4,399	5	6,174	23
Commercial real estate	22,757	138	24,481	39	22,330	302	28,264	153
Residential real estate	104	2			82	4		
Consumer			141	1			47	1
Total	\$ 45,596	\$ 143	\$ 59,011	\$ 163	\$ 48,474	\$ 332	\$ 68,250	\$ 542

Performing loans and leases classified as troubled debt restructuring (TDR) during the three and nine months ended September 30, 2012 and 2011, segregated by class, are shown in the table below. Nonperforming TDRs are shown as nonperforming assets. During 2012 and 2011, modification programs focused on extending maturity dates or modifying payment patterns with most TDRs experiencing a combination of concessions. The modifications did not result in the contractual forgiveness of principal or interest or interest rate reductions below market rates. Consequently, the financial impact of the modifications is immaterial.

(Dollars in thousands)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
Commercial and agricultural loans		\$	6	\$ 356		\$	7	\$ 504
Auto, light truck and environmental equipment								
Medium and heavy duty truck								
Aircraft financing							1	
Construction equipment financing							1	224
Commercial real estate			3	196	1	7,014	4	262
Residential real estate					1	106		
Consumer			2	212			2	212
Total		\$	11	\$ 764	2	\$ 7,120	15	\$ 1,202

Troubled debt restructured loans and leases which had payment defaults within twelve months following modification during the three and nine months ended September 30, 2012 and 2011, segregated by class, are shown in the table below. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.





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(Dollars in thousands)	Three Months Ended September 30, 2012		2011		Nine Months Ended September 30, 2012		2011	
	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment
Commercial and agricultural loans		\$	2	\$ 6,140		\$	2	\$ 6,140
Auto, light truck and environmental equipment								
Medium and heavy duty truck								
Aircraft financing							2	552
Construction equipment financing								
Commercial real estate							2	90
Residential real estate								
Consumer								
Total		\$	2	\$ 6,140		\$	6	\$ 6,782

As of September 30, 2012 and December 31, 2011, the Company had \$8.81 million and \$3.29 million, respectively of performing loans and leases classified as troubled debt restructurings.

## **Note 5. Reserve for Loan and Lease Losses**

The reserve for loan and lease loss methodology has been consistently applied for several years, with enhancements instituted periodically. Reserve ratios are reviewed quarterly and revised periodically to reflect recent loss history and to incorporate current risks and trends which may not be recognized in historical data. As the historical charge-off analysis is updated, the Company reviews the look-back periods for each business loan portfolio. Furthermore, a thorough analysis of charge-offs, non-performing asset levels, special attention outstandings and delinquency is performed in order to review portfolio trends and other factors, including specific industry risks and economic conditions, which may have an impact on the reserves and reserve ratios applied to various portfolios. The Company adjusts the calculated historical based ratio as a result of the analysis of environmental factors, principally economic risk and concentration risk. Key economic factors affecting the portfolios are growth in gross domestic product, unemployment rates, housing market trends, commodity prices, inflation, national and international economic volatility, global debt and capital markets and political stability or lack thereof. Concentration risk is impacted primarily by geographic concentration in Northern Indiana and Southwestern Lower Michigan in the business banking and commercial real estate portfolios and by collateral concentration in the specialty finance portfolios and exposure to foreign markets by geographic risk.

The reserve for loan and lease losses is maintained at a level believed to be appropriate by management to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting management's best estimate of probable loan and lease losses related to specifically identified loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. For purposes of determining the reserve, the Company has segmented loans and leases into classes based on the associated risks within these segments. The Company has determined that eight classes exist within the loan and lease portfolio. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for impaired loans, formula reserves for each business lending division portfolio including percentage allocations for special attention loans and leases not deemed impaired, and reserves for pooled homogeneous loans and leases. Management's evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.



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Changes in the reserve for loan and lease losses, segregated by class, for the three months ended September 30, 2012 and 2011 are shown below.

(Dollars in thousands)	Commercial agricultural loans	Auto, light truck and environmental equipment	Medium and heavy duty truck	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
<b>September 30, 2012</b>									
<i>Reserve for loan and lease losses</i>									
Balance, beginning of period	\$ 13,077	\$ 10,300	\$ 3,618	\$ 29,871	\$ 6,330	\$ 15,172	\$ 3,521	\$ 1,410	\$ 83,299
Charge-offs	214	210		461	1	132	159	311	1,488
Recoveries	60	356	125	163	149	91	4	90	1,038
Net charge-offs (recoveries)	154	(146)	(125)	298	(148)	41	155	221	450
Provision (recovery of provision)	433	(496)	(377)	1,427	(585)	(99)	74	273	650
Balance, end of period	\$ 13,356	\$ 9,950	\$ 3,366	\$ 31,000	\$ 5,893	\$ 15,032	\$ 3,440	\$ 1,462	\$ 83,499
Ending balance, individually evaluated for impairment	\$ 878	\$ 500		\$ 886		\$ 49		\$	\$ 2,313
Ending balance, collectively evaluated for impairment	12,478	9,450	3,366	30,114	5,893	14,983	3,440	1,462	81,186
Total reserve for loan and lease losses	\$ 13,356	\$ 9,950	\$ 3,366	\$ 31,000	\$ 5,893	\$ 15,032	\$ 3,440	\$ 1,462	\$ 83,499
<i>Recorded investment in loans</i>									
Ending balance, individually evaluated for impairment	\$ 9,148	\$ 2,233	\$ 322	\$ 5,734	\$ 4,355	\$ 22,524	\$ 103	\$	\$ 44,419
Ending balance, collectively evaluated for impairment	575,848	454,432	167,387	680,066	271,915	526,397	436,806	111,143	3,223,994
Total recorded investment in loans	\$ 584,996	\$ 456,665	\$ 167,709	\$ 685,800	\$ 276,270	\$ 548,921	\$ 436,909	\$ 111,143	\$ 3,268,413
<b>September 30, 2011</b>									
<i>Reserve for loan and lease losses</i>									
Balance, beginning of period	\$ 16,814	\$ 9,041	\$ 4,584	\$ 28,561	\$ 6,802	\$ 15,400	\$ 2,657	\$ 1,151	\$ 85,010
Charge-offs	152	10		2,073		72	37	341	2,685
Recoveries	118	78	1	96	144	50	19	119	625
Net charge-offs (recoveries)	34	(68)	(1)	1,977	(144)	22	18	222	2,060
Provision (recovery of provision)	(2,056)	(908)	(1,217)	4,482	(691)	1,397	44	209	1,260
Balance, end of period	\$ 14,724	\$ 8,201	\$ 3,368	\$ 31,066	\$ 6,255	\$ 16,775	\$ 2,683	\$ 1,138	\$ 84,210
Ending balance, individually evaluated for impairment	\$ 1,488	\$ 5	\$ 161	\$ 3,120		\$ 1,060		\$	\$ 5,834
Ending balance, collectively evaluated for impairment	13,236	8,196	3,207	27,946	6,255	15,715	2,683	1,138	78,376
Total reserve for loan and lease losses	\$ 14,724	\$ 8,201	\$ 3,368	\$ 31,066	\$ 6,255	\$ 16,775	\$ 2,683	\$ 1,138	\$ 84,210

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## Recorded investment in loans

Ending balance, individually evaluated for impairment	\$	10,491	\$	1,109	\$	3,584	\$	13,241	\$	3,780	\$	23,814	\$		\$	56,019	
Ending balance, collectively evaluated for impairment		546,901		441,018		149,119		600,465		256,461		532,473		404,063		96,775	3,027,275
Total recorded investement in loans	\$	557,392	\$	442,127	\$	152,703	\$	613,706	\$	260,241	\$	556,287	\$	404,063	\$	96,775	\$ 3,083,294

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Changes in the reserve for loan and lease losses, segregated by class, for the nine months ended September 30, 2012 and 2011 are shown below.

