

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

OR

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

For the transition period from _____ to _____

Commission file number 0-6233

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(Exact name of registrant as specified in its charter)

INDIANA

(State or other jurisdiction of incorporation or organization)

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

(Address of principal executive offices)

35-1068133

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

46601

(Zip Code)

(574) 235-2000

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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

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| | March 31, 2013 | December 31, 2012 |
|--|---------------------|----------------------|
| <u>ASSETS</u> | | |
| Cash and due from banks | \$ 43,033 | \$ 83,232 |
| Federal funds sold and interest bearing deposits with other banks | 21,424 | 702 |
| Investment securities available-for-sale (amortized cost of \$830,464 and \$849,139 at March 31, 2013 and December 31, 2012, respectively) | 860,137 | 880,764 |
| Other investments | 22,609 | 22,609 |
| Trading account securities | 162 | 146 |
| Mortgages held for sale | 10,634 | 10,879 |
| Loans and leases - net of unearned discount | | |
| Commercial and agricultural loans | 647,661 | 639,069 |
| Auto, light truck and environmental equipment | 449,646 | 438,147 |
| Medium and heavy duty truck | 166,590 | 172,002 |
| Aircraft financing | 699,241 | 696,479 |
| Construction equipment financing | 285,916 | 278,974 |
| Commercial real estate | 566,355 | 554,968 |
| Residential real estate | 445,160 | 438,641 |
| Consumer loans | 112,649 | 109,273 |
| Total loans and leases | 3,373,218 | 3,327,553 |
| Reserve for loan and lease losses | (84,011) | (83,311) |
| Net loans and leases | 3,289,207 | 3,244,242 |
| Equipment owned under operating leases, net | 53,457 | 52,173 |
| Net premises and equipment | 45,620 | 45,016 |
| Goodwill and intangible assets | 87,207 | 87,502 |
| Accrued income and other assets | 124,538 | 123,428 |
| Total assets | \$ 4,558,028 | \$ 4,550,693 |
| <u>LIABILITIES</u> | | |
| Deposits: | | |
| Noninterest bearing | \$ 647,407 | \$ 646,380 |
| Interest bearing | 3,033,159 | 2,977,967 |
| Total deposits | 3,680,566 | 3,624,347 |
| Short-term borrowings: | | |
| Federal funds purchased and securities sold under agreements to repurchase | 102,672 | 158,680 |
| Other short-term borrowings | 12,205 | 10,508 |
| Total short-term borrowings | 114,877 | 169,188 |
| Long-term debt and mandatorily redeemable securities | 68,258 | 71,021 |
| Subordinated notes | 58,764 | 58,764 |
| Accrued expenses and other liabilities | 67,201 | 68,718 |
| Total liabilities | 3,989,666 | 3,992,038 |
| <u>SHAREHOLDERS' EQUITY</u> | | |
| Preferred stock; no par value | | |
| Authorized 10,000,000 shares; none issued or outstanding | | |
| Common stock; no par value | | |
| Authorized 40,000,000 shares; issued 25,641,887 at March 31, 2013 and December 31, 2012 | 346,535 | 346,535 |
| Retained earnings | 231,664 | 223,715 |

