

1ST SOURCE CORP
Form 10-Q
October 20, 2011
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2011

OR

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

For the transition period from to

Commission file number 0-6233

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(Exact name of registrant as specified in its charter)

INDIANA

(State or other jurisdiction of
incorporation or organization)

35-1068133

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

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

(Address of principal executive
offices)

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

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Number of shares of common stock outstanding as of October 14, 2011 24,213,116 shares

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

| | September 30, 2011 | December 31, 2010 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 57,986 | \$ 62,313 |
| Federal funds sold and interest bearing deposits with other banks | 25,064 | 34,559 |
| Investment securities available-for-sale (amortized cost of \$820,336 and \$952,101 at September 30, 2011 and December 31, 2010, respectively) | 850,507 | 969,018 |
| Other investments | 18,974 | 21,343 |
| Trading account securities | 119 | 138 |
| Mortgages held for sale | 13,219 | 32,599 |
| Loans and leases - net of unearned discount | | |
| Commercial and agricultural loans | 557,392 | 530,228 |
| Auto, light truck and environmental equipment | 442,127 | 396,500 |
| Medium and heavy duty truck | 152,703 | 162,824 |
| Aircraft financing | 613,706 | 614,357 |
| Construction equipment financing | 260,241 | 285,634 |
| Commercial real estate | 556,287 | 594,729 |
| Residential real estate | 404,063 | 390,951 |
| Consumer loans | 96,775 | 95,400 |
| Total loans and leases | 3,083,294 | 3,070,623 |
| Reserve for loan and lease losses | (84,210) | (86,874) |
| Net loans and leases | 2,999,084 | 2,983,749 |
| Equipment owned under operating leases, net | 75,096 | 78,138 |
| Net premises and equipment | 40,958 | 33,881 |
| Goodwill and intangible assets | 88,000 | 88,955 |
| Accrued income and other assets | 136,934 | 140,588 |
| Total assets | \$ 4,305,941 | \$ 4,445,281 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest bearing | \$ 560,932 | \$ 524,564 |
| Interest bearing | 2,886,653 | 3,098,181 |
| Total deposits | 3,447,585 | 3,622,745 |
| Short-term borrowings: | | |
| Federal funds purchased and securities sold under agreements to repurchase | 124,779 | 136,028 |
| Other short-term borrowings | 16,159 | 19,961 |
| Total short-term borrowings | 140,938 | 155,989 |
| Long-term debt and mandatorily redeemable securities | 37,064 | 24,816 |
| Subordinated notes | 89,692 | 89,692 |
| Accrued expenses and other liabilities | 73,783 | 65,656 |
| Total liabilities | 3,789,062 | 3,958,898 |
| SHAREHOLDERS' EQUITY | | |
| Preferred stock; no par value | | |
| Authorized 10,000,000 shares; none issued or outstanding | | |
| Common stock; no par value | | |
| Authorized 40,000,000 shares; issued 25,643,506 at September 30, 2011 and December 31, 2010 | 346,535 | 350,282 |

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|---|--------------|--------------|
| Retained earnings | 183,007 | 157,875 |
| Cost of common stock in treasury (1,430,490 shares at September 30, 2011 and 1,470,696 shares at December 31, 2010) | (31,408) | (32,284) |
| Accumulated other comprehensive income | 18,745 | 10,510 |
| Total shareholders' equity | 516,879 | 486,383 |
| Total liabilities and shareholders' equity | \$ 4,305,941 | \$ 4,445,281 |

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)**

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|---|---------------|--|----------------|
| | 2011 | 2010 | 2011 | 2010 |
| Interest income: | | | | |
| Loans and leases | \$ 40,741 | \$ 43,722 | \$ 123,750 | \$ 129,091 |
| Investment securities, taxable | 4,694 | 4,931 | 14,088 | 15,611 |
| Investment securities, tax-exempt | 934 | 1,369 | 3,124 | 4,258 |
| Other | 217 | 219 | 707 | 743 |
| Total interest income | 46,586 | 50,241 | 141,669 | 149,703 |
| Interest expense: | | | | |
| Deposits | 7,756 | 10,790 | 24,273 | 34,768 |
| Short-term borrowings | 77 | 219 | 240 | 613 |
| Subordinated notes | 1,647 | 1,648 | 4,942 | 4,942 |
| Long-term debt and mandatorily redeemable securities | 480 | 400 | 1,144 | 1,045 |
| Total interest expense | 9,960 | 13,057 | 30,599 | 41,368 |
| Net interest income | 36,626 | 37,184 | 111,070 | 108,335 |
| Provision for loan and lease losses | 1,260 | 5,578 | 3,525 | 15,764 |
| Net interest income after provision for loan and lease losses | 35,366 | 31,606 | 107,545 | 92,571 |
| Noninterest income: | | | | |
| Trust fees | 3,902 | 3,870 | 12,305 | 11,677 |
| Service charges on deposit accounts | 4,748 | 4,918 | 13,622 | 14,813 |
| Mortgage banking income | 1,056 | 2,549 | 2,335 | 3,751 |
| Insurance commissions | 1,212 | 1,180 | 3,416 | 3,706 |
| Equipment rental income | 5,814 | 6,495 | 17,861 | 19,912 |
| Other income | 3,084 | 2,656 | 9,382 | 8,357 |
| Investment securities and other investment gains | 414 | 1,083 | 1,686 | 2,059 |
| Total noninterest income | 20,230 | 22,751 | 60,607 | 64,275 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 19,476 | 18,980 | 57,249 | 56,638 |
| Net occupancy expense | 2,237 | 2,200 | 6,608 | 6,626 |
| Furniture and equipment expense | 3,519 | 3,227 | 10,429 | 9,223 |
| Depreciation - leased equipment | 4,650 | 5,173 | 14,250 | 15,841 |
| Professional fees | 1,326 | 1,563 | 3,502 | 4,495 |
| Supplies and communication | 1,312 | 1,387 | 4,022 | 4,094 |
| FDIC and other insurance | 874 | 1,420 | 3,508 | 4,761 |
| Business development and marketing expense | 968 | 845 | 2,454 | 2,292 |
| Loan and lease collection and repossession expense | 1,387 | 1,449 | 4,211 | 5,822 |
| Other expense | 1,399 | 1,566 | 5,334 | 4,777 |
| Total noninterest expense | 37,148 | 37,810 | 111,567 | 114,569 |
| Income before income taxes | 18,448 | 16,547 | 56,585 | 42,277 |

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|--|------------------|-----------------|------------------|------------------|
| Income tax expense | 6,908 | 5,344 | 19,572 | 13,600 |
| Net income | 11,540 | 11,203 | 37,013 | 28,677 |
| Preferred stock dividends and discount accretion | | (1,721) | | (5,149) |
| Net income available to common shareholders | \$ 11,540 | \$ 9,482 | \$ 37,013 | \$ 23,528 |
| Per common share | | | | |
| Basic net income per common share | \$ 0.47 | \$ 0.39 | \$ 1.51 | \$ 0.96 |
| Diluted net income per common share | \$ 0.47 | \$ 0.39 | \$ 1.51 | \$ 0.96 |
| Dividends | \$ 0.16 | \$ 0.15 | \$ 0.48 | \$ 0.45 |
| Basic weighted average common shares outstanding | 24,213,063 | 24,247,236 | 24,246,041 | 24,247,468 |
| Diluted weighted average common shares outstanding | 24,223,432 | 24,253,883 | 24,255,357 | 24,254,026 |

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

Table of Contents**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, 2010 | \$ 570,320 | \$ 104,930 | \$ 350,269 | \$ 142,407 | \$ (32,380) | \$ 5,094 |
| Comprehensive Income, net of tax: | | | | | | |
| Net Income | 28,677 | | | 28,677 | | |
| Change in unrealized appreciation of available-for-sale securities, net of tax | 11,283 | | | | | 11,283 |
| Reclassification adjustment for gains included in net income, net of tax | (159) | | | | | (159) |
| Total Comprehensive Income | 39,801 | | | | | |
| Issuance of 187,354 common shares under stock based compensation awards, including related tax effects | 2,871 | | | 636 | 2,235 | |
| Cost of 94,927 shares of common stock acquired for treasury | (1,578) | | | | (1,578) | |
| Preferred stock discount accretion | | 987 | | (987) | | |
| Preferred stock dividend (paid and/or accrued) | (4,163) | | | (4,163) | | |
| Common stock dividend (\$0.45 per share) | (10,937) | | | (10,937) | | |
| Stock based compensation | 9 | | 9 | | | |
| Balance at September 30, 2010 | \$ 596,323 | \$ 105,917 | \$ 350,278 | \$ 155,633 | \$ (31,723) | \$ 16,218 |
| Balance at January 1, 2011 | \$ 486,383 | \$ | \$ 350,282 | \$ 157,875 | \$ (32,284) | \$ 10,510 |
| Comprehensive Income, net of tax: | | | | | | |
| Net Income | 37,013 | | | 37,013 | | |
| Change in unrealized appreciation of available-for-sale securities, net of tax | 9,091 | | | | | 9,091 |
| Reclassification adjustment for gains included in net income, net of tax | (856) | | | | | (856) |
| Total Comprehensive Income | 45,248 | | | | | |
| Issuance of 149,731 common shares under stock based compensation awards, including related tax effects | 2,853 | | | (165) | 3,018 | |
| Cost of 109,525 shares of common stock acquired for treasury | (2,142) | | | | (2,142) | |
| Repurchase of common stock warrant | (3,750) | | (3,750) | | | |
| Common stock dividend (\$0.48 per share) | (11,716) | | | (11,716) | | |
| Stock based compensation | 3 | | 3 | | | |
| Balance at September 30, 2011 | \$ 516,879 | \$ | \$ 346,535 | \$ 183,007 | \$ (31,408) | \$ 18,745 |

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)**

| | Nine Months Ended September 30, | |
|--|--|-------------|
| | 2011 | 2010 |
| Operating activities: | | |
| Net income | \$ 37,013 | \$ 28,677 |
| Adjustments to reconcile net income to net cash provided (used) by operating activities: | | |
| Provision for loan and lease losses | 3,525 | 15,764 |
| Depreciation of premises and equipment | 2,698 | 3,103 |
| Depreciation of equipment owned and leased to others | 14,250 | 15,841 |
| Amortization of investment security premiums and accretion of discounts, net | 1,610 | 1,232 |
| Amortization of mortgage servicing rights | 2,125 | 2,277 |
| Mortgage servicing asset impairment | 230 | 821 |
| Deferred income taxes | 3,015 | (3,800) |
| Investment securities and other investment gains | (1,686) | (2,059) |
| Originations/purchases of loans held for sale, net of principal collected | (67,655) | (299,298) |
| Proceeds from the sales of loans held for sale | 88,372 | 215,678 |
| Net gain on sale of loans held for sale | (1,337) | (4,678) |
| Change in trading account securities | 19 | |
| Change in interest receivable | 1,002 | 795 |
| Change in interest payable | 424 | 664 |
| Change in other assets | 1,251 | (4,084) |
| Change in other liabilities | (331) | 9,495 |
| Other | 2,901 | 616 |
| Net change in operating activities | 87,426 | (18,956) |
| Investing activities: | | |
| Proceeds from sales of investment securities | 133,241 | 72,417 |
| Proceeds from maturities of investment securities | 269,416 | 330,904 |
| Purchases of investment securities | (270,817) | (357,465) |
| Net change in other investments | 2,370 | 2,901 |
| Loans sold or participated to others | 15,039 | 13,186 |
| Net change in loans and leases | (33,899) | (46,707) |
| Net change in equipment owned under operating leases | (11,208) | (3,267) |
| Purchases of premises and equipment | (10,587) | (1,577) |
| Net change in investing activities | 93,555 | 10,392 |
| Financing activities: | | |
| Net change in demand deposits, NOW accounts and savings accounts | (129,250) | (23,309) |
| Net change in certificates of deposit | (45,910) | (62,961) |
| Net change in short-term borrowings | (15,051) | 22,114 |
| Proceeds from issuance of long-term debt | 10,710 | 15,418 |
| Payments on long-term debt | (328) | (363) |
| Net proceeds from issuance of treasury stock | 2,853 | 2,871 |
| Acquisition of treasury stock | (2,142) | (1,578) |
| Repurchase of common stock warrant | (3,750) | |
| Cash dividends paid on preferred stock | | (4,163) |
| Cash dividends paid on common stock | (11,935) | (11,125) |
| Net change in financing activities | (194,803) | (63,096) |

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| | | |
|--|-----------|------------|
| Net change in cash and cash equivalents | (13,822) | (71,660) |
| Cash and cash equivalents, beginning of year | 96,872 | 210,102 |
| Cash and cash equivalents, end of period | \$ 83,050 | \$ 138,442 |
| <u>Non-cash transactions:</u> | | |
| Loans transferred to other real estate and repossessed assets | \$ 11,993 | \$ 15,501 |
| Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan | 2,420 | 2,545 |

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

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1ST SOURCE CORPORATION

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

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 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 (2010 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, 2010 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 with the current year presentation.

