

1ST SOURCE CORP
Form 10-Q
April 19, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)

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

For the quarterly period ended March 31, 2018

OR

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

For the transition period from _____ to _____

Commission file number 0-6233
(Exact name of registrant as specified in its charter)
INDIANA 35-1068133
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)
100 North Michigan Street
South Bend, IN 46601
(Address of principal 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. 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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Number of shares of common stock outstanding as of April 13, 2018 — 25,955,181 shares

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

	March 31, 2018	December 31, 2017
ASSETS		
Cash and due from banks	\$29,404	\$73,635
Federal funds sold and interest bearing deposits with other banks	21,748	4,398
Investment securities available-for-sale	942,076	904,033
Other investments	27,265	25,953
Mortgages held for sale	8,626	13,123
Loans and leases, net of unearned discount:		
Commercial and agricultural	1,011,700	929,997
Auto and light truck	511,051	496,816
Medium and heavy duty truck	280,010	296,935
Aircraft	868,419	844,657
Construction equipment	619,219	563,437
Commercial real estate	748,926	741,568
Residential real estate and home equity	518,130	526,122
Consumer	133,642	128,146
Total loans and leases	4,691,097	4,527,678
Reserve for loan and lease losses	(98,331)	(94,883)
Net loans and leases	4,592,766	4,432,795
Equipment owned under operating leases, net	144,129	139,581
Net premises and equipment	54,841	54,612
Goodwill and intangible assets	84,124	83,742
Accrued income and other assets	146,484	155,412
Total assets	\$6,051,463	\$5,887,284
LIABILITIES		
Deposits:		
Noninterest-bearing demand	\$1,030,902	\$1,064,271
Interest-bearing deposits:		
Interest-bearing demand	1,514,299	1,554,898
Savings	855,729	863,588
Time	1,380,395	1,269,973
Total interest-bearing deposits	3,750,423	3,688,459
Total deposits	4,781,325	4,752,730
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	143,913	205,834
Other short-term borrowings	212,051	8,761
Total short-term borrowings	355,964	214,595
Long-term debt and mandatorily redeemable securities	71,335	70,060
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	58,466	72,598
Total liabilities	5,325,854	5,168,747

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 28,205,674 at March 31, 2018 and December 31, 2017	436,538	436,538
Retained earnings	354,608	339,959
Cost of common stock in treasury (2,250,503 shares at March 31, 2018 and 2,268,910 shares at December 31, 2017)	(54,602	) (54,628)
Accumulated other comprehensive loss	(10,935	) (3,332)
Total shareholders' equity	725,609	718,537
Total liabilities and shareholders' equity	\$6,051,463	\$ 5,887,284

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

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

	Three Months Ended	
	March 31,	
	2018	2017
Interest income:		
Loans and leases	\$53,691	\$ 44,884
Investment securities, taxable	4,568	3,514
Investment securities, tax-exempt	571	683
Other	408	291
Total interest income	59,238	49,372
Interest expense:		
Deposits	6,562	3,734
Short-term borrowings	776	227
Subordinated notes	883	1,055
Long-term debt and mandatorily redeemable securities	485	629
Total interest expense	8,706	5,645
Net interest income	50,532	43,727
Provision for loan and lease losses	3,786	1,000
Net interest income after provision for loan and lease losses	46,746	42,727
Noninterest income:		
Trust and wealth advisory	5,188	5,001
Service charges on deposit accounts	2,228	2,239
Debit card	3,103	2,750
Mortgage banking	884	947
Insurance commissions	1,958	1,767
Equipment rental	7,755	6,832
(Losses) gains on investment securities available-for-sale	(345	) 1,285
Other	3,036	2,486
Total noninterest income	23,807	23,307
Noninterest expense:		
Salaries and employee benefits	22,531	21,345
Net occupancy	2,866	2,594
Furniture and equipment	5,455	4,793
Depreciation – leased equipment	6,428	5,680
Professional fees	2,017	1,077
Supplies and communication	1,553	1,250
FDIC and other insurance	698	623
Business development and marketing	1,533	1,652
Loan and lease collection and repossession	951	636
Other	1,525	1,469
Total noninterest expense	45,557	41,119
Income before income taxes	24,996	24,915
Income tax expense	5,880	8,709
Net income	\$19,116	\$ 16,206
Per common share:		
Basic net income per common share	\$0.73	\$ 0.62
Diluted net income per common share	\$0.73	\$ 0.62

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Cash dividends	\$0.22	\$ 0.18
Basic weighted average common shares outstanding	25,950,382	25,903,397
Diluted weighted average common shares outstanding	25,950,382	25,903,397

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

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

	Three Months Ended March 31,	
	2018	2017
Net income	\$19,116	\$16,206
Other comprehensive loss:		
Unrealized (depreciation) appreciation of available-for-sale securities	(9,414)	1,258
Reclassification adjustment for realized losses (gains) included in net income	345	(1,285)
Income tax effect	2,184	10
Other comprehensive loss, net of tax	(6,885)	(17)
Comprehensive income	\$12,231	\$16,189

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)

	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net	Total
Balance at January 1, 2017	\$ —	—\$436,538	\$290,824	\$(56,056)	\$ 1,344	\$672,650
Cumulative-effect adjustment	—	—	(65)	—	—	\$(65)
Balance at January 1, 2017, adjusted	—	436,538	290,759	(56,056)	1,344	672,585
Net income	—	—	16,206	—	—	16,206
Other comprehensive loss	—	—	—	—	(17)	(17)
Issuance of 48,765 common shares under stock based compensation awards	—	—	721	1,157	—	1,878
Cost of 900 shares of common stock acquired for treasury	—	—	—	(41)	—	(41)
Common stock dividend (\$0.18 per share)	—	—	(4,677)	—	—	(4,677)
Balance at March 31, 2017	\$ —	—\$436,538	\$303,009	\$(54,940)	\$ 1,327	\$685,934
Balance at January 1, 2018	\$ —	—\$436,538	\$339,959	\$(54,628)	\$(3,332)	\$718,537
Cumulative-effect adjustment	—	—	718	—	(718)	—
Balance at January 1, 2018, adjusted	—	436,538	340,677	(54,628)	(4,050)	718,537
Net income	—	—	19,116	—	—	19,116
Other comprehensive loss	—	—	—	—	(6,885)	(6,885)
Issuance of 34,191 common shares under stock based compensation awards	—	—	535	811	—	1,346
Cost of 15,784 shares of common stock acquired for treasury	—	—	—	(785)	—	(785)
Common stock dividend (\$0.22 per share)	—	—	(5,720)	—	—	(5,720)
Balance at March 31, 2018	\$ —	—\$436,538	\$354,608	\$(54,602)	\$(10,935)	\$725,609

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

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

	Three Months Ended March 31,	
	2018	2017
Operating activities:		
Net income	\$19,116	\$16,206
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	3,786	1,000
Depreciation of premises and equipment	1,321	1,380
Depreciation of equipment owned and leased to others	6,428	5,680
Stock-based compensation	880	694
Amortization of investment securities premiums and accretion of discounts, net	764	1,116
Amortization of mortgage servicing rights	236	263
Deferred income taxes	(7,531)	(504)
Losses (gains) on investment securities available-for-sale	345	(1,285)
Originations of loans held for sale, net of principal collected	(17,032)	(12,926)
Proceeds from the sales of loans held for sale	21,960	20,871
Net gain on sale of loans held for sale	(431)	(505)
Net (gain) loss on sale of other real estate and repossessions	(6)	94
Change in interest receivable	(1,806)	(251)
Change in interest payable	1,120	(225)
Change in other assets	4,825	(1,398)
Change in other liabilities	323	2,890
Other	(11)	1,177
Net change in operating activities	34,287	34,277
Investing activities:		
Proceeds from sales of investment securities available-for-sale	11,739	1,004
Proceeds from maturities and paydowns of investment securities available-for-sale	47,265	42,617
Purchases of investment securities available-for-sale	(107,225)	(30,198)
Proceeds from liquidation of partnership investment	1,868	—
Net change in other investments	(1,312)	—
Loans sold or participated to others	14,310	266
Net change in loans and leases	(178,326)	(47,385)
Net change in equipment owned under operating leases	(10,976)	(14,210)
Purchases of premises and equipment	(1,566)	(24)
Proceeds from sales of other real estate and repossessions	425	1,730
Net change in investing activities	(223,798)	(46,200)
Financing activities:		
Net change in demand deposits and savings accounts	(81,827)	(52,553)
Net change in time deposits	110,422	55,769
Net change in short-term borrowings	141,369	(12,198)
Proceeds from issuance of long-term debt	—	10,000
Payments on long-term debt	(636)	(401)
Acquisition of treasury stock	(785)	(41)
Cash dividends paid on common stock	(5,913)	(4,841)
Net change in financing activities	162,630	(4,265)

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Net change in cash and cash equivalents	(26,881)	(16,188)
Cash and cash equivalents, beginning of year	78,033	108,304
Cash and cash equivalents, end of period	\$51,152	\$92,116

Supplemental Information:

Non-cash transactions:

Loans transferred to other real estate and repossessed assets	\$259	\$903
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan	583	1,426

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. Accounting Policies

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as “1st Source” or “the Company”), a broad array of financial products and services.

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 comprehensive income, changes in shareholders’ equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted.

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation’s Annual Report on Form 10-K (2017 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The Consolidated Statement of Financial Condition at December 31, 2017 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current period presentation.

Use of Estimates in the Preparation of Financial Statements – Financial statements prepared in accordance with GAAP require the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expense during the reporting period. Actual results could differ from those estimates.

Loans and Leases – Loans are stated at the principal amount outstanding, net of unamortized deferred loan origination fees and costs and net of unearned income. Interest income is accrued as earned based on unpaid principal balances. Origination fees and direct loan and lease origination costs are deferred and the net amount amortized to interest income over the estimated life of the related loan or lease. Loan commitment fees are deferred and amortized into other income over the commitment period.

Direct financing leases are carried at the aggregate of lease payments plus estimated residual value of the leased property, net of unamortized deferred lease origination fees and costs and unearned income. Interest income on direct financing leases is recognized over the term of the lease to achieve a constant periodic rate of return on the outstanding investment.