(Dollars in thousands)	Commercial and agricultural loans	Auto, light truck and environmental equipment	Medium and heavy duty truck	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
September 30, 2012									
<i>Reserve for loan and lease losses</i>									
Balance, beginning of period	\$ 13,091	\$ 8,469	\$ 3,742	\$ 28,626	\$ 6,295	\$ 16,772	\$ 3,362	\$ 1,287	\$ 81,644
Charge-offs	486	3,110		600	120	274	232	1,106	5,928
Recoveries	224	1,214	147	484	233	170	38	314	2,824
Net charge-offs (recoveries)	262	1,896	(147)	116	(113)	104	194	792	3,104
Provision (recovery of provision)	527	3,377	(523)	2,490	(515)	(1,636)	272	967	4,959
Balance, end of period	\$ 13,356	\$ 9,950	\$ 3,366	\$ 31,000	\$ 5,893	\$ 15,032	\$ 3,440	\$ 1,462	\$ 83,499
Ending balance, individually evaluated for impairment	\$ 878	\$ 500		\$ 886		\$ 49		\$	\$ 2,313
Ending balance, collectively evaluated for impairment	12,478	9,450	3,366	30,114	5,893	14,983	3,440	1,462	81,186
Total reserve for loan and lease losses	\$ 13,356	\$ 9,950	\$ 3,366	\$ 31,000	\$ 5,893	\$ 15,032	\$ 3,440	\$ 1,462	\$ 83,499
<i>Recorded investment in loans</i>									
Ending balance, individually evaluated for impairment	\$ 9,148	\$ 2,233	\$ 322	\$ 5,734	\$ 4,355	\$ 22,524	\$ 103	\$	\$ 44,419
Ending balance, collectively evaluated for impairment	575,848	454,432	167,387	680,066	271,915	526,397	436,806	111,143	3,223,994
Total recorded investment in loans	\$ 584,996	\$ 456,665	\$ 167,709	\$ 685,800	\$ 276,270	\$ 548,921	\$ 436,909	\$ 111,143	\$ 3,268,413
September 30, 2011									
<i>Reserve for loan and lease losses</i>									
Balance, beginning of period	\$ 20,544	\$ 7,542	\$ 5,768	\$ 29,811	\$ 8,439	\$ 11,177	\$ 2,518	\$ 1,075	\$ 86,874
Charge-offs	1,109	335		3,701	853	2,537	191	1,193	9,919
Recoveries	1,734	148	2	860	242	336	53	355	3,730
Net charge-offs (recoveries)	(625)	187	(2)	2,841	611	2,201	138	838	6,189
Provision (recovery of provision)	(6,445)	846	(2,402)	4,096	(1,573)	7,799	303	901	3,525
Balance, end of period	\$ 14,724	\$ 8,201	\$ 3,368	\$ 31,066	\$ 6,255	\$ 16,775	\$ 2,683	\$ 1,138	\$ 84,210
Ending balance, individually evaluated for impairment	\$ 1,488	\$ 5	\$ 161	\$ 3,120		\$ 1,060		\$	\$ 5,834
Ending balance, collectively evaluated for impairment	13,236	8,196	3,207	27,946	6,255	15,715	2,683	1,138	78,376
	\$ 14,724	\$ 8,201	\$ 3,368	\$ 31,066	\$ 6,255	\$ 16,775	\$ 2,683	\$ 1,138	\$ 84,210

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Total reserve for loan and  
lease losses

*Recorded investment in  
loans*

Ending balance, individually evaluated for impairment	\$	10,491	\$	1,109	\$	3,584	\$	13,241	\$	3,780	\$	23,814	\$		\$	56,019	
Ending balance, collectively evaluated for impairment		546,901		441,018		149,119		600,465		256,461		532,473		404,063		96,775	3,027,275
Total recorded investment in loans	\$	557,392	\$	442,127	\$	152,703	\$	613,706	\$	260,241	\$	556,287	\$	404,063	\$	96,775	3,083,294

## **Note 6. Mortgage Servicing Assets**

The Company recognizes the rights to service residential mortgage loans for others as separate assets, whether the servicing rights are acquired through a separate purchase or through the sale of originated loans with servicing rights retained. The Company allocates a portion of the total proceeds of a mortgage loan to servicing rights based on the fair value. The unpaid principal balance of residential mortgage loans serviced for third parties was \$940.23 million and \$995.09 million at September 30, 2012 and December 31, 2011, respectively.

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Mortgage servicing assets are evaluated for impairment. For purposes of impairment measurement, mortgage servicing assets are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. If temporary impairment exists within a tranche, a valuation allowance is established through a charge to income equal to the amount by which the carrying value exceeds the fair value. If it is later determined all or a portion of the temporary impairment no longer exists for a particular tranche, the valuation allowance is reduced through a recovery of income.

Changes in the carrying value of mortgage servicing assets and the associated valuation allowance follow:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Mortgage servicing assets:</b>				
Balance at beginning of period	\$ 4,984	\$ 6,419	\$ 5,610	\$ 7,556
Additions	509	270	1,411	591
Amortization	(739)	(667)	(2,267)	(2,125)
Sales				
Carrying value before valuation allowance at end of period	4,754	6,022	4,754	6,022
<b>Valuation allowance:</b>				
Balance at beginning of period	(91)	(16)	(238)	
Impairment (charges) recoveries	(377)	(214)	(230)	(230)
Balance at end of period	\$ (468)	\$ (230)	\$ (468)	\$ (230)
Net carrying value of mortgage servicing assets at end of period	\$ 4,286	\$ 5,792	\$ 4,286	\$ 5,792
Fair value of mortgage servicing assets at end of period	\$ 4,478	\$ 7,364	\$ 4,478	\$ 7,364

During the nine months ended September 30, 2012 and 2011, the Company determined that it was not necessary to permanently write-down any previously established valuation allowance. At September 30, 2012 and 2011, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by \$0.19 million and \$1.57 million, respectively. This difference represents increases in the fair value of certain mortgage servicing assets that could not be recorded above cost basis.

Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$0.90 million and \$1.02 million for the three months ended September 30, 2012 and 2011, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$2.72 million and \$3.07 million for the nine months ended September 30, 2012 and 2011, respectively. Mortgage loan contractual servicing fees are included in mortgage banking income in the consolidated statements of income.

#### **Note 7. Commitments and Financial Instruments with Off-Balance-Sheet Risk**

1st Source Corporation and its subsidiaries are parties to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of

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financial condition. The exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan commitments and standby letters of credit is represented by the dollar amount of those instruments. The Company uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on-balance-sheet instruments.



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1st Source Bank (Bank), a subsidiary of 1st Source Corporation, grants mortgage loan commitments to borrowers, subject to normal loan underwriting standards. The interest rate risk associated with these loan commitments is managed by entering into contracts for future deliveries of loans. Loan commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Bank issues letters of credit which are conditional commitments that guarantee the performance of a client to a third party. The credit risk involved and collateral obtained in issuing letters of credit is essentially the same as that involved in extending loan commitments to clients. Standby letters of credit totaled \$16.24 million and \$14.66 million at September 30, 2012 and December 31, 2011, respectively. Standby letters of credit generally have terms ranging from six months to one year.

On December 28, 2010, the Company entered into an agreement with the City of South Bend for the sale of the South Bend headquarters building parking garage for \$1.95 million. Although the City of South Bend took possession of the parking garage on that date, the proceeds were placed in an escrow account. Under the terms of the agreement, receipt of the proceeds from the escrow were contingent upon the Company investing \$5.40 million into its properties within the City of South Bend by December 31, 2013. As of June 30, 2011, the parking garage asset was classified as held for sale and included in accrued income and other assets on the Statement of Financial Condition. In the third quarter of 2012, the proceeds for the parking garage were received from escrow and a gain on sale of \$1.61 million (or \$1.00 million net of tax) was recognized in Other Expense in the Statement of Income.

**Note 8. Derivative Financial Instruments**

Commitments to originate residential mortgage loans held for sale and forward commitments to sell residential mortgage loans are considered derivative instruments. See Note 7 for further information.

The Company has certain interest rate derivative positions that are not designated as hedging instruments. These derivative positions relate to transactions in which the Company enters into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. In connection with each transaction, the Company agrees to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Company agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to effectively convert a variable rate loan to a fixed rate. Because the terms of the swaps with the customers and the other financial institutions offset each other, with the only difference being counterparty credit risk, changes in the fair value of the underlying derivative contracts are not materially different and do not significantly impact the Company's results of operations.

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At September 30, 2012 and December 31, 2011, the amounts of non-hedging derivative financial instruments are shown in the chart below:

(Dollars in thousands)	Asset derivatives				Liability derivatives	
	Notional or contractual amount	Statement of Financial Condition classification	Fair value	Statement of Financial Condition classification	Fair value	
September 30, 2012						
Interest rate swap contracts	\$ 460,471	Other assets	\$ 17,171	Other liabilities	\$ 17,520	
Loan commitments	46,402	Mortgages held for sale	394	N/A		
Forward contracts	43,000	N/A		Mortgages held for sale	666	
Total	\$ 549,873		\$ 17,565		\$ 18,186	
December 31, 2011						
Interest rate swap contracts	\$ 453,428	Other assets	\$ 17,496	Other liabilities	\$ 17,945	
Loan commitments	38,209	Mortgages held for sale	189	N/A		
Forward contracts	21,247	N/A		Mortgages held for sale	218	
Total	\$ 512,884		\$ 17,685		\$ 18,163	

For the three and nine months ended September 30, 2012 and 2011, the amounts included in the consolidated statements of income for non-hedging derivative financial instruments are shown in the chart below:

(Dollars in thousands)	Statement of Income classification	Three Months Ended September 30,		Gain (loss)		Nine Months Ended September 30,	
		2012	2011	2012	2011	2012	2011
Interest rate swap contracts	Other expense	\$ 21	\$ 230	\$ 100	\$ 47		
Interest rate swap contracts	Other income	333	182	586	351		
Loan commitments	Mortgage banking income	64	191	205	240		
Forward contracts	Mortgage banking income	(350)	(259)	(448)	(718)		
Total		\$ 68	\$ 344	\$ 443	\$ (80)		

## Note 9. Earnings Per Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include non-vested restricted stock awards. Non-vested restricted stock awards are considered participating securities to the extent the holders of these securities receive non-forfeitable dividends at the same rate as holders of common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method. Stock options, where the exercise price was greater than the average market price of the common shares, were excluded from the computation of diluted earnings per common share because the result would have been antidilutive. No stock options were considered antidilutive as of September 30, 2012 or 2011.