Cash Flow For purposes of the consolidated statements of cash flow, we consider cash and due from banks, federal funds sold and interest bearing deposits with other banks with original maturities of three months or less as cash and cash equivalents.

Note 2. Recent Accounting Pronouncements

Goodwill: In September 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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 is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption is permitted. We are assessing the impact of ASU 2011-08 on our goodwill impairment test but do not expect an impact on our 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 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. ASU 2011-05 is effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. We are assessing the impact of ASU 2011-05 on our comprehensive income presentation.

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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 changes 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 is effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early application by public

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entities is not permitted. We are assessing the impact of ASU 2011-04 on our fair value disclosures.

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 removes 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 is 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 occur on or after the effective date. Early adoption is not permitted. We are assessing the impact of ASU 2011-03 on our financial condition, results of operations, and disclosures.

Receivables: In April 2011, the FASB issued ASU No. 2011-02 *Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*. ASU 2011-02 clarifies whether loan modifications constitute troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 was effective for the first interim and annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. The impact of ASU 2011-02 on our disclosures is reflected in Note 4 - Loan and Lease Financings.

Business Combinations: In December 2010, the FASB issued ASU No. 2010-29 *Business Combinations (Topic 805) - Disclosure of Supplementary Pro Forma Information for Business Combinations*. If a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. ASU 2010-29 also expands the supplementary pro forma disclosures. ASU 2010-29 was effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. ASU 2010-29 will only affect us if there are future business combinations.

Intangibles - Goodwill and Other: In December 2010, the FASB issued ASU No. 2010-28 *Intangibles - Goodwill and Other (Topic 350) - When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*. ASU 2010-28 affects all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. ASU 2010-28 was effective for fiscal years and interim periods within those years, beginning after December 15, 2010. ASU 2010-28 did not have an impact on our financial condition, results of operations, or disclosures.

Table of Contents**Note 3. Investment Securities**

Investment securities available-for-sale were as follows:

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|-------------------|---------------------------|----------------------------|------------|
| September 30, 2011 | | | | |
| U.S. Treasury and Federal agencies securities | \$ 356,144 | \$ 10,475 | \$ (113) | \$ 366,506 |
| U.S. States and political subdivisions securities | 104,498 | 6,187 | (674) | 110,011 |
| Mortgage-backed securities Federal agencies | 315,188 | 11,806 | (74) | 326,920 |
| Corporate debt securities | 36,461 | 386 | (186) | 36,661 |
| Foreign government and other securities | 5,699 | 32 | (1) | 5,730 |
| Total debt securities | 817,990 | 28,886 | (1,048) | 845,828 |
| Marketable equity securities | 2,346 | 2,338 | (5) | 4,679 |
| Total investment securities available-for-sale | \$ 820,336 | \$ 31,224 | \$ (1,053) | \$ 850,507 |
| December 31, 2010 | | | | |
| U.S. Treasury and Federal agencies securities | \$ 442,612 | \$ 5,546 | \$ (849) | \$ 447,309 |
| U.S. States and political subdivisions securities | 147,679 | 4,381 | (1,753) | 150,307 |
| Mortgage-backed securities Federal agencies | 309,046 | 7,854 | (232) | 316,668 |
| Corporate debt securities | 45,778 | 182 | (345) | 45,615 |
| Foreign government and other securities | 5,732 | 18 | (34) | 5,716 |
| Total debt securities | 950,847 | 17,981 | (3,213) | 965,615 |
| Marketable equity securities | 1,254 | 2,152 | (3) | 3,403 |
| Total investment securities available-for-sale | \$ 952,101 | \$ 20,133 | \$ (3,216) | \$ 969,018 |

At September 30, 2011 and December 31, 2010, the residential mortgage-backed securities we held 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).

The contractual maturities of debt securities available-for-sale at September 30, 2011 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 | \$ 37,493 | \$ 37,748 |
| Due after one year through five years | 334,790 | 343,533 |
| Due after five years through ten years | 123,342 | 131,124 |
| Due after ten years | 7,177 | 6,503 |
| Mortgage-backed securities | 315,188 | 326,920 |
| Total debt securities available-for-sale | \$ 817,990 | \$ 845,828 |

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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. The gross gains and losses in the first nine months of 2011 primarily reflect the sale of municipal, Farmer Mac, FHLB, corporate and FFCB debt securities. The sale of municipal securities was to reduce credit risk exposure in certain states. The action to sell agency securities was to improve future yield. There was no impact to other than temporary impairment (OTTI) as a result of the 2011 sales. The gross gains and losses in the first nine months of 2010 primarily reflect the disposition of FNMA and FHLMC debt securities. There were no OTTI write-downs in 2011 or 2010.

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| (Dollars in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|-----------------------------|-------------------------------------|---------|------------------------------------|--------|
| | 2011 | 2010 | 2011 | 2010 |
| Gross realized gains | \$ 63 | \$ | \$ 1,662 | \$ 292 |
| Gross realized losses | (46) | (24) | (284) | (36) |
| Net realized gains (losses) | \$ 17 | \$ (24) | \$ 1,378 | \$ 256 |

There were net losses of \$19 thousand for the nine months ended September 30, 2011 and no gains or losses for the nine months ended September 30, 2010 on \$0.12 million and \$0.14 million in trading securities outstanding at September 30, 2011 and at December 31, 2010, respectively.

The following tables summarize our gross unrealized losses and fair value by investment category and age:

| (Dollars in thousands) | Less than 12 Months | | 12 months or Longer | | Total | |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2011 | | | | | | |
| U.S. Treasury and Federal agencies securities | \$ 39,887 | \$ (113) | \$ | \$ | \$ 39,887 | \$ (113) |
| U.S. States and political subdivisions securities | | | 6,503 | (674) | 6,503 | (674) |
| Mortgage-backed securities - Federal agencies | 19,777 | (59) | 3,965 | (14) | 23,742 | (73) |
| Corporate debt securities | 10,245 | (72) | 3,410 | (115) | 13,655 | (187) |
| Foreign government and other securities | 1,004 | (1) | | | 1,004 | (1) |
| Total debt securities | 70,913 | (245) | 13,878 | (803) | 84,791 | (1,048) |
| Marketable equity securities | 4 | (1) | 3 | (4) | 7 | (5) |
| Total investment securities available-for-sale | \$ 70,917 | \$ (246) | \$ 13,881 | \$ (807) | \$ 84,798 | \$ (1,053) |
| December 31, 2010 | | | | | | |
| U.S. Treasury and Federal agencies securities | \$ 158,497 | \$ (849) | \$ | \$ | \$ 158,497 | \$ (849) |
| U.S. States and political subdivisions securities | 9,226 | (246) | 9,055 | (1,507) | 18,281 | (1,753) |
| Mortgage-backed securities - Federal agencies | 23,351 | (213) | 4,887 | (19) | 28,238 | (232) |
| Corporate debt securities | 26,407 | (345) | | | 26,407 | (345) |
| Foreign government and other securities | 3,015 | (34) | | | 3,015 | (34) |
| Total debt securities | 220,496 | (1,687) | 13,942 | (1,526) | 234,438 | (3,213) |
| Marketable equity securities | | | 5 | (3) | 5 | (3) |
| Total investment securities available-for-sale | \$ 220,496 | \$ (1,687) | \$ 13,947 | \$ (1,529) | \$ 234,443 | \$ (3,216) |

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, we consider 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 we will not have to sell any such

securities before a recovery of cost.

At September 30, 2011, we do not have the intent to sell any of the available-for-sale securities in the table above and believe that it is more likely than not that we will not have to sell any such securities before an anticipated recovery of cost. The unrealized losses 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. We do not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of September 30, 2011, we believe the impairments detailed in the table above are temporary and no

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impairment loss has been realized in our consolidated statements of income.

At September 30, 2011 and December 31, 2010, investment securities with carrying values of \$275.36 million and \$299.88 million, respectively, were pledged as collateral to secure government deposits, security repurchase agreements, and for other purposes.

Note 4. Loan and Lease Financings

We evaluate 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). We use 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 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 our 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 adequacy 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 our exposure to increased risk; grade 8 credits are special mention and, following regulatory guidelines, are defined as having potential weaknesses that deserve management's close attention. Credits that exhibit well-defined weaknesses and a distinct possibility of loss are considered classified and are graded 9 through 12 corresponding to the regulatory definitions of substandard (grades 9 and 10) and the more severe doubtful (grade 11) and loss (grade 12).