The accrual of interest on loans and leases is discontinued when a loan or lease becomes contractually delinquent for 90 days, or when an individual analysis of a borrower’s credit worthiness indicates a credit should be placed on nonperforming status, except for residential mortgage loans and consumer loans that are well secured and in the process of collection. Residential mortgage loans are placed on nonaccrual at the time the loan is placed in foreclosure. When interest accruals are discontinued, interest credited to income in the current year is reversed and interest accrued in the prior year is charged to the reserve for loan and lease losses. However, in some cases, the Company may elect to continue the accrual of interest when the net realizable value of collateral is sufficient to cover the principal and accrued interest. When a loan or lease is classified as nonaccrual and the future collectibility of the recorded loan or lease balance is doubtful, collections on interest and principal are applied as a reduction to principal outstanding. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured, which is typically evidenced by a sustained repayment performance of at least six months.

A loan or lease is considered impaired, based on current information and events, if it is probable that the Company 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. Interest on impaired loans and leases, which are not classified as nonaccrual, is recognized on the accrual basis. The Company evaluates loans and leases exceeding \$100,000 for impairment and establishes a specific reserve 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 or lease and the recorded investment in the loan or lease exceeds its fair value.

Loans and leases that have been modified and economic concessions have been granted to borrowers who have experienced financial difficulties are considered a troubled debt restructuring (TDR) and, by definition, are deemed an impaired loan. These concessions typically result from the Company's loss mitigation activities and may 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.

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When the Company modifies loans and leases in a TDR, it evaluates 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 uses the current fair value of the collateral, less selling costs for collateral dependent loans. If the Company determines 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 a reserve for loan and lease losses estimate or a charge-off to the reserve for loan and lease losses. In periods subsequent to modification, the Company evaluates all TDRs, including those that have payment defaults, for possible impairment and recognizes impairment through the reserve for loan and lease losses.

Revenue Recognition

The Company recognizes revenues as they are earned based on contractual terms, as transactions occur, or as services are provided and collectibility is reasonably assured. The Company's principal source of revenue is interest income from loans and leases and investment securities. The Company also earns noninterest income from various banking and financial services offered primarily through 1st Source Bank (Bank) and its subsidiaries.

Interest Income – The largest source of revenue for the Company is interest income which is primarily recognized on an accrual basis according to nondiscretionary formulas in written contracts, such as loan and lease agreements or investment securities contracts.

Noninterest Income – The Company earns noninterest income through a variety of financial and transaction services provided to corporate and consumer clients such as trust and wealth advisory, deposit account, debit card, mortgage banking, insurance, and equipment rental services. Revenue is recorded for noninterest income based on the contractual terms for the service or transaction performed. In certain circumstances, noninterest income is reported net of associated expenses.

Note 2 — Recent Accounting Pronouncements

Accumulated Other Comprehensive Income (Loss): In February 2018, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2018-02 “Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income.” These amendments provide financial statement preparers with an option to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) is recorded. The guidance is effective for all organizations for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in any interim period. The amendments should be applied either in the period adopted or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Company early adopted ASU 2018-02 on January 1, 2018 through a \$0.72 million cumulative-effect adjustment from AOCI to increase retained earnings related to unrealized gains and losses on available-for-sale securities. No other income tax effects related to the application of the Tax Cuts and Jobs Act were reclassified from AOCI to retained earnings.

Premium Amortization: In March 2017, the FASB issued ASU No. 2017-08 “Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” These amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is continuing to assess the impact of ASU 2017-08 on its accounting and disclosures.

Simplifying the Test for Goodwill Impairment: In January 2017, the FASB issued ASU No. 2017-04 “Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment.” These amendments eliminate Step 2 from the goodwill impairment test. The amendments also eliminate the requirements for any reporting unit with a zero

or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The guidance is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. ASU 2017-04 should be adopted on a prospective basis. The Company has assessed ASU 2017-04 and does not expect it to have a material impact on its accounting and disclosures.

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Measurement of Credit Losses on Financial Instruments: In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments-Credit Losses (Topic 326) - Measurement of Credit Losses on Financial Instruments.” The provisions of ASU 2016-13 were issued to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments that are not accounted for at fair value through net income, including loans held for investment, held-to-maturity debt securities, trade and other receivables, net investment in leases and other commitments to extend credit held by a reporting entity at each reporting date. ASU 2016-13 requires that financial assets measured at amortized cost be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The amendments in ASU 2016-13 eliminate the probable incurred loss recognition in current GAAP and reflect an entity’s current estimate of all expected credit losses. The measurement of expected credit losses is based upon historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the financial assets.

For purchased financial assets with a more-than-insignificant amount of credit deterioration since origination (“PCD assets”) that are measured at amortized cost, the initial allowance for credit losses is added to the purchase price rather than being reported as a credit loss expense. Subsequent changes in the allowance for credit losses on PCD assets are recognized through the statement of income as a credit loss expense.

Credit losses relating to available-for-sale debt securities will be recorded through an allowance for credit losses rather than as a direct write-down to the security.

ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company has an implementation team working through the provisions of ASU 2016-13 including assessing the impact on its accounting and disclosures.

Leases: In February 2016, the FASB issued ASU No. 2016-02 “Leases (Topic 842).” ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn’t convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company has an implementation team working through the provisions of ASU 2016-02 including a review of all leases to assess the impact on its accounting, disclosures and the election of certain practical expedients. The Company has selected a third party software solution to assist with the accounting under the new standard. It is expected that the Company will recognize discounted right of use assets and lease liabilities (estimated between \$7 and \$10 million) upon adoption on January 1, 2019. The estimates will change due to changes in the lease portfolio.

Recognition and Measurement of Financial Instruments: In January 2016, the FASB issued ASU No. 2016-01 “Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial

instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. In February 2018, the FASB issued ASU No. 2018-03 which includes technical corrections and improvements to clarify the guidance in ASU No. 2016-01. The Company adopted ASU 2016-01 on January 1, 2018 and it did not have a material effect on its accounting for equity investments, fair value disclosures and other disclosure requirements.

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Revenue from Contracts with Customers: In May 2014, the FASB issued ASU No. 2014-09 “Revenue from Contracts with Customers (Topic 606).” The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. On July 9, 2015, the FASB approved amendments deferring the effective date by one year. ASU 2014-09 is now effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted but not before the original public entity effective date, i.e., annual periods beginning after December 15, 2016. In March 2016, the FASB issued final amendments (ASU No. 2016-08 and ASU No. 2016-10) to clarify the implementation guidance for principal versus agent considerations, identifying performance obligations and the accounting for licenses of intellectual property. The amendments can be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this Update recognized at the date of initial application. In May 2016, the FASB issued final amendments (ASU No. 2016-12 and ASU 2016-11) to address narrow-scope improvements to the guidance on collectibility, non-cash consideration, completed contracts at transition and to provide a practical expedient for contract modifications at transition and an accounting policy election related to the presentation of sales taxes and other similar taxes collected from customers. Additionally, the amendments included a rescission of SEC guidance because of ASU 2014-09 related to revenue and expense recognition for freight services in process, accounting for shipping and handling fees and costs, and accounting for consideration given by a vendor to a customer. In December 2016, the FASB issued final guidance (ASU 2016-20) that allows entities not to make quantitative disclosures about performance obligations in certain cases and requires entities that use any of the new or previously existing optional exemptions to expand their qualitative disclosures. It also makes 12 additional technical corrections and improvements to the new revenue standard. These amendments are effective upon the adoption of ASU 2014-09. The Company’s revenue is comprised of net interest income, which is explicitly excluded from the scope of ASU 2014-09, and noninterest income. ASU 2014-09 required the Company to evaluate how it recognizes certain recurring revenue streams related to noninterest income. The Company adopted ASU 2014-09 on January 1, 2018 and did not identify any significant changes in the timing of revenue recognition when considering the amended accounting guidance. Additional disclosures related to revenue recognition appears in “Note 1. Accounting Policies.”

Note 3. Investment Securities Available-For-Sale

The following table shows investment securities available-for-sale.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2018				
U.S. Treasury and Federal agencies securities	\$ 510,739	\$ 7	\$ (7,749)	) \$ 502,997
U.S. States and political subdivisions securities	98,740	321	(1,076)	) 97,985
Mortgage-backed securities — Federal agencies	301,717	997	(6,384)	) 296,330
Corporate debt securities	44,584	—	(528)	) 44,056
Foreign government and other securities	700	8	—	708
Total debt securities available-for-sale	\$ 956,480	\$ 1,333	\$ (15,737)	) \$ 942,076
December 31, 2017				
U.S. Treasury and Federal agencies securities	\$ 471,508	\$ 57	\$ (3,446)	) \$ 468,119
U.S. States and political subdivisions securities	116,260	648	(908)	) 116,000
Mortgage-backed securities — Federal agencies	289,327	1,456	(2,873)	) 287,910
Corporate debt securities	31,573	5	(284)	) 31,294
Foreign government and other securities	700	10	—	710
Total debt securities available-for-sale	\$ 909,368	\$ 2,176	\$ (7,511)	) \$ 904,033

At March 31, 2018 and December 31, 2017, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).

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The following table shows the contractual maturities of investments in debt securities available-for-sale at March 31, 2018. 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	\$ 73,984	\$ 73,935
Due after one year through five years	560,259	551,743
Due after five years through ten years	20,520	20,068
Due after ten years	—	—
Mortgage-backed securities	301,717	296,330
Total debt securities available-for-sale	\$ 956,480	\$ 942,076

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

(Dollars in thousands)	Less than 12 Months		12 months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2018						
U.S. Treasury and Federal agencies securities	\$ 399,359	\$ (4,388)	\$ 88,465	\$ (3,361)	\$ 487,824	\$ (7,749)
U.S. States and political subdivisions securities	46,927	(484)	18,067	(592)	64,994	(1,076)
Mortgage-backed securities - Federal agencies	175,903	(3,672)	67,169	(2,712)	243,072	(6,384)
Corporate debt securities	34,146	(184)	9,910	(344)	44,056	(528)
Foreign government and other securities	—	—	—	—	—	—
Total debt securities available-for-sale	\$ 656,335	\$ (8,728)	\$ 183,611	\$ (7,009)	\$ 839,946	\$ (15,737)

December 31, 2017

U.S. Treasury and Federal agencies securities	\$ 311,865	\$ (1,161)	\$ 89,617	\$ (2,285)	\$ 401,482	\$ (3,446)
U.S. States and political subdivisions securities	34,971	(287)	24,909	(621)	59,880	(908)
Mortgage-backed securities - Federal agencies	137,169	(1,336)	60,162	(1,537)	197,331	(2,873)
Corporate debt securities	13,747	(57)	10,048	(227)	23,795	(284)
Foreign government and other securities	—	—	—	—	—	—
Total debt securities available-for-sale	\$ 497,752	\$ (2,841)	\$ 184,736	\$ (4,670)	\$ 682,488	\$ (7,511)

The initial indication of potential other-than-temporary-impairment (OTTI) for debt 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 debt securities available-for-sale 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 losses, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

At March 31, 2018, the Company does not have the intent to sell any of the debt securities available-for-sale in the table above and believes that it is more likely than not, that it will not have to sell any such securities before an anticipated recovery of cost. Primarily the unrealized losses on debt securities are due to increases in market rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

The following table shows the gross realized gains and losses from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses of all securities are computed using the specific identification cost basis.

