1ST SOURCE CORP
Form 10-Q
October 21, 2010

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 30,2010

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

(Exact name of registrant as specified in its charter)

INDIANA	35-1068133
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Indentification No.)

100 North Michigan Street	South Bend, IN	46614

(Address of principle executive offices) (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.
x Yes o 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). o Yes o 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 o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

Number of shares of common stock outstanding as of October 15, 2010 – 24,203,450 shares

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

	September 30, 2010	December 31, 2009
ASSETS		
Cash and due from banks	$60,395	$72,872
Federal funds sold and interest bearing deposits with other banks	79,082	141,166
Investment securities available-for-sale (amortized cost of $848,409 and $893,439 at September 30, 2010 and December 31, 2009, respectively)	874,514	901,638
Other investments	21,012	21,012
Trading account securities	125	125
Mortgages held for sale	114,947	26,649
Loans and leases - net of unearned discount		
Commercial and agricultural loans	535,874	546,222
Auto, light truck and environmental equipment	397,297	349,741
Medium and heavy duty truck	174,459	204,545
Aircraft financing	620,996	617,384
Construction equipment financing	304,035	313,300
Loans secured by real estate	979,442	952,223
Consumer loans	100,076	109,735
Total loans and leases	3,112,179	3,093,150
Reserve for loan and lease losses	(89,509)	(88,236)
Net loans and leases	3,022,670	3,004,914
Equipment owned under operating leases, net	84,430	97,004
Net premises and equipment	36,133	37,907
Goodwill and intangible assets	89,287	90,222
Accrued income and other assets	149,718	148,591
Total assets	$4,532,313	$4,542,100
LIABILITIES		
Deposits:		
Noninterest bearing	$495,778	$450,608
Interest bearing	3,070,416	3,201,856
Total deposits	3,566,194	3,652,464
Federal funds purchased and securities sold under agreements to repurchase	145,887	123,787
Other short-term borrowings	26,337	26,323
Long-term debt and mandatorily redeemable securities	34,987	19,761
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	72,893	59,753
Total liabilities	3,935,990	3,971,780
SHAREHOLDERS' EQUITY		
Preferred stock; no par value		

Authorized 10,000,000 shares; issued 111,000 at September 30, 2010, and at December 31, 2009	105,917	104,930
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,643,506 at September 30, 2010, and at December 31, 2009	350,278	350,269
Retained earnings	155,633	142,407
Cost of common stock in treasury (1,440,056 shares at September 30, 2010, and 1,532,483 shares at December 31, 2009)	(31,723)	(32,380)
Accumulated other comprehensive income	16,218	5,094
Total shareholders' equity	596,323	570,320
Total liabilities and shareholders' equity	$4,532,313	$4,542,100

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

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,	
	2010	2009	2010	2009
Interest income:				
Loans and leases	$ 43,722	$ 43,436	$ 129,091	$ 132,507
Investment securities, taxable	4,931	4,357	15,611	12,600
Investment securities, tax-exempt	1,369	1,651	4,258	5,046
Other	219	297	743	894
Total interest income	50,241	49,741	149,703	151,047
Interest expense:				
Deposits	10,790	15,460	34,768	49,662
Short-term borrowings	219	265	613	909
Subordinated notes	1,648	1,648	4,942	4,942
Long-term debt and mandatorily redeemable securities	400	322	1,045	853
Total interest expense	13,057	17,695	41,368	56,366
Net interest income	37,184	32,046	108,335	94,681
Provision for loan and lease losses	5,578	6,469	15,764	22,741
Net interest income after provision for loan and lease losses	31,606	25,577	92,571	71,940
Noninterest income:				
Trust fees	3,870	3,782	11,677	11,473
Service charges on deposit accounts	4,918	5,402	14,813	15,367
Mortgage banking income	2,549	965	3,751	6,874
Insurance commissions	1,180	1,022	3,706	3,614
Equipment rental income	6,495	6,347	19,912	18,896
Other income	2,656	2,022	8,357	6,613
Investment securities and other investment gains	1,083	716	2,059	673
Total noninterest income	22,751	20,256	64,275	63,510
Noninterest expense:				
Salaries and employee benefits	18,980	18,425	56,638	55,340
Net occupancy expense	2,200	2,221	6,626	7,095
Furniture and equipment expense	3,227	3,241	9,223	10,487
Depreciation - leased equipment	5,173	5,021	15,841	15,065
Professional fees	1,563	1,020	4,495	2,897
Supplies and communication	1,387	1,473	4,094	4,468
FDIC and other insurance	1,420	1,582	4,761	6,851
	845	655	2,292	1,934

Business development and marketing expense				
Loan and lease collection and repossession expense	1,449	1,147	5,822	2,776
Other expense	1,566	1,785	4,777	5,646
Total noninterest expense	37,810	36,570	114,569	112,559
Income before income taxes	16,547	9,263	42,277	22,891
Income tax expense	5,344	2,530	13,600	3,624
Net income	11,203	6,733	28,677	19,267
Preferred stock dividends and discount accretion	(1,721)	(1,701)	(5,149)	(4,710)
Net income available to common shareholders	$ 9,482	$ 5,032	$ 23,528	$ 14,557
Per common share				
Basic net income per common share	$ 0.39	$ 0.21	$ 0.96	$ 0.60
Diluted net income per common share	$ 0.39	$ 0.21	$ 0.96	$ 0.60
Dividends	$ 0.15	$ 0.15	$ 0.45	$ 0.43
Basic weighted average common shares outstanding	24,247,236	24,164,884	24,247,468	24,166,887
Diluted weighted average common shares outstanding	24,253,883	24,212,042	24,254,026	24,215,542