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

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

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

| | Three Months Ended March 31, | |
|--|---|---------------|
| | 2013 | 2012 |
| Interest income: | | |
| Loans and leases | \$ 39,170 | \$ 39,896 |
| Investment securities, taxable | 3,695 | 4,327 |
| Investment securities, tax-exempt | 771 | 852 |
| Other | 242 | 226 |
| Total interest income | 43,878 | 45,301 |
| Interest expense: | | |
| Deposits | 4,542 | 5,745 |
| Short-term borrowings | 32 | 53 |
| Subordinated notes | 1,055 | 1,647 |
| Long-term debt and mandatorily redeemable securities | 495 | 471 |
| Total interest expense | 6,124 | 7,916 |
| Net interest income | 37,754 | 37,385 |
| Provision for loan and lease losses | 757 | 2,254 |
| Net interest income after provision for loan and lease losses | 36,997 | 35,131 |
| Noninterest income: | | |
| Trust fees | 4,101 | 3,973 |
| Service charges on deposit accounts | 2,239 | 2,438 |
| Debit card income | 2,065 | 2,067 |
| Mortgage banking income | 1,628 | 1,942 |
| Insurance commissions | 1,446 | 1,357 |
| Equipment rental income | 4,012 | 5,350 |
| Investment securities and other investment gains | 173 | 395 |
| Other income | 3,284 | 3,001 |
| Total noninterest income | 18,948 | 20,523 |
| Noninterest expense: | | |
| Salaries and employee benefits | 19,936 | 20,316 |
| Net occupancy expense | 2,207 | 2,160 |
| Furniture and equipment expense | 3,899 | 3,507 |
| Depreciation - leased equipment | 3,225 | 4,311 |
| Professional fees | 1,355 | 1,398 |
| Supplies and communication | 1,536 | 1,393 |
| FDIC and other insurance | 878 | 949 |
| Business development and marketing expense | 773 | 867 |
| Loan and lease collection and repossession expense | 757 | 1,501 |
| Other expense | 1,984 | 1,646 |
| Total noninterest expense | 36,550 | 38,048 |
| Income before income taxes | 19,395 | 17,606 |
| Income tax expense | 6,991 | 5,891 |

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

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

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

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

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

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

| | Total | Preferred Stock | Common Stock | Retained Earnings | Cost of Common Stock in Treasury | Accumulated Other Comprehensive Income (Loss), Net |
|---|------------|--------------------|-----------------|----------------------|---|---|
| Balance at January 1, 2012 | \$ 523,918 | \$ | \$ 346,535 | \$ 190,261 | \$ (31,389) | \$ 18,511 |
| Net income | 11,715 | | | 11,715 | | |
| Other comprehensive loss | (573) | | | | | (573) |
| Issuance of 150,343 common shares under stock based compensation awards, including related tax effects | 3,375 | | | 126 | 3,249 | |
| Cost of 104,471 shares of common stock acquired for treasury | (2,617) | | | | (2,617) | |
| Common stock dividend (\$0.16 per share) | (3,927) | | | (3,927) | | |
| Balance at March 31, 2012 | \$ 531,891 | \$ | \$ 346,535 | \$ 198,175 | \$ (30,757) | \$ 17,938 |
| Balance at January 1, 2013 | \$ 558,655 | \$ | \$ 346,535 | \$ 223,715 | \$ (31,134) | \$ 19,539 |
| Net income | 12,404 | | | 12,404 | | |
| Other comprehensive loss | (1,206) | | | | | (1,206) |

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

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

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

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

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

Supplemental Information:

Non-cash transactions:

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

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

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1ST SOURCE CORPORATION

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as 1st Source or the Company), a broad array of financial products and services. The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in shareholders' equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted.

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K (2012 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The Consolidated Statement of Financial Condition at December 31, 2012 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current year presentation.

Note 2. Recent Accounting Pronouncements

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

Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities: In January 2013, the FASB issued ASU No. 2013-01 *Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. ASU 2013-01 clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. ASU 2011-11 applies only to derivatives, repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria in the Accounting Standards Codification or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Retrospective disclosure is required for all comparative periods presented. The effect of applying this standard is reflected in Note 8 *Derivative Financial Instruments*.

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Offsetting Assets and Liabilities: In December 2011, the FASB issued ASU No. 2011-11 *Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities*. ASU 2011-11 requires an entity to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Retrospective disclosure is required for all comparative periods presented. The effect of applying this standard is reflected in Note 8 Derivative Financial Instruments.

Note 3. Investment Securities

Investment securities available-for-sale were as follows:

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

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

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The contractual maturities of investments in debt securities available-for-sale at March 31, 2013 are shown below. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

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

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The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. There were no other-than-temporary-impairment (OTTI) write-downs in 2013 or 2012.