Three Months
Ended
March 31,

(Dollars in thousands)	2018	2017
Gross realized gains	\$2	\$1,285
Gross realized losses	(347)	—
OTTI losses	—	—
Net realized gains (losses)	\$(345)	\$1,285

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At March 31, 2018 and December 31, 2017, investment securities available-for-sale with carrying values of \$262.74 million and \$289.05 million, respectively, were pledged as collateral for security repurchase agreements and for other purposes.

Note 4. Loan and Lease Financings

The Company evaluates loans and leases for credit quality at least annually but more frequently if certain circumstances occur (such as material new information which becomes available and indicates a potential change in credit risk). The Company uses two methods to assess credit risk: loan or lease credit quality grades and credit risk classifications. The purpose of the loan or lease credit quality grade is to document the degree of risk associated with individual credits as well as inform management of the degree of risk in the portfolio taken as a whole. Credit risk classifications are used to categorize loans by degree of risk and to designate individual or committee approval authorities for higher risk credits at the time of origination. Credit risk classifications include categories for: Acceptable, Marginal, Special Attention, Special Risk, Restricted by Policy, Regulated and Prohibited by Law. All loans and leases, except residential real estate and home equity loans and consumer loans, are assigned credit quality grades on a scale from 1 to 12 with grade 1 representing superior credit quality. The criteria used to assign grades to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on the Company's safety and soundness. Loans or leases graded 7 or weaker are considered "special attention" credits and, as such, relationships in excess of \$100,000 are reviewed quarterly as part of management's evaluation of the appropriateness of the reserve for loan and lease losses. Grade 7 credits are defined as "watch" and contain greater than average credit risk and are monitored to limit the exposure to increased risk; grade 8 credits are "special mention" and, following regulatory guidelines, are defined as having potential weaknesses that deserve management's close attention. Credits that exhibit well-defined weaknesses and a distinct possibility of loss are considered "classified" and are graded 9 through 12 corresponding to the regulatory definitions of "substandard" (grades 9 and 10) and the more severe "doubtful" (grade 11) and "loss" (grade 12). The following table shows the credit quality grades of the recorded investment in loans and leases, segregated by class.

(Dollars in thousands)	Credit Quality Grades		
	1-6	7-12	Total
March 31, 2018			
Commercial and agricultural	\$984,159	\$27,541	\$1,011,700
Auto and light truck	491,220	19,831	511,051
Medium and heavy duty truck	276,977	3,033	280,010
Aircraft	837,584	30,835	868,419
Construction equipment	599,003	20,216	619,219
Commercial real estate	732,987	15,939	748,926
Total	\$3,921,930	\$117,395	\$4,039,325
December 31, 2017			
Commercial and agricultural	\$906,074	\$23,923	\$929,997
Auto and light truck	482,455	14,361	496,816
Medium and heavy duty truck	293,318	3,617	296,935
Aircraft	815,956	28,701	844,657
Construction equipment	552,684	10,753	563,437
Commercial real estate	726,134	15,434	741,568
Total	\$3,776,621	\$96,789	\$3,873,410

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

(Dollars in thousands)	Performing	Nonperforming	Total
March 31, 2018			
Residential real estate and home equity	\$ 516,208	\$ 1,922	\$ 518,130
Consumer	133,460	182	133,642
Total	\$ 649,668	\$ 2,104	\$ 651,772

December 31, 2017

Residential real estate and home equity	\$ 523,803	\$ 2,319	\$ 526,122
Consumer	127,982	164	128,146
Total	\$ 651,785	\$ 2,483	\$ 654,268

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

(Dollars in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Accruing Loans	Nonaccrual	Total Financing Receivables
March 31, 2018							
Commercial and agricultural	\$ 1,008,424	\$ 16	\$ 22	\$ —	\$ 1,008,462	\$ 3,238	\$ 1,011,700
Auto and light truck	501,029	533	365	—	501,927	9,124	511,051
Medium and heavy duty truck	279,177	496	—	—	279,673	337	280,010
Aircraft	856,589	6,039	—	—	862,628	5,791	868,419
Construction equipment	615,738	2,382	101	—	618,221	998	619,219
Commercial real estate	744,355	680	—	—	745,035	3,891	748,926
Residential real estate and home equity	515,124	657	427	114	516,322	1,808	518,130
Consumer	132,649	746	65	9	133,469	173	133,642
Total	\$ 4,653,085	\$ 11,549	\$ 980	\$ 123	\$ 4,665,737	\$ 25,360	\$ 4,691,097
December 31, 2017							
Commercial and agricultural	\$ 927,113	\$ 281	\$ —	\$ —	\$ 927,394	\$ 2,603	\$ 929,997
Auto and light truck	485,885	2,869	21	—	488,775	8,041	496,816
Medium and heavy duty truck	296,564	—	—	—	296,564	371	296,935
Aircraft	823,638	14,570	4,492	—	842,700	1,957	844,657
Construction equipment	561,665	333	448	—	562,446	991	563,437
Commercial real estate	738,006	23	121	—	738,150	3,418	741,568
Residential real estate and home equity	521,943	1,508	352	429	524,232	1,890	526,122
Consumer	127,107	776	99	30	128,012	134	128,146
Total	\$ 4,481,921	\$ 20,360	\$ 5,533	\$ 459	\$ 4,508,273	\$ 19,405	\$ 4,527,678

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

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Reserve
March 31, 2018			
With no related reserve recorded:			
Commercial and agricultural	\$ 3,013	\$ 3,013	\$ —
Auto and light truck	1,913	1,913	—
Medium and heavy duty truck	337	337	—
Aircraft	1,514	1,514	—
Construction equipment	601	601	—
Commercial real estate	2,870	2,870	—
Residential real estate and home equity	—	—	—
Consumer	—	—	—
Total with no related reserve recorded	10,248	10,248	—
With a reserve recorded:			
Commercial and agricultural	—	—	—
Auto and light truck	6,972	6,972	360
Medium and heavy duty truck	—	—	—
Aircraft	4,238	4,238	431
Construction equipment	344	344	101
Commercial real estate	939	939	173
Residential real estate and home equity	350	352	132
Consumer	—	—	—
Total with a reserve recorded	12,843	12,845	1,197
Total impaired loans	\$ 23,091	\$ 23,093	\$ 1,197
December 31, 2017			
With no related reserve recorded:			
Commercial and agricultural	\$ 2,439	\$ 2,439	\$ —
Auto and light truck	—	—	—
Medium and heavy duty truck	371	371	—
Aircraft	1,901	1,901	—
Construction equipment	584	584	—
Commercial real estate	2,375	2,375	—
Residential real estate and home equity	—	—	—
Consumer	—	—	—
Total with no related reserve recorded	7,670	7,670	—
With a reserve recorded:			
Commercial and agricultural	—	—	—
Auto and light truck	7,780	7,780	243
Medium and heavy duty truck	—	—	—
Aircraft	—	—	—
Construction equipment	344	344	108
Commercial real estate	971	971	181
Residential real estate and home equity	352	354	134
Consumer	—	—	—
Total with a reserve recorded	9,447	9,449	666

Total impaired loans	\$ 17,117	\$ 17,119	\$ 666
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The following table shows average recorded investment and interest income recognized on impaired loans and leases, segregated by class.

(Dollars in thousands)	Three Months Ended March 31,			
	2018		2017	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural	\$2,843	\$ —	\$2,704	\$ 1
Auto and light truck	7,827	—	84	—
Medium and heavy duty truck	347	—	—	—
Aircraft	3,069	—	8,795	—
Construction equipment	1,330	—	1,161	—
Commercial real estate	3,696	—	3,904	—
Residential real estate and home equity	350	4	358	4
Consumer	—	—	—	—
Total	\$19,462	\$ 4	\$17,006	\$ 5

There were no loan and lease modifications classified as a troubled debt restructuring (TDR) during the three months ended March 31, 2018 and 2017. The classification between nonperforming and performing is determined at the time of modification. Modification programs focus on extending maturity dates or modifying payment patterns with most TDRs experiencing a combination of concessions. Modifications do not result in the contractual forgiveness of principal or interest.

There were no TDRs which had payment defaults within the twelve months following modification during the three months ended March 31, 2018 and 2017. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.

The following table shows the recorded investment of loans and leases classified as troubled debt restructurings as of March 31, 2018 and December 31, 2017.

(Dollars in thousands)	March 31, December 31,	
	2018	2017
Performing TDRs	\$ 349	\$ 352
Nonperforming TDRs	125	537
Total TDRs	\$ 474	\$ 889

Note 5. Reserve for Loan and Lease Losses

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

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

The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the three months ended March 31, 2018 and 2017.

(Dollars in thousands)	Commercial agricultural	Auto and light truck	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer loans	Total
March 31, 2018									
Balance, beginning of period	\$ 16,228	\$ 10,103	\$ 4,844	\$ 34,619	\$ 9,343	\$ 14,792	\$ 3,666	\$ 1,288	\$ 94,883
Charge-offs	25	316	—	29	5	7	11	163	556
Recoveries	49	6	—	44	19	21	6	73	218
Net charge-offs (recoveries)	(24)	310	—	(15)	(14)	(14)	5	90	338
Provision (recovery of provision)	1,357	1,017	(351)	202	1,560	(36)	(96)	133	3,786
Balance, end of period	\$ 17,609	\$ 10,810	\$ 4,493	\$ 34,836	\$ 10,917	\$ 14,770	\$ 3,565	\$ 1,331	\$ 98,331
March 31, 2017									
Balance, beginning of period	\$ 14,668	\$ 8,064	\$ 4,740	\$ 34,352	\$ 8,207	\$ 13,677	\$ 3,550	\$ 1,285	\$ 88,543
Charge-offs	208	21	—	1,103	—	2	4	220	1,558
Recoveries	595	1,127	—	183	22	50	71	85	2,133
Net charge-offs (recoveries)	(387)	(1,106)	—	920	(22)	(48)	(67)	135	(575)
Provision (recovery of provision)	934	602	(64)	(1,424)	703	143	(25)	131	1,000
Balance, end of period	\$ 15,989	\$ 9,772	\$ 4,676	\$ 32,008	\$ 8,932	\$ 13,868	\$ 3,592	\$ 1,281	\$ 90,118

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The following table shows the reserve for loan and lease losses and recorded investment in loans and leases, segregated by class, separated between individually and collectively evaluated for impairment as of March 31, 2018 and December 31, 2017.

