

1ST SOURCE CORP  
Form 10-Q  
April 25, 2013  
[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, 2013

OR

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

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

Commission file number 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)

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

(Address of principal executive offices)

**35-1068133**

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

**46601**

(Zip Code)

**(574) 235-2000**

(Registrant's telephone number, including area code)

**Not Applicable**

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

Number of shares of common stock outstanding as of April 12, 2013 24,366,463 shares

---

Table of Contents

**TABLE OF CONTENTS**

	<b>Page</b>
<b>PART I. FINANCIAL INFORMATION</b>	
<u>Item 1.</u>	
Financial Statements (Unaudited)	
<u>Consolidated Statements of Financial Condition – March 31, 2013 and December 31, 2012</u>	3
<u>Consolidated Statements of Income – three months ended March 31, 2013 and 2012</u>	4
<u>Consolidated Statements of Comprehensive Income – three months ended March 31, 2013 and 2012</u>	5
<u>Consolidated Statements of Shareholders' Equity – three months ended March 31, 2013 and 2012</u>	5
<u>Consolidated Statements of Cash Flows – three months ended March 31, 2013 and 2012</u>	6
<u>Notes to the Consolidated Financial Statements</u>	7
<u>Item 2.</u>	
<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	31
<u>Item 3.</u>	
<u>Quantitative and Qualitative Disclosures About Market Risk</u>	39
<u>Item 4.</u>	
<u>Controls and Procedures</u>	39
<b>PART II. OTHER INFORMATION</b>	
<u>Item 1.</u>	
<u>Legal Proceedings</u>	39
<u>Item 1A.</u>	
<u>Risk Factors</u>	39
<u>Item 2.</u>	
<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	40
<u>Item 3.</u>	
<u>Defaults Upon Senior Securities</u>	40
<u>Item 4.</u>	
<u>Mine Safety Disclosures</u>	40
<u>Item 5.</u>	
<u>Other Information</u>	40
<u>Item 6.</u>	
<u>Exhibits</u>	40
<b>SIGNATURES</b>	41
<b>CERTIFICATIONS</b>	
<u>Exhibit 31.1</u>	
<u>Exhibit 31.2</u>	
<u>Exhibit 32.1</u>	
<u>Exhibit 32.2</u>	

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

	March 31, 2013	December 31, 2012
<b><u>ASSETS</u></b>		
Cash and due from banks	\$ 43,033	\$ 83,232
Federal funds sold and interest bearing deposits with other banks	21,424	702
Investment securities available-for-sale (amortized cost of \$830,464 and \$849,139 at March 31, 2013 and December 31, 2012, respectively)	860,137	880,764
Other investments	22,609	22,609
Trading account securities	162	146
Mortgages held for sale	10,634	10,879
Loans and leases - net of unearned discount		
Commercial and agricultural loans	647,661	639,069
Auto, light truck and environmental equipment	449,646	438,147
Medium and heavy duty truck	166,590	172,002
Aircraft financing	699,241	696,479
Construction equipment financing	285,916	278,974
Commercial real estate	566,355	554,968
Residential real estate	445,160	438,641
Consumer loans	112,649	109,273
<b>Total loans and leases</b>	<b>3,373,218</b>	<b>3,327,553</b>
Reserve for loan and lease losses	(84,011)	(83,311)
<b>Net loans and leases</b>	<b>3,289,207</b>	<b>3,244,242</b>
Equipment owned under operating leases, net	53,457	52,173
Net premises and equipment	45,620	45,016
Goodwill and intangible assets	87,207	87,502
Accrued income and other assets	124,538	123,428
<b>Total assets</b>	<b>\$ 4,558,028</b>	<b>\$ 4,550,693</b>
<b><u>LIABILITIES</u></b>		
Deposits:		
Noninterest bearing	\$ 647,407	\$ 646,380
Interest bearing	3,033,159	2,977,967
<b>Total deposits</b>	<b>3,680,566</b>	<b>3,624,347</b>
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	102,672	158,680
Other short-term borrowings	12,205	10,508
<b>Total short-term borrowings</b>	<b>114,877</b>	<b>169,188</b>
Long-term debt and mandatorily redeemable securities	68,258	71,021
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	67,201	68,718
<b>Total liabilities</b>	<b>3,989,666</b>	<b>3,992,038</b>
<b><u>SHAREHOLDERS' EQUITY</u></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 25,641,887 at March 31, 2013 and December 31, 2012	346,535	346,535
Retained earnings	231,664	223,715

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

Cost of common stock in treasury (1,275,434 shares at March 31, 2013 and 1,399,261 shares at December 31, 2012)	(28,170)	(31,134)
Accumulated other comprehensive income	18,333	19,539
<b>Total shareholders equity</b>	568,362	558,655
<b>Total liabilities and shareholders equity</b>	\$ 4,558,028	\$ 4,550,693