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

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

	Total	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net
Balance at January 1, 2009	$ 453,664	$ -	$ 342,982	$ 136,877	$ (32,019)	$ 5,824
Comprehensive Income, net of tax:						
Net Income	19,267	-	-	19,267	-	-
Change in unrealized appreciation of available-for-sale securities, net of tax	3,813	-	-	-	-	3,813
Total Comprehensive Income	23,080	-	-	-	-	-
Issuance of 83,402 common shares under stock based compensation awards, including related tax effects	1,663	-	-	725	938	-
Cost of 52,876 shares of common stock aquired for treasury	(862)				(862)	
Issuance of preferred stock	103,725	103,725	-	-	-	-
Preferred stock discount accretion	-	887		(887)		
Issuance of warrants to purchase common stock	7,275	-	7,275	-	-	-
Preferred stock dividend (paid and/or accrued)	(3,823)	-	-	(3,823)	-	-
Common stock dividend ($0.43 per share)	(10,401)	-	-	(10,401)	-	-
Stock based compensation	9	-	9	-	-	-
Balance at September 30, 2009	$ 574,330	$ 104,612	$ 350,266	$ 141,758	$ (31,943)	$ 9,637

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	11,124	-	-	-	-	11,124
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

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

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

	Nine Months Ended September 30,	
	2010	2009
Operating activities:		
Net income	$28,677	$19,267
Adjustments to reconcile net income to net cash (used) provided by operating activities:		
Provision for loan and lease losses	15,764	22,741
Depreciation of premises and equipment	3,103	3,515
Depreciation of equipment owned and leased to others	15,841	15,065
Amortization of investment security premiums and accretion of discounts, net	1,232	4,477
Amortization of mortgage servicing rights	2,277	2,517
Mortgage servicing asset impairment (recovery)	821	(1,793)
Deferred income taxes	(3,800)	3,460
Investment securities and other investment gains	(2,059)	(673)
Originations/purchases of loans held for sale, net of principal collected	(299,298)	(512,286)
Proceeds from the sales of loans held for sale	215,678	522,780
Net gain on sale of loans held for sale	(4,678)	(3,170)
Change in trading account securities	-	(17)
Change in interest receivable	795	1,352
Change in interest payable	664	2,173
Change in other assets	(4,084)	(8,109)
Change in other liabilities	9,495	4,249
Other	616	754
Net change in operating activities	(18,956)	76,302
Investing activities:		
Proceeds from sales of investment securities	72,417	147,658
Proceeds from maturities of investment securities	330,904	323,295
Purchases of investment securities	(357,465)	(630,642)
Net change in short-term and other investments	62,084	(60,757)
Loans sold or participated to others	13,186	13,482
Net change in loans and leases	(46,707)	173,687
Net change in equipment owned under operating leases	(3,267)	(23,541)
Purchases of premises and equipment	(1,577)	(1,772)
Net change in investing activities	69,575	(58,590)
Financing activities:		
Net change in demand deposits, NOW accounts and savings accounts	(23,309)	74,639
Net change in certificates of deposit	(62,961)	(102,468)
Net change in short-term borrowings	22,114	(141,197)
Proceeds from issuance of long-term debt	15,418	240
Payments on long-term debt	(363)	(10,392)

Net proceeds from issuance of treasury stock	2,871	1,663
Acquisition of treasury stock	(1,578)	(862)
Net proceeds from issuance of preferred stock & common stock warrants	-	111,000
Cash dividends paid on preferred stock	(4,163)	(3,114)
Cash dividends paid on common stock	(11,125)	(10,584)
Net change in financing activities	(63,096)	(81,074)
Net change in cash and cash equivalents	(12,477)	(63,363)
Cash and cash equivalents, beginning of year	72,872	119,771
Cash and cash equivalents, end of period	$60,395	$56,408
Non-cash transactions:		
Loans transferred to other real estate and repossessed assets	$15,501	$12,489
Common stock matching contribution to KSOP plan	2,545	1,254

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

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 (2009 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, 2009 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.

Note 2. Recent Accounting Pronouncements

Receivables: In July 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-20 "Receivables (Topic 310) – Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." ASU 2010-20 requires extensive new disclosures about financing receivables, including credit risk exposures and the allowance for credit losses. For public entities, ASU 2010-20 disclosures of period-end balances are effective for interim or annual reporting periods ending on or after December 15, 2010. Disclosures related to activity that occurs during the reporting period are required for interim and annual reporting periods beginning on or after December 15, 2010. We are assessing the impact of ASU 2010-20 on our disclosures.

Receivables: In April 2010, the FASB issued ASU No. 2010-18 "Receivables (Topic 310) – Effect of a Loan Modification When the Loan is Part of a Pool that is Accounted for as a Single Asset – a consensus of the FASB Emerging Issues Task Force." ASU 2010-18 provides guidance on accounting for acquired loans that have evidence of credit deterioration upon acquisition. It allows acquired assets with common risk characteristics to be accounted for in the aggregate as a pool. ASU 2010-18 was effective for modifications of loans accounted for within pools under Subtopic 310-30 in the first interim or annual reporting period ending on or after July 15, 2010. ASU 2010-18 did not have an impact on our financial condition, results of operations, or disclosures.

Financial Services – Insurance: In April 2010, the FASB issued ASU No. 2010-15 "Financial Services – Insurance (Topic 944) – How Investments Held through Separate Accounts Affect an Insurer's Consolidation Analysis of Those Investments – a consensus of the FASB Emerging Issues Task Force." ASU 2010-15 affects insurance entities that have separate accounts that meet the definition of a separate account in paragraph 944-80-25-2 when evaluating whether to consolidate an investment held through its separate account or through a combination of investments in its separate and general accounts. ASU 2010-15 is effective for fiscal years and interim periods within those fiscal years, beginning after December 15, 2010. We do not expect ASU 2010-15 to have an impact on our financial condition, results of operations, or disclosures.