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The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the three and nine months ended September 30, 2012 and 2011.

(Dollars in thousands - except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Distributed earnings allocated to common stock	\$ 4,127	\$ 3,874	\$ 11,899	\$ 11,650
Undistributed earnings allocated to common stock	8,706	7,482	24,872	24,901
Net earnings allocated to common stock	12,833	11,356	36,771	36,551
Net earnings allocated to participating securities	172	184	516	462
Net income allocated to common stock and participating securities	\$ 13,005	\$ 11,540	\$ 37,287	\$ 37,013
Weighted average shares outstanding for basic earnings per common share	24,279,178	24,213,063	24,267,535	24,246,041
Dilutive effect of stock compensation	10,317	10,369	10,625	9,316
Weighted average shares outstanding for diluted earnings per common share	24,289,495	24,223,432	24,278,160	24,255,357
Basic earnings per common share	\$ 0.53	\$ 0.47	\$ 1.52	\$ 1.51
Diluted earnings per common share	\$ 0.53	\$ 0.47	\$ 1.51	\$ 1.51

## **Note 10. Stock-Based Compensation**

As of September 30, 2012, the Company had five active stock-based employee compensation plans, which are more fully described in Note 16 of the Consolidated Financial Statements in 1st Source's Annual Report on Form 10-K for the year ended December 31, 2011. These plans include the 2001 Stock Option Plan, the 1998 Performance Compensation Plan, the Employee Stock Purchase Plan, the Executive Incentive Plan, and the Restricted Stock Award Plan. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but no grants had been made through September 30, 2012.

Stock-based compensation expense for all stock-based compensation awards granted is based on the grant-date fair value. For all awards except stock option awards, the grant date fair value is either the fair market value per share or book value per share (corresponding to the type of stock awarded) as of the grant date. For stock option awards, the grant date fair value is estimated using the Black-Scholes option pricing model. For all awards the Company recognizes these compensation costs only for those shares expected to vest on a straight-line basis over the requisite service period of the award, for which the Company uses the related vesting term. The Company estimates forfeiture rates based on historical employee option exercise and employee termination experience. The Company has identified separate groups of award recipients that exhibit similar option exercise behavior and employee termination experience and have considered them as separate groups in the valuation models and expense estimates.

The stock-based compensation expense recognized in the condensed consolidated statement of income for the nine months ended September 30, 2012 and 2011 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.



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The aggregate intrinsic value in the table below represents the total pretax intrinsic value (the difference between 1st Source's closing stock price on the last trading day of the third quarter of 2012 (September 28, 2012) and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 28, 2012. This amount changes based on the fair market value of 1st Source's stock. Total fair value of options vested and expensed was zero and \$4 thousand, net of tax, for the nine months ended September 30, 2012 and 2011, respectively.

	Number of Shares		Weighted Average Exercise Price	Average Remaining Contractual Term (in years)		Total Intrinsic Value (in 000's)
Options outstanding, beginning of year	22,000	\$	12.04			
Granted						
Exercised						
Forfeited						
Options outstanding at September 30, 2012	22,000	\$	12.04	0.56	\$	225
Vested and expected to vest at September 30, 2012	22,000	\$	12.04	0.56	\$	225
Exercisable at September 30, 2012	22,000	\$	12.04	0.56	\$	225

As of September 30, 2012, there was \$6.88 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.32 years.

## **Note 11. Income Taxes**

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$1.91 million at September 30, 2012 and \$1.67 million at December 31, 2011. Interest and penalties were recognized through the income tax provision. For the nine months ended September 30, 2012 and 2011, the Company recognized approximately \$(0.06) million and \$(0.04) million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately \$0.51 million and \$0.57 million were accrued at September 30, 2012 and December 31, 2011, respectively.

Tax years that remain open and subject to audit include the federal 2009-2011 years and the Indiana 2008-2011 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

## **Note 12. Fair Value Measurements**

The Company records certain assets and liabilities at fair value. Fair value is defined 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. Fair value measurements are also utilized to determine the initial value of certain assets and liabilities, to perform impairment assessments, and for disclosure purposes. The Company uses quoted market prices and observable inputs to the maximum extent possible when measuring fair value. In the absence of quoted market prices,

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various valuation techniques are utilized to measure fair value. When possible, observable market data for identical or similar financial instruments is used in the valuation. When market data is not available, fair value is determined using valuation models that incorporate management's estimates of the assumptions a market participant would use in pricing the asset or liability.

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Fair value measurements are classified within one of three levels based on the observability of the inputs used to determine fair value, as follows:

- Level 1 The valuation is based on quoted prices in active markets for identical instruments.
- Level 2 The valuation is based on observable inputs such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 The valuation is based on unobservable inputs that are supported by minimal or no market activity and that are significant to the fair value of the instrument. Level 3 valuations are typically performed using pricing models, discounted cash flow methodologies, or similar techniques that incorporate management's own estimates of assumptions that market participants would use in pricing the instrument, or valuations that require significant management judgment or estimation.

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The Company elected fair value accounting for mortgages held for sale. The Company believes the election for mortgages held for sale (which are economically hedged with free standing derivatives) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as economic hedges for these assets. At September 30, 2012 and December 31, 2011, all mortgages held for sale are carried at fair value.

The following table reflects the differences between the fair value carrying amount of mortgages held for sale measured at fair value and the aggregate unpaid principal amount the Company is contractually entitled to receive at maturity on September 30, 2012 and December 31, 2011:

(Dollars in thousands)	Fair value carrying amount	Aggregate unpaid principal	Excess of fair value carrying amount over (under) unpaid principal
September 30, 2012			
Mortgages held for sale reported at fair value	\$ 22,853	\$ 22,082	\$ 771(1)
December 31, 2011			
Mortgages held for sale reported at fair value	\$ 12,644	\$ 12,265	\$ 379(1)

(1) The excess of fair value carrying amount over unpaid principal is included in mortgage banking income and includes changes in fair value at and subsequent to funding, gains and losses on the related loan commitment prior to funding, and premiums on acquired loans.



Financial Instruments on Recurring Basis:

The following is a description of the valuation methodologies used for financial instruments measured at fair value on a recurring basis:

Investment securities available for sale are valued primarily by a third party pricing agent. Prices supplied by the independent pricing agent, as well as their pricing methodologies and assumptions, are reviewed by the Company for reasonableness and to ensure such prices are aligned with traditional pricing matrices. In general, the Company's investment securities do not possess a complex structure that could introduce greater valuation

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risk. The portfolio mainly consists of traditional investments including U.S. Treasury and Federal agencies securities, federal agency mortgage pass-through securities, and general obligation and revenue municipal bonds. Pricing for such instruments is fairly generic and is easily obtained. On a quarterly basis, prices supplied by the pricing agent are validated by comparison to prices obtained from other third party sources for a material portion of the portfolio.

The valuation policy and procedures for Level 3 fair value measurements of available for sale debt securities are decided through collaboration between management of the Corporate Accounting and Funds Management departments. The changes in fair value measurement for Level 3 securities are analyzed on a periodic basis under a collaborative framework with the aforementioned departments. The methodology and variables used for input are derived from the combination of observable and unobservable inputs. The unobservable inputs are determined through internal assumptions that may vary from period to period due to external factors, such as market movement and credit rating adjustments.

Both the market and income valuation approaches are implemented using the following types of inputs:

- U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.
- Government-sponsored agency debt securities and corporate bonds are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.
- Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMOs, are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.
- Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.
- State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Since some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities. Local tax anticipation warrants, with very little market activity, are priced using an appropriate market yield curve.
- Marketable equity (common) securities are primarily priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

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Trading account securities are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

Mortgages held for sale and the related loan commitments and forward contracts (hedges) are valued using a market value approach and utilizing an appropriate current market yield and a loan commitment closing rate based on historical analysis.

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Interest rate swap positions, both assets and liabilities, are valued by a third party pricing agent using an income approach and utilizing models that use as their basis readily observable market parameters. This valuation process considers various factors including interest rate yield curves, time value and volatility factors. Validation of third party agent valuations is accomplished by comparing those values to the Company's swap counterparty valuations. Management believes an adjustment is required to mid-market valuations for derivatives tied to its performing loan portfolio to recognize the imprecision and related exposure inherent in the process of estimating expected credit losses as well as velocity of deterioration evident with systemic risks imbedded in these portfolios.