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>2013</b>	<b>2012</b>
<b>Interest income:</b>		
Loans and leases	\$ 39,170	\$ 39,896
Investment securities, taxable	3,695	4,327
Investment securities, tax-exempt	771	852
Other	242	226
<b>Total interest income</b>	<b>43,878</b>	<b>45,301</b>
<b>Interest expense:</b>		
Deposits	4,542	5,745
Short-term borrowings	32	53
Subordinated notes	1,055	1,647
Long-term debt and mandatorily redeemable securities	495	471
<b>Total interest expense</b>	<b>6,124</b>	<b>7,916</b>
<b>Net interest income</b>	<b>37,754</b>	<b>37,385</b>
Provision for loan and lease losses	757	2,254
<b>Net interest income after provision for loan and lease losses</b>	<b>36,997</b>	<b>35,131</b>
<b>Noninterest income:</b>		
Trust fees	4,101	3,973
Service charges on deposit accounts	2,239	2,438
Debit card income	2,065	2,067
Mortgage banking income	1,628	1,942
Insurance commissions	1,446	1,357
Equipment rental income	4,012	5,350
Investment securities and other investment gains	173	395
Other income	3,284	3,001
<b>Total noninterest income</b>	<b>18,948</b>	<b>20,523</b>
<b>Noninterest expense:</b>		
Salaries and employee benefits	19,936	20,316
Net occupancy expense	2,207	2,160
Furniture and equipment expense	3,899	3,507
Depreciation - leased equipment	3,225	4,311
Professional fees	1,355	1,398
Supplies and communication	1,536	1,393
FDIC and other insurance	878	949
Business development and marketing expense	773	867
Loan and lease collection and repossession expense	757	1,501
Other expense	1,984	1,646
<b>Total noninterest expense</b>	<b>36,550</b>	<b>38,048</b>
Income before income taxes	19,395	17,606
Income tax expense	6,991	5,891

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

<b>Net income</b>	\$	12,404	\$	11,715
Per common share:				
Basic net income per common share	\$	0.50	\$	0.48
Diluted net income per common share	\$	0.50	\$	0.48
Dividends	\$	0.17	\$	0.16
Basic weighted average common shares outstanding		24,321,985		24,259,416
Diluted weighted average common shares outstanding		24,324,328		24,270,866

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)*

	Three Months Ended March 31,	
	2013	2012
Net income	\$ 12,404	\$ 11,715
Other comprehensive (loss) income, net of tax:		
Change in unrealized appreciation of available-for-sale securities, net of tax	(1,206)	(402)
Reclassification adjustment for gains included in net income, net of tax		(171)
Other comprehensive (loss) income	(1,206)	(573)
<b>Comprehensive income</b>	<b>\$ 11,198</b>	<b>\$ 11,142</b>

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)*

	Total	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net
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
Balance at January 1, 2013	\$ 558,655	\$	\$ 346,535	\$ 223,715	\$ (31,134)	\$ 19,539
Net income	12,404			12,404		
Other comprehensive loss	(1,206)					(1,206)

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

Issuance of 148,627 common shares under stock based compensation awards, including related tax effects	3,249		(281)	3,530
Cost of 24,800 shares of common stock acquired for treasury	(566)			(566)
Common stock dividend (\$0.17 per share)	(4,174)		(4,174)	
Balance at March 31, 2013	\$ 568,362	\$	\$ 346,535	\$ 231,664
				\$ (28,170)
				\$ 18,333

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>2013</b>	<b>2012</b>
<b>Operating activities:</b>		
Net income	\$ 12,404	\$ 11,715
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	757	2,254
Depreciation of premises and equipment	1,148	1,032
Depreciation of equipment owned and leased to others	3,225	4,311
Amortization of investment security premiums and accretion of discounts, net	942	1,012
Amortization of mortgage servicing rights	480	692
Mortgage servicing asset recoveries		(234)
Deferred income taxes	433	(1,080)
Investment securities and other investment gains	(173)	(395)
Originations of loans held for sale, net of principal collected	(26,885)	(35,772)
Proceeds from the sales of loans held for sale	28,308	31,574
Net gain on sale of loans held for sale	(1,178)	(1,272)
Change in trading account securities	(16)	(12)
Change in interest receivable	(1,339)	(665)
Change in interest payable	856	1,400
Change in other assets	865	3,311
Change in other liabilities	(728)	(1,596)
Other	285	346
<b>Net change in operating activities</b>	<b>19,384</b>	<b>16,621</b>
<b>Investing activities:</b>		
Proceeds from sales of investment securities		40,236
Proceeds from maturities of investment securities	65,273	99,619
Purchases of investment securities	(47,367)	(160,052)
Loans sold or participated to others	8,109	6,312
Net change in loans and leases	(54,653)	(65,320)
Net change in equipment owned under operating leases	(4,509)	6,399
Purchases of premises and equipment	(1,761)	(1,161)
<b>Net change in investing activities</b>	<b>(34,908)</b>	<b>(73,967)</b>
<b>Financing activities:</b>		
Net change in demand deposits, NOW accounts and savings accounts	(33,078)	(17,501)
Net change in certificates of deposit	89,297	3,034
Net change in short-term borrowings	(54,311)	18,537
Proceeds from issuance of long-term debt	4,912	
Payments on long-term debt	(9,189)	(199)
Net proceeds from issuance of treasury stock	3,249	3,375
Acquisition of treasury stock	(566)	(2,617)
Cash dividends paid on common stock	(4,267)	(4,002)
<b>Net change in financing activities</b>	<b>(3,953)</b>	<b>627</b>
Net change in cash and cash equivalents	(19,477)	(56,719)
Cash and cash equivalents, beginning of year	83,934	114,327