Subsequent Events: In February 2010, the FASB issued ASU No. 2010-09 “Subsequent Events (Topic 855) – Amendments to Certain Recognition and Disclosure Requirements.” ASU 2010-09 amends the subsequent events disclosure guidance. The amendments include a definition of an SEC filer, requires an SEC filer or conduit bond obligor to evaluate subsequent events through the date the financial statements are issued, and removes the requirement for an SEC filer to disclose the date through which subsequent events have been evaluated. ASU 2010-09 was effective upon issuance for us. The impact of ASU 2010-09 on our disclosures is reflected in Note 12 - Subsequent Events.

Fair Value Measurements and Disclosures: In January 2010, the FASB issued ASU No. 2010-06 “Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements.” ASU 2010-06 amends the fair value disclosure guidance. The amendments include new disclosures and changes to clarify existing disclosure requirements. ASU 2010-06 was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements of Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The impact of ASU 2010-06 on our disclosures is reflected in Note 10 - Fair Value Measurements.

Consolidations: In December 2009, the FASB issued ASU No. 2009-17 (formerly Statement No. 167), “Consolidations (Topic 810) – Improvements to Financial Reporting for Enterprises involved with Variable Interest Entities”. ASU 2009-17 amends the consolidation guidance applicable to variable interest entities. The amendments to the consolidation guidance affect all entities, as well as qualifying special-purpose entities (QSPEs) that are currently excluded from previous consolidation guidance. ASU 2009-17 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009. ASU 2009-17 did not have an impact on our financial condition, results of operations, or disclosures.

Accounting for Transfers of Financial Assets: In December 2009, the FASB issued ASU No. 2009-16 (formerly Statement No. 166), “Transfers and Servicing (Topic 860) – Accounting for Transfers of Financial Assets”. ASU 2009-16 amends the derecognition accounting and disclosure guidance. ASU 2009-16 eliminates the exemption from consolidation for QSPEs and also requires a transferor to evaluate all existing QSPEs to determine whether they must be consolidated. ASU 2009-16 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009. ASU 2009-16 did not have an impact on our financial condition, results of operations, or disclosures.

Note 3. Investment Securities

Investment securities available-for-sale were as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2010				
U.S. Treasury and Federal agencies securities	$347,564	$7,563	$-	$355,127
U.S. States and political subdivisions securities	160,583	7,529	(1,550)	166,562
Mortgage-backed securities - Federal agencies	306,711	10,757	(30)	317,438
Corporate debt securities	28,564	261	(6)	28,819
Foreign government and other securities	3,724	37	(2)	3,759
Total debt securities	847,146	26,147	(1,588)	871,705
Marketable equity securities	1,263	1,549	(3)	2,809
Total investment securities available-for-sale	$848,409	$27,696	$(1,591)	$874,514
December 31, 2009				
U.S. Treasury and Federal agencies securities	$390,189	$760	$(1,780)	$389,169
U.S. States and political subdivisions securities	188,706	5,450	(2,337)	191,819
Mortgage-backed securities - Federal agencies	286,415	5,996	(1,434)	290,977
Corporate debt securities	26,166	194	(38)	26,322
Foreign government and other securities	675	-	-	675
Total debt securities	892,151	12,400	(5,589)	898,962
Marketable equity securities	1,288	1,417	(29)	2,676
Total investment securities available-for-sale	$893,439	$13,817	$(5,618)	$901,638

At September 30, 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, 2010 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	$ 41,678	$ 41,955
Due after one year through five years	374,298	384,449
Due after five years through ten years	110,756	115,646
Due after ten years	13,703	12,217
Mortgage-backed securities	306,711	317,438
Total debt securities available-for-sale	$ 847,146	$ 871,705

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 2010 primarily reflect the disposition of FNMA and FHLMC debt securities. The gross gains in the first nine months of 2009 reflect gains on the sale of FHLB and FNMA debt securities. The gross losses in the first nine months of 2009 primarily reflect losses on the sale of preferred equities. There have been no other than temporary impairment (OTTI) writedowns in 2010. There were no gains or losses for the nine months ended September 30, 2010 and net gains of $17 thousand recorded for the nine months ended September 30, 2009 on $0.13 million in trading securities outstanding at both September 30, 2010, and December 31, 2009.

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Gross realized gains	$ -	$ 356	$ 292	$ 1,010
Gross realized losses	(24)	-	(36)	(707)
Net realized gains (losses)	$ (24)	$ 356	$ 256	$ 303

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

	Less than 12 Months		12 months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2010						
U.S. States and political subdivisions securities	$ 2,523	$ (46)	$ 11,450	$ (1,504)	$ 13,973	$ (1,550)
Mortgage-backed securities - Federal agencies	1,627	(10)	5,275	(20)	6,902	(30)
Corporate debt securities	4,520	(6)	-	-	4,520	(6)
Foreign government and other securities	1,038	(2)	-	-	1,038	(2)
Total debt securities	9,708	(64)	16,725	(1,524)	26,433	(1,588)
Marketable equity securities	1	-	4	(3)	5	(3)
Total investment securities available-for-sale	$ 9,709	$ (64)	$ 16,729	$ (1,527)	$ 26,438	$ (1,591)
December 31, 2009						
U.S. Treasury and Federal agencies securities	$ 245,921	$ (1,780)	$ -	$ -	$ 245,921	$ (1,780)
U.S. States and political subdivisions securities	9,501	(178)	16,718	(2,159)	26,219	(2,337)
Mortgage-backed securities - Federal agencies	90,592	(1,137)	22,330	(297)	112,922	(1,434)
Corporate debt securities	7,149	(38)	-	-	7,149	(38)
Total debt securities	353,163	(3,133)	39,048	(2,456)	392,211	(5,589)
Marketable equity securities	2	(2)	4	(27)	6	(29)
Total investment securities available-for-sale	$ 353,165	$ (3,135)	$ 39,052	$ (2,483)	$ 392,217	$ (5,618)

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, 2010, 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, 2010, we believe the impairments detailed in the table above are temporary and no impairment loss has been realized in our consolidated statements of income.

