

1ST SOURCE CORP  
Form 10-Q  
April 26, 2012  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended March 31, 2012

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-6233

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

(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)

**46614**  
(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

Number of shares of common stock outstanding as of April 20, 2012 24,259,894 shares



Table of Contents

## TABLE OF CONTENTS

	<b>Page</b>
<b>PART I. FINANCIAL INFORMATION</b>	
<b>Item 1.</b>	
Financial Statements (Unaudited)	
<u>Consolidated Statements of Financial Condition</u> March 31, 2012 and December 31, 2011	3
<u>Consolidated Statements of Income</u> three months ended March 31, 2012 and 2011	4
<u>Consolidated Statements of Comprehensive Income</u> three months ended March 31, 2012 and 2011	5
<u>Consolidated Statements of Shareholders' Equity</u> three months ended March 31, 2012 and 2011	5
<u>Consolidated Statements of Cash Flows</u> three months ended March 31, 2012 and 2011	6
<u>Notes to the Consolidated Financial Statements</u>	7
<b>Item 2.</b>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	31
<b>Item 3.</b>	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	39
<b>Item 4.</b>	
<u>Controls and Procedures</u>	39
<b>PART II. OTHER INFORMATION</b>	
<b>Item 1.</b>	
<u>Legal Proceedings</u>	40
<b>Item 1A.</b>	
<u>Risk Factors</u>	40
<b>Item 2.</b>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	40
<b>Item 3.</b>	
<u>Defaults Upon Senior Securities</u>	40
<b>Item 4.</b>	
<u>Mine Safety Disclosures</u>	40
<b>Item 5.</b>	
<u>Other Information</u>	41
<b>Item 6.</b>	
<u>Exhibits</u>	41
<b>SIGNATURES</b>	42
<b>CERTIFICATIONS</b>	
<u>Exhibit 31.1</u>	50
<u>Exhibit 31.2</u>	51
<u>Exhibit 32.1</u>	52
<u>Exhibit 32.2</u>	53

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

	March 31, 2012	December 31, 2011
<b>ASSETS</b>		
Cash and due from banks	\$ 56,707	\$ 61,406
Federal funds sold and interest bearing deposits with other banks	901	52,921
Investment securities available-for-sale (amortized cost of \$872,783 and \$853,204 at March 31, 2012 and December 31, 2011, respectively)	901,817	883,000
Other investments	18,974	18,974
Trading account securities	144	132
Mortgages held for sale	18,114	12,644
Loans and leases - net of unearned discount		
Commercial and agricultural loans	545,057	545,570
Auto, light truck and environmental equipment	455,873	435,965
Medium and heavy duty truck	175,471	159,796
Aircraft financing	621,500	620,782
Construction equipment financing	271,475	261,204
Commercial real estate	539,112	545,457
Residential real estate	439,562	423,606
Consumer loans	98,840	98,163
Total loans and leases	3,146,890	3,090,543
Reserve for loan and lease losses	(82,394)	(81,644)
Net loans and leases	3,064,496	3,008,899
Equipment owned under operating leases, net	58,840	69,551
Net premises and equipment	39,963	39,857
Goodwill and intangible assets	88,475	87,675
Accrued income and other assets	136,265	139,012
Total assets	\$ 4,384,696	\$ 4,374,071
<b>LIABILITIES</b>		
Deposits:		
Noninterest bearing	\$ 587,324	\$ 580,101
Interest bearing	2,918,350	2,940,040
Total deposits	3,505,674	3,520,141
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	125,010	106,991
Other short-term borrowings	18,761	18,243
Total short-term borrowings	143,771	125,234
Long-term debt and mandatorily redeemable securities	39,828	37,156
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	73,840	77,930
Total liabilities	3,852,805	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 March 31, 2012 and December 31, 2011	346,535	346,535
Retained earnings	198,175	190,261

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Cost of common stock in treasury (1,383,612 shares at March 31, 2012 and 1,429,484 shares at December 31, 2011)	(30,757)	(31,389)
Accumulated other comprehensive income	17,938	18,511
Total shareholders' equity	531,891	523,918
Total liabilities and shareholders' equity	\$ 4,384,696	\$ 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 March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Interest income:</b>		
Loans and leases	\$ 39,896	\$ 41,299
Investment securities, taxable	4,327	4,482
Investment securities, tax-exempt	852	1,186
Other	226	243
<b>Total interest income</b>	<b>45,301</b>	<b>47,210</b>
<b>Interest expense:</b>		
Deposits	5,745	8,355
Short-term borrowings	53	89
Subordinated notes	1,647	1,647
Long-term debt and mandatorily redeemable securities	471	259
<b>Total interest expense</b>	<b>7,916</b>	<b>10,350</b>
<b>Net interest income</b>	<b>37,385</b>	<b>36,860</b>
Provision for loan and lease losses	2,254	2,198
<b>Net interest income after provision for loan and lease losses</b>	<b>35,131</b>	<b>34,662</b>
<b>Noninterest income:</b>		
Trust fees	3,973	3,992
Service charges on deposit accounts	4,505	4,236
Mortgage banking income	1,942	444
Insurance commissions	1,357	1,142
Equipment rental income	5,350	6,038
Other income	3,001	2,971
Investment securities and other investment gains	395	130
<b>Total noninterest income</b>	<b>20,523</b>	<b>18,953</b>
<b>Noninterest expense:</b>		
Salaries and employee benefits	20,316	18,638
Net occupancy expense	2,160	2,320
Furniture and equipment expense	3,507	3,349
Depreciation - leased equipment	4,311	4,805
Professional fees	1,398	1,096
Supplies and communication	1,393	1,394
FDIC and other insurance	949	1,676
Business development and marketing expense	867	622
Loan and lease collection and repossession expense	1,501	1,324
Other expense	1,646	3,252
<b>Total noninterest expense</b>	<b>38,048</b>	<b>38,476</b>
Income before income taxes	17,606	15,139
Income tax expense	5,891	4,531
<b>Net income</b>	<b>\$ 11,715</b>	<b>\$ 10,608</b>

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Per common share			
Basic net income per common share	\$	0.48	\$ 0.43
Diluted net income per common share	\$	0.48	\$ 0.43
Dividends	\$	0.16	\$ 0.16
Basic weighted average common shares outstanding		24,259,416	24,271,366
Diluted weighted average common shares outstanding		24,270,866	24,279,517