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

Cash and cash equivalents, end of period	\$	64,457	\$	57,608
--	----	--------	----	--------

**Supplemental Information:**

Non-cash transactions:

Loans transferred to other real estate and repossessed assets	\$	822	\$	1,158
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan		2,801		2,643

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 (2012 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The Consolidated Statement of Financial Condition at December 31, 2012 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**

**Comprehensive Income:** In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-02 *Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU 2013-02 requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. ASU 2013-02 is effective prospectively during interim and annual periods beginning after December 15, 2012. The Company has adopted the standard as required, however the effect of applying this standard is not reflected in the March 31, 2013 Form 10Q as the Company did not have amounts reclassified out of Accumulated Other Comprehensive Income during the quarter ended March 31, 2013. Amounts in future periods, when they occur, will be reflected in the investment securities and other investment gains and the income tax expense line items in the Consolidated Statements of Income.

**Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities:** In January 2013, the FASB issued ASU No. 2013-01 *Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. ASU 2013-01 clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. ASU 2011-11 applies only to derivatives, repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria in the Accounting Standards Codification or subject to a master netting arrangement or similar agreement. 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 effect of applying this standard is reflected in Note 8 *Derivative Financial Instruments*.



Table of Contents

**Offsetting Assets and Liabilities:** In December 2011, the FASB issued 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 effect of applying this standard is reflected in Note 8 Derivative Financial Instruments.

**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, 2013</b>				
U.S. Treasury and Federal agencies securities	\$ 395,414	\$ 10,545	\$ (118)	\$ 405,841
U.S. States and political subdivisions securities	100,578	5,515	(570)	105,523
Mortgage-backed securities Federal agencies	299,897	10,174	(272)	309,799
Corporate debt securities	29,507	408	(20)	29,895
Foreign government and other securities	2,700	18		2,718
Total debt securities	828,096	26,660	(980)	853,776
Marketable equity securities	2,368	3,996	(3)	6,361
Total investment securities available-for-sale	\$ 830,464	\$ 30,656	\$ (983)	\$ 860,137
<b>December 31, 2012</b>				
U.S. Treasury and Federal agencies securities	\$ 410,983	\$ 11,353	\$ (83)	\$ 422,253
U.S. States and political subdivisions securities	100,055	5,864	(482)	105,437
Mortgage-backed securities Federal agencies	301,136	11,296	(25)	312,407
Corporate debt securities	30,897	445	(94)	31,248
Foreign government and other securities	3,700	26		3,726
Total debt securities	846,771	28,984	(684)	875,071
Marketable equity securities	2,368	3,329	(4)	5,693
Total investment securities available-for-sale	\$ 849,139	\$ 32,313	\$ (688)	\$ 880,764

At March 31, 2013 and December 31, 2012, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).

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

The contractual maturities of investments in debt securities available-for-sale at March 31, 2013 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.

<b>(Dollars in thousands)</b>	<b>Amortized Cost</b>		<b>Fair Value</b>	
Due in one year or less	\$	113,060	\$	113,307
Due after one year through five years		336,416		349,286
Due after five years through ten years		77,460		80,131
Due after ten years		1,263		1,253
Mortgage-backed securities		299,897		309,799
Total debt securities available-for-sale	\$	828,096	\$	853,776



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

Table of Contents

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 2013 or 2012.

(Dollars in thousands)	Three Months Ended	
	March 31	
	2013	2012
Gross realized gains	\$	\$ 275
Gross realized losses		
Net realized gains	\$	\$ 275

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, 2013						
U.S. Treasury and Federal agencies securities	\$ 37,231	\$ (118)	\$	\$	\$ 37,231	\$ (118)
U.S. States and political subdivisions securities	10,530	(55)	3,481	(515)	14,011	(570)
Mortgage-backed securities - Federal agencies	29,087	(271)	57	(1)	29,144	(272)
Corporate debt securities			4,505	(20)	4,505	(20)
Foreign government and other securities						
Total debt securities	76,848	(444)	8,043	(536)	84,891	(980)
Marketable equity securities			5	(3)	5	(3)
Total investment securities available-for-sale	\$ 76,848	\$ (444)	\$ 8,048	\$ (539)	\$ 84,896	\$ (983)
December 31, 2012						
U.S. Treasury and Federal agencies securities	\$ 37,316	\$ (83)	\$	\$	\$ 37,316	\$ (83)
U.S. States and political subdivisions securities	7,730	(46)	3,364	(436)	11,094	(482)
Mortgage-backed securities - Federal agencies	6,264	(24)	60	(1)	6,324	(25)
Corporate debt securities			4,431	(94)	4,431	(94)
Foreign government and other securities	100				100	
Total debt securities	51,410	(153)	7,855	(531)	59,265	(684)
Marketable equity securities			5	(4)	5	(4)
Total investment securities available-for-sale	\$ 51,410	\$ (153)	\$ 7,860	\$ (535)	\$ 59,270	\$ (688)

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

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

sell any such securities before a recovery of cost.

At March 31, 2013, 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. Primarily the unrealized losses on debt securities are due to market volatility and market illiquidity on auction rate securities which are reflected in U.S. States and political subdivisions. 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.