The table below presents the balance of assets and liabilities at September 30, 2012 and December 31, 2011 measured at fair value on a recurring basis:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
September 30, 2012				
<u>Assets:</u>				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 20,297	\$ 362,047	\$	\$ 382,344
U.S. States and political subdivisions securities		98,972	7,741	106,713
Mortgage-backed securities Federal agencies		332,155		332,155
Corporate debt securities		36,247		36,247
Foreign government and other securities		4,736		4,736
Total debt securities	20,297	834,157	7,741	862,195
Marketable equity securities	6,117			6,117
Total investment securities available-for-sale	26,414	834,157	7,741	868,312
Trading account securities	145			145
Mortgages held for sale		22,853		22,853
Accrued income and other assets (Interest rate swap agreements)		17,171		17,171
Total	\$ 26,559	\$ 874,181	\$ 7,741	\$ 908,481
<u>Liabilities:</u>				
Accrued expenses and other liabilities (Interest rate swap agreements)	\$	\$ 17,520	\$	\$ 17,520
Total	\$	\$ 17,520	\$	\$ 17,520
December 31, 2011				
<u>Assets:</u>				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 20,016	\$ 381,109	\$	\$ 401,125
U.S. States and political subdivisions securities		96,867	10,493	107,360
Mortgage-backed securities Federal agencies		328,948		328,948
Corporate debt securities		36,310		36,310
Foreign government and other securities		4,038	675	4,713
Total debt securities	20,016	847,272	11,168	878,456
Marketable equity securities	4,403	141		4,544
Total investment securities available-for-sale	24,419	847,413	11,168	883,000
Trading account securities	132			132
Mortgages held for sale		12,644		12,644
Accrued income and other assets (Interest rate swap agreements)		17,496		17,496
Total	\$ 24,551	\$ 877,553	\$ 11,168	\$ 913,272
<u>Liabilities:</u>				

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Accrued expenses and other liabilities (Interest rate swap agreements)	\$	\$	17,945	\$	\$	17,945
Total	\$	\$	17,945	\$	\$	17,945

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The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended September 30, 2012 and 2011 are summarized as follows:

	U.S. States and political subdivisions securities	Foreign government and other securities	Investment securities available- for-sale
<b>(Dollars in thousands)</b>			
Beginning balance July 1, 2012	\$ 8,143	\$	\$ 8,143
Total gains or losses (realized/unrealized):			
Included in earnings			
Included in other comprehensive income	72		72
Purchases			
Issuances			
Settlements			
Maturities	(474)		(474)
Transfers into Level 3			
Transfers out of Level 3			
Ending balance September 30, 2012	\$ 7,741	\$	\$ 7,741
Beginning balance July 1, 2011	\$ 12,455	\$ 675	\$ 13,130
Total gains or losses (realized/unrealized):			
Included in earnings			
Included in other comprehensive income	94		94
Purchases	350		350
Issuances			
Settlements			
Maturities	(1,746)		(1,746)
Transfers into Level 3			
Transfers out of Level 3			
Ending balance September 30, 2011	\$ 11,153	\$ 675	\$ 11,828

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at September 30, 2012 or 2011. No transfers between levels occurred during the three months ended September 30, 2012. One transfer between levels occurred during the nine months ended September 30, 2012. No transfers between Level 1 and 2 occurred during the period ended September 30, 2012. A foreign government debt security was transferred from Level 3 to Level 2 as of March 31, 2012 due to the Company's periodic review of valuation methodologies and inputs. The Company determined that the observable inputs used in determining fair value warranted a transfer to Level 2 as the unobservable inputs were deemed to be insignificant to the overall fair value measurement.

The table below presents the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a recurring basis at September 30, 2012.

<b>(Dollars in thousands)</b>	<b>Fair Value</b>	<b>Valuation Methodology</b>	<b>Unobservable Inputs</b>	<b>Range of Inputs</b>
Investment securities available-for sale				
Adjustable rate securities	\$ 3,371	Discounted cash flows	Illiquidity adjustment	4% - 8%
			Term assumption (1)	5 years
			Coupon forecast assumption	0.50% - 0.88%

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Tax anticipation warrants	4,370	Discounted cash flows	Credit spread assumption	1.03% - 1.85%
Total investment securities available-for-sale	\$	7,741		

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(1) Term assumption is influenced by security call history

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The sensitivity to changes in the unobservable inputs and their impact on the fair value measurement can be significant. The significant unobservable inputs for Adjustable Rate Securities are illiquidity, term and coupon forecast assumptions. The illiquidity adjustment is negatively correlated to the fair value measure. An increase (decrease) in the determined illiquidity adjustment will lower (increase) the fair value measure. The term assumption is negatively correlated to the fair value measure. An increase (decrease) in the determined term adjustment will decrease (increase) the fair value measure. The coupon forecast is positively correlated to the fair value measure. An increase (decrease) in the determined coupon forecast will increase (decrease) the fair value measure. A permutation that includes a change in the coupon forecast with a change in either or both of the two variables will mitigate the significance of the change to the fair value measure. The significant unobservable input for Tax Anticipation Warrants is the underlying market level used to determine the fair value measure. An increase (decrease) in the estimated yield level of the market will decrease (increase) the fair value measure of the securities.

## Financial Instruments on Non-recurring Basis:

The Company may be required, from time to time, to measure certain other financial assets at fair value on a non-recurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower of cost or market accounting or impairment charges of individual assets.

The Credit Policy Committee, a management committee, is responsible for overseeing the valuation processes and procedures for Level 3 measurements of impaired loans, other real estate and repossessions. The Committee reviews these assets on a quarterly basis to determine the accuracy of the observable inputs, generally third party appraisals, auction values, values derived from trade publications and data submitted by the borrower, and the appropriateness of the unobservable inputs, generally discounts due to current market conditions and collection issues. The Committee establishes discounts based on asset type and valuation source; deviations from the standard are documented. The discounts are reviewed periodically, annually at a minimum, to determine they remain appropriate. Consideration is given to current trends in market values for the asset categories and gain and losses on sales of similar assets. The Loan and Funds Management Committee of the Board of Directors is responsible for overseeing the Credit Policy Committee.

Discounts range from 10% to 90% depending on the nature of the assets and the source of value. Aircraft are generally valued using quarterly trade publications adjusted for engine time, condition, maintenance programs, discounted by 10%. Likewise, autos are valued using current auction values, discounted by 10%; medium and heavy duty trucks are valued using trade publications and auction values, discounted by 15%. Construction equipment and environmental equipment is generally valued using trade publications and auction values, discounted by 20%. Real estate is valued based on appraisals or evaluations, discounted by 20% at a minimum with higher discounts for property in poor condition or property with characteristics which may make it more difficult to market. Commercial loans subject to borrowing base certificates are generally discounted by 20% for receivables and 40-75% for inventory with higher discounts when monthly borrowing base certificates are not required or received.

Impaired loans and related write-downs are based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are reviewed quarterly and estimated using customized discounting criteria, appraisals and dealer and trade magazine quotes which are used in a market valuation approach. In accordance with fair value measurements, only impaired loans for which a reserve for loan loss has been established based on the fair value of collateral require classification in the fair value hierarchy. As a result, only a portion of the Company's impaired loans are classified in the fair value hierarchy.





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Partnership investments and the adjustments to fair value primarily result from application of lower of cost or fair value accounting. The partnership investments are priced using financial statements provided by the partnerships. Quantitative unobservable inputs are not reasonably available for reporting purposes.

The Company has established mortgage servicing rights (MSRs) valuation policies and procedures based on industry standards and to ensure valuation methodologies are consistent and verifiable. MSRs and related adjustments to fair value result from application of lower of cost or fair value accounting. For purposes of impairment, MSRs are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. The fair value of each tranche of the servicing portfolio is estimated by calculating the present value of estimated future net servicing cash flows, taking into consideration actual and expected mortgage loan prepayment rates, discount rates, servicing costs, and other economic factors. Prepayment rates and discount rates are derived through a third party pricing agent. Changes in the most significant inputs, including prepayment rates and discount rates, are compared to the changes in the fair value measurements and appropriate resolution is made. A fair value analysis is also obtained from an independent third party agent and compared to the internal valuation for reasonableness. MSRs do not trade in an active, open market with readily observable prices and though sales of MSRs do occur, precise terms and conditions typically are not readily available and the characteristics of the Company's servicing portfolio may differ from those of any servicing portfolios that do trade.

Other real estate is based on the lower of cost or fair value of the underlying collateral less expected selling costs. Collateral values are estimated primarily using appraisals and reflect a market value approach. Fair values are reviewed quarterly and new appraisals are obtained annually. Repossessions are similarly valued.

For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended September 30, 2012: impaired loans - \$0.66 million; partnership investments \$(0.09) million; mortgage servicing rights - \$0.38 million; repossessions - \$0.00 million, and other real estate - \$0.04 million.