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

| (Dollars in thousands) | Credit Quality Grades | | |
|---|-----------------------|------------|--------------|
| | 1-6 | 7-12 | Total |
| September 30, 2011 | | | |
| Commercial and agricultural loans | \$ 511,070 | \$ 46,322 | \$ 557,392 |
| Auto, light truck and environmental equipment | 437,914 | 4,213 | 442,127 |
| Medium and heavy duty truck | 145,420 | 7,283 | 152,703 |
| Aircraft financing | 571,714 | 41,992 | 613,706 |
| Construction equipment financing | 236,950 | 23,291 | 260,241 |
| Commercial real estate | 501,843 | 54,444 | 556,287 |
| Total | \$ 2,404,911 | \$ 177,545 | \$ 2,582,456 |
| December 31, 2010 | | | |
| Commercial and agricultural loans | \$ 483,603 | \$ 46,625 | \$ 530,228 |
| Auto, light truck and environmental equipment | 389,774 | 6,726 | 396,500 |
| Medium and heavy duty truck | 143,431 | 19,393 | 162,824 |
| Aircraft financing | 555,106 | 59,251 | 614,357 |
| Construction equipment financing | 246,644 | 38,990 | 285,634 |
| Commercial real estate | 532,581 | 62,148 | 594,729 |
| Total | \$ 2,351,139 | \$ 233,133 | \$ 2,584,272 |

The table below presents the recorded investment in residential real estate and consumer loans by performing or non-performing status. Non-performing loans are those loans which are on nonaccrual status or are 90 days or more past due.

| (Dollars in thousands) | Performing | | Nonperforming | | Total |
|-------------------------|------------|---------|---------------|-------|------------|
| September 30, 2011 | | | | | |
| Residential real estate | \$ | 399,224 | \$ | 4,839 | \$ 404,063 |
| Consumer | | 96,312 | | 463 | 96,775 |
| Total | \$ | 495,536 | \$ | 5,302 | \$ 500,838 |
| December 31, 2010 | | | | | |
| Residential real estate | \$ | 385,729 | \$ | 5,222 | \$ 390,951 |
| Consumer | | 94,973 | | 427 | 95,400 |
| Total | \$ | 480,702 | \$ | 5,649 | \$ 486,351 |

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

| (Dollars in thousands) | Current | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due and Accruing | Total Accruing Loans | Nonaccrual | Total Financing Receivables |
|---|--------------|------------------------|------------------------|--|-------------------------|------------|--------------------------------|
| September 30, 2011 | | | | | | | |
| Commercial and agricultural loans | \$ 546,144 | \$ 366 | \$ | \$ | \$ 546,510 | \$ 10,882 | \$ 557,392 |
| Auto, light truck and environmental equipment | 439,360 | 439 | 246 | | 440,045 | 2,082 | 442,127 |
| Medium and heavy duty truck | 149,070 | 61 | | | 149,131 | 3,572 | 152,703 |
| Aircraft financing | 596,710 | 228 | 3,356 | | 600,294 | 13,412 | 613,706 |
| Construction equipment financing | 255,074 | 688 | 541 | | 256,303 | 3,938 | 260,241 |
| Commercial real estate | 530,110 | 279 | 2,913 | | 533,302 | 22,985 | 556,287 |
| Residential real estate | 396,369 | 2,289 | 566 | 517 | 399,741 | 4,322 | 404,063 |
| Consumer | 94,873 | 1,189 | 250 | 107 | 96,419 | 356 | 96,775 |
| Total | \$ 3,007,710 | \$ 5,539 | \$ 7,872 | \$ 624 | \$ 3,021,745 | \$ 61,549 | \$ 3,083,294 |
| December 31, 2010 | | | | | | | |
| Commercial and agricultural loans | \$ 521,363 | \$ 760 | \$ 22 | \$ | \$ 522,145 | \$ 8,083 | \$ 530,228 |
| Auto, light truck and environmental equipment | 391,925 | 528 | 715 | | 393,168 | 3,332 | 396,500 |
| Medium and heavy duty truck | 157,723 | 33 | | | 157,756 | 5,068 | 162,824 |
| Aircraft financing | 580,174 | 16,097 | 188 | | 596,459 | 17,898 | 614,357 |
| Construction equipment financing | 275,204 | 1,254 | 601 | | 277,059 | 8,575 | 285,634 |
| Commercial real estate | 567,254 | 759 | 94 | | 568,107 | 26,622 | 594,729 |
| Residential real estate | 381,368 | 3,781 | 580 | 264 | 385,993 | 4,958 | 390,951 |
| Consumer | 93,290 | 1,152 | 531 | 98 | 95,071 | 329 | 95,400 |
| Total | \$ 2,968,301 | \$ 24,364 | \$ 2,731 | \$ 362 | \$ 2,995,758 | \$ 74,865 | \$ 3,070,623 |

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 and interest when due according to the contractual terms of the loan or lease agreement. Loans or leases, for which the terms have been materially modified for borrowers experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. The table below presents impaired loans and leases, segregated by class, and the corresponding reserve for impaired loan and lease losses.

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| (Dollars in thousands) | Recorded Investment | Unpaid Principal Balance | Related Allowance |
|---|--------------------------------|---|------------------------------|
| September 30, 2011 | | | |
| With no related allowance recorded: | | | |
| Commercial and agricultural loans | \$ 2,201 | \$ 2,201 | \$ |
| Auto, light truck and environmental equipment | 1,002 | 1,002 | |
| Medium and heavy duty truck | 2,725 | 2,725 | |
| Aircraft financing | 1,412 | 1,412 | |
| Construction equipment financing | 3,780 | 3,780 | |
| Commercial real estate | 16,304 | 16,303 | |
| Residential real estate | | | |
| Consumer | 212 | 211 | |
| Total with no related allowance recorded | 27,636 | 27,634 | |
| With an allowance recorded: | | | |
| Commercial and agricultural loans | 8,290 | 8,290 | 1,488 |
| Auto, light truck and environmental equipment | 107 | 107 | 5 |
| Medium and heavy duty truck | 859 | 859 | 161 |
| Aircraft financing | 11,829 | 11,829 | 3,120 |
| Construction equipment financing | | | |
| Commercial real estate | 7,510 | 7,515 | 1,060 |
| Residential real estate | | | |
| Consumer | | | |
| Total with an allowance recorded | 28,595 | 28,600 | 5,834 |
| Total impaired loans | \$ 56,231 | \$ 56,234 | \$ 5,834 |
| December 31, 2010 | | | |
| With no related allowance recorded: | | | |
| Commercial and agricultural loans | \$ 4,930 | \$ 4,930 | \$ |
| Auto, light truck and environmental equipment | 1,596 | 1,597 | |
| Medium and heavy duty truck | 1,748 | 1,748 | |
| Aircraft financing | 4,509 | 4,509 | |
| Construction equipment financing | 5,534 | 5,535 | |
| Commercial real estate | 21,071 | 21,071 | |
| Residential real estate | | | |
| Consumer | | | |
| Total with no related allowance recorded | 39,388 | 39,390 | |
| With an allowance recorded: | | | |
| Commercial and agricultural loans | 8,282 | 8,281 | 4,190 |
| Auto, light truck and environmental equipment | 1,136 | 1,136 | 377 |
| Medium and heavy duty truck | 3,347 | 3,347 | 1,049 |
| Aircraft financing | 13,913 | 13,913 | 2,050 |
| Construction equipment financing | 3,374 | 3,379 | 648 |
| Commercial real estate | 8,625 | 8,630 | 893 |
| Residential real estate | | | |
| Consumer | | | |
| Total with an allowance recorded | 38,677 | 38,686 | 9,207 |
| Total impaired loans | \$ 78,065 | \$ 78,076 | \$ 9,207 |

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

| (Dollars in thousands) | Three Months Ended September 30, 2011 | | | Nine Months Ended September 30, 2011 | | |
|---|---------------------------------------|-----------------|-----------------|--------------------------------------|-----------------|-----------------|
| | Average Recorded Investment | Interest Income | Interest Income | Average Recorded Investment | Interest Income | Interest Income |
| Commercial and agricultural loans | \$ 10,437 | \$ 101 | \$ 244 | \$ 11,583 | \$ 331 | \$ 450 |
| Auto, light truck and environmental equipment | 1,378 | | 2 | 1,796 | 1 | 2 |
| Medium and heavy duty truck | 3,770 | 15 | 2 | 4,310 | 18 | 5 |
| Aircraft financing | 14,882 | | (29) | 16,076 | 15 | 74 |
| Construction equipment financing | 3,922 | 7 | 62 | 6,174 | 23 | 231 |
| Commercial real estate | 24,481 | 39 | 46 | 28,264 | 153 | 90 |
| Residential real estate | | | | | | |
| Consumer | 141 | 1 | | 47 | 1 | |
| Total | \$ 59,011 | \$ 163 | \$ 327 | \$ 68,250 | \$ 542 | \$ 852 |

Our loan and lease portfolio also includes certain loans and leases that have been modified in a troubled debt restructuring (TDR), where economic concessions have been granted to borrowers who have experienced financial difficulties. These concessions typically result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Certain TDRs are classified as nonperforming at the time of restructuring and typically are returned to performing status after considering the borrower's sustained repayment performance for a reasonable period of at least six months.

When we modify loans and leases in a TDR, we evaluate any possible impairment similar to other impaired loans based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan or lease agreement, or use the current fair value of the collateral, less selling costs for collateral dependent loans. If we determine that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance. In periods subsequent to modification, we evaluate all TDRs, including those that have payment defaults, for possible impairment and recognize impairment through the allowance.

Performing loans and leases classified as troubled debt restructuring during the three and nine months ended September 30, 2011, segregated by class, are shown in the table below. Nonperforming TDRs are shown as nonperforming assets.

| (Dollars in thousands) | Three Months Ended September 30, 2011 | | Nine Months Ended September 30, 2011 | |
|---|---------------------------------------|---------------------|--------------------------------------|---------------------|
| | Number of Modifications | Recorded Investment | Number of Modifications | Recorded Investment |
| Commercial and agricultural loans | 6 | \$ 356 | 7 | \$ 504 |
| Auto, light truck and environmental equipment | | | | |
| Medium and heavy duty truck | | | | |
| Aircraft financing | | | 1 | |
| Construction equipment financing | | | 1 | 224 |

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| | | | | | | |
|-------------------------|----|----|-----|----|----|-------|
| Commercial real estate | 3 | | 196 | 4 | | 262 |
| Residential real estate | | | | | | |
| Consumer | 2 | | 212 | 2 | | 212 |
| Total | 11 | \$ | 764 | 15 | \$ | 1,202 |

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Troubled debt restructured loans and leases which had payment defaults during the three and nine months ended September 30, 2011, segregated by class, are shown in the table below. Default occurs when a loan or lease is 90 days or more past due or transferred to nonaccrual and is within 12 months of restructuring.

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

As of December 31, 2010, we had \$7.31 million of performing loans and leases classified as troubled debt restructuring.

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 we update our historical charge-off analysis, we review the look-back periods for each business loan portfolio. Furthermore, we perform a thorough analysis of charge-offs, non-performing asset levels, special attention outstandings and delinquency 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. We adjust the calculated historical based ratio as a result of our analysis of environmental factors, principally economic risk and concentration risk. Key economic factors affecting our 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 our business banking and commercial real estate portfolios and by collateral concentration in our 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 adequate by management to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant

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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, we have segmented our loans and leases into classes based on the associated risks within these segments. We have determined that eight classes exist within our 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 (calculated by applying loss factors based upon a review of historical loss experience and qualitative factors) for each business lending division portfolio, and reserves for pooled homogeneous loans and leases. Management's evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

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Changes in the reserve for loan and lease losses, segregated by class, for the three months ended September 30, 2011 and 2010 are shown below.