At September 30, 2010 and December 31, 2009, investment securities with carrying values of $370.43 million and $351.84 million, respectively, were pledged as collateral to secure government deposits, security repurchase agreements, and for other purposes.

Note 4. Reserve for Loan and Lease Losses

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 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. 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 (classified loans and leases and internal watch list credits) without specific reserves, formula reserves 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.

Note 5. 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 cost of a mortgage loan to servicing rights based on the fair value.

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, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Mortgage servicing assets:				
Balance at beginning of period	$ 8,168	$ 9,335	$ 8,749	$ 6,708
Additions	1,493	1,447	3,034	6,370
Amortization	(816)	(945)	(2,277)	(2,517)
Sales	(657)	(392)	(1,318)	(1,116)
Carrying value before valuation allowance at end of period	8,188	9,445	8,188	9,445
Valuation allowance:				
Balance at beginning of period	(971)	(566)	(1)	(2,073)
Impairment recoveries (charges)	149	286	(821)	1,793
Balance at end of period	$ (822)	$ (280)	$ (822)	$ (280)
Net carrying value of mortgage servicing assets at end of period	$ 7,366	$ 9,165	$ 7,366	$ 9,165
Fair value of mortgage servicing assets at end of period	$ 7,646	$ 9,648	$ 7,646	$ 9,648

During the nine months ended September 30, 2010 and 2009, management determined that it was not necessary to permanently write-down any previously established valuation allowance. At September 30, 2010, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by $0.28 million. 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,	
	2010	2009
Expected weighted-average life (in years)	3.59	3.49
Weighted-average constant prepayment rate (CPR)	29.76 %	23.16 %
Weighted-average discount rate	8.41 %	8.54 %

Mortgage loan contractual servicing fees, including late fees and ancillary income, were $1.00 million and $0.96 million for the three months ended September 30, 2010 and 2009, respectively. Mortgage loan contractual servicing fees were $2.98 million and $2.71 million for the nine months ended September 30, 2010 and 2009, respectively. Mortgage loan contractual servicing fees are included in mortgage banking income in the consolidated statements of income.

Note 6. Financial Instruments with Off-Balance-Sheet Risk and Derivative Transactions

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, purchase and sell loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition. 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.

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.

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. Commitments to originate or purchase residential mortgage loans held for sale and forward commitments to sell residential mortgage loans are considered derivative instruments.

At September 30, 2010 and December 31, 2009, 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, 2010					
Interest rate swap contracts	$ 423,069	Other assets	$ 18,933	Other liabilities	$ 19,473
Loan commitments	118,840	Mortgages held for sale	476	N/A	-
Forward contracts	173,340	N/A	-	Mortgages held for sale	849
Total			$ 19,409		$ 20,322
December 31, 2009					
Interest rate swap contracts	$ 412,717	Other assets	$ 13,516	Other liabilities	$ 13,988
Loan commitments	48,821	Mortgages held for sale	77	N/A	-
Forward contracts	38,940	Mortgages held for sale	411	N/A	-
Total			$ 14,004		$ 13,988

For the three and nine months ended September 30, 2010 and 2009, the amounts included in the consolidated statements of income for non-hedging derivative financial instruments are shown in the chart below:

		Gain (loss)			
		Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	Statement of Income location	2010	2009	2010	2009
Interest rate swap contracts	Other expense	$ 110	$ (121)	$ (68)	$ (53)
Loan commitments	Mortgage banking income	3	(249)	399	(1,277)
Forward contracts	Mortgage banking income	1,093	(258)	(1,260)	714
Total		$ 1,206	$ (628)	$ (929)	$ (616)

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 $18.07 million and $19.02 million at September 30, 2010 and December 31, 2009, respectively. Standby letters of credit generally have terms ranging from six months to one year.

Note 7. 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 and warrants, 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 and 54,472 were considered antidilutive as of September 30, 2010 and 2009. Stock warrants of 837,947 were considered antidilutive as of September 30, 2010 and 2009.

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, 2010 and 2009.

(Dollars in thousands - except per share amounts)	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Distributed earnings allocated to common stock	$ 3,641	$ 3,626	$ 10,900	$ 10,386
Undistributed earnings allocated to common stock	5,732	1,381	12,390	4,095
Net earnings allocated to common stock	9,373	5,007	23,290	14,481
Net earnings allocated to participating securities	109	25	238	76
Net income allocated to common stock and participating securities	$ 9,482	$ 5,032	$ 23,528	$ 14,557
Weighted average shares outstanding for basic earnings per common share	24,247,236	24,164,884	24,247,468	24,166,887
Dilutive effect of stock compensation	6,647	47,158	6,558	48,655
Weighted average shares outstanding for diluted earnings per common share	24,253,883	24,212,042	24,254,026	24,215,542
Basic earnings per common share	$ 0.39	$ 0.21	$ 0.96	$ 0.60
Diluted earnings per common share	$ 0.39	$ 0.21	$ 0.96	$ 0.60

Note 8. Stock-Based Compensation

As of September 30, 2010, we had five 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, 2009. These plans include two stock option plans, the Employee Stock Purchase Plan, the Executive Incentive Plan, and the Restricted Stock Award Plan.