Table of Contents

At March 31, 2013 and December 31, 2012, investment securities with carrying values of \$220.26 million and \$216.34 million, respectively, were pledged as collateral to secure government deposits, security repurchase agreements, and for other purposes.

**Note 4. Loan and Lease Financings**

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

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

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, 2013			
Commercial and agricultural loans	\$ 615,574	\$ 32,087	\$ 647,661
Auto, light truck and environmental equipment	444,354	5,292	449,646
Medium and heavy duty truck	165,627	963	166,590
Aircraft financing	647,395	51,846	699,241
Construction equipment financing	269,302	16,614	285,916
Commercial real estate	521,041	45,314	566,355
Total	\$ 2,663,293	\$ 152,116	\$ 2,815,409
December 31, 2012			
Commercial and agricultural loans	\$ 612,567	\$ 26,502	\$ 639,069
Auto, light truck and environmental equipment	428,582	9,565	438,147
Medium and heavy duty truck	170,116	1,886	172,002
Aircraft financing	648,316	48,163	696,479
Construction equipment financing	262,980	15,994	278,974
Commercial real estate	507,219	47,749	554,968
Total	\$ 2,629,780	\$ 149,859	\$ 2,779,639



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

Table of Contents

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, 2013			
Residential real estate	\$ 442,655	\$ 2,505	\$ 445,160
Consumer	112,201	448	112,649
Total	\$ 554,856	\$ 2,953	\$ 557,809
December 31, 2012			
Residential real estate	\$ 435,962	\$ 2,679	\$ 438,641
Consumer	108,814	459	109,273
Total	\$ 544,776	\$ 3,138	\$ 547,914

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
March 31, 2013							
Commercial and agricultural loans	\$ 639,249	\$ 416	\$	\$	\$ 639,665	\$ 7,996	\$ 647,661
Auto, light truck and environmental equipment	448,775	122	41		448,938	708	449,646
Medium and heavy duty truck	166,229		354		166,583	7	166,590
Aircraft financing	683,727	673			684,400	14,841	699,241
Construction equipment financing	281,153	507	40		281,700	4,216	285,916
Commercial real estate	553,821	248			554,069	12,286	566,355
Residential real estate	441,817	826	12	115	442,770	2,390	445,160
Consumer	111,373	663	165	116	112,317	332	112,649
Total	\$ 3,326,144	\$ 3,455	\$ 612	\$ 231	\$ 3,330,442	\$ 42,776	\$ 3,373,218
December 31, 2012							
Commercial and agricultural loans	\$ 629,035	\$ 807	\$ 48	\$	\$ 629,890	\$ 9,179	\$ 639,069
Auto, light truck and environmental equipment	437,087	202			437,289	858	438,147
Medium and heavy duty truck	171,950				171,950	52	172,002
Aircraft financing	691,187				691,187	5,292	696,479
Construction equipment financing	272,817	598	274		273,689	5,285	278,974
Commercial real estate	541,811	102			541,913	13,055	554,968
Residential real estate	434,434	1,019	509	356	436,318	2,323	438,641
Consumer	107,630	816	368	86	108,900	373	109,273
Total	\$ 3,285,951	\$ 3,544	\$ 1,199	\$ 442	\$ 3,291,136	\$ 36,417	\$ 3,327,553



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, 2013</b>			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 1,434	\$ 1,433	\$
Auto, light truck and environmental equipment	464	465	
Medium and heavy duty truck			
Aircraft financing	447	447	
Construction equipment financing	4,154	4,152	
Commercial real estate	20,203	20,203	
Residential real estate			
Consumer loans			
Total with no related allowance recorded	26,702	26,700	
With an allowance recorded:			
Commercial and agricultural loans	5,638	5,638	434
Auto, light truck and environmental equipment			
Medium and heavy duty truck			
Aircraft financing	14,315	14,315	1,639
Construction equipment financing			
Commercial real estate			
Residential real estate			
Consumer loans			
Total with an allowance recorded	19,953	19,953	2,073
Total impaired loans	\$ 46,655	\$ 46,653	\$ 2,073
<b>December 31, 2012</b>			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 2,572	\$ 2,572	\$
Auto, light truck and environmental equipment	474	474	
Medium and heavy duty truck			
Aircraft financing	3,115	3,115	
Construction equipment financing	5,109	5,107	
Commercial real estate	19,597	19,597	
Residential real estate	101	101	
Consumer loans			
Total with no related allowance recorded	30,968	30,966	
With an allowance recorded:			
Commercial and agricultural loans	6,075	6,074	729
Auto, light truck and environmental equipment			
Medium and heavy duty truck			
Aircraft financing	2,086	2,086	852
Construction equipment financing			
Commercial real estate	1,588	1,588	42
Residential real estate			
Consumer loans			
Total with an allowance recorded	9,749	9,748	1,623
Total impaired loans	\$ 40,717	\$ 40,714	\$ 1,623

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,			
	2013		2012	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural loans	\$ 8,319	\$ 3	\$ 9,993	\$ 8
Auto, light truck and environmental equipment	466		1,591	7
Medium and heavy duty truck			1,375	1
Aircraft financing	8,268		12,268	
Construction equipment financing	4,705	2	3,665	4
Commercial real estate	20,545	152	21,226	49
Residential real estate			36	1
Consumer				
Total	\$ 42,303	\$ 157	\$ 50,154	\$ 70

The number of loans and leases classified as troubled debt restructuring (TDR) during the three months ended March 31, 2013 and 2012, segregated by class, are shown in the table below as well as the recorded investment as of March 31. The classification between nonperforming and performing is shown at the time of modification. During 2013 and 2012, modification programs focused on extending maturity dates or modifying payment patterns with most TDRs experiencing a combination of concessions. The modifications did not result in the contractual forgiveness of principal or interest or interest rate reductions below market rates. Consequently, the financial impact of the modifications is immaterial.