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

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

| (Dollars in thousands) | Less than 12 Months | | 12 months or Longer | | Total | |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| March 31, 2013 | | | | | | |
| U.S. Treasury and Federal agencies securities | \$ 37,231 | \$ (118) | \$ | \$ | \$ 37,231 | \$ (118) |
| U.S. States and political subdivisions securities | 10,530 | (55) | 3,481 | (515) | 14,011 | (570) |
| Mortgage-backed securities - Federal agencies | 29,087 | (271) | 57 | (1) | 29,144 | (272) |
| Corporate debt securities | | | 4,505 | (20) | 4,505 | (20) |
| Foreign government and other securities | | | | | | |
| Total debt securities | 76,848 | (444) | 8,043 | (536) | 84,891 | (980) |
| Marketable equity securities | | | 5 | (3) | 5 | (3) |
| Total investment securities available-for-sale | \$ 76,848 | \$ (444) | \$ 8,048 | \$ (539) | \$ 84,896 | \$ (983) |
| December 31, 2012 | | | | | | |
| U.S. Treasury and Federal agencies securities | \$ 37,316 | \$ (83) | \$ | \$ | \$ 37,316 | \$ (83) |
| U.S. States and political subdivisions securities | 7,730 | (46) | 3,364 | (436) | 11,094 | (482) |
| Mortgage-backed securities - Federal agencies | 6,264 | (24) | 60 | (1) | 6,324 | (25) |
| Corporate debt securities | | | 4,431 | (94) | 4,431 | (94) |
| Foreign government and other securities | 100 | | | | 100 | |
| Total debt securities | 51,410 | (153) | 7,855 | (531) | 59,265 | (684) |
| Marketable equity securities | | | 5 | (4) | 5 | (4) |
| Total investment securities available-for-sale | \$ 51,410 | \$ (153) | \$ 7,860 | \$ (535) | \$ 59,270 | \$ (688) |

The initial indication of OTTI for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, the impaired securities are analyzed on a qualitative and quantitative basis in determining OTTI. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In estimating OTTI impairment losses, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to

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sell any such securities before a recovery of cost.

At March 31, 2013, the Company does not have the intent to sell any of the available-for-sale securities in the table above and believes that it is more likely than not that it will not have to sell any such securities before an anticipated recovery of cost. Primarily the unrealized losses on debt securities are due to market volatility and market illiquidity on auction rate securities which are reflected in U.S. States and political subdivisions. The fair value is expected to recover on all debt securities as they approach their maturity date or repricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

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

Note 4. Loan and Lease Financings

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

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

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

| (Dollars in thousands) | Credit Quality Grades | | |
|---|-----------------------|------------|--------------|
| | 1-6 | 7-12 | Total |
| March 31, 2013 | | | |
| Commercial and agricultural loans | \$ 615,574 | \$ 32,087 | \$ 647,661 |
| Auto, light truck and environmental equipment | 444,354 | 5,292 | 449,646 |
| Medium and heavy duty truck | 165,627 | 963 | 166,590 |
| Aircraft financing | 647,395 | 51,846 | 699,241 |
| Construction equipment financing | 269,302 | 16,614 | 285,916 |
| Commercial real estate | 521,041 | 45,314 | 566,355 |
| Total | \$ 2,663,293 | \$ 152,116 | \$ 2,815,409 |
| December 31, 2012 | | | |
| Commercial and agricultural loans | \$ 612,567 | \$ 26,502 | \$ 639,069 |
| Auto, light truck and environmental equipment | 428,582 | 9,565 | 438,147 |
| Medium and heavy duty truck | 170,116 | 1,886 | 172,002 |
| Aircraft financing | 648,316 | 48,163 | 696,479 |
| Construction equipment financing | 262,980 | 15,994 | 278,974 |
| Commercial real estate | 507,219 | 47,749 | 554,968 |
| Total | \$ 2,629,780 | \$ 149,859 | \$ 2,779,639 |