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, 2010 and 2009 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

The aggregate intrinsic value in the table below represents the total pretax intrinsic value (the difference between 1st Source's closing stock price on the last trading day of the third quarter of 2010 (September 30, 2010) 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, 2010. This amount changes based on the fair market value of 1st Source's stock. Total fair value of options vested and expensed was $9 thousand, net of tax, for both the nine months ended September 30, 2010 and 2009.

	Number of Shares	Weighted Average Exercise Price	Average Remaining Contractual Term (in years)	Total Intrinsic Value (in 000's)
Options outstanding, beginning of year	71,763	$18.19		
Granted	-	-		
Exercised	-	-		
Forfeited	(9,255)	25.03		
Options outstanding, September 30, 2010	62,508	$17.18	1.36	$117
Vested and expected to vest at September 30, 2010	62,508	$17.18	1.36	$117
Exercisable at September 30, 2010	59,758	$17.42	1.31	$103

No options were granted during the nine months ended September 30, 2010.

As of September 30, 2010, there was $3.16 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 3.38 years.

The following table summarizes information about stock options outstanding at September 30, 2010:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of shares Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number of shares Exercisable	Weighted Average Exercise Price
$ 12.04 to $17.99	29,508	1.99	$ 13.38	26,758	$ 13.52
$ 18.00 to $26.99	33,000	0.80	20.58	33,000	20.58

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

Note 9. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was $1.56 million at September 30, 2010 and $1.30 million at December 31, 2009. Interest and penalties were recognized through the income tax provision. For the nine months ending September 30, 2010 and the twelve months ending December 31, 2009, we recognized approximately $0.03 million and $(0.73) million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately $0.58 million and $0.55 million were accrued at September 30, 2010 and December 31, 2009, respectively.

Tax years that remain open and subject to audit include the federal 2007-2009 years and the Indiana 2006-2009 years. Additionally, during the first quarter of 2009 we reached a resolution of audit examinations for the 2002-2007 years and as a result recorded a reduction of unrecognized tax benefits in the amount of $4.85 million that affected the effective tax rate and increased earnings in the amount of $2.60 million. We do not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

Note 10. 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 new mortgages held for sale (MHFS) originations starting on January 1, 2008. We believe the election for MHFS (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, 2010, all MHFS 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, 2010:

(Dollars in thousands)	Fair value carrying amount	Aggregate unpaid principal	Excess of fair value carrrying amount over (under) unpaid principal	
Mortgages held for sale reported at fair value:				
Total loans	$ 114,947	$ 111,631	$ 3,316	(1)
Nonaccrual loans	-	-	-	
Loans 90 days or more past due and still accruing	-	-	-	

(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 process considers various factors including interest rate yield curves, time value and volatility factors.

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

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	$ 20,242	$ 334,885	$ -	$ 355,127
U.S. States and political subdivisions securities	-	146,942	19,620	166,562
Mortgage-backed securities - Federal agencies	-	317,438	-	317,438
Corporate debt securities	-	28,819	-	28,819
Foreign government and other securities	-	3,084	675	3,759
Total debt securities	20,242	831,168	20,295	871,705
Marketable equity securities	2,800	-	9	2,809
Total investment securities available-for-sale	23,042	831,168	20,304	874,514
Trading account securities	125	-	-	125
Mortgages held for sale	-	114,947	-	114,947
Accrued income and other assets (Interest rate swap agreements)	-	18,933	-	18,933
Total	$ 23,167	$ 965,048	$ 20,304	$ 1,008,519
Liabilities:				
Accrued expenses and other liabilities (Interest rate swap agreements)	$ -	$ 19,473	$ -	$ 19,473
Total	$ -	$ 19,473	$ -	$ 19,473

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

(Dollars in thousands)	U.S. States and political subdivisions securities	Foreign government and other securities	Marketable equity securities	Investment securities available-for-sale
Beginning balance July 1, 2010	$ 9,324	$ 675	$ 9	$ 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	$	675	$	9	$	20,304

Transfers into Level 3 represent auction rate securities which were previously classified as Level 2. We have determined that Level 3 is a more appropriate classification based on the fair value methodology used due to market illiquidity and the lack of other observable inputs. The transfer was made as of the end of the reporting period.

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, 2010.

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 estimated using customized discounting criteria, appraisals and dealer and trade magazine quotes which are used in a market valuation approach. Repossessions are similarly valued.

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, 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 fair value of the underlying collateral less expected selling costs. Collateral values are estimated primarily using appraisals and reflect a market value approach.

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, 2010: impaired loans - $4.43 million; partnership investments - $0.41 million; mortgage servicing rights - $(0.15) million; repossessions - $0.03 million, and other real estate - $0.03 million.

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

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
Loans	$ -	$ -	$ 87,081	$ 87,081
Accrued income and other assets (partnership investments)	-	-	2,889	2,889
Accrued income and other assets (mortgage servicing rights)	-	-	7,366	7,366
Accrued income and other assets (repossessions)	-	-	9,665	9,665
	-	-	9,200	9,200

Accrued income and other assets (other real estate)								
	$	-	$	-	$	116,201	$	116,201

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

The fair values of our financial instruments as of September 30, 2010, and December 31, 2009, are summarized in the table below.