(Dollars in thousands)	Commercial and agricultural	Auto and light trucks	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer loans	Total
March 31, 2018									
Reserve for loan and lease losses									
Ending balance, individually evaluated for impairment	\$—	\$360	\$—	\$431	\$101	\$173	\$132	\$—	\$1,197
Ending balance, collectively evaluated for impairment	17,609	10,450	4,493	34,405	10,816	14,597	3,433	1,331	97,134
Total reserve for loan and lease losses	\$17,609	\$10,810	\$4,493	\$34,836	\$10,917	\$14,770	\$3,565	\$1,331	\$98,331
Recorded investment in loans									
Ending balance, individually evaluated for impairment	\$3,013	\$8,885	\$337	\$5,752	\$945	\$3,809	\$350	\$—	\$23,091
Ending balance, collectively evaluated for impairment	1,008,687	502,166	279,673	862,667	618,274	745,117	517,780	133,642	4,668,006
Total recorded investment in loans	\$1,011,700	\$511,051	\$280,010	\$868,419	\$619,219	\$748,926	\$518,130	\$133,642	\$4,691,097
December 31, 2017									
Reserve for loan and lease losses									
Ending balance, individually evaluated for impairment	\$—	\$243	\$—	\$—	\$108	\$181	\$134	\$—	\$666
Ending balance, collectively evaluated for impairment	16,228	9,860	4,844	34,619	9,235	14,611	3,532	1,288	94,217
Total reserve for loan and lease losses	\$16,228	\$10,103	\$4,844	\$34,619	\$9,343	\$14,792	\$3,666	\$1,288	\$94,883
Recorded investment in loans									
Ending balance, individually evaluated for impairment	\$2,439	\$7,780	\$371	\$1,901	\$928	\$3,346	\$352	\$—	\$17,117
Ending balance, collectively evaluated	927,558	489,036	296,564	842,756	562,509	738,222	525,770	128,146	4,510,561

for impairment

Total recorded investment in loans	\$929,997	\$496,816	\$296,935	\$844,657	\$563,437	\$741,568	\$526,122	\$128,146	\$4,527,678
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Note 6. Mortgage Servicing Rights

The Company recognizes the rights to service residential mortgage loans for others as separate assets, whether the servicing rights are acquired through a separate purchase or through the sale of originated loans with servicing rights retained. The Company allocates a portion of the total proceeds of a mortgage loan to servicing rights based on the relative fair value. The unpaid principal balance of residential mortgage loans serviced for third parties was \$752.26 million and \$752.99 million at March 31, 2018 and December 31, 2017, respectively.

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

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The following table shows changes in the carrying value of MSR's and the associated valuation allowance.

(Dollars in thousands)	Three Months Ended March 31,	
	2018	2017
Mortgage servicing rights:		
Balance at beginning of period	\$4,349	\$4,297
Additions	243	247
Amortization	(236)	(263)
Sales	—	—
Carrying value before valuation allowance at end of period	4,356	4,281
Valuation allowance:		
Balance at beginning of period	—	—
Impairment recoveries	—	—
Balance at end of period	\$—	\$—
Net carrying value of mortgage servicing rights at end of period	\$4,356	\$4,281
Fair value of mortgage servicing rights at end of period	\$7,389	\$7,452

At March 31, 2018 and 2017, the fair value of MSR's exceeded the carrying value reported in the Statements of Financial Condition by \$3.03 million and \$3.17 million, respectively. This difference represents increases in the fair value of certain MSR's that could not be recorded above cost basis.

Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$0.66 million and \$0.68 million for the three months ended March 31, 2018 and 2017, respectively. Mortgage loan contractual servicing fees are included in Mortgage Banking on the Statements of Income.

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

Commitments — 1st Source Bank (Bank), a subsidiary of 1st Source Corporation, has made investments directly in various tax-advantaged and other operating partnerships formed by third parties. The Bank's investments are primarily related to investments promoting affordable housing, community development and renewable energy sources. As a limited partner in these operating partnerships, we are allocated credits and deductions associated with the underlying properties. The Bank has determined that it is not the primary beneficiary of these investments because the general partners have the power to direct the activities that most significantly influence the economic performance of their respective partnerships. At March 31, 2018 and December 31, 2017, investment balances, including all legally binding commitments to fund future investments totaled \$14.39 million and \$23.76 million, respectively. In addition, the Bank had a liability for all legally binding unfunded commitments of \$15.24 million and \$15.71 million at March 31, 2018 and December 31, 2017, respectively.

Financial Instruments with Off-Balance-Sheet Risk — 1st Source and its subsidiaries are parties to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Statements of Financial Condition. The following table shows financial instruments whose contract amounts represent credit risk.

(Dollars in thousands)	March 31, 2018	December 31, 2017
Amounts of commitments:		
Loan commitments to extend credit	\$1,031,638	\$1,030,334
Standby letters of credit	\$31,421	\$29,961
Commercial and similar letters of credit	\$756	\$1,837

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

does for on-balance-sheet instruments.

The Bank 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.

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Standby letters of credit are conditional commitments that guarantee the performance of a client to a third party. The credit risk involved in and collateral obtained when issuing standby letters of credit is essentially the same as that involved in extending loan commitments to clients. Standby letters of credit generally have terms ranging from six months to one year.

Commercial letters of credit are issued specifically to facilitate commerce and typically result in the commitment being drawn on when the underlying transaction is consummated between the customer and the third party.

Commercial letters of credit generally have terms ranging from three months to six months.

Note 8. Derivative Financial Instruments

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

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

(Dollars in thousands)	Notional or contractual amount	Asset derivatives		Liability derivatives	
		Statement of Financial Condition classification	Fair value	Statement of Financial Condition classification	Fair value
March 31, 2018					
Interest rate swap contracts	\$ 781,975	Other assets	\$5,342	Other liabilities	\$5,439
Loan commitments	8,114	Mortgages held for sale	62	N/A	—
Forward contracts - mortgage loan	15,755	N/A	—	Mortgages held for sale	7
Total	\$ 805,844		\$5,404		\$5,446
December 31, 2017					
Interest rate swap contracts	\$ 756,550	Other assets	\$5,167	Other liabilities	\$5,262
Loan commitments	8,504	Mortgages held for sale	66	N/A	—
Forward contracts - mortgage loan	19,390	N/A	—	Mortgages held for sale	10
Total	\$ 784,444		\$5,233		\$5,272

The following table shows the amounts included in the Statements of Income for non-hedging derivative financial instruments.

(Dollars in thousands)	Statement of Income classification	Gain (loss)	
		Three Months Ended March 31, 2018	2017
Interest rate swap contracts	Other expense	\$(1)	\$20

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Interest rate swap contracts	Other income	333	119
Loan commitments	Mortgage banking	(4) 55
Forward contracts - mortgage loan	Mortgage banking	3	(312)
Total		\$331	\$(118)

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The following table shows the offsetting of financial assets and derivative assets.

(Dollars in thousands)	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Condition	Net Amounts of Assets Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition		
				Financial Instruments	Cash Collateral Received	Net Amount
March 31, 2018						
Interest rate swaps	\$ 5,360	\$ 18	\$ 5,342	\$ —	\$ —	—\$ 5,342
December 31, 2017						
Interest rate swaps	\$ 5,194	\$ 27	\$ 5,167	\$ —	\$ —	—\$ 5,167

The following table shows the offsetting of financial liabilities and derivative liabilities.

(Dollars in thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statement of Financial Condition	Net Amounts of Liabilities Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition		
				Financial Instruments	Cash Collateral Pledged	Net Amount
March 31, 2018						
Interest rate swaps	\$ 5,457	\$ 18	\$ 5,439	\$ —	\$ 365	\$ 5,074
Repurchase agreements	123,913	—	123,913	123,913	—	—
Total	\$ 129,370	\$ 18	\$ 129,352	\$ 123,913	\$ 365	\$ 5,074
December 31, 2017						
Interest rate swaps	\$ 5,289	\$ 27	\$ 5,262	\$ —	\$ 2,705	\$ 2,557
Repurchase agreements	149,835	—	149,835	149,835	—	—
Total	\$ 155,124	\$ 27	\$ 155,097	\$ 149,835	\$ 2,705	\$ 2,557

If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions. At March 31, 2018 and December 31, 2017, repurchase agreements had a remaining contractual maturity of \$122.30 million and \$148.22 million in overnight, \$1.31 million and \$1.32 million in up to 30 days, and \$0.30 million and \$0.30 million in greater than 90 days, respectively and were collateralized by U.S. Treasury and Federal agencies securities.

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. There were no stock options outstanding as of March 31, 2018 and 2017.

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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.

	Three Months Ended March 31,	
(Dollars in thousands - except per share amounts)	2018	2017
Distributed earnings allocated to common stock	\$5,704	\$ 4,663
Undistributed earnings allocated to common stock	13,278	11,422
Net earnings allocated to common stock	18,982	16,085
Net earnings allocated to participating securities	134	121
Net income allocated to common stock and participating securities	\$19,116	\$ 16,206
Weighted average shares outstanding for basic earnings per common share	25,950,387	25,903,397
Dilutive effect of stock compensation	—	—
Weighted average shares outstanding for diluted earnings per common share	25,950,387	25,903,397
Basic earnings per common share	\$0.73	\$ 0.62
Diluted earnings per common share	\$0.73	\$ 0.62

Note 10. Stock Based Compensation

As of March 31, 2018, the Company had four active stock-based employee compensation plans, which are more fully described in Note 16 of the Consolidated Financial Statements in 1st Source's Annual Report on Form 10-K for the year ended December 31, 2017. These plans include three executive stock award plans, the Executive Incentive Plan, the Restricted Stock Award Plan, the Strategic Deployment Incentive Plan; and the Employee Stock Purchase Plan. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but the Company had not made any grants through March 31, 2018.