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 March 31,</b>	
	<b>2012</b>	<b>2011</b>
Net income	\$ 11,715	\$ 10,608
Other comprehensive (loss) income, net of tax:		
Change in unrealized appreciation of available-for-sale securities, net of tax	(402)	(1,250)
Reclassification adjustment for gains included in net income, net of tax	(171)	(128)
Other comprehensive (loss) income	(573)	(1,378)
Comprehensive income	\$ 11,142	\$ 9,230

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	10,608			10,608		
Other Comprehensive Loss	(1,378)					(1,378)
Issuance of 139,736 common shares under stock based compensation awards, including related tax effects	2,666			(126)	2,792	
Cost of 8,900 shares of common stock acquired for treasury	(163)				(163)	
Repurchase of common stock warrant	(3,750)		(3,750)			
Common stock dividend (\$0.16 per share)	(3,902)			(3,902)		
Stock based compensation	3		3			
Balance at March 31, 2011	\$ 490,467	\$	\$ 346,535	\$ 164,455	\$ (29,655)	\$ 9,132

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Balance at January 1, 2012	\$	523,918	\$		\$	346,535	\$	190,261	\$	(31,389)	\$	18,511
Net Income		11,715						11,715				
Other Comprehensive Loss		(573)										(573)
Issuance of 150,343 common shares under stock based compensation awards, including related tax effects		3,375						126		3,249		
Cost of 104,471 shares of common stock acquired for treasury		(2,617)								(2,617)		
Common stock dividend (\$0.16 per share)		(3,927)						(3,927)				
Balance at March 31, 2012	\$	531,891	\$		\$	346,535	\$	198,175	\$	(30,757)	\$	17,938

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

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

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating activities:</b>		
Net income	\$ 11,715	\$ 10,608
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	2,254	2,198
Depreciation of premises and equipment	1,032	873
Depreciation of equipment owned and leased to others	4,311	4,805
Amortization of investment security premiums and accretion of discounts, net	1,012	485
Amortization of mortgage servicing rights	692	734
Mortgage servicing asset (recovery) impairment	(234)	5
Deferred income taxes	(1,080)	(297)
Investment securities and other investment gains	(395)	(130)
Originations of loans held for sale, net of principal collected	(35,772)	(25,343)
Proceeds from the sales of loans held for sale	31,574	52,560
Net gain on sale of loans held for sale	(1,272)	(85)
Change in trading account securities	(12)	(8)
Change in interest receivable	(665)	(116)
Change in interest payable	1,400	1,905
Change in other assets	3,311	6,701
Change in other liabilities	(1,596)	(2,083)
Other	346	1,696
Net change in operating activities	16,621	54,508
<b>Investing activities:</b>		
Proceeds from sales of investment securities	40,236	66,989
Proceeds from maturities of investment securities	99,619	67,756
Purchases of investment securities	(160,052)	(110,522)
Net change in other investments		840
Loans sold or participated to others	6,312	4,010
Net change in loans and leases	(65,320)	11,983
Net change in equipment owned under operating leases	6,399	(7,971)
Purchases of premises and equipment	(1,161)	(3,047)
Net change in investing activities	(73,967)	30,038
<b>Financing activities:</b>		
Net change in demand deposits, NOW accounts and savings accounts	(17,501)	(33,730)
Net change in certificates of deposit	3,034	19,992
Net change in short-term borrowings	18,537	(23,836)
Proceeds from issuance of long-term debt		417
Payments on long-term debt	(199)	(114)
Net proceeds from issuance of treasury stock	3,375	2,666
Acquisition of treasury stock	(2,617)	(163)
Repurchase of common stock warrant		(3,750)
Cash dividends paid on common stock	(4,002)	(3,968)
Net change in financing activities	627	(42,486)
Net change in cash and cash equivalents	(56,719)	42,060

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Cash and cash equivalents, beginning of year		114,327		96,872
Cash and cash equivalents, end of period	\$	57,608	\$	138,932
<u>Non-cash transactions:</u>				
Loans transferred to other real estate and repossessed assets	\$	1,158	\$	3,931
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.

Table of Contents

**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

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

statement of comprehensive income or in two separate but consecutive statements. In both choices, 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

Table of Contents

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
<b>March 31, 2012</b>				
U.S. Treasury and Federal agencies securities	\$ 388,248	\$ 9,795	\$ (268)	\$ 397,775
U.S. States and political subdivisions securities	103,951	6,124	(842)	109,233
Mortgage-backed securities - Federal agencies	337,295	11,660	(124)	348,831
Corporate debt securities	36,236	380	(319)	36,297
Foreign government and other securities	4,686	42	(1)	4,727
Total debt securities	870,416	28,001	(1,554)	896,863
Marketable equity securities	2,367	2,743	(156)	4,954
Total investment securities available-for-sale	\$ 872,783	\$ 30,744	\$ (1,710)	\$ 901,817
<b>December 31, 2011</b>				
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

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Total investment securities available-for-sale	\$	853,204	\$	31,376	\$	(1,580)	\$	883,000
--	----	---------	----	--------	----	---------	----	---------

At March 31, 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 (or Government Sponsored Enterprise, GSEs).



Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

The contractual maturities of debt securities available-for-sale at March 31, 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	\$ 27,743	\$ 28,152
Due after one year through five years	379,459	388,521
Due after five years through ten years	115,566	121,689
Due after ten years	10,353	9,670
Mortgage-backed securities	337,295	348,831
Total debt securities available-for-sale	\$ 870,416	\$ 896,863

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	
	2012	2011
Gross realized gains	\$ 275	\$ 445
Gross realized losses		(238)
Net realized gains (losses)	\$ 275	\$ 207

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
March 31, 2012						
U.S. Treasury and Federal agencies securities	\$ 110,118	\$ (268)	\$	\$	\$ 110,118	\$ (268)
U.S. States and political subdivisions securities	8,828	(172)	5,131	(670)	13,959	(842)
Mortgage-backed securities - Federal agencies	49,401	(90)	17,002	(34)	66,403	(124)
Corporate debt securities	4,927	(73)	8,513	(246)	13,440	(319)
Foreign government and other securities	199	(1)			199	(1)
Total debt securities	173,473	(604)	30,646	(950)	204,119	(1,554)
Marketable equity securities	961	(153)	4	(3)	965	(156)
Total investment securities available-for-sale	\$ 174,434	\$ (757)	\$ 30,650	\$ (953)	\$ 205,084	\$ (1,710)
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)



Table of Contents

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-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 March 31, 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.

The unrealized losses on marketable equity securities relate primarily to one common stock investment. The Company evaluated the investments near term prospects in relation to the severity and duration of the impairment. Based on the evaluation and the intent to hold the investment for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider the investment other-than-temporarily impaired at March 31, 2012. Accordingly, as of March 31, 2012, the Company believes the impairments detailed in the table above are temporary and no impairment loss has been realized in its consolidated statements of income.