(Dollars in thousands)	September 30, 2010 Carrying or Contract Value	September 30, 2010 Fair Value	December 31, 2009 Carrying or Contract Value	December 31, 2009 Fair Value
Assets:				
Cash and due from banks	$ 60,395	$ 60,395	$ 72,872	$ 72,872
Federal funds sold and interest bearing deposits with other banks	79,082	79,082	141,166	141,166
Investment securities, available-for-sale	874,514	874,514	901,638	901,638
Other investments and trading account securities	21,138	21,138	21,137	21,137
Mortgages held for sale	114,947	114,947	26,649	26,649
Loans and leases, net of reserve for loan and lease losses	3,022,670	3,077,572	3,004,914	3,042,251
Cash surrender value of life insurance policies	52,907	52,907	51,342	51,342
Mortgage servicing rights	7,366	7,646	8,748	10,180
Interest rate swaps	18,933	18,933	13,516	13,516
Liabilities:				
Deposits	$ 3,566,194	$ 3,601,646	$ 3,652,464	$ 3,692,203
Short-term borrowings	172,224	172,224	150,110	150,110
Long-term debt and mandatorily redeemable securities	34,987	35,474	19,761	19,831
Subordinated notes	89,692	73,078	89,692	81,118
Interest rate swaps	19,473	19,473	13,988	13,988
Off-balance-sheet instruments *	-	139	-	150

* 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 cash equivalents and cash surrender value of life insurance policies. The methodologies for other financial assets and financial liabilities are discussed below:

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

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

Short-Term Borrowings — The carrying values of Federal funds purchased, securities sold under repurchase agreements, and other short-term borrowings, including 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 approximate fair values.

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

Off-Balance-Sheet Instruments — Contract and fair values for certain 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.

Note 11. Borrowed Funds

During 2007, we entered into a line of credit agreement whereby we may borrow up to $30.00 million. During 2008, $10.00 million was drawn on this line and converted to a term loan bearing a fixed interest rate of 4.28%. Interest is payable quarterly with principal due at the October 30, 2010 maturity. We do not intend to renew the credit facility upon maturity.

Note 12. Subsequent Events

We have evaluated subsequent events through the date our financial statements were issued. We do not believe any subsequent events have occurred that would require further disclosure or adjustment to our financial statements.

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" "remain," "estimate," "anticipate," "project," "will," "should," "indicate," "would," "may" and similar expressions indicate forward-looking statements. Those statements, including statements, projections, estimates or assumptions concerning future events or performance, and other statements that are other than statements of historical fact, are subject to material risks and uncertainties. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. We may make other written or oral forward-looking statements from time to time. Readers are advised that various important factors could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected in such forward-looking statements. Such factors include, but are not limited to, changes in law, regulations or U. S. generally accepted accounting principles; our competitive position within the markets we serve; increasing consolidation within the banking industry; unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2009, 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, 2010, as compared to December 31, 2009, and the results of operations for the three and nine months ended September 30, 2010 and 2009. 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 2009 Annual Report.

REGULATORY DEVELOPMENTS

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes provisions affecting large and small financial institutions alike, including several provisions that will profoundly affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolish the Office of Thrift Supervision and transfer its functions to the other federal banking agencies, relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, change the scope of federal deposit insurance coverage, and impose new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also establishes the Bureau of Consumer Financial Protection as an independent entity within the Federal Reserve, which will be given the authority to promulgate consumer protection regulations applicable to all entities offering consumer financial services or products, including banks. Additionally, the Dodd-Frank Act includes a series of provisions covering mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards, and pre-payments. The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, many of which may have an impact on our operating environment in substantial and unpredictable ways. Consequently, the Dodd-Frank Act is likely to affect our cost of doing business, it may limit or expand our permissible activities, and it may affect the competitive balance within our industry and market areas. Our management is actively reviewing the provisions of the Dodd-Frank Act and assessing its probable impact on our business, financial condition, and results of operations. However, the ultimate effect of the Dodd-Frank Act on the financial services industry in general, and on us in particular, is uncertain at this time.

FINANCIAL CONDITION

Our total assets at September 30, 2010, were $4.53 billion, a decrease of $9.79 million or 0.22% from December 31, 2009. Total loans and leases were $3.11 billion, an increase of $19.03 million or 0.62% from December 31, 2009. Fed funds sold and interest bearing deposits with other banks were $79.08 million, a decrease of $62.08 million or 43.98% from December 31, 2009. Total investment securities, available for sale were $874.51 million which represented a decrease of $27.12 million or 3.01% and total deposits were $3.57 billion, a decrease of $86.27 million or 2.36% over the comparable figures at the end of 2009.

Nonperforming assets at September 30, 2010, were $99.37 million, which was a decrease of $1.64 million or 1.62% from the $101.01 million reported at December 31, 2009. At September 30, 2010, nonperforming assets were 3.09% of net loans and leases compared to 3.15% at December 31, 2009.

Accrued income and other assets were as follows:

(Dollars in thousands)	September 30, 2010	December 31, 2009
Accrued income and other assets:		
Bank owned life insurance cash surrender value	$ 52,907	$ 51,342
Accrued interest receivable	15,392	16,187
Mortgage servicing assets	7,366	8,748
Other real estate	7,010	4,039
Former bank premises held for sale	2,190	2,490
Repossessions	9,665	10,165
All other assets	55,188	55,620
Total accrued income and other assets	$ 149,718	$ 148,591

CAPITAL

As of September 30, 2010, total shareholders' equity was $596.32 million, up $26.00 million or 4.56% from the $570.32 million at December 31, 2009. In addition to net income of $28.68 million, other significant changes in shareholders’ equity during the first nine months of 2010 included $15.10 million of dividends paid and/or accrued. The accumulated other comprehensive income/(loss) component of shareholders’ equity totaled $16.22 million at September 30, 2010, compared to $5.09 million at December 31, 2009. The increase in accumulated other comprehensive income/(loss) during 2010 was primarily a result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 13.16% as of September 30, 2010, compared to 12.56% at December 31, 2009. Book value per common share rose to $20.26 at September 30, 2010, from $19.30 at December 31, 2009.