Stock-based compensation expense for all stock-based compensation awards granted is based on the grant-date fair value. For all awards except stock option awards, the grant date fair value is either the fair market value per share or book value per share (corresponding to the type of stock awarded) as of the grant date. For stock option awards, the grant date fair value is estimated using the Black-Scholes option pricing model. For all awards the Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, for which the Company uses the related vesting term.

Total fair value of options vested and expensed was zero for the three months ended March 31, 2018 and 2017. As of March 31, 2018 and 2017 there were no outstanding stock options. There were no stock options exercised during the three months ended March 31, 2018 and 2017. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of March 31, 2018, there was \$7.42 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.40 years.

Note 11. Accumulated Other Comprehensive Income

The following table presents reclassifications out of accumulated other comprehensive income related to unrealized gains and losses on available-for-sale securities.

	Three Months Ended March 31,		Affected Line Item in the Statements of Income
(Dollars in thousands)	2018	2017	
Realized (losses) gains included in net income	\$(345)	\$ 1,285	(Losses) gains on investment securities available-for-sale
	(345)	1,285	Income before income taxes

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Tax effect	83	(482)	Income tax expense
Net of tax	\$(262)	\$803		Net income

Note 12. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$0.95 million at March 31, 2018 and \$0.72 million at December 31, 2017. Interest and penalties are recognized through the income tax provision. For the three months ended March 31, 2018 and 2017, the Company recognized \$0.01 million and \$0.00 million in interest or penalties, respectively. There was \$0.10 million and \$0.09 million in accrued interest and penalties at March 31, 2018 and December 31, 2017, respectively.

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Tax years that remain open and subject to audit include the federal 2014-2017 years and the Indiana 2014-2017 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

The Tax Cuts and Jobs Act was enacted on December 22, 2017. The Act reduces the U.S. federal corporate tax rate from 35% to 21%, effective January 1, 2018. At March 31, 2018 and December 31, 2017, the Company had not completed its accounting for the tax effects of enactment of the Act; however, in certain cases, as described below, the Company made a reasonable estimate of the effects on its existing deferred tax balances. The Company will continue to make and refine its calculations as additional analysis is completed. In addition, the Company's estimates may also be affected as it gains a more thorough understanding of the tax law.

Provisional amounts

Deferred tax assets and liabilities: The Company remeasured certain deferred tax assets and liabilities based on the rates at which it expects to reverse in the future, which is generally 21%. However, the Company is still analyzing certain aspects of the Act and refining its calculations, which could potentially affect the measurement of these balances or potentially give rise to new deferred tax amounts. The provisional amount recorded related to the remeasurement of its deferred tax balance was a benefit of \$2.61 million, which was included as a component of Income Tax Expense in the December 31, 2017 Consolidated Statements of Income and decreased the effective rate by 2.6%.

Further, at March 31, 2018 and December 31, 2017, the Company was unable to fully revalue the deferred tax liabilities associated with its partnership investments in renewable energy and affordable housing and estimated the deferred tax liability associated with those projects to be \$1.92 million. This estimation was necessary due to incomplete information for 2017 operations from those partnerships. Upon receipt of the partnership Form 1065 K-1's, the Company will complete the revaluation of those related deferred tax liabilities as provided by the U.S. Securities and Exchange Commission's SAB No. 118, Income Tax Accounting Implications of the Tax Cuts and Jobs Act.

Note 13. Fair Value Measurements

The Company records certain assets and liabilities at fair value. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements are also utilized to determine the initial value of certain assets and liabilities, to perform impairment assessments, and for disclosure purposes. The Company uses quoted market prices and observable inputs to the maximum extent possible when measuring fair value. In the absence of quoted market prices, various valuation techniques are utilized to measure fair value. When possible, observable market data for identical or similar financial instruments is used in the valuation. When market data is not available, fair value is determined using valuation models that incorporate management's estimates of the assumptions a market participant would use in pricing the asset or liability.

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

Level 1 — The valuation is based on quoted prices in active markets for identical instruments.

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

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

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

The Company elected fair value accounting for mortgages held for sale. The Company believes the election for mortgages held for sale (which are economically hedged with free-standing derivatives) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as

economic hedges for these assets. At March 31, 2018 and December 31, 2017, all mortgages held for sale were carried at fair value.

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The following table shows the differences between the fair value carrying amount of mortgages held for sale measured at fair value and the aggregate unpaid principal amount the Company is contractually entitled to receive at maturity.

(Dollars in thousands)	Fair value carrying amount	Aggregate unpaid principal	Excess of fair value carrying amount over (under) unpaid principal	
March 31, 2018				
Mortgages held for sale reported at fair value	\$ 8,626	\$ 8,611	\$ 15	(1)
December 31, 2017				
Mortgages held for sale reported at fair value	\$ 13,123	\$ 12,967	\$ 156	(1)

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

Financial Instruments on Recurring Basis:

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

Investment securities available-for-sale are valued primarily by a third party pricing agent. Prices supplied by the independent pricing agent, as well as their pricing methodologies and assumptions, are reviewed by the Company for reasonableness and to ensure such prices are aligned with market levels. In general, the Company's investment securities do not possess a complex structure that could introduce greater valuation risk. The portfolio mainly consists of traditional investments including U.S. Treasury and Federal agencies securities, federal agency mortgage pass-through securities, and general obligation and revenue municipal bonds. Pricing for such instruments is fairly generic and is easily obtained. On a quarterly basis, prices supplied by the pricing agent are validated by comparison to prices obtained from other third party sources for a material portion of the portfolio.

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

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.

Inactively traded government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.

State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Since some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities. Local direct placement municipal securities, with very little market activity, are priced using an appropriate market yield curve, which includes a credit spread

assumption.

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

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

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

The following table shows the balance of assets and liabilities measured at fair value on a recurring basis.

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
March 31, 2018				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$27,726	\$475,271	\$—	\$502,997
U.S. States and political subdivisions securities	—	95,830	2,155	97,985
Mortgage-backed securities — Federal agencies	—	296,330	—	296,330
Corporate debt securities	—	44,056	—	44,056
Foreign government and other securities	—	—	708	708
Total debt securities available-for-sale	27,726	911,487	2,863	942,076
Mortgages held for sale	—	8,626	—	8,626
Accrued income and other assets (interest rate swap agreements)	—	5,342	—	5,342
Total	\$27,726	\$925,455	\$2,863	\$956,044
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	\$—	\$5,439	\$—	\$5,439
Total	\$—	\$5,439	\$—	\$5,439
December 31, 2017				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$27,971	\$440,148	\$—	\$468,119
U.S. States and political subdivisions securities	—	113,845	2,155	116,000
Mortgage-backed securities — Federal agencies	—	287,910	—	287,910
Corporate debt securities	—	31,294	—	31,294
Foreign government and other securities	—	—	710	710
Total debt securities available-for-sale	27,971	873,197	2,865	904,033
Mortgages held for sale	—	13,123	—	13,123
Accrued income and other assets (interest rate swap agreements)	—	5,167	—	5,167
Total	\$27,971	\$891,487	\$2,865	\$922,323
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	\$—	\$5,262	\$—	\$5,262
Total	\$—	\$5,262	\$—	\$5,262

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The following table shows changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended March 31, 2018 and 2017.

(Dollars in thousands)	U.S. States and political subdivisions securities	Foreign government and other securities	Investment securities available-for-sale
Beginning balance January 1, 2018	\$ 2,155	\$ 710	\$ 2,865
Total gains or losses (realized/unrealized):			
Included in earnings	—	—	—
Included in other comprehensive income	—	(2)	(2)
Purchases	—	—	—
Issuances	—	—	—
Sales	—	—	—
Settlements	—	—	—
Maturities	—	—	—
Transfers into Level 3	—	—	—
Transfers out of Level 3	—	—	—
Ending balance March 31, 2018	\$ 2,155	\$ 708	\$ 2,863
Beginning balance January 1, 2017	\$ 2,699	\$ 807	\$ 3,506
Total gains or losses (realized/unrealized):			
Included in earnings	—	—	—
Included in other comprehensive income	19	(3)	16
Purchases	—	—	—
Issuances	—	—	—
Sales	—	—	—
Settlements	—	—	—
Maturities	(700)	—	(700)
Transfers into Level 3	—	—	—
Transfers out of Level 3	—	—	—
Ending balance March 31, 2017	\$ 2,018	\$ 804	\$ 2,822

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at March 31, 2018 or 2017. No transfers between levels occurred during the three months ended March 31, 2018 or 2017.

The following table shows the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a recurring basis.

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
March 31, 2018				
Debt securities available-for sale				
Direct placement municipal securities	\$ 2,155	Discounted cash flows	Credit spread assumption	2.26% - 3.08%
Foreign government	\$ 708	Discounted cash flows	Market yield assumption	0.22% - 1.33%
December 31, 2017				
Debt securities available-for sale				
Direct placement municipal securities	\$ 2,155	Discounted cash flows	Credit spread assumption	2.21% - 2.93%

Foreign government	\$ 710	Discounted cash flows	Market yield assumption	0.35% - 1.23%
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The sensitivity to changes in the unobservable inputs and their impact on the fair value measurement can be significant. The significant unobservable input for direct placement municipal securities are the credit spread assumptions used to determine the fair value measure. An increase (decrease) in the estimated spread assumption of the market will decrease (increase) the fair value measure of the securities. The significant unobservable input for foreign government securities are the market yield assumptions. The market yield assumption is negatively correlated to the fair value measure. An increase (decrease) in the determined market yield assumption will decrease (increase) the fair value measurement.

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Financial Instruments on Non-recurring Basis:

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

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

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

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

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

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

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

For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended March 31, 2018: impaired loans - \$0.30 million; partnership

investments - \$0.00 million; mortgage servicing rights - \$0.00 million; repossessions - \$0.65 million; and other real estate - \$0.00 million.

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The following table shows the carrying value of assets measured at fair value on a non-recurring basis.

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
March 31, 2018				
Impaired loans - collateral based	\$ —	—\$	—\$4,477	\$4,477
Accrued income and other assets (partnership investments)	—	—	1,000	1,000
Accrued income and other assets (mortgage servicing rights)	—	—	4,356	4,356
Accrued income and other assets (repossessions)	—	—	9,432	9,432
Accrued income and other assets (other real estate)	—	—	1,184	1,184
Total	\$ —	—\$	—\$20,449	\$20,449

December 31, 2017

Impaired loans - collateral based	\$ —	—\$	—\$7,994	\$7,994
Accrued income and other assets (partnership investments)	—	—	1,000	1,000
Accrued income and other assets (mortgage servicing rights)	—	—	4,349	4,349
Accrued income and other assets (repossessions)	—	—	10,114	10,114
Accrued income and other assets (other real estate)	—	—	1,312	1,312
Total	\$ —	—\$	—\$24,769	\$24,769

The following table below shows the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a non-recurring basis.