| | Auto, light truck | | | Construction | | | Commercial Residential | | Consumer | Total |
|---|-----------------------------------|-----------------------------|-----------------------------|--------------------|---------------------|-------------|------------------------|------------|----------|-----------|
| (Dollars in thousands) | Commercial and agricultural loans | and environmental equipment | Medium and heavy duty truck | Aircraft financing | equipment financing | real estate | real estate | loans | | |
| September 30, 2011 | | | | | | | | | | |
| Reserve for loan and lease losses | | | | | | | | | | |
| Balance, beginning of period | \$ 16,814 | \$ 9,041 | \$ 4,584 | \$ 28,561 | \$ 6,802 | \$ 15,400 | \$ 2,657 | \$ 1,151 | \$ | 85,010 |
| Charge-offs | 152 | 10 | | 2,073 | | 72 | 37 | 341 | | 2,685 |
| Recoveries | 118 | 78 | 1 | 96 | 144 | 50 | 19 | 119 | | 625 |
| Net charge-offs (recoveries) | 34 | (68) | (1) | 1,977 | (144) | 22 | 18 | 222 | | 2,060 |
| Provision (recovery of provision) | (2,056) | (908) | (1,217) | 4,482 | (691) | 1,397 | 44 | 209 | | 1,260 |
| Balance, end of period | \$ 14,724 | \$ 8,201 | \$ 3,368 | \$ 31,066 | \$ 6,255 | \$ 16,775 | \$ 2,683 | \$ 1,138 | \$ | 84,210 |
| Ending balance: individually evaluated for impairment | \$ 1,488 | \$ 5 | \$ 161 | \$ 3,120 | \$ | \$ 1,060 | \$ | \$ | \$ | 5,834 |
| Ending balance: collectively evaluated for impairment | \$ 13,236 | \$ 8,196 | \$ 3,207 | \$ 27,946 | \$ 6,255 | \$ 15,715 | \$ 2,683 | \$ 1,138 | \$ | 78,376 |
| Financing receivables: | | | | | | | | | | |
| Ending balance | \$ 557,392 | \$ 442,127 | \$ 152,703 | \$ 613,706 | \$ 260,241 | \$ 556,287 | \$ 404,063 | \$ 96,775 | \$ | 3,083,294 |
| Ending balance: individually evaluated for impairment | \$ 10,491 | \$ 1,109 | \$ 3,584 | \$ 13,241 | \$ 3,780 | \$ 23,814 | \$ | \$ | \$ | 56,019 |
| Ending balance: collectively evaluated for impairment | \$ 546,901 | \$ 441,018 | \$ 149,119 | \$ 600,465 | \$ 256,461 | \$ 532,473 | \$ 404,063 | \$ 96,775 | \$ | 3,027,275 |
| September 30, 2010 | | | | | | | | | | |
| Reserve for loan and lease losses | | | | | | | | | | |
| Balance, beginning of period | \$ 19,680 | \$ 9,340 | \$ 7,683 | \$ 24,936 | \$ 9,178 | \$ 12,750 | \$ 984 | \$ 3,463 | \$ | 88,014 |
| Charge-offs | 694 | 103 | | 1,493 | | 2,572 | 19 | 470 | | 5,351 |
| Recoveries | 897 | 17 | 8 | 61 | 129 | 15 | 20 | 121 | | 1,268 |
| Net charge-offs (recoveries) | (203) | 86 | (8) | 1,432 | (129) | 2,557 | (1) | 349 | | 4,083 |
| Provision (recovery of provision) | 1,409 | 26 | (648) | 4,291 | (952) | 1,035 | (7) | 424 | | 5,578 |
| Balance, end of period | \$ 21,292 | \$ 9,280 | \$ 7,043 | \$ 27,795 | \$ 8,355 | \$ 11,228 | \$ 978 | \$ 3,538 | \$ | 89,509 |
| Ending balance: individually evaluated for impairment | \$ 4,313 | \$ 408 | \$ 1,393 | \$ 2,066 | \$ 999 | \$ 908 | \$ | \$ | \$ | 10,087 |
| Ending balance: collectively evaluated for impairment | \$ 16,979 | \$ 8,872 | \$ 5,650 | \$ 25,729 | \$ 7,356 | \$ 10,320 | \$ 978 | \$ 3,538 | \$ | 79,422 |
| Financing receivables: | | | | | | | | | | |
| Ending balance | \$ 535,874 | \$ 397,297 | \$ 174,459 | \$ 620,996 | \$ 304,035 | \$ 584,108 | \$ 395,334 | \$ 100,076 | \$ | 3,112,179 |
| Ending balance: individually evaluated for impairment | \$ 21,875 | \$ 3,149 | \$ 6,348 | \$ 14,623 | \$ 11,713 | \$ 29,371 | \$ | \$ | \$ | 87,079 |
| Ending balance: collectively evaluated for impairment | \$ 513,999 | \$ 394,148 | \$ 168,111 | \$ 606,373 | \$ 292,322 | \$ 554,737 | \$ 395,334 | \$ 100,076 | \$ | 3,025,100 |

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Changes in the reserve for loan and lease losses, segregated by class, for the nine months ended September 30, 2011 and 2010 are shown below.

| (Dollars in thousands) | Commercial and agricultural loans | | Auto, light truck and environmental equipment | Medium and heavy duty truck | Aircraft financing | Construction equipment financing | | Commercial real estate | Residential real estate | Consumer loans | Total | | | | | | | |
|---|-----------------------------------|---------|---|-----------------------------|--------------------|----------------------------------|----|------------------------|-------------------------|----------------|-------|---------|----|---------|----|--------|----|-----------|
| | | | | | | | | | | | | | | | | | | |
| September 30, 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 | | 1,109 | | 335 | | | | 3,701 | | 853 | | 2,537 | | 191 | | 1,193 | | 9,919 |
| Recoveries | | 1,734 | | 148 | | 2 | | 860 | | 242 | | 336 | | 53 | | 355 | | 3,730 |
| Net charge-offs (recoveries) | | (625) | | 187 | | (2) | | 2,841 | | 611 | | 2,201 | | 138 | | 838 | | 6,189 |
| Provision (recovery of provision) | | (6,445) | | 846 | | (2,402) | | 4,096 | | (1,573) | | 7,799 | | 303 | | 901 | | 3,525 |
| Balance, end of period | \$ | 14,724 | \$ | 8,201 | \$ | 3,368 | \$ | 31,066 | \$ | 6,255 | \$ | 16,775 | \$ | 2,683 | \$ | 1,138 | \$ | 84,210 |
| Ending balance: individually evaluated for impairment | \$ | 1,488 | \$ | 5 | \$ | 161 | \$ | 3,120 | \$ | | \$ | 1,060 | \$ | | \$ | | \$ | 5,834 |
| Ending balance: collectively evaluated for impairment | \$ | 13,236 | \$ | 8,196 | \$ | 3,207 | \$ | 27,946 | \$ | 6,255 | \$ | 15,715 | \$ | 2,683 | \$ | 1,138 | \$ | 78,376 |
| Financing receivables: | | | | | | | | | | | | | | | | | | |
| Ending balance | \$ | 557,392 | \$ | 442,127 | \$ | 152,703 | \$ | 613,706 | \$ | 260,241 | \$ | 556,287 | \$ | 404,063 | \$ | 96,775 | \$ | 3,083,294 |
| Ending balance: individually evaluated for impairment | \$ | 10,491 | \$ | 1,109 | \$ | 3,584 | \$ | 13,241 | \$ | 3,780 | \$ | 23,814 | \$ | | \$ | | \$ | 56,019 |
| Ending balance: collectively evaluated for impairment | \$ | 546,901 | \$ | 441,018 | \$ | 149,119 | \$ | 600,465 | \$ | 256,461 | \$ | 532,473 | \$ | 404,063 | \$ | 96,775 | \$ | 3,027,275 |
| September 30, 2010 | | | | | | | | | | | | | | | | | | |
| Reserve for loan and lease losses | | | | | | | | | | | | | | | | | | |
| Balance, beginning of period | \$ | 24,017 | \$ | 9,630 | \$ | 6,186 | \$ | 24,807 | \$ | 8,875 | \$ | 10,453 | \$ | 880 | \$ | 3,388 | \$ | 88,236 |
| Charge-offs | | 1,584 | | 907 | | 1,879 | | 4,268 | | 1,648 | | 5,112 | | 379 | | 1,279 | | 17,056 |
| Recoveries | | 1,461 | | 60 | | 47 | | 224 | | 273 | | 38 | | 44 | | 418 | | 2,565 |
| Net charge-offs (recoveries) | | 123 | | 847 | | 1,832 | | 4,044 | | 1,375 | | 5,074 | | 335 | | 861 | | 14,491 |
| Provision (recovery of provision) | | (2,602) | | 497 | | 2,689 | | 7,032 | | 855 | | 5,849 | | 433 | | 1,011 | | 15,764 |
| Balance, end of period | \$ | 21,292 | \$ | 9,280 | \$ | 7,043 | \$ | 27,795 | \$ | 8,355 | \$ | 11,228 | \$ | 978 | \$ | 3,538 | \$ | 89,509 |
| Ending balance: individually evaluated for impairment | \$ | 4,313 | \$ | 408 | \$ | 1,393 | \$ | 2,066 | \$ | 999 | \$ | 908 | \$ | | \$ | | \$ | 10,087 |
| | \$ | 16,979 | \$ | 8,872 | \$ | 5,650 | \$ | 25,729 | \$ | 7,356 | \$ | 10,320 | \$ | 978 | \$ | 3,538 | \$ | 79,422 |

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Ending balance:
collectively
evaluated for
impairment

Financing
receivables:

| | | | | | | | | | | | | | | | | | | |
|----------------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|-----------|
| Ending balance | \$ | 535,874 | \$ | 397,297 | \$ | 174,459 | \$ | 620,996 | \$ | 304,035 | \$ | 584,108 | \$ | 395,334 | \$ | 100,076 | \$ | 3,112,179 |
|----------------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|-----------|

Ending balance:
individually
evaluated for
impairment

| | | | | | | | | | | | | | | | | | | |
|--|----|--------|----|-------|----|-------|----|--------|----|--------|----|--------|----|--|----|--|----|--------|
| | \$ | 21,875 | \$ | 3,149 | \$ | 6,348 | \$ | 14,623 | \$ | 11,713 | \$ | 29,371 | \$ | | \$ | | \$ | 87,079 |
|--|----|--------|----|-------|----|-------|----|--------|----|--------|----|--------|----|--|----|--|----|--------|

Ending balance:
collectively
evaluated for
impairment

| | | | | | | | | | | | | | | | | | | |
|--|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|-----------|
| | \$ | 513,999 | \$ | 394,148 | \$ | 168,111 | \$ | 606,373 | \$ | 292,322 | \$ | 554,737 | \$ | 395,334 | \$ | 100,076 | \$ | 3,025,100 |
|--|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|-----------|

Note 6. Mortgage Servicing Assets

We recognize 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. We allocate 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 \$1.03 billion and \$1.08 billion at September 30, 2011 and December 31, 2010, respectively.

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Mortgage servicing assets are evaluated for impairment. For purposes of impairment measurement, mortgage servicing assets are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type 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 September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|----------|------------------------------------|----------|
| | 2011 | 2010 | 2011 | 2010 |
| Mortgage servicing assets: | | | | |
| Balance at beginning of period | \$ 6,419 | \$ 8,168 | \$ 7,556 | \$ 8,749 |
| Additions | 270 | 1,493 | 591 | 3,034 |
| Amortization | (667) | (816) | (2,125) | (2,277) |
| Sales | | (657) | | (1,318) |
| Carrying value before valuation allowance at end of period | 6,022 | 8,188 | 6,022 | 8,188 |
| Valuation allowance: | | | | |
| Balance at beginning of period | (16) | (971) | | (1) |
| Impairment (charges) recoveries | (214) | 149 | (230) | (821) |
| Balance at end of period | \$ (230) | \$ (822) | \$ (230) | \$ (822) |
| Net carrying value of mortgage servicing assets at end of period | \$ 5,792 | \$ 7,366 | \$ 5,792 | \$ 7,366 |
| Fair value of mortgage servicing assets at end of period | \$ 7,364 | \$ 7,646 | \$ 7,364 | \$ 7,646 |

During the nine months ended September 30, 2011 and 2010, management determined that it was not necessary to permanently write-down any previously established valuation allowance. At September 30, 2011 and 2010, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by \$1.57 million and \$0.28 million, respectively. This difference represents increases in the fair value of certain mortgage servicing assets that could not be recorded above cost basis.