We declared and paid dividends per common share of $0.15 during the third quarter of 2010. The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 52.59%. 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, 2010, are presented in the table below:

	Actual		Minimum Capital Adequacy		To Be Well Capitalized Under Prompt Corrective Action Provisions	
(Dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-Weighted Assets):						
1st Source Corporation	$621,785	18.15 %	$274,132	8.00 %	$342,665	10.00 %
1st Source Bank	584,673	17.13	273,009	8.00	341,261	10.00
Tier 1 Capital (to Risk-Weighted Assets):						
1st Source Corporation	577,681	16.86	137,066	4.00	205,599	6.00
1st Source Bank	541,405	15.86	136,504	4.00	204,757	6.00
Tier 1 Capital (to Average Assets):						
1st Source Corporation	577,681	13.04	177,164	4.00	221,455	5.00
1st Source Bank	541,405	12.28	176,421	4.00	220,526	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 borrowings, Federal Reserve Bank borrowings, and the capability to package loans for sale. Our loan to asset ratio was 68.67% at September 30, 2010 compared to 68.10% at December 31, 2009 and 70.11% at September 30, 2009. Cash and cash equivalents totaled $60.40 million at September 30, 2010 compared to $72.87 million at December 31, 2009 and $56.41 million at September 30, 2009. A term loan principal payment of $10.00 million will be due on October 30, 2010. The related line of credit agreement matures on October 30, 2010 and we do not intend to renew the credit facility. Refer to Note 11 of the Notes to the Consolidated Financial Statements for additional information. At September 30, 2010, the consolidated statement of financial condition was rate sensitive by $140.01 million more liabilities than assets scheduled to reprice within one year, or approximately 0.95%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

RESULTS OF OPERATIONS

Net income for the three and nine month periods ended September 30, 2010 was $11.20 million and $28.68 million respectively, compared to $6.73 million and $19.27 million for the same periods in 2009. Diluted net income per common share was $0.39 and $0.96 respectively, for the three and nine month periods ended September 30, 2010, compared to $0.21 and $0.60 for the same periods in 2009. Return on average common shareholders' equity was 6.52% for the nine months ended September 30, 2010, compared to 4.16% in 2009. The return on total average assets was 0.85% for the nine months ended September 30, 2010, compared to 0.57% in 2009.

The increase in net income for the nine months ended September 30, 2010, over the first nine months of 2009, was primarily the result of a decrease in provision for loan and leases losses and an increase in net interest income. This positive impact to net income was partially offset by an increase in income tax expense. 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, 2010 was $38.02 million, an increase of 15.11% over the same period in 2009. The net interest margin on a fully taxable equivalent basis was 3.61% for the three months ended September 30, 2010, compared to 3.15% for the three months ended September 30, 2009. The taxable equivalent net interest income for the nine months ended September 30, 2010 was $110.91 million, an increase of 13.74% over 2009, resulting in a net yield of 3.56%, compared to a net yield of 3.10% for the same period in 2009.

During the three and nine month periods ended September 30, 2010, average earning assets increased $23.01 million or 0.55% and decreased $38.89 million or 0.92% respectively, over the comparable periods in 2009. Average interest-bearing liabilities decreased $32.52 million or 0.96% and $69.15 million or 2.00% respectively, for the three and nine month periods ended September 30, 2010 over the comparable periods one year ago. The yield on average earning assets increased 1 basis point to 4.85% for the third quarter of 2010 from 4.84% for the third quarter of 2009. The yield on average earning assets for the nine month period ended September 30, 2010 remained flat at 4.89% compared to the nine month period ended September 30, 2009. Although the overall rates earned on assets were relatively stable, there was a change in asset mix. Total cost of average interest-bearing liabilities decreased 53 basis points to 1.54% for the third quarter 2010 from 2.07% for the third quarter 2009. Total cost of average interest-bearing liabilities decreased 55 basis points to 1.63% for the nine months ended September 30, 2010, from 2.18% for the nine months ended September 30, 2009. 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 46 basis points for both the three and nine month periods ended September 30, 2010 from September 30, 2009.

The largest contributor to the increase in the yield on average earning assets for the three months ended September 30, 2010, compared to the three months ended September 30, 2009, was a slight improvement in yields on loans and leases. Total average investment securities increased $69.28 million or 8.38% and $83.35 million or 10.18% respectively, for the three and nine month periods over one year ago. Average mortgages held for sale increased $3.66 million or 5.06% and decreased $45.77 million or 50.89% respectively, for the three and nine month periods ended September 30, 2010, over the comparable periods a year ago primarily due to fluctuations in refinance activity. Average net loans and leases decreased $0.92 million or 0.03% for the third quarter of 2010 from the third quarter of 2009 and $67.47 million or 2.12% for the nine months ended September 30, 2010 compared to the same period in 2009. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, decreased $49.00 million or 37.63% and $9.01 million or 7.92% for the three and nine month periods ended September 30, 2010, over the comparable periods a year ago.

Average interest-bearing deposits decreased $29.75 million or 0.96% and $41.54 million or 1.32% respectively, for the third quarter of 2010 and first nine months of 2010 over the same periods in 2009. The effective rate paid on average interest-bearing deposits decreased 59 basis points to 1.39% for the third quarter 2010 compared to 1.98% for the third quarter 2009. The effective rate paid on average interest-bearing deposits decreased 62 basis points to 1.49% for the first nine months of 2010 compared to 2.11% for the first nine months of 2009. The decline in the average cost of interest-bearing deposits during the third quarter and first nine months of 2010 as compared to the third quarter and first nine months of 2009 was primarily the result of interest rate repricing on maturing certificates of deposit.

Average short-term borrowings decreased $15.99 million or 9.05% and $33.86 million or 17.61% respectively, for the third quarter of 2010 and the first nine months of 2010, compared to the same periods in 2009.