(Dollars in thousands) Carrying Value Fair Value Valuation Methodology Unobservable Inputs Range of Inputs

	Carrying Value	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
March 31, 2018					
Impaired loans	\$ 4,477	\$ 4,477	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	10%-20%
Mortgage servicing rights	4,356	7,389	Discounted cash flows	Constant prepayment rate (CPR) Discount rate	7.4% - 23.6% 10.1% - 13.0%
Repossessions	9,432	9,905	Appraisals, trade publications and auction values	Discount for lack of marketability	4% - 10%
Other real estate	1,184	1,312	Appraisals	Discount for lack of marketability	7% - 9%
December 31, 2017					
Impaired loans	\$ 7,994	\$ 7,994	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	3% - 20%
Mortgage servicing rights	4,349	7,187	Discounted cash flows	Constant prepayment rate (CPR) Discount rate	8.6% - 20.7% 9.6% - 12.5%
Repossessions	10,114	10,493	Appraisals, trade publications and auction values	Discount for lack of marketability	3% - 10%

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Other real estate	1,312	1,441	Appraisals	Discount for lack of marketability	7% - 9%
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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 following table shows the fair values of the Company's financial instruments.

(Dollars in thousands)	Carrying or Contract Value	Fair Value	Level 1	Level 2	Level 3
March 31, 2018					
Assets:					
Cash and due from banks	\$ 29,404	\$29,404	\$29,404	\$—	\$ —
Federal funds sold and interest bearing deposits with other banks	21,748	21,748	21,748	—	—
Investment securities, available-for-sale	942,076	942,076	27,726	911,487	2,863
Other investments	27,265	27,265	27,265	—	—
Mortgages held for sale	8,626	8,626	—	8,626	—
Loans and leases, net of reserve for loan and lease losses	4,592,766	4,565,022	—	—	4,565,022
Mortgage servicing rights	4,356	7,389	—	—	7,389
Interest rate swaps	5,342	5,342	—	5,342	—
Liabilities:					
Deposits	\$ 4,781,325	\$4,769,080	\$3,400,930	\$1,368,150	\$ —
Short-term borrowings	355,964	355,964	144,454	211,510	—
Long-term debt and mandatorily redeemable securities	71,335	68,657	—	68,657	—
Subordinated notes	58,764	50,198	—	50,198	—
Interest rate swaps	5,439	5,439	—	5,439	—
Off-balance-sheet instruments *	—	287	—	287	—
December 31, 2017					
Assets:					
Cash and due from banks	\$ 73,635	\$73,635	\$73,635	\$—	\$ —
Federal funds sold and interest bearing deposits with other banks	4,398	4,398	4,398	—	—
Investment securities, available-for-sale	904,033	904,033	27,971	873,197	2,865
Other investments	25,953	25,953	25,953	—	—
Mortgages held for sale	13,123	13,123	—	13,123	—
Loans and leases, net of reserve for loan and lease losses	4,432,795	4,428,848	—	—	4,428,848
Mortgage servicing rights	4,349	7,187	—	—	7,187
Interest rate swaps	5,167	5,167	—	5,167	—
Liabilities:					
Deposits	\$ 4,752,730	\$4,745,111	\$3,482,757	\$1,262,354	\$ —
Short-term borrowings	214,595	214,595	206,862	7,733	—
Long-term debt and mandatorily redeemable securities	70,060	67,857	—	67,857	—
Subordinated notes	58,764	57,103	—	57,103	—
Interest rate swaps	5,262	5,262	—	5,262	—
Off-balance-sheet instruments *	—	286	—	286	—

* 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 other investments. The methodologies for other financial assets and financial liabilities are discussed below:

Loans and Leases — For March 31, 2018, fair values of loans and leases are estimated on an exit price basis incorporating discounts for credit, liquidity and marketability factors. This is not comparable with the fair values disclosed for December 31, 2017, which were based on an entrance price basis. For that date, fair values of variable rate loans and leases that reprice frequently and with no significant change in credit risk were based on carrying values. The fair values of other loans and leases as of that date were estimated using discounted cash flow analyses which used interest rates then 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 the liability related to mortgage loans available for repurchase under GNMA optional repurchase programs, approximate their fair values.

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

Subordinated Notes — Fair values are estimated based on calculated market prices of comparable securities.

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

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

These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. These estimates are subjective in nature and require considerable judgment to interpret market data. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange, nor are they intended to represent the fair value of the Company 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 the Company is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.

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

ITEM 2.

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

The following management's discussion and analysis is presented to provide information concerning 1st Source Corporation and its subsidiaries' (collectively referred to as "the Company", "we", and "our") financial condition as of March 31, 2018, as compared to December 31, 2017, and the results of operations for the three months ended March 31, 2018 and 2017. 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 2017 Annual Report.

Except for historical information contained herein, the matters discussed in this document express "forward-looking statements." Generally, the words "believe," "contemplate," "seek," "plan," "possible," "assume," "expect," "intend," "targeted," "remain," "estimate," "anticipate," "project," "will," "should," "indicate," "would," "may" and other similar expressions are used to identify forward-looking statements but are not the exclusive means of identifying such 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 GAAP; 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 2017, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

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FINANCIAL CONDITION

Our total assets at March 31, 2018 were \$6.05 billion, an increase of \$164.18 million or 2.79% from December 31, 2017. Total investment securities, available-for-sale were \$942.08 million, an increase of \$38.04 million or 4.21% from December 31, 2017.

Total loans and leases were \$4.69 billion, an increase of \$163.42 million, or 3.61% from December 31, 2017. Our foreign loan and lease outstandings, all denominated in U.S. dollars were \$241.27 million and \$233.37 million as of March 31, 2018 and December 31, 2017, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were \$97.35 million and \$120.90 million as of March 31, 2018, respectively, compared to \$101.35 million and \$121.02 million as of December 31, 2017, respectively. As of March 31, 2018 and December 31, 2017 there was not a significant concentration in any other country. Solar loan and lease outstandings were \$88.91 million as of March 31, 2018, an increase of \$12.43 million or 16.25% from the \$76.48 million at December 31, 2017. Solar loan and lease outstandings are included in commercial and agricultural. Equipment owned under operating leases was \$144.13 million, an increase of \$4.55 million, or 3.26% compared to December 31, 2017.

Total deposits were \$4.78 billion, an increase of \$28.60 million or 0.60% from the end of 2017. Short-term borrowings were \$355.96 million, an increase of \$141.37 million, or 65.88% from December 31, 2017. Long-term debt and mandatorily redeemable securities were \$71.34 million, an increase of \$1.28 million or 1.82% from December 31, 2017.

The following table shows accrued income and other assets.

(Dollars in thousands)	March 31, 2018	December 31, 2017
Accrued income and other assets:		
Bank owned life insurance cash surrender value	\$ 66,371	\$ 65,816
Accrued interest receivable	18,939	17,133
Mortgage servicing rights	4,356	4,349
Other real estate	1,184	1,312
Repossessions	9,432	10,114
All other assets	46,202	56,688
Total accrued income and other assets	\$ 146,484	\$ 155,412

CAPITAL

As of March 31, 2018, total shareholders' equity was \$725.61 million, up \$7.07 million, or 0.98% from the \$718.54 million at December 31, 2017. In addition to net income of \$19.12 million, other significant changes in shareholders' equity during the first three months of 2018 included \$5.72 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$(10.94) million at March 31, 2018, compared to \$(3.33) million at December 31, 2017. Our equity-to-assets ratio was 11.99% as of March 31, 2018, compared to 12.20% at December 31, 2017. Book value per common share rose to \$27.96 at March 31, 2018, from \$27.70 at December 31, 2017.

We declared and paid cash dividends per common share of \$0.22 during the first quarter of 2018. The trailing four quarters dividend payout ratio, representing cash dividends per common share divided by diluted earnings per common share, was 29.41%. The dividend payout is continually reviewed by management and the Board of Directors subject to the Company's capital and dividend policy.

The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations.

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The actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of March 31, 2018, are presented in the table below.

(Dollars in thousands)	Actual		Minimum Capital Adequacy		Minimum Capital Adequacy with Capital Buffer ⁽¹⁾		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-Weighted Assets):								
1st Source Corporation	\$781,279	14.54%	\$429,762	8.00%	\$530,487	9.875%	\$537,202	10.00%
1st Source Bank	708,018	13.16	430,471	8.00	531,363	9.875	538,089	10.00
Tier 1 Capital (to Risk-Weighted Assets):								
1st Source Corporation	713,708	13.29	322,321	6.00	423,047	7.875	429,762	8.00
1st Source Bank	640,337	11.90	322,853	6.00	423,745	7.875	430,471	8.00
Common Equity Tier 1 Capital (to Risk-Weighted Assets):								
1st Source Corporation	656,708	12.22	241,741	4.50	342,466	6.375	349,182	6.50
1st Source Bank	640,337	11.90	242,140	4.50	343,032	6.375	349,758	6.50
Tier 1 Capital (to Average Assets):								
1st Source Corporation	713,708	12.13	235,315	4.00	N/A	N/A	294,144	5.00
1st Source Bank	640,337	10.89	235,243	4.00	N/A	N/A	294,054	5.00

(1) The capital conservation buffer requirement will be phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019.

LIQUIDITY AND INTEREST RATE SENSITIVITY

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as our operating cash needs are met. Funds are available from a number of sources, including the securities portfolio, the core deposit base, access to the national brokered certificates of deposit market, national listing service certificates of deposit, 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. At March 31, 2018, we borrowed \$20.00 million in the federal funds market. We could borrow \$245.00 million in additional funds for a short time from these banks on a collective basis. As of March 31, 2018, we had \$251.94 million outstanding in FHLB advances and could borrow an additional \$50.08 million. We also had no outstandings with the FRB and could borrow \$560.72 million as of March 31, 2018.