The key economic assumptions used to estimate the fair value of the mortgage servicing rights follow:

| | September 30, | |
|---|---------------|--------|
| | 2011 | 2010 |
| Expected weighted-average life (in years) | 3.48 | 3.59 |
| Weighted-average constant prepayment rate (CPR) | 27.00% | 29.76% |
| Weighted-average discount rate | 8.85% | 8.41% |

Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$1.02 million and \$1.00 million for the three months ended September 30, 2011 and 2010, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$3.07 million and \$2.98 million for the nine months ended September 30, 2011 and 2010, 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

To meet the financing needs of our customers, 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

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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. Our 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. We use the same credit policies and collateral requirements in making commitments and conditional obligations as we do 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 commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

We issue letters of credit which are conditional commitments that guarantee the performance of a customer 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 customers. Standby letters of credit totaled \$13.97 million and \$17.84 million at September 30, 2011 and December 31, 2010, 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.

We have certain interest rate derivative positions that are not designated as hedging instruments. These derivative positions relate to transactions in which we enter 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, we agree 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, we agree 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 our client to effectively convert a variable rate loan to a fixed rate. Because the terms of the swaps with our 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 our results of operations.

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At September 30, 2011 and December 31, 2010, the amounts of non-hedging derivative financial instruments are shown in the chart below:

| (Dollars in thousands) | Asset derivatives | | | | Liability derivatives | |
|------------------------------|--------------------------------|---|------------|---|-----------------------|--|
| | Notional or contractual amount | Statement of Financial Condition location | Fair value | Statement of Financial Condition location | Fair value | |
| September 30, 2011 | | | | | | |
| Interest rate swap contracts | \$ 439,883 | Other assets | \$ 17,792 | Other liabilities | \$ 18,251 | |
| Loan commitments | 64,972 | Mortgages held for sale | 270 | N/A | | |
| Forward contracts | 30,000 | N/A | | Mortgages held for sale | 267 | |
| Total | \$ 534,855 | | \$ 18,062 | | \$ 18,518 | |
| December 31, 2010 | | | | | | |
| Interest rate swap contracts | \$ 446,224 | Other assets | \$ 14,959 | Other liabilities | \$ 15,384 | |
| Loan commitments | 28,666 | Mortgages held for sale | 30 | N/A | | |
| Forward contracts | 40,320 | Mortgages held for sale | 451 | N/A | | |
| Total | \$ 515,210 | | \$ 15,440 | | \$ 15,384 | |

For the three and nine months ended September 30, 2011 and 2010, 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 location | Gain (loss) | | | |
|------------------------------|------------------------------|----------------------------------|----------|---------------------------------|----------|
| | | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | | 2011 | 2010 | 2011 | 2010 |
| Interest rate swap contracts | Other expense | \$ 230 | \$ 110 | \$ 47 | \$ (68) |
| Interest rate swap contracts | Other income | 182 | 79 | 351 | 197 |
| Loan commitments | Mortgage banking income | 191 | 3 | 240 | 399 |
| Forward contracts | Mortgage banking income | (259) | 1,093 | (718) | (1,260) |
| Total | | \$ 344 | \$ 1,285 | \$ (80) | \$ (732) |

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 40,508 were considered antidilutive as of September 30, 2010. No stock options were considered antidilutive as of September 30, 2011. A stock warrant of 837,947 shares was considered antidilutive as of September 30, 2010. No stock warrants were outstanding as of September 30, 2011.

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The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the three and nine months ended September 30, 2011 and 2010.

| (Dollars in thousands - except per share amounts) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Distributed earnings allocated to common stock | \$ 3,874 | \$ 3,641 | \$ 11,650 | \$ 10,900 |
| Undistributed earnings allocated to common stock | 7,482 | 5,732 | 24,901 | 12,390 |
| Net earnings allocated to common stock | 11,356 | 9,373 | 36,551 | 23,290 |
| Net earnings allocated to participating securities | 184 | 109 | 462 | 238 |
| Net income allocated to common stock and participating securities | \$ 11,540 | \$ 9,482 | \$ 37,013 | \$ 23,528 |
| Weighted average shares outstanding for basic earnings per common share | 24,213,063 | 24,247,236 | 24,246,041 | 24,247,468 |
| Dilutive effect of stock compensation | 10,369 | 6,647 | 9,316 | 6,558 |
| Weighted average shares outstanding for diluted earnings per common share | 24,223,432 | 24,253,883 | 24,255,357 | 24,254,026 |
| Basic earnings per common share | \$ 0.47 | \$ 0.39 | \$ 1.51 | \$ 0.96 |
| Diluted earnings per common share | \$ 0.47 | \$ 0.39 | \$ 1.51 | \$ 0.96 |

Note 10. Stock-Based Compensation

As of September 30, 2011, we 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, 2010. 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 we had not made any grants through September 30, 2011.

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 we recognize 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 we use the related vesting term. We estimate forfeiture rates based on historical employee option exercise and employee termination experience. We have 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 nine months ended September 30, 2011 and 2010 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

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The aggregate intrinsic value in the table below represents the total pretax intrinsic value (the difference between 1st Source's closing stock price on the last trading day of the third quarter of 2011 (September 30, 2011) and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2011. This amount changes based on the fair market value of 1st Source's stock. Total fair value of options vested and expensed was \$4 thousand and \$9 thousand, net of tax, for the nine months ended September 30, 2011 and 2010,

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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 | 62,508 | \$ 17.18 | | |
| Granted | | | | |
| Exercised | | | | |
| Forfeited | (35,008) | 20.10 | | |
| Options outstanding at September 30, 2011 | 27,500 | \$ 13.46 | 1.26 | \$ 203 |
| Vested and expected to vest at September 30, 2011 | 27,500 | \$ 13.46 | 1.26 | \$ 203 |
| Exercisable at September 30, 2011 | 27,500 | \$ 13.46 | 1.26 | \$ 203 |

No options were granted during the nine months ended September 30, 2011.

The following table summarizes information about stock options outstanding at September 30, 2011:

| Options Outstanding | | | | Options Exercisable | | | |
|---------------------|------------------------------------|---|--|---------------------|------------------------------------|--|--|
| Exercise Price | Number of shares Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Exercise Price | Number of shares Exercisable | Weighted Average Exercise Price | Weighted Average Exercise Price |
| \$ 12.04 | 22,000 | 1.56 | \$ 12.04 | \$ 12.04 | 22,000 | \$ 12.04 | \$ 12.04 |
| 19.15 | 5,500 | 0.07 | 19.15 | 19.15 | 5,500 | 19.15 | 19.15 |

The fair value of each stock option was estimated on the date of grant using the Black-Scholes option-pricing model.

As of September 30, 2011, there was \$6.89 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 3.78 years.

Note 11. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$1.58 million at September 30, 2011 and \$1.52 million at December 31, 2010. Interest and penalties were recognized through the income tax provision. For the nine months ending September 30, 2011 and 2010, we recognized approximately \$(0.04) million and \$0.03 million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately \$0.56 million and \$0.60 million were accrued at September 30, 2011 and December 31, 2010, respectively.

Tax years that remain open and subject to audit include the federal 2008-2010 years and the Indiana 2007-2010 years. 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. We do not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

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Note 12. Fair Value Measurements

We record 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. We use 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.

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.

We elected fair value accounting for mortgages held for sale. We believe 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 September 30, 2011 and December 31, 2010, all mortgages held for sale are carried at fair value.

The following table reflects the differences between fair value carrying amount of mortgages held for sale measured at fair value and the aggregate unpaid principal amount we are contractually entitled to receive at maturity on September 30, 2011 and December 31, 2010:

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| (Dollars in thousands) | Fair value carrying amount | Aggregate unpaid principal | Excess of fair value carrying amount over (under) unpaid principal |
|--|----------------------------|----------------------------|--|
| September 30, 2011 | | | |
| Mortgages held for sale reported at fair value | \$ 13,219 | \$ 12,781 | \$ 438(1) |
| December 31, 2010 | | | |
| Mortgages held for sale reported at fair value | \$ 32,599 | \$ 32,285 | \$ 314(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 and both the market and income valuation approaches are implemented using the following types of inputs:

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

yield curve.

- Marketable equity (common) securities are primarily priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

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

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process considers various factors including interest rate yield curves, time value and volatility factors. 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 credit losses as well as velocity of deterioration evident with systemic risks imbedded in these portfolios.

The table below presents the balance of assets and liabilities at September 30, 2011 and December 31, 2010 measured at fair value on a recurring basis:

| (Dollars in thousands) | Level 1 | Level 2 | Level 3 | Total |
|--|-----------|------------|-----------|--------------|
| September 30, 2011 | | | | |
| <u>Assets:</u> | | | | |
| Investment securities available-for-sale: | | | | |
| U.S. Treasury and Federal agencies securities | \$ 20,073 | \$ 346,433 | \$ | \$ 366,506 |
| U.S. States and political subdivisions securities | | 98,858 | 11,153 | 110,011 |
| Mortgage-backed securities Federal agencies | | 326,920 | | 326,920 |
| Corporate debt securities | | 36,661 | | 36,661 |
| Foreign government and other securities | | 5,055 | 675 | 5,730 |
| Total debt securities | 20,073 | 813,927 | 11,828 | 845,828 |
| Marketable equity securities | 4,679 | | | 4,679 |
| Total investment securities available-for-sale | 24,752 | 813,927 | 11,828 | 850,507 |
| Trading account securities | 119 | | | 119 |
| Mortgages held for sale | | 13,219 | | 13,219 |
| Accrued income and other assets (Interest rate swap agreements) | | 17,792 | | 17,792 |
| Total | \$ 24,871 | \$ 844,938 | \$ 11,828 | \$ 881,637 |
| <u>Liabilities:</u> | | | | |
| Accrued expenses and other liabilities (Interest rate swap agreements) | \$ | \$ 18,251 | \$ | \$ 18,251 |
| Total | \$ | \$ 18,251 | \$ | \$ 18,251 |
| December 31, 2010 | | | | |
| <u>Assets:</u> | | | | |
| Investment securities available-for-sale: | | | | |
| U.S. Treasury and Federal agencies securities | \$ 20,186 | \$ 427,123 | \$ | \$ 447,309 |
| U.S. States and political subdivisions securities | | 134,001 | 16,306 | 150,307 |
| Mortgage-backed securities Federal agencies | | 316,668 | | 316,668 |
| Corporate debt securities | | 35,623 | 9,992 | 45,615 |
| Foreign government and other securities | | 5,041 | 675 | 5,716 |
| Total debt securities | 20,186 | 918,456 | 26,973 | 965,615 |
| Marketable equity securities | 3,403 | | | 3,403 |
| Total investment securities available-for-sale | 23,589 | 918,456 | 26,973 | 969,018 |
| Trading account securities | 138 | | | 138 |
| Mortgages held for sale | | 32,599 | | 32,599 |
| Accrued income and other assets (Interest rate swap agreements) | | 14,959 | | 14,959 |
| Total | \$ 23,727 | \$ 966,014 | \$ 26,973 | \$ 1,016,714 |
| <u>Liabilities:</u> | | | | |
| Accrued expenses and other liabilities (Interest rate swap agreements) | \$ | \$ 15,384 | \$ | \$ 15,384 |
| Total | \$ | \$ 15,384 | \$ | \$ 15,384 |

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The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended September 30, 2011 and 2010 are summarized as follows:

| (Dollars in thousands) | U.S. States and political subdivisions securities | Marketable equity securities | Foreign government and other securities | Investment securities available- for-sale |
|--|--|------------------------------------|--|--|
| Beginning balance July 1, 2011 | \$ 12,455 | \$ | \$ 675 | \$ 13,130 |
| Total gains or losses (realized/unrealized): | | | | |
| Included in earnings | | | | |
| Included in other comprehensive income | 94 | | | 94 |
| Purchases | 350 | | | 350 |
| Issuances | | | | |
| Settlements | | | | |
| Maturities | (1,746) | | | (1,746) |
| Transfers into Level 3 | | | | |
| Transfers out of Level 3 | | | | |
| Ending balance September 30, 2011 | \$ 11,153 | \$ | \$ 675 | \$ 11,828 |
| Beginning balance July 1, 2010 | \$ 9,324 | \$ 9 | \$ 675 | \$ 10,008 |
| Total gains or losses (realized/unrealized): | | | | |
| Included in earnings | | | | |
| Included in other comprehensive income | 73 | | | 73 |
| Purchases | | | 100 | 100 |
| Issuances | | | | |
| Settlements | | | | |
| Maturities | (642) | | (100) | (742) |
| Transfers into Level 3 | 10,865 | | | 10,865 |
| Transfers out of Level 3 | | | | |
| Ending balance September 30, 2010 | \$ 19,620 | \$ 9 | \$ 675 | \$ 20,304 |

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at September 30, 2011 or 2010. No transfers between levels occurred during the nine months ended September 30, 2011.