The decrease in average short-term borrowings was primarily due to lower repurchase agreements. Interest paid on short-term borrowings decreased 6 basis points for the third quarter of 2010 and 11 basis points for the first nine months of 2010 due to the interest rate decrease on adjustable rate borrowings. Average long-term debt increased $13.21 million or 66.29% during the third quarter of 2010 as compared to the third quarter of 2009 and increased $6.26 million or 30.36% during the first nine months of 2010 as compared to the first nine months of 2009. The increase in long-term borrowings was the result of higher borrowings with the Federal Home Loan Bank. Interest paid on long-term borrowings decreased 163 basis points for the third quarter and 33 basis points for the first nine months of 2010 due to lower effective rates on new Federal Home Loan Bank borrowings.

Average demand deposits increased $62.16 million or 14.40% and $48.70 million or 11.59%, respectively during the third quarter and first nine months of 2010, compared to the same periods one year ago.

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

DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY
INTEREST RATES AND INTEREST DIFFERENTIAL
(Dollars in thousands)

	Three months ended September 30,								Nine months ended Septemb				
	2010				2009				2010				
	Average Balance	Interest Income/ Expense	Yield/ Rate		Average Balance	Interest Income/ Expense	Yield/ Rate		Average Balance	Interest Income/ Expense	Yield/ Rate		Average Balance
ASSETS:													
Investment securities:													
Taxable	$728,684	$4,931	2.68	%	$622,975	$4,357	2.78	%	$728,427	$15,611	2.87	%	$611,456
Tax exempt	167,059	2,018	4.79	%	203,493	2,464	4.80	%	173,417	6,258	4.82	%	207,042
Mortgages - held for sale	75,934	886	4.63	%	72,278	933	5.12	%	44,175	1,610	4.87	%	89,942
Net loans and leases	3,129,445	43,022	5.45	%	3,130,362	42,673	5.41	%	3,116,927	128,055	5.49	%	3,184,39
Other investments	81,210	219	1.07	%	130,210	297	0.90	%	104,659	743	0.95	%	113,664
Total Earning Assets	4,182,332	51,076	4.85	%	4,159,318	50,724	4.84	%	4,167,605	152,277	4.89	%	4,206,49
Cash and due from banks	62,339				57,028				60,392				58,807
Reserve for loan and lease losses	(89,572)				(84,382)				(89,248)				(84,240
Other assets	363,294				331,360				368,509				327,137
Total	$4,518,393				$4,463,324				$4,507,258				$4,508,20

LIABILITIES AND SHAREHOLDERS' EQUITY:												
Interest-bearing deposits	$3,074,493	$10,790	1.39	%	$3,104,240	$15,460	1.98	%	$3,109,528	$34,768	1.49	%	$3,151,07
Short-term borrowings	160,594	219	0.54	%	176,580	265	0.60	%	158,385	613	0.52	%	192,245
Subordinated notes	89,692	1,648	7.29	%	89,692	1,648	7.29	%	89,692	4,942	7.37	%	89,692
Long-term debt and mandatorily redeemable securities	33,138	400	4.79	%	19,928	322	6.42	%	26,868	1,045	5.20	%	20,610
Total Interest-Bearing Liabilities	3,357,917	13,057	1.54	%	3,390,440	17,695	2.07	%	3,384,473	41,368	1.63	%	3,453,61
Noninterest-bearing deposits	493,935				431,773				468,912				420,209
Other liabilities	68,813				67,292				66,078				71,212
Shareholders' equity	597,728				573,819				587,795				563,163
Total	$4,518,393				$4,463,324				$4,507,258				$4,508,20
Net Interest Income		$38,019				$33,029				$110,909			
Net Yield on Earning Assets on a Taxable Equivalent Basis			3.61	%			3.15	%			3.56	%	

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PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES

The provision for loan and lease losses for the three and nine month periods ended September 30, 2010 was $5.58 million and $15.76 million respectively, compared to a provision for loan and lease losses in the three and nine month periods ended September 30, 2009 of $6.47 million and $22.74 million respectively. Net charge-offs of $4.08 million were recorded for the third quarter 2010, compared to $4.09 million for the same quarter a year ago. Year-to-date net charge-offs of $14.49 million have been recorded in 2010, compared to $17.01 million through September 30, 2009.

On September 30, 2010, 30 day and over loan and lease delinquencies were 0.86% as compared to 0.91% on September 30, 2009. The decrease in delinquencies was primarily in medium and heavy duty trucks and commercial loans offset by increases in delinquencies in aircraft loans. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.88% as compared to 2.76% one year ago. A summary of loan and lease loss experience during the three and nine month periods ended September 30, 2010 and 2009 is provided below.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2010	2009	2010	2009
Reserve for loan and lease losses - beginning balance	$ 88,014	$ 83,124	$ 88,236	$ 79,776
Charge-offs	(5,351)	(4,701)	(17,056)	(20,156)
Recoveries	1,268	612	2,565	3,143
Net charge-offs	(4,083)	(4,089)	(14,491)	(17,013)
Provision for loan and lease losses	5,578	6,469	15,764	22,741
Reserve for loan and lease losses - ending balance	$ 89,509	$ 85,504	$ 89,509	$ 85,504
Loans and leases outstanding at end of period	$ 3,112,179	$ 3,094,030	$ 3,112,179	$ 3,094,030
Average loans and leases outstanding during period	3,129,445	3,130,362	3,116,927	3,184,394
Reserve for loan and lease losses as a percentage of loans and leases outstanding at end of period	2.88 %	2.76 %	2.88 %	2.76 %
Ratio of annualized net charge-offs during period to				