Our loan to asset ratio was 77.52% at March 31, 2018 compared to 76.91% at December 31, 2017 and 76.98% at March 31, 2017. Cash and cash equivalents totaled \$51.15 million at March 31, 2018 compared to \$78.03 million at December 31, 2017 and \$92.12 million at March 31, 2017. At March 31, 2018, the Statement of Financial Condition was rate sensitive by \$331.43 million more assets than liabilities scheduled to reprice within one year, or approximately 1.13%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

Under Indiana law governing the collateralization of public fund deposits, the Indiana Board of Depositories determines which financial institutions are required to pledge collateral based on the strength of their financial ratings. We have been informed that no collateral is required for our public fund deposits. However, the Board of Depositories could alter this requirement in the future and adversely impact our liquidity. Our potential liquidity exposure if we must pledge collateral is approximately \$680 million.

RESULTS OF OPERATIONS

Net income for the three month period ended March 31, 2018 was \$19.12 million, compared to \$16.21 million for the same period in 2017. Diluted net income per common share was \$0.73 for the three month period ended March 31, 2018, compared to \$0.62 for the same period in 2017. Return on average common shareholders' equity was 10.67% for the three months ended March 31, 2018, compared to 9.61% in 2017. The return on total average assets was 1.31% for the three months ended March 31, 2018, compared to 1.21% in 2017.

Net income increased for the three months ended March 31, 2018 compared to the first three months of 2017. Net interest income and noninterest income increased and income tax expense decreased which was offset by an increase in provision for loan and lease losses and noninterest expense. Details of the changes in the various components of net income are discussed further below.

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NET INTEREST INCOME

The following tables provide an analysis of net interest income and illustrates the interest income 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 21% rate (35% for periods prior to 2018). 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)	March 31, 2018			Three Months Ended December 31, 2017			March 31, 2017		
	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
ASSETS									
Investment securities									
available-for-sale:									
Taxable	\$807,447	\$4,568	2.29%	\$764,239	\$3,761	1.95%	\$708,249	\$3,514	2.01%
Tax exempt ⁽¹⁾	109,532	695	2.57%	119,970	853	2.82%	131,034	994	3.08%
Mortgages held for sale	7,719	80	4.20%	10,654	107	3.98%	8,155	81	4.03%
Loans and leases, net of unearned discount ⁽¹⁾	4,588,782	53,699	4.75%	4,446,794	51,441	4.59%	4,187,231	44,953	4.35%
Other investments	39,299	408	4.21%	76,648	458	2.37%	40,741	291	2.90%
Total earning assets ⁽¹⁾	5,552,779	59,450	4.34%	5,418,305	56,620	4.15%	5,075,410	49,833	3.98%
Cash and due from banks	61,395			64,356			59,967		
Reserve for loan and lease losses	(95,707)			(94,265)			(90,222)		
Other assets	421,107			430,441			392,092		
Total assets	\$5,939,574			\$5,818,837			\$5,437,247		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest-bearing deposits	\$3,702,882	\$6,562	0.72%	\$3,644,989	\$5,771	0.63%	\$3,345,670	\$3,734	0.45%
Short-term borrowings	322,257	776	0.98%	211,786	220	0.41%	267,823	227	0.34%
Subordinated notes	58,764	883	6.09%	58,764	870	5.87%	58,764	1,055	7.28%
Long-term debt and mandatorily redeemable securities	70,311	485	2.79%	70,170	510	2.88%	75,495	629	3.38%
Total interest-bearing liabilities	4,154,214	8,706	0.85%	3,985,709	7,371	0.73%	3,747,752	5,645	0.61%
Noninterest-bearing deposits	1,005,557			1,041,156			953,294		
Other liabilities	53,561			72,914			52,554		

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Shareholders' equity	726,242		719,058		683,647	
Total liabilities and shareholders' equity	\$5,939,574		\$5,818,837		\$5,437,247	
Less: Fully tax-equivalent adjustments	(212)		(435)		(461)	
Net interest income/margin (GAAP-derived) ⁽¹⁾	\$ 50,532	3.69 %	\$ 48,814	3.57 %	\$ 43,727	3.49 %
Fully tax-equivalent adjustments	212		435		461	
Net interest income/margin - FTE ⁽¹⁾	\$ 50,744	3.71 %	\$ 49,249	3.61 %	\$ 44,188	3.53 %

(1) See "Reconciliation of Non-GAAP Financial Measures" at the end of this section for additional information on this performance measure/ratio.

Quarter Ended March 31, 2018 compared to the Quarter Ended March 31, 2017

The taxable-equivalent net interest income for the three months ended March 31, 2018 was \$50.74 million, an increase of 14.84% over the same period in 2017. The net interest margin on a fully taxable-equivalent basis was 3.71% for the three months ended March 31, 2018, compared to 3.53% for the three months ended March 31, 2017. During the three month period ended March 31, 2018, average earning assets increased \$477.37 million or 9.41% over the comparable period in 2017. Average interest-bearing liabilities increased \$406.46 million or 10.85%. The yield on average earning assets increased 36 basis points to 4.34% from 3.98% primarily due to higher rates on loans and leases and investment securities available-for-sale. Total cost of average interest-bearing liabilities increased 24 basis points to 0.85% from 0.61% as a result of the rising interest rate environment. The result to the net interest margin, or the ratio of net interest income to average earning assets, was an increase of 18 basis points.

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The largest contributors to the improved yield on average earning assets for the three months ended March 31, 2018, compared to the three months ended March 31, 2017, was an increase in yields on net loans and leases of 40 basis points and growth in yields on investment securities available-for-sale of 15 basis points primarily due to market conditions as a result of recent Federal interest rate increases as well as the recognition of an unaccreted purchased loan discount due to early payoff of \$0.62 million which had a positive 6 basis point effect. Average net loans and leases increased \$401.55 million or 9.59%. Total average investment securities increased \$77.70 million or 9.26%. Average mortgages held for sale decreased \$0.44 million or 5.35%. 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 (FHLB) stock and commercial paper declined \$1.44 million or 3.54% from the first quarter of 2017. Average interest-bearing deposits increased \$357.21 million or 10.68% for the first quarter of 2018 over the same period in 2017. The effective rate paid on average interest-bearing deposits grew 27 basis points to 0.72% from 0.45%. The increase in the average cost of interest-bearing deposits was primarily the result of higher rates and a shift in the deposit mix from the first quarter of 2017.

Average short-term borrowings increased \$54.43 million or 20.32% for the first quarter of 2018 compared to the same period in 2017. Interest paid on short-term borrowings increased 64 basis points due to recent Federal interest rate increases as well as higher average FHLB borrowings. Interest paid on subordinated notes decreased 119 basis points during the first quarter of 2018 from the same period a year ago due to a conversion to a variable rate associated with one tranche that took effect September 15, 2017. Average long-term debt and mandatorily redeemable securities decreased \$5.18 million or 6.87%. Interest paid on long-term debt and mandatorily redeemable securities decreased 58 basis points during the first quarter of 2018 from the same period in 2017 primarily due to lower rates on mandatorily redeemable securities.

Reconciliation of Non-GAAP Financial Measures

The accounting and reporting policies of 1st Source conform to generally accepted accounting principles (“GAAP”) in the United States and prevailing practices in the banking industry. However, certain non-GAAP performance measures are used by management to evaluate and measure the Company’s performance. These include taxable-equivalent net interest income (including its individual components) and net interest margin (including its individual components). Management believes that these measures provide users of the Company’s financial information a more meaningful view of the performance of the interest-earning assets and interest-bearing liabilities. Management reviews yields on certain asset categories and the net interest margin of the Company and its banking subsidiaries on a fully taxable-equivalent (“FTE”) basis. In this non-GAAP presentation, net interest income is adjusted to reflect tax-exempt interest income on an equivalent before-tax basis. This measure ensures comparability of net interest income arising from both taxable and tax-exempt sources.

	Three Months Ended			
	March 31, 2018	December 31, 2017	March 31, 2017	
(Dollars in thousands)				
Calculation of Net Interest Margin				
(A) Interest income (GAAP)	\$59,238	\$56,185	\$49,372	
Fully tax-equivalent adjustments:				
(B) - Loans and leases	88	167	150	
(C) - Tax-exempt investment securities	124	268	311	
(D) Interest income - FTE (A+B+C)	59,450	56,620	49,833	
(E) Interest expense (GAAP)	8,706	7,371	5,645	
(F) Net interest income (GAAP) (A-E)	50,532	48,814	43,727	
(G) Net interest income - FTE (D-E)	50,744	49,249	44,188	
(H) Annualization factor	4.056	3.967	4.056	
(I) Total earning assets	\$5,552,779	\$5,418,305	\$5,075,410	
Net interest margin (GAAP-derived) (F*H)/I	3.69	% 3.57	% 3.49	%

Net interest margin - FTE (G*H)/I 3.71 %3.61 %3.53 %

PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES

The provision for loan and lease losses for the three month period ended March 31, 2018 was \$3.79 million compared to a provision for loan and lease losses in the three month period ended March 31, 2017 of \$1.00 million. Net charge-offs of \$0.34 million were recorded for the first quarter 2018, compared to net recoveries of \$0.58 million for the same quarter a year ago.

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The increase in the amount of the provision for the most recent quarter was principally driven by strong loan growth. Loan growth during the first quarter of 2018 was \$163.42 million compared to \$46.79 million for the same period last year. We also realized a slight increase in our special attention credits and nonaccrual loans this quarter.

We continue to evaluate risks which may impact our loan portfolios. We believe geopolitical events have the potential to negatively impact the U.S. economy. Current concerns include the tariff dispute between China and the U.S. and the potential for an escalating trade war. Political uncertainty continues in Latin America, with ongoing corruption scandals. Forthcoming elections in Brazil and Mexico raise the possibility that new leadership could reverse recent structural reform. There is also uncertainty in the U.S. trade relationship with Mexico and the threat of renegotiating NAFTA. Concerns continue to be heightened globally of terrorist attacks.

Another area of concern continues to be our aircraft portfolio where we have a collateral concentration and \$241 million in foreign exposure. The aircraft industry was among the sectors affected most by the sluggish economy. Values for some aircraft have not fully recovered. We remain concerned about the prolonged low prices for several models. We have some foreign exposure in Mexico and Brazil. Brazil is beginning to show some positive economic signs as it emerges from its worst recession in twenty-five years. However, the country continues to be plagued by corruption scandals. We continue to monitor individual customer performance and assess risks in the portfolio as a whole.

On March 31, 2018, 30 day and over loan and lease delinquencies as a percentage of loan and lease outstandings were 0.27% compared to 0.17% on March 31, 2017. The increase in delinquencies is largely attributable to the aircraft and construction equipment portfolios. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.10% compared to 2.13% one year ago. A summary of loan and lease loss experience during the three months ended March 31, 2018 and 2017 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 a specific reserve 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 or lease and the recorded investment in the loan or lease exceeds its fair value. A summary of impaired loans as of March 31, 2018 and December 31, 2017 is reflected in Note 4 of the Consolidated Financial Statements.