Financial Instruments on Non-recurring Basis:

We may be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring 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.

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.

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Partnership investments and the adjustments to fair value primarily result from application of lower of cost or fair value accounting. The partnership investments are priced using financial statements provided by the partnerships.

Mortgage servicing rights (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,

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servicing costs, and other economic factors. A fair value analysis is also obtained from an independent third party agent. 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 our 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. New appraisals are obtained annually. Repossessions are similarly valued.

For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended September 30, 2011: impaired loans - \$0.00 million; partnership investments \$(0.06) million; mortgage servicing rights - \$0.21 million; repossessions - \$0.27 million, and other real estate - \$0.09 million.

The table below presents the carrying value of assets at September 30, 2011 and December 31, 2010 measured at fair value on a non-recurring basis:

| (Dollars in thousands) | Level 1 | Level 2 | Level 3 | Total |
|---|----------------|----------------|----------------|--------------|
| September 30, 2011 | | | | |
| Loans | \$ | \$ | \$ 56,234 | \$ 56,234 |
| Accrued income and other assets (partnership investments) | | | 1,847 | 1,847 |
| Accrued income and other assets (mortgage servicing rights) | | | 5,792 | 5,792 |
| Accrued income and other assets (repossessions) | | | 4,918 | 4,918 |
| Accrued income and other assets (other real estate) | | | 9,546 | 9,546 |
| | \$ | \$ | \$ 78,337 | \$ 78,337 |
| December 31, 2010 | | | | |
| Loans | \$ | \$ | \$ 78,076 | \$ 78,076 |
| Accrued income and other assets (partnership investments) | | | 1,964 | 1,964 |
| Accrued income and other assets (mortgage servicing rights) | | | 7,556 | 7,556 |
| Accrued income and other assets (repossessions) | | | 5,670 | 5,670 |
| Accrued income and other assets (other real estate) | | | 7,592 | 7,592 |
| | \$ | \$ | \$ 100,858 | \$ 100,858 |

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

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The fair values of our financial instruments as of September 30, 2011 and December 31, 2010 are summarized in the table below.

| (Dollars in thousands) | September 30, 2011 | | December 31, 2010 | |
|---|-------------------------------|--------------|-------------------------------|--------------|
| | Carrying or Contract Value | Fair Value | Carrying or Contract Value | Fair Value |
| Assets: | | | | |
| Cash and due from banks | \$ 57,986 | \$ 57,986 | \$ 62,313 | \$ 62,313 |
| Federal funds sold and interest bearing deposits with other banks | 25,064 | 25,064 | 34,559 | 34,559 |
| Investment securities, available-for-sale | 850,507 | 850,507 | 969,018 | 969,018 |
| Other investments and trading account securities | 19,092 | 19,092 | 21,481 | 21,481 |
| Mortgages held for sale | 13,219 | 13,219 | 32,599 | 32,599 |
| Loans and leases, net of reserve for loan and lease losses | 2,999,084 | 3,114,118 | 2,983,749 | 3,040,895 |
| Cash surrender value of life insurance policies | 54,222 | 54,222 | 54,182 | 54,182 |
| Mortgage servicing rights | 5,792 | 7,364 | 7,556 | 8,785 |
| Interest rate swaps | 17,792 | 17,792 | 14,959 | 14,959 |
| Liabilities: | | | | |
| Deposits | \$ 3,447,585 | \$ 3,476,014 | \$ 3,622,745 | \$ 3,654,067 |
| Short-term borrowings | 140,938 | 140,938 | 155,989 | 155,989 |
| Long-term debt and mandatorily redeemable securities | 37,064 | 37,556 | 24,816 | 25,072 |
| Subordinated notes | 89,692 | 82,864 | 89,692 | 79,811 |
| Interest rate swaps | 18,251 | 18,251 | 15,384 | 15,384 |
| Off-balance-sheet instruments * | | 128 | | 134 |

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

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, 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.

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Short-Term Borrowings The carrying values of Federal funds purchased, securities sold under repurchase agreements, and other short-term borrowings, including our 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 our current estimated incremental borrowing rates for similar types of borrowing arrangements. The carrying values of mandatorily redeemable securities are based on our current estimated cost of redeeming these securities which approximate their fair values.

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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 of our 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 our 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 our 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 we 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 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 management 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.

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**

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

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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 2010,

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which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

The following management's discussion and analysis is presented to provide information concerning our financial condition as of September 30, 2011, as compared to December 31, 2010, and the results of operations for the three and nine months ended September 30, 2011 and 2010. 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 2010 Annual Report.

FINANCIAL CONDITION

Our total assets at September 30, 2011 were \$4.31 billion, a decrease of \$139.34 million or 3.13% from December 31, 2010. Total loans and leases were \$3.08 billion, an increase of \$12.67 million or 0.41% from December 31, 2010. Fed funds sold and interest bearing deposits with other banks were \$25.06 million, a decrease of \$9.50 million or 27.47% from December 31, 2010. Net premises and equipment increased \$7.08 million or 20.89% from \$33.88 million as of December 31, 2010 to \$40.96 million as of September 30, 2011. Total investment securities, available for sale were \$850.51 million which represented a decrease of \$118.51 million or 12.23% and total deposits were \$3.45 billion, a decrease of \$175.16 million or 4.84% over the comparable figures at the end of 2010.

Nonperforming assets at September 30, 2011 were \$77.03 million, which was a decrease of \$11.68 million or 13.17% from the \$88.71 million reported at December 31, 2010. At September 30, 2011 and December 31, 2010, nonperforming assets were 2.43% and 2.81 %, respectively of net loans and leases.

Accrued income and other assets were as follows:

| (Dollars in thousands) | September 30, 2011 | December 31, 2010 |
|--|-------------------------------|------------------------------|
| Accrued income and other assets: | | |
| Bank owned life insurance cash surrender value | \$ 54,222 | \$ 54,182 |
| Accrued interest receivable | 13,216 | 14,218 |
| Mortgage servicing assets | 5,792 | 7,556 |
| Other real estate | 8,032 | 6,392 |
| Former bank premises held for sale | 1,514 | 1,200 |
| Repossessions | 4,918 | 5,670 |
| All other assets | 49,240 | 51,370 |
| Total accrued income and other assets | \$ 136,934 | \$ 140,588 |

CAPITAL

As of September 30, 2011, total shareholders' equity was \$516.88 million, up \$30.50 million or 6.27% from the \$486.38 million at December 31, 2010. In addition to net income of \$37.01 million, other significant changes in shareholders' equity during the first nine months of 2011 included

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\$11.72 million of dividends paid and \$3.75 million of a common stock warrant repurchased. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$18.75 million at September 30, 2011, compared to \$10.51 million at December 31, 2010. The increase in accumulated other comprehensive income/(loss) during 2011 was primarily a result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 12.00% as of September 30, 2011, compared to 10.94% at December 31, 2010. Book value per common share rose to \$21.35 at September 30, 2011, from \$20.12 at December 31, 2010.

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We declared and paid dividends per common share of \$0.16 during the third quarter of 2011. The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 36.36%. The dividend payout is continually reviewed by management and the Board of Directors subject to the Corporation's capital and dividend policy.

The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations. The actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of September 30, 2011, are presented in the table below:

| (Dollars in thousands) | Actual | | Minimum Capital Adequacy | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|------------|--------|--------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to Risk-Weighted Assets): | | | | | | |
| 1st Source Corporation | \$ 540,223 | 16.26% | \$ 265,804 | 8.00% | \$ 332,255 | 10.00% |
| 1st Source Bank | 531,713 | 16.05 | 264,966 | 8.00 | 331,207 | 10.00 |
| Tier 1 Capital (to Risk-Weighted Assets): | | | | | | |
| 1st Source Corporation | 497,091 | 14.96 | 132,902 | 4.00 | 199,353 | 6.00 |
| 1st Source Bank | 489,495 | 14.78 | 132,483 | 4.00 | 198,724 | 6.00 |
| Tier 1 Capital (to Average Assets): | | | | | | |
| 1st Source Corporation | 497,091 | 11.76 | 169,084 | 4.00 | 211,356 | 5.00 |
| 1st Source Bank | 489,495 | 11.61 | 168,626 | 4.00 | 210,783 | 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 September 30, 2011 there were no amounts outstanding, we could borrow approximately \$255.00 million for a short time from these banks on a collective basis. As of September 30, 2011, the Bank had \$25.93 million outstanding in FHLB advances and could borrow an additional \$169.70 million. We also had \$360.30 million available to borrow from the FRB with no amounts outstanding as of September 30, 2011.

Our loan to asset ratio was 71.61% at September 30, 2011 compared to 69.08% at December 31, 2010 and 68.67% at September 30, 2010. Cash and cash equivalents totaled \$83.05 million at September 30, 2011 compared to \$96.87 million at December 31, 2010 and \$138.44 million at September 30, 2010. At September 30, 2011, the consolidated statement of financial condition was rate sensitive by \$49.93 million more assets than liabilities scheduled to reprice within one year, or approximately 1.02%. 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. We have been informed that no collateral is necessary through December 31, 2011 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 \$473 million.

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RESULTS OF OPERATIONS

Net income for the three and nine month periods ended September 30, 2011 was \$11.54 million and \$37.01 million, compared to \$11.20 million and \$28.68 million for the same periods in 2010. Diluted net income per common share was \$0.47 and \$1.51 respectively, for the three and nine month periods ended September 30, 2011, compared to \$0.39 and \$0.96 for the same periods in 2010. Return on average common shareholders equity was 9.86% for the nine months ended September 30, 2011, compared to 6.52% in 2010. The return on total average assets was 1.13% for the nine months ended September 30, 2011, compared to 0.85% in 2010.