(Dollars in thousands)	Three Months Ended March 31,			
	2013		2012	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
<i>Performing TDRs:</i>				
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 performing TDR modifications		\$	1	\$ 108
<i>Nonperforming TDRs:</i>				
Commercial and agricultural loans	1	\$ 25		\$
Auto, light truck and environmental equipment				
Medium and heavy duty truck				



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

Aircraft financing					
Construction equipment financing					
Commercial real estate					
Residential real estate					
Consumer					
Total nonperforming TDR modifications	1	\$	25	\$	
Total TDR modifications	1	\$	25	1	\$ 108

Table of Contents

There were no TDRs which had payment defaults within twelve months following modification during the three months ended March 31, 2013 and 2012. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.

The table below presents the recorded investment of loans and leases classified as troubled debt restructurings as of March 31, 2013 and December 31, 2012.

(Dollars in thousands)	March 31, 2013		December 31, 2012	
Performing TDRs	\$	8,582	\$	8,839
Nonperforming TDRs		10,873		12,869
Total TDRs	\$	19,455	\$	21,708

**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 and global economic and political issues, particularly the European debt crisis. 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 the Company to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting the Company's best estimate of probable loan and lease losses related to specifically identified impaired 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 risk within these segments. The Company has determined that eight classes exist within the loan and lease portfolio. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for impaired loans, formula reserves for each business lending division portfolio including percentage allocations for special attention loans and leases not deemed impaired, and reserves for pooled homogeneous loans and leases. The Company'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, 2013 and 2012 are shown below.

(Dollars in thousands)	Commercial and agricultural loans	Auto, light truck and environmental equipment	Medium and heavy duty truck	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
<b>March 31, 2013</b>									
<i>Reserve for loan and lease losses</i>									
Balance, beginning of period	\$ 12,326	\$ 9,584	\$ 3,001	\$ 34,205	\$ 5,390	\$ 13,778	\$ 3,652	\$ 1,375	\$ 83,311
Charge-offs	285	1		31	83	62	77	423	962
Recoveries	109	123	14	178	35	329	6	111	905
Net charge-offs (recoveries)	176	(122)	(14)	(147)	48	(267)	71	312	57
Provision (recovery of provision)	1,077	(376)	(176)	(520)	383	(124)	125	368	757
Balance, end of period	\$ 13,227	\$ 9,330	\$ 2,839	\$ 33,832	\$ 5,725	\$ 13,921	\$ 3,706	\$ 1,431	\$ 84,011
Ending balance, individually evaluated for impairment	\$ 434	\$	\$	\$ 1,639	\$	\$	\$	\$	\$ 2,073
Ending balance, collectively evaluated for impairment	12,793	9,330	2,839	32,193	5,725	13,921	3,706	1,431	81,938
Total reserve for loan and lease losses	\$ 13,227	\$ 9,330	\$ 2,839	\$ 33,832	\$ 5,725	\$ 13,921	\$ 3,706	\$ 1,431	\$ 84,011
<i>Recorded investment in loans</i>									
Ending balance, individually evaluated for impairment	\$ 7,072	\$ 464	\$	\$ 14,762	\$ 4,154	\$ 20,203	\$	\$	\$ 46,655
Ending balance, collectively evaluated for impairment	640,589	449,182	166,590	684,479	281,762	546,152	445,160	112,649	3,326,563
Total recorded investment in loans	\$ 647,661	\$ 449,646	\$ 166,590	\$ 699,241	\$ 285,916	\$ 566,355	\$ 445,160	\$ 112,649	\$ 3,373,218
<b>March 31, 2012</b>									
<i>Reserve for loan and lease losses</i>									
Balance, beginning of period	\$ 13,091	\$ 8,469	\$ 3,742	\$ 28,626	\$ 6,295	\$ 16,772	\$ 3,362	\$ 1,287	\$ 81,644
Charge-offs	146	2,033		139	119	33	41	256	2,767
Recoveries	96	783	21	125	34	34	32	138	1,263
Net charge-offs (recoveries)	50	1,250	(21)	14	85	(1)	9	118	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
Total reserve for loan and lease losses	\$ 12,525	\$ 9,769	\$ 3,667	\$ 28,598	\$ 6,851	\$ 16,326	\$ 3,378	\$ 1,280	\$ 82,394

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

*Recorded investment in loans*

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	
Total recorded investment in loans	\$	545,057	\$	455,873	\$	175,471	\$	621,500	\$	271,475	\$	539,112	\$	439,562	\$	98,840	\$	3,146,890

Table of Contents**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 relative fair value. The unpaid principal balance of residential mortgage loans serviced for third parties was \$888.37 million and \$921.20 million at March 31, 2013 and December 31, 2012, respectively.