At March 31, 2012 and December 31, 2011, investment securities with carrying values of \$230.86 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



Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

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).

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
March 31, 2012			
Commercial and agricultural loans	\$ 514,269	\$ 30,788	\$ 545,057
Auto, light truck and environmental equipment	450,261	5,612	455,873
Medium and heavy duty truck	171,644	3,827	175,471
Aircraft financing	580,508	40,992	621,500
Construction equipment financing	246,552	24,923	271,475
Commercial real estate	485,803	53,309	539,112
Total	\$ 2,449,037	\$ 159,451	\$ 2,608,488
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
March 31, 2012			
Residential real estate	\$ 436,350	\$ 3,212	\$ 439,562
Consumer	97,200	1,640	98,840
Total	\$ 533,550	\$ 4,852	\$ 538,402
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

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

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
<b>March 31, 2012</b>							
Commercial and agricultural loans	\$ 533,744	\$ 667	\$	\$	\$ 534,411	\$ 10,646	\$ 545,057
Auto, light truck and environmental equipment	450,550	777	45		451,372	4,501	455,873
Medium and heavy duty truck	174,240				174,240	1,231	175,471
Aircraft financing	607,038	2,265			609,303	12,197	621,500
Construction equipment financing	265,709	862	1,160		267,731	3,744	271,475
Commercial real estate	520,650	67	145		520,862	18,250	539,112
Residential real estate	433,414	2,123	813	177	436,527	3,035	439,562
Consumer	96,266	832	102	217	97,417	1,423	98,840
<b>Total</b>	<b>\$ 3,081,611</b>	<b>\$ 7,593</b>	<b>\$ 2,265</b>	<b>\$ 394</b>	<b>\$ 3,091,863</b>	<b>\$ 55,027</b>	<b>\$ 3,146,890</b>
<b>December 31, 2011</b>							
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
<b>Total</b>	<b>\$ 3,024,900</b>	<b>\$ 7,490</b>	<b>\$ 1,252</b>	<b>\$ 461</b>	<b>\$ 3,034,103</b>	<b>\$ 56,440</b>	<b>\$ 3,090,543</b>

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

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
<b>March 31, 2012</b>			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 1,903	\$ 1,903	\$
Auto, light truck and environmental equipment	381	381	
Medium and heavy duty truck	1,227	1,227	
Aircraft financing	10,936	10,936	
Construction equipment financing	3,431	3,431	
Commercial real estate	14,249	14,248	
Residential real estate	108	108	
Consumer loans			
Total with no related allowance recorded	32,235	32,234	
With an allowance recorded:			
Commercial and agricultural loans	7,651	7,651	1,187
Auto, light truck and environmental equipment	3,148	3,148	1,200
Medium and heavy duty truck			
Aircraft financing	1,086	1,086	557
Construction equipment financing			
Commercial real estate	5,491	5,491	277
Residential real estate			
Consumer loans			
Total with an allowance recorded	17,376	17,376	3,221
Total impaired loans	\$ 49,611	\$ 49,610	\$ 3,221
<b>December 31, 2011</b>			
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

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

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 March 31,			
	2012		2011	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural loans	\$ 9,993	\$ 8	\$ 12,970	\$ 116
Auto, light truck and environmental equipment	1,591	7	2,237	1
Medium and heavy duty truck	1,375	1	4,810	1
Aircraft financing	12,268		16,277	9
Construction equipment financing	3,665	4	8,311	9
Commercial real estate	21,226	49	29,863	65
Residential real estate	36	1		
Consumer				
Total	\$ 50,154	\$ 70	\$ 74,468	\$ 201

Performing loans and leases classified as troubled debt restructuring (TDR) during the three months ended March 31, 2012, segregated by class, are shown in the table below. Nonperforming TDRs are shown as nonperforming assets. During 2012, modification programs focused on extending maturity dates or modifying payment patterns. The modification did not result in the contractual forgiveness of principal or interest or interest rate reductions below market rates. Consequently, the financial impact of the modification is immaterial.

(Dollars in thousands)	Three Months Ended March 31, 2012	
	Number of Modifications	Recorded Investment
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	1	108
Consumer		
Total	1	\$ 108

There were no troubled debt restructured loans and leases which had payment defaults within twelve months following modification during the three months ended March 31, 2012. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.

As of March 31, 2012 and December 31, 2011, the Company had \$2.20 million and \$3.29 million, respectively of performing loans and leases classified as troubled debt restructurings.





Table of Contents

**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, percentage allocations for special attention loans and leases without specific reserves, 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.

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

Changes in the reserve for loan and lease losses, segregated by class, for the three months ended March 31, 2012 and 2011 are shown below.