The increase in net income for the nine months ended September 30, 2011, over the first nine months of 2010, was primarily the result of decreases in provision for loan and lease losses and noninterest expense and an increase in net interest income. This positive impact to net income was partially offset by a decrease in noninterest income. Details of the changes in the various components of net income are discussed further below.

NET INTEREST INCOME

The taxable equivalent net interest income for the three months ended September 30, 2011 was \$37.22 million, a decrease of 2.11% over the same period in 2010. The net interest margin on a fully taxable equivalent basis was 3.66% for the three months ended September 30, 2011, compared to 3.61% for the three months ended September 30, 2010. The taxable equivalent net interest income for the nine months ended September 30, 2011 was \$113.01 million, an increase of 1.90% over 2010, resulting in a net yield of 3.70%, compared to a net yield of 3.56% for the same period in 2010.

During the three and nine month periods ended September 30, 2011, average earning assets decreased \$148.61 million or 3.55% and \$81.46 million or 1.95% respectively, over the comparable periods in 2010. Average interest-bearing liabilities decreased \$145.98 million or 4.35% and \$85.13 million or 2.52% respectively, for the three and nine month periods ended September 30, 2011 over the comparable periods one year ago. The yield on average earning assets decreased 21 basis points to 4.64% for the third quarter of 2011 from 4.85% for the third quarter of 2010. The yield on average earning assets for the nine month period ended September 30, 2011 decreased 19 basis points to 4.70% from 4.89% for the nine month period ended September 30, 2010. 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 31 basis points to 1.23% for the third quarter 2011 from 1.54% for the third quarter 2010. Total cost of average interest-bearing liabilities decreased 39 basis points to 1.24% for the nine months ended September 30, 2011, from 1.63% for the nine months ended September 30, 2010. The result to the net interest margin, or the difference between interest income on earning assets and interest expense on interest-bearing liabilities, was an increase of 5 basis points and 14 basis points respectively, for the three and nine month periods ended September 30, 2011 from September 30, 2010.

The largest contributor to the decrease in the yield on average earning assets for the nine months ended September 30, 2011, compared to the nine months ended September 30, 2010, was a reduction in yields on taxable investment securities of 49 basis points. Total average investment securities decreased \$21.99 million or 2.45% for the third quarter and increased \$11.85 million or 1.31% for the nine month period over one year ago. Average mortgages held for sale decreased \$67.59 million or 89.02% and \$34.00 million or 76.97% respectively, for the three and nine month periods ended September 30, 2011, over the comparable periods a year ago due to the elimination of our wholesale broker activity. Average net loans and leases decreased \$33.28 million or 1.06% for the third quarter of 2011 from the third quarter of 2010 and \$33.18 million or 1.06% for the nine months ended September 30, 2011 compared to the same period in 2010. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances,

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Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, decreased \$25.75 million or 31.71% and \$26.13 million or 24.97% respectively, for the three and nine month periods ended September 30, 2011, over the comparable periods a year ago.

Average interest-bearing deposits decreased \$142.47 million or 4.63% and \$80.19 million or 2.58% respectively, for the third quarter of 2011 and first nine months of 2011 over the same periods in 2010. The effective rate paid on average interest-bearing deposits decreased 34 basis points to 1.05% for the third quarter 2011 compared to 1.39% for the third quarter 2010. The effective rate paid on average interest-bearing deposits decreased 42 basis points to 1.07% for the first nine months of 2011 compared to 1.49% for the first nine months of 2010. The decline in the average cost of interest-bearing deposits during the third quarter and first nine months of 2011 as compared to the third quarter and first nine months of 2010 was primarily the result of interest rate re-pricing on maturing certificates of deposit.

Average short-term borrowings decreased \$7.25 million or 4.51% and \$9.83 million or 6.21% respectively, for the third quarter of 2011 and the first nine months of 2011, compared to the same periods in 2010. The decrease in average short-term borrowings was primarily due to lower repurchase agreements and lower secured borrowings. Interest paid on short-term borrowings decreased 34 basis points for the third quarter of 2011 and 30 basis points for the first nine months of 2011 due to the interest rate decrease on adjustable rate borrowings. Average long-term debt increased \$3.74 million or 11.30% during the third quarter of 2011 as compared to the third quarter of 2010 and increased \$4.89 million or 18.22% during the first nine months of 2011 as compared to the first nine months of 2010. The increase in long-term borrowings was the result of higher borrowings with the Federal Home Loan Bank offset by lower borrowings on a line of credit. Interest paid on long-term borrowings increased 37 basis points for the third quarter due to higher effective rates on mandatorily redeemable securities and decreased 38 basis points for the first nine months of 2011 due to lower effective rates on new Federal Home Loan Bank borrowings.

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.

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DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS EQUITY

INTEREST RATES AND INTEREST DIFFERENTIAL

(Dollars in thousands)

| | Three months ended September 30, 2011 | | | 2010 | | | Nine months ended September 30, 2011 | | | 2010 | | |
|--|--|--------------------------------|----------------|--------------------|--------------------------------|----------------|---|--------------------------------|----------------|--------------------|--------------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate |
| ASSETS: | | | | | | | | | | | | |
| Investment securities: | | | | | | | | | | | | |
| Taxable | \$ 762,807 | \$ 4,694 | 2.44% | \$ 728,684 | \$ 4,931 | 2.68% | \$ 790,029 | \$ 14,088 | 2.38% | \$ 728,427 | \$ 15,611 | 2.87% |
| Tax exempt | 110,946 | 1,375 | 4.92% | 167,059 | 2,018 | 4.79% | 123,667 | 4,610 | 4.98% | 173,417 | 6,258 | 4.82% |
| Mortgages - held for sale | 8,341 | 96 | 4.57% | 75,934 | 886 | 4.63% | 10,174 | 335 | 4.40% | 44,175 | 1,610 | 4.87% |
| Net loans and leases | 3,096,168 | 40,794 | 5.23% | 3,129,445 | 43,022 | 5.45% | 3,083,747 | 123,873 | 5.37% | 3,116,927 | 128,055 | 5.49% |
| Other investments | 55,461 | 217 | 1.55% | 81,210 | 219 | 1.07% | 78,527 | 707 | 1.20% | 104,659 | 743 | 0.95% |
| Total Earning Assets | 4,033,723 | 47,176 | 4.64% | 4,182,332 | 51,076 | 4.85% | 4,086,144 | 143,613 | 4.70% | 4,167,605 | 152,277 | 4.89% |
| Cash and due from banks | 58,759 | | | 62,339 | | | 58,792 | | | 60,392 | | |
| Reserve for loan and lease losses | (85,635) | | | (89,572) | | | (87,154) | | | (89,248) | | |
| Other assets | 335,559 | | | 363,294 | | | 338,468 | | | 368,509 | | |
| Total | \$ 4,342,406 | | | \$ 4,518,393 | | | \$ 4,396,250 | | | \$ 4,507,258 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY: | | | | | | | | | | | | |
| Interest-bearing deposits | \$ 2,932,021 | \$ 7,756 | 1.05% | \$ 3,074,493 | \$ 10,790 | 1.39% | \$ 3,029,337 | \$ 24,273 | 1.07% | \$ 3,109,528 | \$ 34,768 | 1.49% |
| Short-term borrowings | 153,344 | 77 | 0.20% | 160,594 | 219 | 0.54% | 148,557 | 240 | 0.22% | 158,385 | 613 | 0.52% |
| Subordinated notes | 89,692 | 1,647 | 7.29% | 89,692 | 1,648 | 7.29% | 89,692 | 4,942 | 7.37% | 89,692 | 4,942 | 7.37% |
| Long-term debt and mandatorily redeemable securities | 36,882 | 480 | 5.16% | 33,138 | 400 | 4.79% | 31,762 | 1,144 | 4.82% | 26,868 | 1,045 | 5.20% |
| Total Interest-Bearing Liabilities | 3,211,939 | 9,960 | 1.23% | 3,357,917 | 13,057 | 1.54% | 3,299,348 | 30,599 | 1.24% | 3,384,473 | 41,368 | 1.63% |
| Noninterest-bearing deposits | 545,427 | | | 493,935 | | | 528,546 | | | 468,912 | | |
| Other liabilities | 71,484 | | | 68,813 | | | 66,582 | | | 66,078 | | |
| Shareholders equity | 513,556 | | | 597,728 | | | 501,774 | | | 587,795 | | |
| Total | \$ 4,342,406 | | | \$ 4,518,393 | | | \$ 4,396,250 | | | \$ 4,507,258 | | |

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| | | | | |
|---|-----------|-----------|------------|------------|
| Net Interest Income | \$ 37,216 | \$ 38,019 | \$ 113,014 | \$ 110,909 |
| Net Yield on Earning Assets on a Taxable Equivalent Basis | 3.66% | 3.61% | 3.70% | 3.56% |

PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES

The provision for loan and lease losses for the three and nine month periods ended September 30, 2011 was \$1.26 million and \$3.53 million respectively, compared to a provision for loan and lease losses in the three and nine month periods ended September 30, 2010 of \$5.58 million and \$15.76 million respectively. Net charge-offs of \$2.06 million were recorded for the third quarter 2011, compared to \$4.08 million for the same quarter a year ago. Year-to-date net charge-offs of \$6.19 million have been recorded in 2011, compared to \$14.49 million through September 30, 2010.

On September 30, 2011, 30 day and over loan and lease delinquencies were 0.45% as compared to 0.86% on September 30, 2010. 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 2.73% as compared to 2.88% one year ago. A summary of loan and lease loss experience during the three and nine months ended September 30, 2011 and 2010 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 September 30, 2011 and December 31, 2010 is reflected in Note 4 of the Consolidated Financial Statements.

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Nonperforming assets were as follows:

| (Dollars in thousands) | September 30, 2011 | December 31, 2010 | September 30, 2010 |
|---|-------------------------------|------------------------------|-------------------------------|
| Loans and leases past due 90 days or more | \$ 624 | \$ 361 | \$ 1,104 |
| Nonaccrual loans and leases | 61,549 | 74,853 | 79,094 |
| Other real estate | 8,032 | 6,392 | 7,010 |
| Former bank premises held for sale | 1,514 | 1,200 | 2,190 |
| Repossessions | 4,918 | 5,670 | 9,665 |
| Equipment owned under operating leases | 389 | 236 | 311 |
| Total nonperforming assets | \$ 77,026 | \$ 88,712 | \$ 99,374 |

Nonperforming assets as a percentage of total loans and leases were 2.43% at September 30, 2011, 2.81% at December 31, 2010, and 3.09% at September 30, 2010. Nonperforming assets totaled \$77.03 million at September 30, 2011, a decrease of 13.17% from the \$88.71 million reported at December 31, 2010, and a 22.49% decrease from the \$99.37 million reported at September 30, 2010. The decrease during the first nine months of 2011 compared to the same period in 2010 was primarily related to decreases in nonaccrual loans and leases and repossessions as the economy slowly improves.

The decrease in nonaccrual loans and leases at September 30, 2011 from September 30, 2010 was spread among the various loan portfolios except for a slight increase in commercial loans. The largest dollar decreases at September 30, 2011 from December 31, 2010 occurred in the construction equipment, aircraft and commercial real estate portfolios and was offset by an increase in commercial loans. A summary of nonaccrual loans and leases and past due aging for the period ended September 30, 2011 and December 31, 2010 is located in Note 4 of the Consolidated Financial Statements.