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

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

(Dollars in thousands)	Three Months Ended	
	March 31	
	2013	2012
Mortgage servicing assets:		
Balance at beginning of period	\$ 4,645	\$ 5,610
Additions	363	330
Amortization	(480)	(692)
Sales		
Carrying value before valuation allowance at end of period	4,528	5,248
Valuation allowance:		
Balance at beginning of period		(238)
Impairment (charges) recoveries		234
Balance at end of period	\$	\$ (4)
Net carrying value of mortgage servicing assets at end of period	\$ 4,528	\$ 5,244
Fair value of mortgage servicing assets at end of period	\$ 6,137	\$ 7,494

During the three months ended March 31, 2012, the Company determined that it was not necessary to permanently write-down any previously established valuation allowance. At March 31, 2013 and 2012, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by \$1.61 million and \$2.25 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 \$0.82 million and \$0.94 million for the three months ended March 31, 2013 and 2012, 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 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 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.

Table of Contents

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

The Bank issues letters of credit which are conditional commitments that guarantee the performance of a client to a third party. The credit risk involved and collateral obtained in issuing letters of credit is essentially the same as that involved in extending loan commitments to clients. Standby letters of credit totaled \$17.84 million and \$17.29 million at March 31, 2013 and December 31, 2012, respectively. Standby letters of credit generally have terms ranging from six months to one year.

**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. Derivative assets and liabilities are recorded at fair value on the balance sheet and do take into account the effects of master netting agreements. Master netting agreements allow the Company to settle all derivative contracts held with a single counterparty on a net basis, and to offset net derivative positions with related collateral, where applicable. These derivative positions relate to transactions in which the Company enters into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. In connection with each transaction, the Company agrees to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Company agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to effectively convert a variable rate loan to a fixed rate. Because the terms of the swaps with the customers and the other financial institutions offset each other, with the only difference being counterparty credit risk, changes in the fair value of the underlying derivative contracts are not materially different and do not significantly impact the Company's results of operations.

At March 31, 2013 and December 31, 2012, 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, 2013					
Interest rate swap contracts	\$ 444,440	Other assets	\$ 14,649	Other liabilities	\$ 14,937
Loan commitments	18,911	Mortgages held for sale	264	N/A	
Forward contracts	21,500	N/A		Mortgages held for sale	16
Total	\$ 484,851		\$ 14,913		\$ 14,953

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

December 31, 2012					
Interest rate swap contracts	\$ 446,024	Other assets	\$ 16,126	Other liabilities	\$ 16,444
Loan commitments	33,961	Mortgages held for sale	220	N/A	
Forward contracts	21,500	N/A		Mortgages held for sale	33
Total	\$ 501,485		\$ 16,346		\$ 16,477



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

Table of Contents

For the three months ended March 31, 2013 and 2012, 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,	
		2013	2012
Interest rate swap contracts	Other expense	\$ 30	\$ 75
Interest rate swap contracts	Other income	194	39
Loan commitments	Mortgage banking income	44	213
Forward contracts	Mortgage banking income	17	276
Total		\$ 285	\$ 603

At March 31, 2013 and December 31, 2012 the offsetting of financial assets and derivative assets are shown in the chart below:

(Dollars in thousands)	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Assets Presented in the Statement of Financial Position	Gross Amounts Not Offset in the Statement of Financial Position		
				Financial Instruments	Cash Collateral Received	Net Amount
March 31, 2013						
Interest Rate Swaps	\$ 15,801	\$ 1,152	\$ 14,649	\$	\$	\$ 14,649
December 31, 2012						
Interest Rate Swaps	\$ 17,422	\$ 1,296	\$ 16,126	\$	\$	\$ 16,126

At March 31, 2013 and December 31, 2012 the offsetting of financial liabilities and derivative liabilities are shown in the chart below:

(Dollars in thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statement of Financial Position	Net Amounts of Liabilities Presented in the Statement of Financial Position	Gross Amounts Not Offset in the Statement of Financial Position		
				Financial Instruments	Cash Collateral Pledged	Net Amount
March 31, 2013						
Interest Rate Swaps	\$ 16,089	\$ 1,152	\$ 14,937	\$	\$ 13,453	\$ 1,484
December 31, 2012						
Interest Rate Swaps	\$ 17,740	\$ 1,296	\$ 16,444	\$	\$ 15,811	\$ 633

**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

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

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. There were no stock options outstanding as of March 31, 2013. No stock options were considered antidilutive as of March 31, 2012.

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

### Table of Contents

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, 2013 and 2012.

(Dollars in thousands - except per share amounts)	Three Months Ended March 31	
	2013	2012
Distributed earnings allocated to common stock	\$ 4,143	\$ 3,891
Undistributed earnings allocated to common stock	8,101	7,651
Net earnings allocated to common stock	12,244	11,542
Net earnings allocated to participating securities	160	173
Net income allocated to common stock and participating securities	\$ 12,404	\$ 11,715
Weighted average shares outstanding for basic earnings per common share	24,321,985	24,259,416
Dilutive effect of stock compensation	2,343	11,450
Weighted average shares outstanding for diluted earnings per common share	24,324,328	24,270,866
Basic earnings per common share	\$ 0.50	\$ 0.48
Diluted earnings per common share	\$ 0.50	\$ 0.48

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

As of March 31, 2013, the Company had four active stock-based employee compensation plans, which are more fully described in Note 15 of the Consolidated Financial Statements in 1st Source's Annual Report on Form 10-K for the year ended December 31, 2012. These plans include three executive stock award plans, namely, the Executive Incentive Plan (EIP), the Restricted Stock Award Plan, and the 1998 Performance Compensation Plan, and the Employee Stock Purchase Plan. The last outstanding grant under the 2001 Stock Option Plan was exercised in March 2013. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but the Company had not made any grants through March 31, 2013.