(Dollars in thousands)	Auto, light truck Commercial and environmental agricultural loans equipment heavy duty truck			Construction equipment Commercial Residential financing real estate real estate			Consumer	Total										
							loans											
March 31, 2012																		
Reserve for loan and lease losses																		
Balance, beginning of period	\$	13,091	\$	8,469	\$	3,742	\$	28,626	\$	6,295	\$	16,772	\$	3,362	\$	1,287	\$	81,644
Charge-offs		146		2,033		139		119		33		41		256		2,767		
Recoveries		96		783		21		125		34		34		32		1,263		
Net charge-offs (recoveries)		50		1,250		(21)		14		85		(1)		9		1,504		
Provision (recovery of provision)		(516)		2,550		(96)		(14)		641		(447)		25		111		2,254
Balance, end of period	\$	12,525	\$	9,769	\$	3,667	\$	28,598	\$	6,851	\$	16,326	\$	3,378	\$	1,280	\$	82,394
Ending balance:																		
individually evaluated for impairment	\$	1,187	\$	1,200	\$		\$	557	\$		\$	277	\$		\$		\$	3,221
Ending balance:																		
collectively evaluated for impairment	\$	11,338	\$	8,569	\$	3,667	\$	28,041	\$	6,851	\$	16,049	\$	3,378	\$	1,280	\$	79,173
Financing receivables:																		
Ending balance	\$	545,057	\$	455,873	\$	175,471	\$	621,500	\$	271,475	\$	539,112	\$	439,562	\$	98,840	\$	3,146,890
Ending balance:																		
individually evaluated for impairment	\$	9,554	\$	3,529	\$	1,227	\$	12,022	\$	3,431	\$	19,740	\$	108	\$		\$	49,611
Ending balance:																		
collectively evaluated for impairment	\$	535,503	\$	452,344	\$	174,244	\$	609,478	\$	268,044	\$	519,372	\$	439,454	\$	98,840	\$	3,097,279
March 31, 2011																		
Reserve for loan and lease losses																		
Balance, beginning of period	\$	20,544	\$	7,542	\$	5,768	\$	29,811	\$	8,439	\$	11,177	\$	2,518	\$	1,075	\$	86,874
Charge-offs		422		68				1,098		585		1,231		34		595		4,033
Recoveries		124		45		1		674		35		105		3		134		1,121
Net charge-offs (recoveries)		298		23		(1)		424		550		1,126		31		461		2,912
Provision (recovery of provision)		(3,941)		405		(704)		1,516		(1,091)		5,484		55		474		2,198
Balance, end of period	\$	16,305	\$	7,924	\$	5,065	\$	30,903	\$	6,798	\$	15,535	\$	2,542	\$	1,088	\$	86,160
Ending balance:																		
individually evaluated for impairment	\$	4,025	\$	308	\$	171	\$	2,174	\$	47	\$	1,348	\$		\$		\$	8,073
Ending balance:																		
collectively evaluated for impairment	\$	12,280	\$	7,616	\$	4,894	\$	28,729	\$	6,751	\$	14,187	\$	2,542	\$	1,088	\$	78,087
Financing receivables:																		
Ending balance	\$	547,381	\$	416,957	\$	156,022	\$	601,480	\$	271,490	\$	578,648	\$	386,290	\$	93,450	\$	3,051,718
Ending balance:																		
individually evaluated for impairment	\$	12,769	\$	1,993	\$	4,692	\$	16,462	\$	8,065	\$	31,489	\$		\$		\$	75,470
Ending balance:																		
collectively evaluated for impairment	\$	534,612	\$	414,964	\$	151,330	\$	585,018	\$	263,425	\$	547,159	\$	386,290	\$	93,450	\$	2,976,248

**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 \$959.12 million and \$995.09 million at March 31, 2012 and December 31, 2011, respectively.

Table of Contents

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 and interest rate. 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	
	2012	March 31, 2011
Mortgage servicing assets:		
Balance at beginning of period	\$ 5,610	\$ 7,556
Additions	330	146
Amortization	(692)	(734)
Sales		
Carrying value before valuation allowance at end of period	5,248	6,968
Valuation allowance:		
Balance at beginning of period	(238)	
Impairment recoveries (charges)	234	(5)
Balance at end of period	\$ (4)	\$ (5)
Net carrying value of mortgage servicing assets at end of period	\$ 5,244	\$ 6,963
Fair value of mortgage servicing assets at end of period	\$ 7,494	\$ 10,194

During the three months ended March 31, 2012 and 2011, the Company determined that it was not necessary to permanently write-down any previously established valuation allowance. At March 31, 2012 and 2011, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by \$2.25 million and \$3.23 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 \$0.94 million and \$1.02 million for the three months ended March 31, 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 financial condition. The exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

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.

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

Table of Contents

commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Company 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 \$15.63 million and \$14.66 million at March 31, 2012 and December 31, 2011, respectively. Standby letters of credit generally have terms ranging from six months to one year.

On December 28, 2010, 1st Source 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 is contingent upon 1st Source investing \$5.40 million into its properties within the City of South Bend by December 31, 2013. 1st Source intends to fulfill that commitment and expects to receive the proceeds from escrow within the next twelve months. 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.

**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 institution 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.

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

(Dollars in thousands)	Notional or contractual amount	Asset derivatives		Liability derivatives	
		Statement of Financial Condition classification	Fair value	Statement of Financial Condition classification	Fair value
March 31, 2012					
Interest rate swap contracts	\$ 432,013	Other assets	\$ 15,912	Other liabilities	\$ 16,286
Loan commitments	54,437	Mortgages held for sale	402	N/A	
Forward contracts	42,606	N/A	58	N/A	

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Total	\$	529,056	\$	16,372	\$	16,286		
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		



## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

### Table of Contents

For the three months ended March 31, 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	Gain (loss) Three Months Ended March 31,		
		2012	2011	
Interest rate swap contracts	Other expense	\$ 75	\$	2
Interest rate swap contracts	Other income	39		27
Loan commitments	Mortgage banking income	213		41
Forward contracts	Mortgage banking income	276		(493)
<b>Total</b>		<b>\$ 603</b>	<b>\$</b>	<b>(423)</b>

### **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. Stock options of 33,000 were considered antidilutive as of March 31, 2011. No stock options were considered antidilutive as of March 31, 2012.

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 months ended March 31, 2012 and 2011.

(Dollars in thousands - except per share amounts)	Three Months Ended March 31,		
	2012	2011	
Distributed earnings allocated to common stock	\$ 3,891	\$	3,888
Undistributed earnings allocated to common stock	7,651		6,612
Net earnings allocated to common stock	11,542		10,500
Net earnings allocated to participating securities	173		108
Net income allocated to common stock and participating securities	\$ 11,715	\$	10,608
Weighted average shares outstanding for basic earnings per common share	24,259,416		24,271,366
Dilutive effect of stock compensation	11,450		8,151
Weighted average shares outstanding for diluted earnings per common share	24,270,866		24,279,517
Basic earnings per common share	\$ 0.48	\$	0.43
Diluted earnings per common share	\$ 0.48	\$	0.43



Table of Contents**Note 10. Stock-Based Compensation**

As of March 31, 2012, the Company had four 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 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 March 31, 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 awardees 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 three months ended March 31, 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.

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 first quarter of 2012 (March 31, 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 March 31, 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 \$3 thousand, net of tax, for the three months ended March 31, 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 March 31, 2012	22,000	\$ 12.04	1.06	\$ 274
Vested and expected to vest at March 31, 2012	22,000	\$ 12.04	1.06	\$ 274
Exercisable at March 31, 2012	22,000	\$ 12.04	1.06	\$ 274

As of March 31, 2012, there was \$7.75 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 3.74 years.



Table of Contents

**Note 11. Income Taxes**

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$1.80 million at March 31, 2012 and \$1.67 million at December 31, 2011. Interest and penalties were recognized through the income tax provision. For the three months ending March 31, 2012 and 2011, the Company recognized approximately \$(0.05) million and \$(0.12) million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately \$0.52 million and \$0.57 million were accrued at March 31, 2012 and December 31, 2011, respectively.

Tax years that remain open and subject to audit include the federal 2008-2011 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, various valuation techniques are utilized to measure fair value. When possible, observable market data for identical or similar financial instruments are 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.

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.