NONPERFORMING ASSETS

The following table shows nonperforming assets.

(Dollars in thousands)	March 31, 2018	December 31, 2017	March 31, 2017
Loans and leases past due 90 days or more	\$ 123	\$ 459	\$ 344
Nonaccrual loans and leases	25,360	19,405	18,090
Other real estate	1,184	1,312	916
Repossessions	9,432	10,114	8,121
Equipment owned under operating leases	2	9	27
Total nonperforming assets	\$ 36,101	\$ 31,299	\$ 27,498

Nonperforming assets as a percentage of loans and leases were 0.74% at March 31, 2018, 0.67% at December 31, 2017, and 0.63% at March 31, 2017. Nonperforming assets totaled \$36.10 million at March 31, 2018, an increase of 15.34% from the \$31.30 million reported at December 31, 2017, and a 31.29% increase from the \$27.50 million reported at March 31, 2017. The increase in nonperforming assets during the first three months of 2018 was mainly related to higher nonaccrual loans and leases offset by a reduction in repossessions and other real estate. The increase in nonperforming assets at March 31, 2018 from March 31, 2017 occurred primarily in nonaccrual loans and leases and repossessions.

The increase in nonaccrual loans and leases at March 31, 2018 from December 31, 2017 occurred primarily in the aircraft and auto and light truck portfolios. The increase in nonaccrual loans and leases at March 31, 2018 from

March 31, 2017 occurred primarily in the auto and light truck, commercial real estate and commercial and agricultural portfolios offset by decreases in the aircraft and residential real estate and home equity portfolios. A summary of nonaccrual loans and leases and past due aging for the period ended March 31, 2018 and December 31, 2017 is located in Note 4 of the Consolidated Financial Statements.

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

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Repossessions consisted mainly of aircraft financing. At the time of repossession, the recorded amount of the loan or lease is written down to the fair value of the equipment or vehicle by a charge to the reserve for loan and lease losses or other income, if a positive adjustment, unless the equipment is in the process of immediate sale. Any subsequent fair value write-downs or write-ups, to the extent of previous write-downs, are included in noninterest expense.

The following table shows a summary of other real estate and repossessions.

(Dollars in thousands)	March 31, December 31, March 31,		
	2018	2017	2017
Commercial and agricultural	\$ —	\$ —	\$ 23
Auto and light truck	167	165	31
Medium and heavy duty truck	—	—	—
Aircraft	8,735	9,335	8,079
Construction equipment	530	582	—
Commercial real estate	482	481	485
Residential real estate and home equity	702	831	417
Consumer	—	32	2
Total	\$ 10,616	\$ 11,426	\$ 9,037

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.

NONINTEREST INCOME

The following table shows the details of noninterest income.

(Dollars in thousands)	Three Months Ended			
	March 31,		\$	%
	2018	2017	Change	Change
Noninterest income:				
Trust and wealth advisory	\$5,188	\$5,001	187	3.74 %
Service charges on deposit accounts	2,228	2,239	(11)	(0.49)%
Debit card	3,103	2,750	353	12.84 %
Mortgage banking	884	947	(63)	(6.65)%
Insurance commissions	1,958	1,767	191	10.81 %
Equipment rental	7,755	6,832	923	13.51 %
(Losses) gains on investment securities available-for-sale	(345)	1,285	(1,630)	NM
Other	3,036	2,486	550	22.12 %
Total noninterest income	\$23,807	\$23,307	500	2.15 %

NM = Not Meaningful

Trust and wealth advisory fees (which include investment management fees, estate administration fees, mutual fund fees, annuity fees, and fiduciary fees) increased during the three months ended March 31, 2018 compared with the same period a year ago. Trust and wealth advisory fees are largely based on the number and size of client relationships and the market value of assets under management. The market value of trust assets under management at March 31, 2018 and December 31, 2017 was \$4.62 billion and \$4.63 billion, respectively.

Service charges on deposit accounts were relatively flat for the three months ended March 31, 2018 over the comparable period in 2017.

Debit card income improved in the three months ended March 31, 2018 over the same period a year ago. The majority of the improvement in debit card income was the result of an increased volume of debit card transactions in 2018. Mortgage banking income decreased in the three months ended March 31, 2018 as compared to the same period a year ago. The decrease was primarily caused by mark to market adjustments due to rising interest rates during the first quarter of 2018 offset by higher realized gains on loans sold.

Insurance commissions were higher during the three months ended March 31, 2018 over the same period a year ago. The increase in insurance commissions during the first quarter of 2018 compared to the same period in 2017 was primarily due to an increased book of business and higher contingent commissions received.

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Equipment rental income grew for the three months ended March 31, 2018 over the comparable period in 2017. The increase was the result of the average equipment rental portfolio growing 17% over the same period a year ago due to improving market conditions for equipment finance mainly in medium and heavy duty trucks. The growth in equipment rental income was offset by a similar increase in depreciation on equipment owned under operating leases. Losses on investment securities available-for-sale during the three months ended March 31, 2018 compared with gains on investment securities available-for-sale in the same period in 2017 resulted primarily from repositioning the portfolio during the first quarter of 2018 in response to recent tax reform.

Other income increased for the three months ended March 31, 2018 over the comparable period in 2017. The increase during the first quarter of 2018 was primarily a result of higher customer swap fees and net partnership investment gains offset by lower brokerage fees and commissions.

NONINTEREST EXPENSE

The following table shows the details of noninterest expense.

(Dollars in thousands)	Three Months Ended March 31,		\$ Change	% Change	
	2018	2017			
Noninterest expense:					
Salaries and employee benefits	\$22,531	\$21,345	1,186	5.56	%
Net occupancy	2,866	2,594	272	10.49	%
Furniture and equipment	5,455	4,793	662	13.81	%
Depreciation – leased equipment	6,428	5,680	748	13.17	%
Professional fees	2,017	1,077	940	87.28	%
Supplies and communication	1,553	1,250	303	24.24	%
FDIC and other insurance	698	623	75	12.04	%
Business development and marketing	1,533	1,652	(119)	(7.20)	%
Loan and lease collection and repossession	951	636	315	49.53	%
Other	1,525	1,469	56	3.81	%
Total noninterest expense	\$45,557	\$41,119	4,438	10.79	%

Salaries and employee benefits increased during the three months ended March 31, 2018 compared to the same period in 2017. The increase for 2018 was mainly the result of higher base salary expense due to normal merit increases and a rise in incentive compensation.

Net occupancy expense grew during the three months ended March 31, 2018 compared to the same period a year ago. The increase in 2018 was primarily attributed to higher snow removal costs compared to 2017.

Furniture and equipment expense, including depreciation, increased during the three months ended March 31, 2018 compared to the same period in 2017. Furniture and equipment expense was higher in 2018 mainly due to software maintenance costs related to a customer relationship management project.

During the first three months of 2018, depreciation on leased equipment correlates with the growth in equipment rental income as compared to the same period one year ago.

Professional fees increased during the first quarter of 2018 compared to the same period a year ago. The increase was mainly due to increased utilization of consulting services related to a customer relationship management project and information technology projects as well as higher legal fees.

Supplies and communication grew during the first quarter of 2018 compared to the same period a year ago. The increase resulted primarily from higher data communication line charges as bandwidth is improved and a one-time reduction in postage costs in 2017 offset by reduced printing costs.

FDIC and other insurance rose slightly during the three months ended March 31, 2018 compared to the same period in 2017. The increase in 2018 was mainly due to higher assessments for FDIC and other general insurance.

Business development and marketing expense decreased during the first quarter of 2018 compared to the same period a year ago. The expense reduction during 2018 was mainly the result of lower charitable contributions offset by increased marketing promotions.

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Loan and lease collection and repossession expense increased during the three months ended March 31, 2018 compared to the same period in 2017. The higher expense during the first quarter of 2018 was mainly due to increased valuation adjustments on repossessed assets offset by lower general collection and repossession expenses.

Other expenses were relatively flat during the three months ended March 31, 2018 compared to the same period in 2017. The increase during the first quarter of 2018 over a year ago primarily related to higher trust losses offset by a decrease in provision for unfunded loan commitments, intangible asset amortization as items fully amortize and impairment writedowns on branches in 2017 not present in 2018.

INCOME TAXES

The provision for income taxes for the three month period ended March 31, 2018 was \$5.88 million, compared to \$8.71 million for the same period in 2017. The effective tax rate was 23.52% and 34.95% for the first quarter ended March 31, 2018 and 2017, respectively. The change in effective tax rate was due primarily to the decrease in the federal tax rate from 35% in 2017 to 21% in 2018. See Note 12 for further information regarding the Tax Cuts and Jobs Act.

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, 2017. For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2017.

ITEM 4.

CONTROLS AND PROCEDURES

As of the end of the period covered by this report an evaluation was carried out, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, at March 31, 2018, 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 first fiscal quarter of 2018 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings.

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

ITEM 1A. Risk Factors.

There have been no material changes in risks faced by 1st Source since December 31, 2017. For information regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2017.

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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*	Maximum Number (or Approximate Dollar Value) of Shares that may yet be Purchased Under the Plans or Programs
January 01 - 31, 2018	—	\$ —	—	1,386,174
February 01 - 28, 2018	—	—	—	1,386,174
March 01 - 31, 2018	15,784	49.75	15,784	1,370,390

* 1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on July 24, 2014. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock from time to time to mitigate the potential dilutive effects of stock-based incentive plans and other potential uses of common stock for corporate purposes. Since the inception of the plan, 1st Source has repurchased a total of 629,610 shares.

ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Mine Safety Disclosures.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits

The following exhibits are filed with this report:

31.1 Certification of Chief Executive Officer required by Rule 13a-14(a).

31.2 Certification of Chief Financial Officer required by Rule 13a-14(a).

32.1 Certification pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer.

32.2 Certification pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.LAB XBRL Taxonomy Extension Labels Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

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SIGNATURES

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

1st Source Corporation

DATE April 19, 2018 /s/ CHRISTOPHER J. MURPHY III
Christopher J. Murphy III
Chairman of the Board and CEO

DATE April 19, 2018 /s/ ANDREA G. SHORT
Andrea G. Short
Treasurer and Chief Financial Officer
Principal Accounting Officer