The table below presents the carrying value of assets at September 30, 2012 and December 31, 2011 measured at fair value on a non-recurring basis:

<b>(Dollars in thousands)</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>September 30, 2012</b>				
Impaired loans - collateral based	\$	\$	\$ 4,210	\$ 4,210
Accrued income and other assets (partnership investments)			1,992	1,992
Accrued income and other assets (mortgage servicing rights)			4,286	4,286
Accrued income and other assets (repossessions)			1,248	1,248
Accrued income and other assets (other real estate)			5,943	5,943
	\$	\$	\$ 17,679	\$ 17,679
<b>December 31, 2011</b>				
Impaired loans - collateral based	\$	\$	\$ 7,419	\$ 7,419
Accrued income and other assets (partnership investments)			2,799	2,799
Accrued income and other assets (mortgage servicing rights)			5,372	5,372

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Accrued income and other assets (repossessions)			6,792		6,792
Accrued income and other assets (other real estate)			8,755		8,755
	\$	\$	\$	31,137	\$ 31,137

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The table below presents the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a non-recurring basis at September 30, 2012.

(Dollars in thousands)	Carrying Value	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
Impaired loans	\$ 4,210	\$ 4,210	Collateral based measurements including appraisals, trade publications, auction values	Discount for lack of marketability and current conditions	10% - 90%
Mortgage servicing rights	4,286	4,478	Discounted cash flows	Constant prepayment rate (CPR) Discount rate	22.3% - 33.2% 8.5% - 11.5%
Repossessions	1,248	1,505	Appraisals, trade publications and auction values	Discount for lack of marketability	0% - 9%
Other real estate	5,943	7,485	Appraisals	Discount for lack of marketability	0% - 40%

GAAP requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring or non-recurring basis.

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The fair values of the Company's financial instruments as of September 30, 2012 and December 31, 2011 are summarized in the table below.

(Dollars in thousands)	Carrying or Contract Value	Fair Value	Level 1	Level 2	Level 3
September 30, 2012					
<u>Assets:</u>					
Cash and due from banks	\$ 54,635	\$ 54,635	\$ 54,635	\$	
Federal funds sold and interest bearing deposits with other banks	17,179	17,179	17,179		
Investment securities, available-for-sale	868,312	868,312	26,414	834,157	7,741
Other investments and trading account securities	22,509	22,509	22,509		
Mortgages held for sale	22,853	22,853		22,853	
Loans and leases, net of reserve for loan and lease losses	3,184,914	3,227,342			3,227,342
Cash surrender value of life insurance policies	56,068	56,068	56,068		
Mortgage servicing rights	4,286	4,478			4,478
Interest rate swaps	17,171	17,171		17,171	
<u>Liabilities:</u>					
Deposits	\$ 3,568,668	\$ 3,589,580	\$ 2,452,214	\$ 1,137,366	\$
Short-term borrowings	136,635	136,635	127,807	8,828	
Long-term debt and mandatorily redeemable securities	66,964	67,763		67,763	
Subordinated notes	89,692	115,224		115,224	
Interest rate swaps	17,520	17,520		17,520	
Off-balance-sheet instruments *		152		152	
December 31, 2011					
<u>Assets:</u>					
Cash and due from banks	\$ 61,406	\$ 61,406			
Federal funds sold and interest bearing deposits with other banks	52,921	52,921			
Investment securities, available-for-sale	883,000	883,000			
Other investments and trading account securities	19,106	19,106			
Mortgages held for sale	12,644	12,644			
Loans and leases, net of reserve for loan and lease losses	3,008,899	3,125,581			
Cash surrender value of life insurance policies	54,729	54,729			
Mortgage servicing rights	5,372	6,725			
Interest rate swaps	17,496	17,496			
<u>Liabilities:</u>					
Deposits	\$ 3,520,141	\$ 3,546,366			
Short-term borrowings	125,234	125,234			
Long-term debt and mandatorily redeemable securities	37,156	37,865			
Subordinated notes	89,692	87,527			
Interest rate swaps	17,945	17,945			
Off-balance-sheet instruments *		131			

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\* Represents estimated cash outflows required to currently settle the obligations at current market rates.

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The methodologies for estimating fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The estimated fair value approximates carrying value for cash and due from banks, federal funds sold and interest bearing deposits with other banks, other investments, and cash surrender value of life insurance policies. The methodologies for other financial assets and financial liabilities are discussed below:

Loans and Leases For variable rate loans and leases that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values of other loans and leases are estimated using discounted cash flow analyses which use interest rates currently being offered for loans and leases with similar terms to borrowers of similar credit quality.

Deposits The fair values for all deposits other than time deposits are equal to the amounts payable on demand (the carrying value). Fair values of variable rate time deposits are equal to their carrying values. Fair values for fixed rate time deposits are estimated using discounted cash flow analyses using interest rates currently being offered for deposits with similar remaining maturities.

Short-Term Borrowings The carrying values of Federal funds purchased, securities sold under repurchase agreements, and other short-term borrowings, including the liability related to mortgage loans available for repurchase under GNMA optional repurchase programs, approximate their fair values.

Long-Term Debt and Mandatorily Redeemable Securities The fair values of long-term debt are estimated using discounted cash flow analyses, based on the current estimated incremental borrowing rates for similar types of borrowing arrangements. The carrying values of mandatorily redeemable securities are based on the current estimated cost of redeeming these securities which approximate their fair values.

Subordinated Notes Fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are estimated based on calculated market prices of comparable securities.

Off-Balance-Sheet Instruments Contract and fair values for certain off-balance-sheet financial instruments (guarantees) are estimated based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Limitations Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instruments. Because no market exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other such factors.

These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. These estimates are subjective in nature and require considerable judgment to interpret market data. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange, nor are they intended to represent the fair value of 1st Source as a whole. The use of different market assumptions and/or estimation

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methodologies may have a material effect on the estimated fair value amounts. The fair value estimates presented herein are based on pertinent information available to management as of the respective balance sheet date. Although the Company is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.



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Other significant assets, such as premises and equipment, other assets, and liabilities not defined as financial instruments, are not included in the above disclosures. Also, the fair value estimates for deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market.

**ITEM 2.**

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following management's discussion and analysis is presented to provide information concerning 1st Source Corporation and its subsidiaries (collectively referred to as "the Company", "we", and "our") financial condition as of September 30, 2012, as compared to December 31, 2011, and the results of operations for the three and nine months ended September 30, 2012 and 2011. This discussion and analysis should be read in conjunction with our consolidated financial statements and the financial and statistical data appearing elsewhere in this report and our 2011 Annual Report.

Except for historical information contained herein, the matters discussed in this document express forward-looking statements. Generally, the words believe, contemplate, seek, plan, possible, assume, expect, intend, targeted, continue, remain, estimate, anticipate, indicate, would, may and similar expressions indicate forward-looking statements. Those statements, including statements, projections, estimates or assumptions concerning future events or performance, and other statements that are other than statements of historical fact, are subject to material risks and uncertainties. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. We may make other written or oral forward-looking statements from time to time. Readers are advised that various important factors could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected in such forward-looking statements. Such factors include, but are not limited to, changes in law, regulations or U.S. generally accepted accounting principles; our competitive position within the markets we serve; increasing consolidation within the banking industry; unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2011, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

**FINANCIAL CONDITION**

Our total assets at September 30, 2012 were \$4.49 billion, an increase of \$114.15 million or 2.61% from December 31, 2011. Total loans and leases were \$3.27 billion, an increase of \$177.87 million or 5.76% from December 31, 2011. Fed funds sold and interest bearing deposits with other banks were \$17.18 million, a decrease of \$35.74 million or 67.54% from December 31, 2011 as a result of funding loan growth. Total investment securities, available for sale were \$868.31 million which represented a decrease of \$14.69 million or 1.66% and total deposits were \$3.57 billion, an increase of \$48.53 million or 1.38% over the comparable figures at the end of 2011.

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Nonperforming assets at September 30, 2012 were \$50.46 million, which was a decrease of \$22.02 million or 30.38% from the \$72.48 million reported at December 31, 2011. At September 30, 2012 and December 31, 2011, nonperforming assets were 1.51% and 2.28%, respectively of net loans and leases.

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Accrued income and other assets were as follows:

(Dollars in thousands)	September 30, 2012	December 31, 2011
Accrued income and other assets:		
Bank owned life insurance cash surrender value	\$ 56,068	\$ 54,729
Accrued interest receivable	14,260	13,626
Mortgage servicing assets	4,286	5,372
Other real estate	4,842	7,621
Former bank premises held for sale	1,101	1,134
Repossessions	1,248	6,792
All other assets	46,548	49,738
Total accrued income and other assets	\$ 128,353	\$ 139,012

## CAPITAL

As of September 30, 2012, total shareholders' equity was \$553.67 million, up \$29.75 million or 5.68% from the \$523.92 million at December 31, 2011. In addition to net income of \$37.29 million, other significant changes in shareholders' equity during the first nine months of 2012 included \$12.00 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$21.85 million at September 30, 2012, compared to \$18.51 million at December 31, 2011. The increase in accumulated other comprehensive income/(loss) during 2012 was the result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 12.34% as of September 30, 2012, compared to 11.98% at December 31, 2011. Book value per common share rose to \$22.80 at September 30, 2012, from \$21.64 at December 31, 2011.