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

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 hedged with free-standing derivatives [economic hedges]) 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 March 31, 2012 and December 31, 2011, all mortgages held for sale are carried at fair value.

Table of Contents

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 March 31, 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
March 31, 2012			
Mortgages held for sale reported at fair value	\$ 18,114	\$ 17,327	\$ 787(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 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 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:

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

- 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



Table of Contents

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.

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.

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.

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

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

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
<b>March 31, 2012</b>				
<u>Assets:</u>				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 20,415	\$ 377,360	\$	\$ 397,775
U.S. States and political subdivisions securities		99,299	9,934	109,233
Mortgage-backed securities Federal agencies		348,831		348,831
Corporate debt securities		36,297		36,297
Foreign government and other securities		4,727		4,727
Total debt securities	20,415	866,514	9,934	896,863
Marketable equity securities	4,954			4,954
Total investment securities available-for-sale	25,369	866,514	9,934	901,817
Trading account securities	144			144
Mortgages held for sale		18,114		18,114
Accrued income and other assets (Interest rate swap agreements)		15,912		15,912
Total	\$ 25,513	\$ 900,540	\$ 9,934	\$ 935,987

<u>Liabilities:</u>				
Accrued expenses and other liabilities (Interest rate swap agreements)	\$	\$ 16,286	\$	\$ 16,286
Total	\$	\$ 16,286	\$	\$ 16,286

<b>December 31, 2011</b>				
<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>				
Accrued expenses and other liabilities (Interest rate swap agreements)	\$	\$ 17,945	\$	\$ 17,945
Total	\$	\$ 17,945	\$	\$ 17,945

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended March 31, 2012 and 2011 are summarized as follows:

(Dollars in thousands)	U.S. States and political subdivisions securities	Corporate debt securities	Foreign government and other securities	Investment securities available-for-sale
Beginning balance January 1, 2012	\$ 10,493	\$	\$ 675	\$ 11,168
Total gains or losses (realized/unrealized):				
Included in earnings				
Included in other comprehensive income	17			17
Purchases				
Issuances				
Settlements				
Maturities	(576)			(576)
Transfers into Level 3				
Transfers out of Level 3			(675)	(675)
Ending balance March 31, 2012	\$ 9,934	\$	\$	\$ 9,934
Beginning balance January 1, 2011	\$ 16,306	\$ 9,992	\$ 675	\$ 26,973
Total gains or losses (realized/unrealized):				
Included in earnings				
Included in other comprehensive income	577			577
Purchases	350			350
Issuances				
Settlements				
Maturities	(695)	(9,992)		(10,687)
Transfers into Level 3				
Transfers out of Level 3				
Ending balance March 31, 2011	\$ 16,538	\$	\$ 675	\$ 17,213

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 March 31, 2012 or 2011. One transfer between levels occurred during the three months ended March 31, 2012. No transfers between Level 1 and 2 occurred during the period ended March 31, 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 March 31, 2012.

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
Investment securities available-for sale				
Adjustable rate securities	\$ 5,130	Discounted cash flows	Illiquidity adjustment	4% - 8%
			Term assumption (1)	5 years
			Coupon forecast assumption	0.38% - 0.66%

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Tax anticipation warrants	4,804	Discounted cash flows	Credit spread assumption	1.56% - 2.75%
Total investment securities available-for-sale	\$ 9,934			

---

(1) Term assumption is influenced by security call history

Table of Contents

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 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.

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.



Table of Contents

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 and interest rate. 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 March 31, 2012: impaired loans - \$2.14 million; partnership investments \$(0.10) million; mortgage servicing rights - \$(0.23) million; repossessions - \$0.31 million, and other real estate - \$0.15 million.

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

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
<b>March 31, 2012</b>				
Impaired loans	\$	\$	\$ 46,390	\$ 46,390
Accrued income and other assets (partnership investments)			1,920	1,920
Accrued income and other assets (mortgage servicing rights)			5,244	5,244
Accrued income and other assets (repossessions)			6,109	6,109
Accrued income and other assets (other real estate)			8,853	8,853
	\$	\$	\$ 68,516	\$ 68,516
<b>December 31, 2011</b>				
Impaired loans	\$	\$	\$ 50,007	\$ 50,007
Accrued income and other assets (partnership investments)			2,799	2,799
Accrued income and other assets (mortgage servicing rights)			5,372	5,372
Accrued income and other assets (repossessions)			6,792	6,792
Accrued income and other assets (other real estate)			8,755	8,755
	\$	\$	\$ 73,725	\$ 73,725

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

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 March 31, 2012.

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
Impaired loans	\$ 6,389	Discounted cash flows	Expected percent of total contractual cash flows not expected to be collected	0% - 50%
	40,001	Collateral based measurements	Discount to reflect current market conditions and ultimate collectibility	0% - 90%
	46,390			
Mortgage servicing rights	7,494	Discounted cash flows	Constant prepayment rate (CPR)	17.8% - 22.5%
			Discount rate	8.5% - 11.5%
Repossessions	6,559	Appraisals, trade publications and auction values	Discount to reflect current market conditions	0% - 30%
Other real estate	8,853	Appraisals	Discount to reflect current market conditions	0% - 55%

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.

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



Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Table of Contents

(Dollars in thousands)	Carrying or Contract Value	Fair Value	Level 1	Level 2	Level 3
<b>March 31, 2012</b>					
<u>Assets:</u>					
Cash and due from banks	\$ 56,707	\$ 56,707	\$ 56,707	\$	\$
Federal funds sold and interest bearing deposits with other banks	901	901	901		
Investment securities, available-for-sale	901,817	901,817	25,369	866,514	9,934
Other investments and trading account securities	19,118	19,118	19,118		
Mortgages held for sale	18,114	18,114		18,114	
Loans and leases, net of reserve for loan and lease losses	3,064,496	3,178,230		3,123,023	55,027
Cash surrender value of life insurance policies	55,223	55,223	55,223		
Mortgage servicing rights	5,244	7,494			7,494
Interest rate swaps	15,912	15,912		15,912	
<u>Liabilities:</u>					
Deposits	\$ 3,505,674	\$ 3,529,341	\$ 2,315,584	\$ 1,213,757	\$
Short-term borrowings	143,770	143,770	132,094	11,676	
Long-term debt and mandatorily redeemable securities	39,828	40,497		40,497	
Subordinated notes	89,692	97,891		97,891	
Interest rate swaps	16,286	16,286		16,286	
Off-balance-sheet instruments *		150		150	
<b>December 31, 2011</b>					
<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			

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



Table of Contents

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

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

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.