As of September 30, 2011, 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 \$13.83 million which were comprised of \$12.29 million secured by commercial real estate and included in loans secured by real estate and \$1.54 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, whether local real estate developers in our commercial portfolio or customers in our niche portfolios such as aircraft whose underlying business is dependent on developing, marketing and managing real estate properties, have suffered as a result of declining real estate values and minimal sales activity. Furthermore, aircraft values declined during 2011 and 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 September 30, 2011. At the time of repossession, the recorded amount of the loan or lease is written down, if necessary, to the estimated value of the equipment or vehicle by a charge to the reserve for loan and lease losses, unless the equipment is in the process of immediate sale. Any subsequent write-downs are included in noninterest expense.

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

| (Dollars in thousands) | September 30, 2011 | | December 31, 2010 | | September 30, 2010 | |
|---|-----------------------|--------|----------------------|--------|-----------------------|--------|
| Commercial and agricultural loans | \$ | 42 | \$ | 24 | \$ | 22 |
| Auto, light truck and environmental equipment | | 151 | | 475 | | 317 |
| Medium and heavy duty truck | | | | 170 | | 308 |
| Aircraft financing | | 4,593 | | 4,795 | | 7,127 |
| Construction equipment financing | | 114 | | 201 | | 1,879 |
| Commercial real estate | | 7,193 | | 5,308 | | 5,694 |
| Residential real estate | | 839 | | 1,084 | | 1,316 |
| Consumer loans | | 18 | | 5 | | 12 |
| Total | \$ | 12,950 | \$ | 12,062 | \$ | 16,675 |

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 \$211.75 million and \$201.03 million as of September 30, 2011 and December 31, 2010, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were \$147.91 million and \$38.02 million as of September 30, 2011, respectively, compared to \$134.34 million and \$34.03 million as of December 31, 2010, respectively. Outstanding balances to borrowers in other countries were insignificant.

NONINTEREST INCOME

Noninterest income for the three month period ended September 30, 2011 and 2010 was \$20.23 million and \$22.75 million, respectively. Noninterest income for the nine month period ended September 30, 2011 and 2010 was \$60.61 million and \$64.28 million, respectively. Details of noninterest income follow:

| (Dollars in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Noninterest income: | | | | |
| Trust fees | \$ 3,902 | \$ 3,870 | \$ 12,305 | \$ 11,677 |
| Service charges on deposit accounts | 4,748 | 4,918 | 13,622 | 14,813 |
| Mortgage banking income | 1,056 | 2,549 | 2,335 | 3,751 |
| Insurance commissions | 1,212 | 1,180 | 3,416 | 3,706 |
| Equipment rental income | 5,814 | 6,495 | 17,861 | 19,912 |
| Other income | 3,084 | 2,656 | 9,382 | 8,357 |
| Investment securities and other investment gains | 414 | 1,083 | 1,686 | 2,059 |
| Total noninterest income | \$ 20,230 | \$ 22,751 | \$ 60,607 | \$ 64,275 |

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Noninterest income decreased \$2.52 million or 11.08% for the third quarter and \$3.67 million or 5.71% for year-to-date 2011 as compared to the same periods in 2010.

Trust fees were flat for the three months ended September 30, 2011 and increased \$0.63 million or 5.38% for the nine month periods ended September 30, 2011 over the three and nine month periods ended September 30, 2010. The increase in trust fees was a result of an increase in market values of investment accounts.

Service charges on deposit accounts decreased \$0.17 million or 3.44% and \$1.19 million or 8.04% for the three and nine months ended September 30, 2011, respectively over the comparable periods one year ago. The decline in service charges on deposit accounts reflects a lower volume of nonsufficient fund transactions.

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Mortgage banking income decreased \$1.49 million or 58.57% in the third quarter of 2011 as compared to the third quarter of 2010 and \$1.42 million or 37.75% for the nine months ended September 30, 2011 compared to the same period in 2010. This negative variance was caused by reduced gains on loan sales due to lower production volumes in 2011 as a result of the elimination of broker business in late 2010.

Insurance commissions were relatively flat in the three months ended September 30, 2011 and decreased \$0.29 million or 7.83% in the nine months ended September 30, 2011 over the same periods a year ago. The decrease was due to reduced contingent commissions, primarily as a result of a high level of claims activity in our books of business. We also experienced a loss of commercial business premiums in the Fort Wayne market due to declines in business relationships.

Equipment rental income declined \$0.68 million or 10.49% in the third quarter of 2011 compared to the third quarter 2010. Equipment rental income declined \$2.05 million or 10.30% for year-to-date 2011 compared to the same period in 2010. The average equipment rental portfolio decreased 5.74% in 2011 over the same period in 2010 resulting in lower rental income. In addition, new leases are at lower rates due to current market conditions including lower rates and increased competition.

Other income increased \$0.43 million or 16.11% and \$1.03 million or 12.27% for the three and nine month periods ended September 30, 2011, respectively as compared to the same periods in 2010, mainly due to higher earnout fees on the sale of assets of 1st Source Investment Advisors related to the management of the 1st Source Monogram Funds.

The decrease in investment securities and other investment gains of \$0.67 million or 61.77% in the three months ended September 30, 2011 was primarily due to a gain on sale of a venture capital investment in 2010 versus no similar sale in 2011. The decrease in investment securities and other investment gains of \$0.37 million or 18.12% in the nine months ended September 30, 2011 was due to a gain on sale of a venture capital investment in 2010 versus no similar sale in 2011 and lower gains on partnership investments in 2011 versus 2010. These negative results were offset by gains on the sale of agency securities year-to-date 2011 compared to the same period a year earlier.

NONINTEREST EXPENSE

Noninterest expense for the three month period ended September 30, 2011 and 2010 was \$37.15 million and \$37.81 million, respectively. Noninterest expense for the nine month period ended September 30, 2011 and 2010 was \$111.57 million and \$114.57 million, respectively. Details of noninterest expense follow:

| (Dollars in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | \$ 19,476 | \$ 18,980 | \$ 57,249 | \$ 56,638 |
| Net occupancy expense | 2,237 | 2,200 | 6,608 | 6,626 |
| Furniture and equipment expense | 3,519 | 3,227 | 10,429 | 9,223 |
| Depreciation - leased equipment | 4,650 | 5,173 | 14,250 | 15,841 |
| Professional fees | 1,326 | 1,563 | 3,502 | 4,495 |

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| | | | | |
|--|-----------|-----------|------------|------------|
| Supplies and communication | 1,312 | 1,387 | 4,022 | 4,094 |
| Business development and marketing expense | 968 | 845 | 2,454 | 2,292 |
| Intangible asset amortization | 325 | 331 | 975 | 993 |
| Loan and lease collection and repossession expense | 1,387 | 1,449 | 4,211 | 5,822 |
| FDIC and other insurance | 874 | 1,420 | 3,508 | 4,761 |
| Other expense | 1,074 | 1,235 | 4,359 | 3,784 |
| Total noninterest expense | \$ 37,148 | \$ 37,810 | \$ 111,567 | \$ 114,569 |

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Noninterest expense decreased \$0.66 million or 1.75% for the third quarter and \$3.00 million or 2.62% for year-to-date 2011 as compared to the same periods in 2010. Net occupancy, supplies and communication, and intangible asset amortization all changed slightly in 2011 over the same periods in 2010.

Salaries and employee benefits increased \$0.50 million or 2.62% and \$0.61 million or 1.08% in the three and nine months ended September 30, 2011 versus the three and nine months ended September 30, 2010 primarily due to higher group insurance costs.

During the third quarter and first nine months of 2011, furniture and equipment expense increased \$0.29 million or 9.05% and \$1.21 million or 13.08%, respectively compared to the third quarter and first nine months of 2010. The higher expense was mainly due to increased computer processing charges and corporate aircraft maintenance.

Depreciation on leased equipment decreased \$0.52 million or 10.11% and \$1.59 million or 10.04% in conjunction with the decrease in equipment rental income for the three and nine months ended September 30, 2011, respectively as compared to the same periods one year ago.

Professional fees decreased \$0.24 million or 15.16% for the three month period ended September 30, 2011 as compared to the three month period ended September 30, 2010 and \$0.99 million or 22.09% for the nine month period ended September 30, 2011 as compared to the same period a year earlier. The reduction in professional fees in 2011 was the result of lower consulting and legal fees.

Business development and marketing increased \$0.12 million or 14.56% and \$0.16 million or 7.07% for the three and nine months ended September 30, 2011, respectively versus the three and nine months ended September 30, 2010. The higher expense was primarily due to business meals and client entertainment expense.

Loan and lease collection and repossession expense decreased slightly in the third quarter and decreased \$1.61 million or 27.67% for the first nine months of 2011 as compared to the same periods in 2010 mainly due to negative valuation adjustments on repossessed aircraft in 2010 which were much lower in 2011. This positive variance was offset by higher repurchased mortgage loan losses in 2011 compared to 2010.

FDIC and other insurance expense decreased \$0.55 million or 38.45% and \$1.25 million or 26.32% for the three and nine months ended September 30, 2011, respectively compared to the three and nine months ended September 30, 2010. The lower premium expense in 2011 was a result of a new assessment base and rates imposed by the FDIC.

Other expenses decreased \$0.16 million or 13.04% in the three months ended September 30, 2011 as compared to the three months ended September 30, 2010. Other expense increased \$0.58 million or 15.20% for the nine months ended September 30, 2011 over the same period one year ago due to a charge of \$1.85 million for provision on unfunded loan commitments offset by the gain on sale of the corporate aircraft.

INCOME TAXES

The provision for income taxes for the three and nine month periods ended September 30, 2011 was \$6.91 million and \$19.57 million, respectively compared to \$5.34 million and \$13.60 million for the same periods in 2010. The effective tax rates were 37.45% and 32.30% for the third quarter ended September 30, 2011 and 2010, respectively and 34.59% and 32.17% for the nine months ended September 30, 2011 and 2010, respectively. The effective tax rates are higher in 2011 compared to 2010 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.

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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, 2010. For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2010.

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 Acting 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 Acting Chief Financial Officer concluded that, at September 30, 2011, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by 1st Source in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are designed to ensure that information required to be disclosed in those reports is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.

In addition, there were no changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the third fiscal quarter of 2011 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Table of Contents**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. Our 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, 2010. For information regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2010.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs (1) | Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs |
|--------------------|---|-------------------------------------|---|---|
| July 01 - 31, 2011 | | \$ | | 1,128,973 |
| Aug 01 - 31, 2011 | 126 | 22.97 | 126 | 1,128,847 |
| Sept 01 - 30, 2011 | | | | 1,128,847 |

(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 871,153 shares.

ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. (Removed and reserved).

ITEM 5. Other Information.

None

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ITEM 6. Exhibits

The following exhibits are filed with this report:

| | |
|---------|---|
| 31.1 | Certification of Chief Executive Officer required by Rule 13a-14(a). |
| 31.2 | Certification of Acting 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 Acting Chief Financial Officer. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema Document |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document |
| 101.LAB | XBRL Taxonomy Extension Labels Linkbase Document |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase Document |

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SIGNATURES

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

1st Source Corporation

| | | |
|------|------------------|--|
| DATE | October 20, 2011 | /s/ CHRISTOPHER J. MURPHY III Christopher J. Murphy III Chairman of the Board, President and CEO |
|------|------------------|--|

| | | |
|------|------------------|---|
| DATE | October 20, 2011 | /s/ ANDREA G. SHORT Andrea G. Short Acting Treasurer and Chief Financial Officer Acting Principal Accounting Officer |
|------|------------------|---|