We declared and paid dividends per common share of \$0.17 during the third quarter of 2012. The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 32.99%. The dividend payout is continually reviewed by management and the Board of Directors subject to the Company's capital and dividend policy.

The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations. The actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of September 30, 2012, are presented in the table below:

(Dollars in thousands)	Actual		Minimum Capital Adequacy		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-Weighted Assets):						
1st Source Corporation	\$ 576,862	16.42%	\$ 281,122	8.00%	\$ 351,403	10.00%
1st Source Bank	558,351	15.93	280,345	8.00	350,431	10.00
Tier 1 Capital (to Risk-Weighted Assets):						

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1st Source Corporation	530,735	15.10	140,561	4.00	210,842	6.00
1st Source Bank	513,601	14.66	140,172	4.00	210,259	6.00
Tier 1 Capital (to Average Assets):						
1st Source Corporation	530,735	12.12	175,221	4.00	219,026	5.00
1st Source Bank	513,601	11.75	174,864	4.00	218,580	5.00

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In June 2012 the Board of Governors of the Federal Reserve System (the Federal Reserve ) proposed rules that would revise the general risk-based capital rules to make them consistent with heightened international capital standards, known as Basel III, as well as certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act ). Under the proposed rules, banking organizations would be subject to the following capital requirements:

- common equity tier 1 capital to total risk-weighted assets of 7.0% (4.5% plus a capital conservation buffer of 2.5%), on a fully phased-in basis;
- tier 1 capital to total risk-weighted assets of 6%;
- total capital to total risk-weighted assets of 8%; and
- tier 1 capital to adjusted average total assets (leverage ratio) of 4%

Capital instruments issued by banking organizations would be subject to a set of strict eligibility criteria that would prohibit, for example, the inclusion in tier 1 capital of instruments that are not perpetual or that permit the accumulation of unpaid dividends or interest. Trust preferred securities, for example, would be excluded from tier 1 capital, consistent with both Basel III and the Dodd-Frank Act. The Company has three series of trust preferred securities outstanding, representing an aggregate principal amount of \$89.69 million, which would no longer qualify as Tier 1 capital if the proposed rules are adopted as proposed and once they are fully implemented. If adopted as proposed, the rules would be effective as of January 1, 2013. Full compliance with most aspects would not be required until January 1, 2019. Transition periods apply in several areas of the proposed rules, including the gradual phase-out of certain non-qualifying capital instruments like trust preferred securities.

**LIQUIDITY AND INTEREST RATE SENSITIVITY**

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as the operating cash needs of the Company, are met. Funds are available from a number of sources, including the securities portfolio, the core deposit base, Federal Home Loan Bank (FHLB) borrowings, Federal Reserve Bank (FRB) borrowings, and the capability to package loans for sale.

We have borrowing sources available to supplement deposits and meet our funding needs. 1st Source Bank has established relationships with several banks to provide short term borrowings in the form of federal funds purchased. While at September 30, 2012 there were no such borrowings outstanding, we could borrow approximately \$240.00 million for a short time from these banks on a collective basis. As of September 30, 2012, we had \$52.70 million outstanding in FHLB advances and could borrow an additional \$144.56 million. We also had \$349.24 million available to borrow from the FRB with no amounts outstanding as of September 30, 2012.

Our loan to asset ratio was 72.82% at September 30, 2012 compared to 70.66% at December 31, 2011 and 71.61% at September 30, 2011. Cash and cash equivalents totaled \$71.81 million at September 30, 2012 compared to \$114.33 million at December 31, 2011 and \$83.05 million at September 30, 2011. At September 30, 2012, the consolidated statement of financial condition was rate sensitive by \$579.15 million more assets than liabilities scheduled to reprice within one year, or approximately 1.33%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.



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Under Indiana law governing the collateralization of public fund deposits, the Indiana Board of Depositories determines what financial institutions are required to pledge collateral on a quarterly basis. We have been informed that no collateral is necessary for our Indiana public fund deposits. However, the Board of Depositories could alter this requirement in the future. Our potential liquidity exposure if we must pledge collateral is approximately \$505 million.

**RESULTS OF OPERATIONS**

Net income for the three and nine month periods ended September 30, 2012 was \$13.01 million and \$37.29 million, compared to \$11.54 million and \$37.01 million for the same periods in 2011. Diluted net income per common share was \$0.53 and \$1.51 respectively, for the three and nine month periods ended September 30, 2012, compared to \$0.47 and \$1.51 for the same periods in 2011. Return on average common shareholders equity was 9.21% for the nine months ended September 30, 2012, compared to 9.86% in 2011. The return on total average assets was 1.12% for the nine months ended September 30, 2012, compared to 1.13% in 2011.

The increase in net income for the three months ended September 30, 2012, over the first three months of 2011, was primarily the result of an increase in net interest income and a decrease in provision for loan and lease losses. Net income for the nine months ended September 30, 2012 improved slightly compared to the nine months ended September 30, 2011. Details of the changes in the various components of net income are discussed further below.

**NET INTEREST INCOME**

The taxable equivalent net interest income for the three months ended September 30, 2012 was \$38.42 million, an increase of 3.24% over the same period in 2011. The net interest margin on a fully taxable equivalent basis was 3.63% for the three months ended September 30, 2012, compared to 3.66% for the three months ended September 30, 2011. The taxable equivalent net interest income for the nine months ended September 30, 2012 was \$114.84 million, an increase of 1.62% over 2011, resulting in a net yield of 3.70% for both periods.

During the three and nine month periods ended September 30, 2012, average earning assets increased \$173.26 million or 4.30% and \$59.36 million or 1.45% respectively, over the comparable periods in 2011. Average interest-bearing liabilities increased \$31.51 million or 0.98% and decreased \$68.55 million or 2.08% respectively, for the three and nine month periods ended September 30, 2012 over the comparable periods one year ago. The yield on average earning assets decreased 28 basis points to 4.36% for the third quarter of 2012 from 4.64% for the third quarter of 2011. The yield on average earning assets for the nine month period ended September 30, 2012 decreased 25 basis points to 4.45% from 4.70% for the nine month period ended September 30, 2011. The rate earned on assets decreased due to the reduction in loan and investment yields in the current interest rate environment. Total cost of average interest-bearing liabilities decreased 29 basis points to 0.94% for the third quarter 2012 from 1.23% for the third quarter 2011. Total cost of average interest-bearing liabilities decreased 27 basis points to 0.97% for the nine months ended September 30, 2012, from 1.24% for the nine months ended September 30, 2011. The result to the net interest margin, or the ratio of net interest income to average earning assets, was a decrease of 3 basis points for the three month period ended September 30, 2012 from September 30, 2011. The net interest margin was flat for the nine months ended September 30, 2012 compared to the same period in 2011.





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The largest contributor to the decrease in the yield on average earning assets for the nine months ended September 30, 2012, compared to the nine months ended September 30, 2011, was a reduction in yields on net loans and leases of 31 basis points. Total average investment securities decreased \$18.76 million or 2.15% for the third quarter and decreased \$37.51 million or 4.11% for the nine month period over one year ago. Average mortgages held for sale increased \$14.13 million or 169.39% and \$6.85 million or 67.31% respectively, for the three and nine month periods ended September 30, 2012, over the comparable periods a year ago. Average net loans and leases increased \$172.14 million or 5.56% for the third quarter of 2012 from the third quarter of 2011 and \$105.78 million or 3.43% for the nine months ended September 30, 2012 compared to the same period in 2011. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, increased \$5.75 million or 10.37% and decreased \$15.76 million or 20.07% respectively, for the three and nine month periods ended September 30, 2012, over the comparable periods a year ago.

Average interest-bearing deposits increased \$16.00 million or 0.55% and decreased \$79.61 million or 2.63% respectively, for the third quarter of 2012 and first nine months of 2012 over the same periods in 2011. The effective rate paid on average interest-bearing deposits decreased 32 basis points to 0.73% for the third quarter 2012 compared to 1.05% for the third quarter 2011. The effective rate paid on average interest-bearing deposits decreased 31 basis points to 0.76% for the first nine months of 2012 compared to 1.07% for the first nine months of 2011. The decline in the average cost of interest-bearing deposits during the third quarter and first nine months of 2012 as compared to the third quarter and first nine months of 2011 was primarily the result of interest rate re-pricing on maturing certificates of deposit.

Average short-term borrowings decreased \$13.39 million or 8.73% and \$8.26 million or 5.56%, respectively for the third quarter of 2012 and the first nine months of 2012, compared to the same periods in 2011. Interest paid on short-term borrowings decreased 10 basis points for the third quarter and 9 basis points for the first nine months of 2012 due to the interest rate decrease on adjustable rate borrowings. Average long-term debt increased \$28.90 million or 78.35% during the third quarter of 2012 as compared to the third quarter of 2011 and increased \$19.33 million or 60.85% during the first nine months of 2012 as compared to the first nine months of 2011. The increase in long-term borrowings was mainly the result of higher borrowings with the Federal Home Loan Bank. Interest paid on long-term borrowings decreased 171 basis points for the third quarter and 116 basis points for the first nine months of 2012 due to lower effective rates on Federal Home Loan Bank borrowings.