Table of Contents

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 March 31, 2012, as compared to December 31, 2011, and the results of operations for the three months ended March 31, 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 March 31, 2012 were \$4.38 billion, an increase of \$10.63 million or 0.24% from December 31, 2011. Total loans and leases were \$3.15 billion, an increase of \$56.35 million or 1.82% from December 31, 2011. Fed funds sold and interest bearing deposits with other banks were \$0.09 million, a decrease of \$52.02 million or 98.30% from December 31, 2011 as a result of funding for loan growth. Total investment securities, available for sale were \$901.82 million which represented an increase of \$18.82 million or 2.13% and total deposits were \$3.51 billion, a decrease of \$14.47 million or 0.41% over the comparable figures at the end of 2011.

Nonperforming assets at March 31, 2012 were \$70.42 million, which was a decrease of \$2.06 million or 2.83% from the \$72.48 million reported at December 31, 2011. At March 31, 2012 and December 31, 2011, nonperforming assets were 2.19% and 2.28%, respectively of net loans and

leases.

Table of Contents

Accrued income and other assets were as follows:

(Dollars in thousands)	March 31, 2012	December 31, 2011
Accrued income and other assets:		
Bank owned life insurance cash surrender value	\$ 55,223	\$ 54,729
Accrued interest receivable	14,291	13,626
Mortgage servicing assets	5,244	5,372
Other real estate	7,719	7,621
Former bank premises held for sale	1,134	1,134
Repossessions	6,109	6,792
All other assets	46,545	49,738
Total accrued income and other assets	\$ 136,265	\$ 139,012

CAPITAL

As of March 31, 2012, total shareholders' equity was \$531.89 million, up \$7.97 million or 1.52% from the \$523.92 million at December 31, 2011. In addition to net income of \$11.72 million, other significant changes in shareholders' equity during the first three months of 2012 included \$3.93 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$17.94 million at March 31, 2012, compared to \$18.51 million at December 31, 2011. The decrease 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 12.13% as of March 31, 2012, compared to 11.98% at December 31, 2011. Book value per common share rose to \$21.92 at March 31, 2012, from \$21.64 at December 31, 2011.

We declared and paid dividends per common share of \$0.16 during the first quarter of 2012. The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 31.84%. 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 March 31, 2012, are presented in the table below:

Table of Contents

(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	\$ 556,295	16.49%	\$ 269,858	8.00%	\$ 337,323	10.00%
1st Source Bank	542,751	16.14	268,995	8.00	336,243	10.00
Tier 1 Capital (to Risk-Weighted Assets):						
1st Source Corporation	512,440	15.19	134,929	4.00	202,394	6.00
1st Source Bank	500,178	14.88	134,497	4.00	201,746	6.00
Tier 1 Capital (to Average Assets):						
1st Source Corporation	512,440	12.08	169,717	4.00	212,146	5.00
1st Source Bank	500,178	11.82	169,244	4.00	211,555	5.00

**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 1st Source Corporation, 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 March 31, 2012 there was \$16.00 million outstanding, we could borrow approximately \$265.00 million for a short time from these banks on a collective basis. As of March 31, 2012, we had \$25.90 million outstanding in FHLB advances and could borrow an additional \$169.79 million. We also had \$343.36 million available to borrow from the FRB with no amounts outstanding as of March 31, 2012.

Our loan to asset ratio was 71.77% at March 31, 2012 compared to 70.66% at December 31, 2011 and 69.16% at March 31, 2011. Cash and cash equivalents totaled \$57.61 million at March 31, 2012 compared to \$114.33 million at December 31, 2011 and \$138.93 million at March 31, 2011. At March 31, 2012, the consolidated statement of financial condition was rate sensitive by \$189.57 million more liabilities than assets scheduled to reprice within one year, or approximately 0.93%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

In addition, the State of Indiana recently changed the law governing the collateralization of public fund deposits. Under the new law, the Indiana Board of Depositories will determine 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, pending legislation could alter this requirement in the future. Our potential liquidity exposure if we must pledge collateral is approximately \$447 million.

**RESULTS OF OPERATIONS**



## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Net income for the three month period ended March 31, 2012 was \$11.72 million, compared to \$10.61 million for the same period in 2011. Diluted net income per common share was \$0.48 for the three month period ended March 31, 2012, compared to \$0.43 for the same period in 2011. Return on average common shareholders' equity was 8.84% for the three months ended March 31, 2012, compared to 8.73% in 2011. The return on total average assets was 1.08% for the three months ended March 31, 2012, compared to 0.97% in 2011.

The increase in net income for the three months ended March 31, 2012, over the first three months of 2011, was primarily the result of an increase in noninterest income. Details of the changes in the various components of net income are discussed further below.

Table of Contents

**NET INTEREST INCOME**

The taxable equivalent net interest income for the three months ended March 31, 2012 was \$37.92 million, an increase of 0.95% over the same period in 2011. The net interest margin on a fully taxable equivalent basis was 3.77% for the three months ended March 31, 2012, compared to 3.73% for the three months ended March 31, 2011.

During the three month period ended March 31, 2012, average earning assets decreased \$59.91 million or 1.46%, over the comparable period in 2011. Average interest-bearing liabilities decreased \$171.05 million or 5.11%, for the three month period ended March 31, 2012 over the comparable period one year ago. The yield on average earning assets decreased 18 basis points to 4.55% for the first quarter of 2012 from 4.73% for the first quarter of 2011. The rate earned on assets decreased due to the reduction in short-term market interest rates from a year ago. Total cost of average interest-bearing liabilities decreased 25 basis points to 1.00% for the first quarter 2012 from 1.25% for the first quarter 2011. The result to the net interest margin, or the ratio of net interest income to average earning assets, was an increase of 6 basis points for the three month period ended March 31, 2012 from March 31, 2011.

The largest contributor to the decrease in the yield on average earning assets for the three months ended March 31, 2012, compared to the three months ended March 31, 2011, was a reduction in yields on net loans and leases of 28 basis points. Total average investment securities decreased \$66.84 million or 6.99% for the first quarter over one year ago. Average mortgages held for sale decreased \$7.17 million or 41.67% for the three month period ended March 31, 2012, over the comparable period a year ago. Average net loans and leases increased \$35.86 million or 1.17% for the first quarter of 2012 from the first quarter of 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, decreased \$21.76 million or 26.87% for the three month period ended March 31, 2012, over the comparable period a year ago.