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

The stock-based compensation expense recognized in the consolidated statements of income for the three months ended March 31, 2013 and 2012 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.

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

Total fair value of options vested and expensed was zero for the three months ended March 31, 2013 and 2012. As of March 31, 2013 there were no outstanding stock options. There were 7,500 stock options exercised at a

Table of Contents

weighted average price of \$12.04 during the three months ended March 31, 2013. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of March 31, 2013, there was \$7.01 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.65 years.

**Note 11. Income Taxes**

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$2.09 million at March 31, 2013 and \$2.02 million at December 31, 2012. Interest and penalties were recognized through the income tax provision. For the three months ended March 31, 2013 and 2012, the Company recognized approximately \$0.03 million and \$(0.05) million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately \$0.58 million and \$0.55 million were accrued at March 31, 2013 and December 31, 2012, respectively.

Tax years that remain open and subject to audit include the federal 2009-2012 years and the Indiana 2009-2012 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 is used in the valuation. When market data is not available, fair value is determined using valuation models that incorporate management's estimates of the assumptions a market participant would use in pricing the asset or liability.

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

- Level 1 The valuation is based on quoted prices in active markets for identical instruments.
- Level 2 The valuation is based on observable inputs such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are

observable in the market.

- Level 3 The valuation is based on unobservable inputs that are supported by minimal or no market activity and that are significant to the fair value of the instrument. Level 3 valuations are typically performed using pricing models, discounted cash flow methodologies, or similar techniques that incorporate management's own estimates of assumptions that market participants would use in pricing the instrument, or valuations that require significant management judgment or estimation.

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

Table of Contents

The Company elected fair value accounting for mortgages held for sale. The Company believes the election for mortgages held for sale (which are economically hedged with free standing derivatives) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as economic hedges for these assets. At March 31, 2013 and December 31, 2012, all mortgages held for sale are carried at fair value.

The following table reflects the differences between the fair value carrying amount of mortgages held for sale measured at fair value and the aggregate unpaid principal amount the Company is contractually entitled to receive at maturity on March 31, 2013 and December 31, 2012:

(Dollars in thousands)	Fair value carrying amount	Aggregate unpaid principal	Excess of fair value carrying amount over (under) unpaid principal
<b>March 31, 2013</b>			
Mortgages held for sale reported at fair value			
Total Loans	\$ 10,634	\$ 10,101	\$ 533(1)
<b>December 31, 2012</b>			
Mortgages held for sale reported at fair value			
Total Loans	\$ 10,879	\$ 10,293	\$ 586(1)

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

**Financial Instruments on Recurring Basis:**

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

Investment securities available for sale are valued primarily by a third party pricing agent. Prices supplied by the independent pricing agent, as well as their pricing methodologies and assumptions, are reviewed by the Company for reasonableness and to ensure such prices are aligned with market levels. 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.



Table of Contents

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

- U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.
- Government-sponsored agency debt securities and corporate bonds are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.
- Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMOs, are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.
- Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.
- State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Since some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities. Local direct placement municipal securities, 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, 2013 and December 31, 2012 measured at fair value on a recurring basis:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
<b>March 31, 2013</b>				
<u>Assets:</u>				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 20,071	\$ 385,770	\$	\$ 405,841
U.S. States and political subdivisions securities		98,453	7,070	105,523
Mortgage-backed securities Federal agencies		309,799		309,799
Corporate debt securities		29,895		29,895
Foreign government and other securities		2,718		2,718
Total debt securities	20,071	826,635	7,070	853,776
Marketable equity securities	6,361			6,361
Total investment securities available-for-sale	26,432	826,635	7,070	860,137
Trading account securities	162			162
Mortgages held for sale		10,634		10,634
Accrued income and other assets (Interest rate swap agreements)		14,649		14,649
Total	\$ 26,594	\$ 851,918	\$ 7,070	\$ 885,582
<u>Liabilities:</u>				
Accrued expenses and other liabilities (Interest rate swap agreements)	\$	\$ 14,937	\$	\$ 14,937
Total	\$	\$ 14,937	\$	\$ 14,937
<b>December 31, 2012</b>				
<u>Assets:</u>				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 20,063	\$ 402,190	\$	\$ 422,253
U.S. States and political subdivisions securities		97,736	7,701	105,437
Mortgage-backed securities Federal agencies		312,407		312,407
Corporate debt securities		31,248		31,248
Foreign government and other securities		3,726		3,726
Total debt securities	20,063	847,307	7,701	875,071
Marketable equity securities	5,693			5,693
Total investment securities available-for-sale	25,756	847,307	7,701	880,764
Trading account securities	146			146
Mortgages held for sale		10,879		10,879
Accrued income and other assets (Interest rate swap agreements)		16,126		16,126
Total	\$ 25,902	\$ 874,312	\$ 7,701	\$ 907,915
<u>Liabilities:</u>				
Accrued expenses and other liabilities (Interest rate swap agreements)	\$	\$ 16,444	\$	\$ 16,444
Total	\$	\$ 16,444	\$	\$ 16,444