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The following table provides an analysis of net interest income and illustrates the interest earned and interest expense charged for each major component of interest-earning assets and interest-bearing liabilities. Yields/rates are computed on a tax-equivalent basis, using a 35% rate. Nonaccrual loans and leases are included in the average loan and lease balance outstanding.

**DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS EQUITY****INTEREST RATES AND INTEREST DIFFERENTIAL**

(Dollars in thousands)

	Three months ended September 30, 2012			2011			Nine months ended September 30, 2012			2011		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
<b>ASSETS:</b>												
Investment securities:												
Taxable	\$ 750,003	\$ 3,913	2.08%	\$ 762,807	\$ 4,694	2.44%	\$ 768,994	\$ 12,574	2.18%	\$ 790,029	\$ 14,088	2.38%
Tax exempt	104,991	1,225	4.64%	110,946	1,375	4.92%	107,189	3,739	4.66%	123,667	4,610	4.98%
Mortgages - held for sale	22,470	193	3.42%	8,341	96	4.57%	17,022	451	3.54%	10,174	335	4.40%
Net loans and leases	3,268,304	40,531	4.93%	3,096,168	40,794	5.23%	3,189,526	120,733	5.06%	3,083,747	123,873	5.37%
Other investments	61,214	231	1.50%	55,461	217	1.55%	62,769	688	1.46%	78,527	707	1.20%
Total Earning Assets	4,206,982	46,093	4.36%	4,033,723	47,176	4.64%	4,145,500	138,185	4.45%	4,086,144	143,613	4.70%
Cash and due from banks	58,226			58,759			60,048			58,792		
Reserve for loan and lease losses	(84,120)			(85,635)			(83,221)			(87,154)		
Other assets	318,337			335,559			325,126			338,468		
Total	\$ 4,499,425			\$ 4,342,406			\$ 4,447,453			\$ 4,396,250		
<b>LIABILITIES AND SHAREHOLDERS EQUITY:</b>												
Interest-bearing deposits	\$ 2,948,022	\$ 5,419	0.73%	\$ 2,932,021	\$ 7,756	1.05%	\$ 2,949,726	\$ 16,868	0.76%	\$ 3,029,337	\$ 24,273	1.07%
Short-term borrowings	139,951	36	0.10%	153,344	77	0.20%	140,294	136	0.13%	148,557	240	0.22%
Subordinated notes	89,692	1,647	7.31%	89,692	1,647	7.29%	89,692	4,942	7.36%	89,692	4,942	7.37%
Long-term debt and mandatorily redeemable securities	65,780	571	3.45%	36,882	480	5.16%	51,090	1,399	3.66%	31,762	1,144	4.82%
Total Interest-Bearing Liabilities	3,243,445	7,673	0.94%	3,211,939	9,960	1.23%	3,230,802	23,345	0.97%	3,299,348	30,599	1.24%
Noninterest-bearing deposits	635,152			545,427			603,805			528,546		
Other liabilities	70,865			71,484			71,806			66,582		
Shareholders equity	549,963			513,556			541,040			501,774		
Total	\$ 4,499,425			\$ 4,342,406			\$ 4,447,453			\$ 4,396,250		
Net Interest Income		\$ 38,420			\$ 37,216			\$ 114,840			\$ 113,014	

Net Yield on Earning Assets on a Taxable Equivalent Basis	3.63%	3.66%	3.70%	3.70%
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### **PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES**

The provision for loan and lease losses for the three and nine month periods ended September 30, 2012 was \$0.65 million and \$4.96 million respectively, compared to a provision for loan and lease losses in the three and nine month periods ended September 30, 2011 of \$1.26 million and \$3.53 million respectively. Net charge-offs of \$0.45 million were recorded for the third quarter 2012, compared to \$2.06 million for the same quarter a year ago. Year-to-date net charge-offs of \$3.10 million have been recorded in 2012, compared to \$6.19 million through September 30, 2011.

On September 30, 2012, 30 day and over loan and lease delinquencies were 0.54% as compared to 0.45% on September 30, 2011. The increase in delinquencies was primarily in residential real estate and aircraft loans. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.55% as compared to 2.73% one year ago. A summary of loan and lease loss experience during the three and nine months ended September 30, 2012 and 2011 is located in Note 5 of the Consolidated Financial Statements.

A loan or lease is considered impaired, based on current information and events, if it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan or lease agreement. We evaluate loans and leases exceeding \$100,000 for impairment and establish an allowance as a component of the reserve for loan and lease losses when it is probable all amounts due will not

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be collected pursuant to the contractual terms of the loan and lease and the recorded investment in the loan or lease exceeds its fair value. A summary of impaired loans as of September 30, 2012 and December 31, 2011 is reflected in Note 4 of the Consolidated Financial Statements.

**NONPERFORMING ASSETS**

Nonperforming assets were as follows:

(Dollars in thousands)	September 30, 2012	December 31, 2011	September 30, 2011
Loans and leases past due 90 days or more	\$ 477	\$ 460	\$ 624
Nonaccrual loans and leases	42,756	56,440	61,549
Other real estate	4,842	7,621	8,032
Former bank premises held for sale	1,101	1,134	1,514
Repossessions	1,248	6,792	4,918
Equipment owned under operating leases	32	29	389
Total nonperforming assets	\$ 50,456	\$ 72,476	\$ 77,026

Nonperforming assets as a percentage of total loans and leases were 1.51% at September 30, 2012, 2.28% at December 31, 2011, and 2.43% at September 30, 2011. Nonperforming assets totaled \$50.46 million at September 30, 2012, a decrease of 30.38% from the \$72.48 million reported at December 31, 2011, and a 34.49% decrease from the \$77.03 million reported at September 30, 2011. The decrease during the first nine months of 2012 compared to the same period in 2011 was primarily related to decreases in nonaccrual loans and leases and the sale of repossessed assets and other real estate as the economy slowly improves.

The decrease in nonaccrual loans and leases at September 30, 2012 from December 31, 2011 and September 30, 2011 occurred primarily in the commercial real estate and aircraft portfolios. A summary of nonaccrual loans and leases and past due aging for the period ended September 30, 2012 and December 31, 2011 is located in Note 4 of the Consolidated Financial Statements.

As of September 30, 2012, the industry with the largest dollar exposure was with borrowers whose primary source of income was derived from commercial real estate. These impaired loans totaled approximately \$16.06 million which were comprised of \$14.05 million secured by commercial real estate and included in loans secured by real estate and \$2.01 million secured by aircraft and included in aircraft financing. We have limited exposure to commercial real estate. However, our borrowers with commercial real estate exposure have suffered as a result of declining real estate values and minimal sales activity. Furthermore, aircraft values for some models have been declining since 2010, increasing the risk in aircraft secured transactions.

Other real estate is the result of foreclosing on real estate in the local market for which we have a current appraisal and are well secured. Other real estate decreased over the past year due to sales of existing properties outpacing current foreclosures.

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Repossessions consisted mainly of aircraft at September 30, 2012. At the time of repossession, the recorded amount of the loan or lease is written down, if necessary, to the estimated value of the equipment or vehicle by a charge to the reserve for loan and lease losses, unless the equipment is in the process of immediate sale. Any subsequent write-downs are included in noninterest expense.

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A summary of other real estate and repossessions is shown in the table below:

(Dollars in thousands)	September 30, 2012	December 31, 2011	September 30, 2011
Commercial and agricultural loans	\$	\$	\$ 42
Auto, light truck and environmental equipment	79	222	151
Medium and heavy duty truck			
Aircraft financing	1,165	6,490	4,593
Construction equipment financing			114
Commercial real estate	3,589	6,634	7,193
Residential real estate	1,253	1,020	839
Consumer loans	4	47	18
Total	\$ 6,090	\$ 14,413	\$ 12,950

For financial statement purposes, nonaccrual loans and leases are included in loan and lease outstandings, whereas repossessions and other real estate are included in other assets.

**Foreign Outstandings** Our foreign loan and lease outstandings, all denominated in U.S. dollars were \$265.08 million and \$216.93 million as of September 30, 2012 and December 31, 2011, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were \$174.33 million and \$46.73 million as of September 30, 2012, respectively, compared to \$149.21 million and \$41.27 million as of December 31, 2011, respectively. Outstanding balances to borrowers in other countries were insignificant.

## **NONINTEREST INCOME**

Noninterest income for the three month period ended September 30, 2012 and 2011 was \$20.31 million and \$20.23 million, respectively. Noninterest income for the nine month period ended September 30, 2012 and 2011 was \$60.62 million and \$60.61 million, respectively. Details of noninterest income follow:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Noninterest income:				
Trust fees	\$ 4,055	\$ 3,902	\$ 12,407	\$ 12,305
Service charges on deposit accounts	4,708	4,748	14,028	13,622
Mortgage banking income	2,020	1,056	5,464	2,335
Insurance commissions	1,483	1,212	4,051	3,416
Equipment rental income	4,604	5,814	14,620	17,861
Other income	3,346	3,084	9,556	9,382
Investment securities and other investment gains	89	414	492	1,686
Total noninterest income	\$ 20,305	\$ 20,230	\$ 60,618	\$ 60,607

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Noninterest income was flat for the third quarter and year-to-date 2012 as compared to the same periods in 2011.