Average interest-bearing deposits decreased \$170.19 million or 5.52% for the first quarter of 2012 over the same period in 2011. The effective rate paid on average interest-bearing deposits decreased 31 basis points to 0.79% for the first quarter 2012 compared to 1.10% for the first quarter 2011. The decline in the average cost of interest-bearing deposits during the first quarter of 2012 as compared to the first quarter of 2011 was primarily the result of interest rate re-pricing on maturing certificates of deposit.

Average short-term borrowings decreased \$13.81 million or 9.29% for the first quarter of 2012, compared to the same period in 2011. The decrease in average short-term borrowings was primarily due to lower repurchase agreements and lower treasury demand notes. Interest paid on short-term borrowings decreased 8 basis points for the first quarter of 2012 due to the interest rate decrease on adjustable rate borrowings. Average long-term debt increased \$12.95 million or 50.93% during the first quarter of 2012 as compared to the first quarter 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 increased 81 basis points for the first quarter due to higher effective rates on mandatorily redeemable securities.

Table of Contents

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 March 31,					
	Average Balance	2012 Interest Income/ Expense	Yield/ Rate	Average Balance	2011 Interest Income/ Expense	Yield/ Rate
<b>ASSETS:</b>						
Investment securities:						
Taxable	\$ 781,982	\$ 4,327	2.23%	\$ 815,564	\$ 4,482	2.23%
Tax exempt	107,745	1,260	4.70%	141,004	1,734	4.99%
Mortgages - held for sale	10,041	98	3.93%	17,213	179	4.22%
Net loans and leases	3,089,868	39,928	5.20%	3,054,013	41,278	5.48%
Other investments	59,194	226	1.54%	80,949	243	1.22%
<b>Total Earning Assets</b>	<b>4,048,830</b>	<b>45,839</b>	<b>4.55%</b>	<b>4,108,743</b>	<b>47,916</b>	<b>4.73%</b>
Cash and due from banks	59,558			58,710		
Reserve for loan and lease losses	(82,462)			(88,263)		
Other assets	334,736			340,974		
<b>Total</b>	<b>\$ 4,360,662</b>			<b>\$ 4,420,164</b>		
<b>LIABILITIES AND SHAREHOLDERS EQUITY:</b>						
Interest-bearing deposits	\$ 2,914,588	\$ 5,745	0.79%	\$ 3,084,779	\$ 8,355	1.10%
Short-term borrowings	134,919	53	0.16%	148,729	89	0.24%
Subordinated notes	89,692	1,647	7.39%	89,692	1,647	7.45%
Long-term debt and mandatorily redeemable securities	38,375	471	4.94%	25,426	259	4.13%
<b>Total Interest-Bearing Liabilities</b>	<b>3,177,574</b>	<b>7,916</b>	<b>1.00%</b>	<b>3,348,626</b>	<b>10,350</b>	<b>1.25%</b>
Noninterest-bearing deposits	574,305			515,236		
Other liabilities	76,055			63,629		
Shareholders equity	532,728			492,673		
<b>Total</b>	<b>\$ 4,360,662</b>			<b>\$ 4,420,164</b>		
<b>Net Interest Income</b>		<b>\$ 37,923</b>			<b>\$ 37,566</b>	
<b>Net Yield on Earning Assets on a Taxable Equivalent Basis</b>			<b>3.77%</b>			<b>3.71%</b>

**PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES**

The provision for loan and lease losses for the three month period ended March 31, 2012 was \$2.25 million, compared to a provision for loan and lease losses in the three month period ended March 31, 2011 of \$2.20 million. Net charge-offs of \$1.50 million were recorded for the first quarter 2012, compared to \$2.91 million for the same quarter a year ago.

On March 31, 2012, 30 day and over loan and lease delinquencies were 0.33% as compared to 0.56% on March 31, 2011. The decrease in delinquencies was primarily in aircraft, construction equipment and commercial loans. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.62% as compared to 2.82% one year ago. A summary of loan and lease loss experience during the three months ended March 31, 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 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 March 31, 2012 and December 31, 2011 is reflected in Note 4 of the Consolidated Financial Statements.

Table of Contents**NONPERFORMING ASSETS**

Nonperforming assets were as follows:

(Dollars in thousands)	March 31, 2012	December 31, 2011	March 31, 2011
Loans and leases past due 90 days or more	\$ 393	\$ 460	\$ 515
Nonaccrual loans and leases	55,027	56,440	74,038
Other real estate	7,719	7,621	6,813
Former bank premises held for sale	1,134	1,134	1,200
Repossessions	6,109	6,792	5,482
Equipment owned under operating leases	41	29	300
Total nonperforming assets	\$ 70,423	\$ 72,476	\$ 88,348

Nonperforming assets as a percentage of total loans and leases were 2.19% at March 31, 2012, 2.28% at December 31, 2011, and 2.81% at March 31, 2011. Nonperforming assets totaled \$70.42 million at March 31, 2012, a decrease of 2.83% from the \$72.48 million reported at December 31, 2011, and a 20.29% decrease from the \$88.35 million reported at March 31, 2011. The decrease during the first three months of 2012 compared to the same period in 2011 was primarily related to decreases in nonaccrual loans and leases as the economy slowly improves.

The decrease in nonaccrual loans and leases at March 31, 2012 from March 31, 2011 occurred primarily in the commercial real estate, construction equipment, aircraft, and medium and heavy duty truck portfolios. The largest dollar decreases at March 31, 2012 from December 31, 2011 occurred in the commercial real estate and residential real estate portfolios and was offset by an increase in auto, light truck and environmental equipment loans. A summary of nonaccrual loans and leases and past due aging for the period ended March 31, 2012 and December 31, 2011 is located in Note 4 of the Consolidated Financial Statements.

As of March 31, 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 \$12.22 million which were comprised of \$10.57 million secured by commercial real estate and included in loans secured by real estate and \$1.65 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 have been declining since 2010, increasing the risk in aircraft secured transactions.

The increase over the past year in other real estate is due to foreclosing on real estate in the local market for which we have a current appraisal and is well secured.

Repossessions consisted mainly of aircraft at March 31, 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.



## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

### Table of Contents

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

(Dollars in thousands)	March 31, 2012	December 31, 2011	March 31, 2011
Commercial and agricultural loans	\$	\$	\$
Auto, light truck and environmental equipment	100	222	261
Medium and heavy duty truck			60
Aircraft financing	5,980	6,490	4,946
Construction equipment financing			200
Commercial real estate	6,895	6,634	6,083
Residential real estate	844	1,020	730
Consumer loans	9	47	15
<b>Total</b>	<b>\$ 13,828</b>	<b>\$ 14,413</b>	<b>\$ 12,295</b>

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 \$224.13 million and \$216.93 million as of March 31, 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 \$150.34 million and \$42.63 million as of March 31, 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 March 31, 2012 and 2011 was \$20.52 million and \$18.95 million, respectively. Details of noninterest income follow:

(Dollars in thousands)	Three Months Ended March 31,	
	2012	2011
<b>Noninterest income:</b>		
Trust fees	\$ 3,973	\$ 3,992
Service charges on deposit accounts	4,505	4,236
Mortgage banking income	1,942	444
Insurance commissions	1,357	1,142
Equipment rental income	5,350	6,038
Other income	3,001	2,971
Investment securities and other investment gains	395	130
<b>Total noninterest income</b>	<b>\$ 20,523</b>	<b>\$ 18,953</b>

Noninterest income increased \$1.57 million or 8.28% for the first quarter 2012 as compared to the same period in 2011.

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Trust fees were flat for the three months ended March 31, 2012 over the three month period ended March 31, 2011.

Service charges on deposit accounts increased \$0.27 million or 6.35% for the three months ended March 31, 2012 over the comparable period one year ago. The improvement in service charges on deposit accounts reflects higher debit card fee income.

Mortgage banking income increased \$1.50 million or 337.39% in the first quarter of 2012 as compared to the first quarter of 2011. This positive variance was caused by increased gains on loan sales due to higher production volumes and improved margins in 2012.



Table of Contents

Insurance commissions improved \$0.22 million or 18.83% in the three months ended March 31, 2012 over the same period 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 \$0.69 million or 11.39% in the first quarter of 2012 compared to the first quarter 2011. The average equipment rental portfolio decreased 10.00% 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 was relatively flat for the three month period ended March 31, 2012 as compared to the same period in 2011.

The increase in investment securities and other investment gains of \$0.27 million or 203.85% in the three months ended March 31, 2012 over the comparable period one year ago was primarily due to a loss on a venture capital investment in 2011 which was not present in 2012.

**NONINTEREST EXPENSE**

Noninterest expense for the three month period ended March 31, 2012 and 2011 was \$38.05 million and \$38.48 million, respectively. Details of noninterest expense follow:

(Dollars in thousands)	Three Months Ended	
	2012	March 31, 2011
Noninterest expense:		
Salaries and employee benefits	\$ 20,316	\$ 18,638
Net occupancy expense	2,160	2,320
Furniture and equipment expense	3,507	3,349
Depreciation - leased equipment	4,311	4,805
Professional fees	1,398	1,096
Supplies and communication	1,393	1,394
Business development and marketing expense	867	622
Intangible asset amortization	351	325
Loan and lease collection and repossession expense	1,501	1,324
FDIC and other insurance	949	1,676
Other expense	1,295	2,927
Total noninterest expense	\$ 38,048	\$ 38,476

Noninterest expense decreased \$0.43 million or 1.11% for the first quarter as compared to the same period in 2011. Net occupancy, furniture and equipment expense, supplies and communication, and intangible asset amortization all changed slightly in 2012 over the same period in 2011.

## Edgar Filing: 1ST SOURCE CORP - Form 10-Q

Salaries and employee benefits increased \$1.68 million or 9.00% in the three months ended March 31, 2012 versus the three months ended March 31, 2011 primarily due to higher base salaries and executive incentive costs.

Depreciation on leased equipment decreased \$0.49 million or 10.28% in conjunction with the decrease in equipment rental income for the three months ended March 31, 2012 as compared to the same period one year ago.

Professional fees increased \$0.30 million or 27.55% for the three month period ended March 31, 2012 as compared to the three month period ended March 31, 2011. The increase in professional fees in 2012 was the

Table of Contents

result of higher consulting fees offset by reduced legal fees.

Business development and marketing increased \$0.25 million or 39.39% for the three months ended March 31, 2012 versus the three months ended March 31, 2011. The higher expense was primarily due to increased marketing promotions and public relations expense.

Loan and lease collection and repossession expense increased \$0.18 million or 13.37% in the first quarter of 2012 as compared to the same period in 2011 mainly due to gains on sale of other real estate in 2011 which were not present in 2012 and higher negative valuation adjustments on repossessed aircraft in 2012. These negative variances were offset by lower collection activity in 2012 compared to 2011.

FDIC and other insurance expense decreased \$0.73 million or 43.38% for the three months ended March 31, 2012 compared to the three months ended March 31, 2011. The lower premium expense in 2012 was a result of a new assessment base and rates imposed by the FDIC.

Other expenses decreased \$1.63 million or 55.76% in the three months ended March 31, 2012 as compared to the three months ended March 31, 2011 due to a lower provision on unfunded loan commitments in 2012.

**INCOME TAXES**

The provision for income taxes for the three month period ended March 31, 2012 was \$5.89 million compared to \$4.53 million for the same period in 2011. The effective tax rates were 33.46% and 29.93% for the first quarter ended March 31, 2012 and 2011, respectively. The effective tax rates are higher in 2012 compared to 2011 due to a decrease in tax-exempt interest in relation to income before taxes. 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 March 31, 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.

Table of Contents

In addition, there were no changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the first 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.

We received notice in April 2011 that the United States Department of Justice has initiated an investigation of 1st Source prompted by pricing practices of certain brokers from whom we purchased mortgages in prior years that were originated by them. The investigation is pursuant to the Equal Credit Opportunity Act and Fair Housing Act. As previously disclosed, we ended our relationships with third-party mortgage brokers in 2010. We are cooperating fully with the investigation and, based on our present understanding, do not expect an outcome that would have any 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 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**

<b>Period</b>	<b>Total number of shares purchased</b>	<b>Average price paid per share</b>	<b>Total number of shares purchased as part of publicly announced plans or programs (1)</b>	<b>Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs</b>
Jan 01 - 31, 2012	24	\$ 24.67	24	1,124,639
Feb 01 - 29, 2012	104,000	25.05	104,000	1,020,639
Mar 01 - 31, 2012	447	24.16	447	1,020,192

(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 979,808 shares.

ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Mine Safety Disclosures.

None

Table of Contents

ITEM 5. Other Information.

None

ITEM 6. Exhibits

The following exhibits are filed with this report:

10(a)(4)	Employment agreement of Steven J. Wessell, dated June 1, 2011
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

Edgar Filing: 1ST SOURCE CORP - Form 10-Q

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document



Table of Contents

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	April 26, 2012	/s/ CHRISTOPHER J. MURPHY III Christopher J. Murphy III Chairman of the Board, President and CEO
DATE	April 26, 2012	/s/ LARRY E. LENTYCH Larry E. Lentych Treasurer and Chief Financial Officer Principal Accounting Officer