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, 2013 and 2012 are summarized as follows:

<b>(Dollars in thousands)</b>	<b>U.S. States and political subdivisions securities</b>	<b>Foreign government and other securities</b>	<b>Investment securities available- for-sale</b>
Beginning balance January 1, 2013	\$ 7,701	\$	\$ 7,701
Total gains or losses (realized/unrealized):			
Included in earnings			
Included in other comprehensive income	(93)		(93)
Purchases			
Issuances			
Settlements			
Maturities	(538)		(538)
Transfers into Level 3			
Transfers out of Level 3			
Ending balance March 31, 2013	\$ 7,070	\$	\$ 7,070
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

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, 2013 or 2012. No transfers between levels occurred during the three months ended March 31, 2013. 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, 2013. 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.

## 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 recurring basis at March 31, 2013 and 2012.

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
<b>March 31, 2013</b>				
Investment securities available-for sale				
Adjustable rate securities	\$ 3,285	Discounted cash flows	Illiquidity adjustment	4.00% - 8.00%
			Term assumption (1)	5 yrs
			Coupon forecast assumption	0.26% - 0.42%
Direct placement municipal securities	3,785	Discounted cash flows	Credit spread assumption	1.26% - 2.04%
Total investment securities available-for-sale	\$ 7,070			
<b>March 31, 2012</b>				
Investment securities available-for sale				
Adjustable rate securities	\$ 5,130	Discounted cash flows	Illiquidity adjustment	4.00% - 8.00%
			Term assumption (1)	5 yrs
			Coupon forecast assumption	0.38% - 0.66%
Direct placement municipal securities	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

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 direct placement municipal securities is the underlying market level used to determine the fair value measure. An increase (decrease) in the estimated yield level of the market will decrease (increase) the fair value measure of the securities.

### ***Financial Instruments on Non-recurring Basis:***

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

The Credit Policy Committee, a management committee, is responsible for overseeing the valuation processes and procedures for Level 3 measurements of impaired loans, other real estate and repossessions. The

Table of Contents

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

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

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

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

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

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





Table of Contents

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, 2013: impaired loans - \$0.03 million; partnership investments - \$(0.17) million; mortgage servicing rights - \$0.00 million; repossessions - \$0.00 million, and other real estate - \$0.02 million.

The table below presents the carrying value of assets at March 31, 2013 and December 31, 2012 measured at fair value on a non-recurring basis:

<b>(Dollars in thousands)</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>March 31, 2013</b>				
Impaired loans - collateral based	\$	\$	\$ 12,688	\$ 12,688
Accrued income and other assets (partnership investments)			2,206	2,206
Accrued income and other assets (mortgage servicing rights)			4,528	4,528
Accrued income and other assets (repossessions)			103	103
Accrued income and other assets (other real estate)			5,323	5,323
<b>Total</b>	<b>\$</b>	<b>\$</b>	<b>\$ 24,848</b>	<b>\$ 24,848</b>
<b>December 31, 2012</b>				
Impaired loans - collateral based	\$	\$	\$ 2,027	\$ 2,027
Accrued income and other assets (partnership investments)			2,032	2,032
Accrued income and other assets (mortgage servicing rights)			4,645	4,645
Accrued income and other assets (repossessions)			63	63
Accrued income and other assets (other real estate)			5,344	5,344
<b>Total</b>	<b>\$</b>	<b>\$</b>	<b>\$ 14,111</b>	<b>\$ 14,111</b>

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, 2013 and December 31, 2012.

March 31, 2013						
Impaired loans	\$	2,027	\$	2,027	Collateral based measurements including appraisals, trade publications, auction values	Discount for lack of marketability and current conditions 10% - 90%
Mortgage servicing rights		4,645		5,760	Discounted cash flows	Constant prepayment rate (CPR) Discount rate 14.1% - 23.2% 8.5% - 11.5%
Repossessions		63		59	Appraisals, trade publications and auction values	Discount for lack of marketability 0% - 45%
Other real estate		5,344		6,550	Appraisals	Discount for lack of marketability 0% - 68%

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.

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

Table of Contents

The fair values of the Company's financial instruments as of March 31, 2013 and December 31, 2012 are summarized in the table below.

(Dollars in thousands)	Carrying or Contract Value	Fair Value	Level 1	Level 2	Level 3
<b>March 31, 2013</b>					
<u>Assets:</u>					
Cash and due from banks	\$ 43,033	\$ 43,033	\$ 43,033	\$	\$
Federal funds sold and interest bearing deposits with other banks	21,424	21,424	21,424		
Investment securities, available-for-sale	860,137	860,137	26,432	826,635	7,070
Other investments and trading account securities	22,771	22,771	22,771		
Mortgages held for sale	10,634	10,634		10,634	
Loans and leases, net of reserve for loan and lease losses	3,289,207	3,309,349			3,309,349
Cash surrender value of life insurance policies	57,058	57,058	57,058		
Mortgage servicing rights	4,528	6,137			6,137
Interest rate swaps					