Trust fees increased \$0.15 million or 3.92% for the three months ended September 30, 2012 and increased slightly for the nine months ended September 30, 2012 over the three and nine month periods ended September 30, 2011. The increase in trust fees for the third quarter was a result of an increase in market values of investment accounts.

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Service charges on deposit accounts decreased slightly for the third quarter and increased \$0.41 million or 2.98% for the nine months ended September 30, 2012 over the comparable periods one year ago. The year-to-date improvement in service charges on deposit accounts reflects higher debit card income offset by a lower volume of nonsufficient fund transactions.

Mortgage banking income increased \$0.96 million or 91.29% in the third quarter of 2012 as compared to the third quarter of 2011. Mortgage banking income increased \$3.13 million or 134.00% during the first nine months of 2012 versus the first nine months of 2011. This positive variance was caused by increased gains on loan sales due to higher production volumes and improved margins in 2012.

Insurance commissions improved \$0.27 million or 22.36% and \$0.64 million or 18.59% in the three and nine months ended September 30, 2012 over the same periods a year ago. The increase was due to the acquisition of a book of business of a benefits agency in January 2012.

Equipment rental income declined \$1.21 million or 20.81% in the third quarter of 2012 compared to the third quarter 2011. Equipment rental income declined \$3.24 million or 18.15% for year-to-date 2012 compared to the same period in 2011. The average equipment rental portfolio decreased 16.45% in 2012 over the same period in 2011 resulting in lower rental income. In addition, new leases are at lower rates due to current market conditions including lower rates and increased competition.

Other income increased \$0.26 million or 8.50% and \$0.17 million or 1.85% for the three and nine month periods ended September 30, 2012 as compared to the same periods in 2011 primarily due to higher fees on customer swaps.

The decrease in investment securities and other investment gains of \$0.33 million or 78.50% and \$1.19 million or 70.82% in the three and nine months ended September 30, 2012 over the comparable periods one year ago was primarily due to gains on sale of agency securities in 2011 which were not present in 2012.

## **NONINTEREST EXPENSE**

Noninterest expense for the three month period ended September 30, 2012 and 2011 was \$37.19 million and \$37.15 million, respectively. Noninterest expense for the nine month period ended September 30, 2012 and 2011 was \$111.82 million and \$111.57 million, respectively. Details of noninterest expense follow:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Noninterest expense:				
Salaries and employee benefits	\$ 20,982	\$ 19,476	\$ 61,668	\$ 57,249
Net occupancy expense	1,652	2,237	5,660	6,608
Furniture and equipment expense	3,817	3,519	11,155	10,429
Depreciation - leased equipment	3,795	4,650	11,909	14,250



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Professional fees	1,385	1,326	4,232	3,502
Supplies and communication	1,387	1,312	4,165	4,022
Business development and marketing expense	1,008	968	2,925	2,454
Intangible asset amortization	339	325	1,030	975
Loan and lease collection and repossession expense	1,866	1,387	4,346	4,211
FDIC and other insurance	913	874	2,716	3,508
Other expense	49	1,074	2,013	4,359
Total noninterest expense	\$ 37,193	\$ 37,148	\$ 111,819	\$ 111,567

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Noninterest expense was flat for the third quarter and year-to-date 2012 as compared to the same periods in 2011.

Salaries and employee benefits increased \$1.51 million or 7.73% and \$4.42 million or 7.72% in the three and nine months ended September 30, 2012 respectively, versus the three and nine months ended September 30, 2011. Salaries were higher mainly due to increased base salaries and commission expense. Benefits increased primarily due to higher group insurance costs.

Net occupancy expense was lower by \$0.59 million or 26.15% for the third quarter of 2012 and \$0.95 million or 14.35% for year-to-date 2012 compared to the same periods one year ago. The decline was primarily a result of reduced real estate taxes.

Furniture and equipment expense increased \$0.30 million or 8.47% and 0.73 million or 6.96% for the three and nine months ended September 30, 2012, respectively versus the three and nine months ended September 30, 2011. Furniture and equipment expense was higher mainly due to increased equipment depreciation, computer processing charges and software maintenance costs offset by lower aircraft maintenance expense.

During the third quarter and first nine months of 2012, depreciation on leased equipment decreased \$0.86 million or 18.39% and \$2.34 million or 16.43% respectively, in conjunction with the decrease in equipment rental income as compared to the same periods one year ago.

Professional fees increased \$0.06 million or 4.45% and \$0.73 million or 20.85% for the three and nine month periods ended September 30, 2012 respectively, as compared to the three and nine month periods ended September 30, 2011. The increase in professional fees in 2012 was primarily the result of higher consulting fees.

Business development and marketing increased \$0.04 million or 4.13% for the three months ended September 30, 2012 versus the three months ended September 30, 2011 and \$0.47 million or 19.19% for the nine months ended September 30, 2012 versus the nine months ended September 30, 2011. The higher expense was primarily due to increased marketing promotions.

Loan and lease collection and repossession expense was higher by \$0.48 million or 34.53% and \$0.14 million or 3.21% in the third quarter and first nine months of 2012, respectively as compared to the same periods in 2011 mainly due to lower gains on sales of other real estate properties and higher repurchased mortgage loan losses in 2012 compared to 2011.

FDIC and other insurance expense increased \$0.04 million or 4.46% for the three months ended and decreased \$0.79 million or 22.58% for the nine months ended September 30, 2012, respectively compared to the three and nine months ended September 30, 2011. The lower premium expense in 2012 was a result of a new assessment base and rates imposed by the FDIC.

Other expenses decreased \$1.03 million or 95.44% in the three months ended September 30, 2012 as compared to the three months ended September 30, 2011 primarily due to a gain on sale of the corporate headquarters parking garage of \$1.61 million (or \$1.00 million net of tax).

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Other expense decreased \$2.35 million or 53.82% for the nine months ended September 30, 2012 over the same period one year ago mainly due to a lower provision on unfunded loan commitments and the gain on sale of the corporate headquarters parking garage in 2012.

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**INCOME TAXES**

The provision for income taxes for the three and nine month periods ended September 30, 2012 was \$7.36 million and \$19.82 million, respectively compared to \$6.91 million and \$19.57 million for the same periods in 2011. The effective tax rates were 36.15% and 37.45% for the third quarter ended September 30, 2012 and 2011, respectively and 34.71% and 34.59% for the nine months ended September 30, 2012 and 2011, respectively. Additionally, during the first quarter of 2011 we reached a state tax settlement for the 2008 year and as a result recorded a reduction of unrecognized tax benefits in the amount of \$0.84 million that affected the effective tax rate and increased earnings in the amount of \$0.47 million.

**ITEM 3.**

**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes in market risks faced by 1st Source since December 31, 2011. For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2011.

**ITEM 4.**

**CONTROLS AND PROCEDURES**

As of the end of the period covered by this report an evaluation was carried out, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, at September 30, 2012, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by 1st Source in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are designed to ensure that information required to be disclosed in those reports is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.

In addition, there were no changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the third fiscal quarter of 2012 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

**PART II. OTHER INFORMATION**

ITEM 1. Legal Proceedings.

1st Source and its subsidiaries are involved in various legal proceedings incidental to the conduct of our businesses. Management does not expect that the outcome of any such proceedings will have a material adverse effect on our consolidated financial position or results of operations.

ITEM 1A. Risk Factors.

There have been no material changes in risks faced by 1st Source since December 31, 2011. For information

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regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2011.

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

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total number of shares purchased	Average price paid per share	Total number of shares purchased as part of publicly announced plans or programs (1)	Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs
July 01 - 31, 2012		\$		1,020,192
Aug 01 - 31, 2012				1,020,192
Sept 01 - 30, 2012	208	19.21	208	1,019,984

(1) 1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on April 26, 2007. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock when favorable conditions exist on the open market or through private transactions at various prices from time to time. Since the inception of the plan, 1st Source has repurchased a total of 980,016 shares.

ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Mine Safety Disclosures.

None

ITEM 5. Other Information.

None

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### ITEM 6. Exhibits

The following exhibits are filed with this report:

31.1	Certification of Chief Executive Officer required by Rule 13a-14(a).
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a).
32.1	Certification pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer.
32.2	Certification pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document

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SIGNATURES

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

1st Source Corporation

DATE                      October 25, 2012

/s/ CHRISTOPHER J. MURPHY III  
Christopher J. Murphy III  
Chairman of the Board, President and CEO

DATE                      October 25, 2012

/s/ LARRY E. LENTYCH  
Larry E. Lentych  
Treasurer and Chief Financial Officer  
Principal Accounting Officer