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

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

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

| (Dollars in thousands) | Current | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due and Accruing | Total Accruing Loans | Nonaccrual | Total Financing Receivables |
|---|--------------|---------------------|---------------------|---------------------------------------|----------------------|------------|-----------------------------|
| March 31, 2013 | | | | | | | |
| Commercial and agricultural loans | \$ 639,249 | \$ 416 | \$ | \$ | \$ 639,665 | \$ 7,996 | \$ 647,661 |
| Auto, light truck and environmental equipment | 448,775 | 122 | 41 | | 448,938 | 708 | 449,646 |
| Medium and heavy duty truck | 166,229 | | 354 | | 166,583 | 7 | 166,590 |
| Aircraft financing | 683,727 | 673 | | | 684,400 | 14,841 | 699,241 |
| Construction equipment financing | 281,153 | 507 | 40 | | 281,700 | 4,216 | 285,916 |
| Commercial real estate | 553,821 | 248 | | | 554,069 | 12,286 | 566,355 |
| Residential real estate | 441,817 | 826 | 12 | 115 | 442,770 | 2,390 | 445,160 |
| Consumer | 111,373 | 663 | 165 | 116 | 112,317 | 332 | 112,649 |
| Total | \$ 3,326,144 | \$ 3,455 | \$ 612 | \$ 231 | \$ 3,330,442 | \$ 42,776 | \$ 3,373,218 |
| December 31, 2012 | | | | | | | |
| Commercial and agricultural loans | \$ 629,035 | \$ 807 | \$ 48 | \$ | \$ 629,890 | \$ 9,179 | \$ 639,069 |
| Auto, light truck and environmental equipment | 437,087 | 202 | | | 437,289 | 858 | 438,147 |
| Medium and heavy duty truck | 171,950 | | | | 171,950 | 52 | 172,002 |
| Aircraft financing | 691,187 | | | | 691,187 | 5,292 | 696,479 |
| Construction equipment financing | 272,817 | 598 | 274 | | 273,689 | 5,285 | 278,974 |
| Commercial real estate | 541,811 | 102 | | | 541,913 | 13,055 | 554,968 |
| Residential real estate | 434,434 | 1,019 | 509 | 356 | 436,318 | 2,323 | 438,641 |
| Consumer | 107,630 | 816 | 368 | 86 | 108,900 | 373 | 109,273 |
| Total | \$ 3,285,951 | \$ 3,544 | \$ 1,199 | \$ 442 | \$ 3,291,136 | \$ 36,417 | \$ 3,327,553 |

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

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

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

| (Dollars in thousands) | Three Months Ended March 31, | | | |
|---|------------------------------|-----------------|-----------------------------|-----------------|
| | 2013 | | 2012 | |
| | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income |
| Commercial and agricultural loans | \$ 8,319 | \$ 3 | \$ 9,993 | \$ 8 |
| Auto, light truck and environmental equipment | 466 | | 1,591 | 7 |
| Medium and heavy duty truck | | | 1,375 | 1 |
| Aircraft financing | 8,268 | | 12,268 | |
| Construction equipment financing | 4,705 | 2 | 3,665 | 4 |
| Commercial real estate | 20,545 | 152 | 21,226 | 49 |
| Residential real estate | | | 36 | 1 |
| Consumer | | | | |
| Total | \$ 42,303 | \$ 157 | \$ 50,154 | \$ 70 |

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

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

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

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

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

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

Note 5. Reserve for Loan and Lease Losses

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

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

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Changes in the reserve for loan and lease losses, segregated by class, for the three months ended March 31, 2013 and 2012 are shown below.

| (Dollars in thousands) | Commercial and agricultural loans | Auto, light truck and environmental equipment | Medium and heavy duty truck | Aircraft financing | Construction equipment financing | Commercial real estate | Residential real estate | Consumer loans | Total |
|---|-----------------------------------|---|-----------------------------|--------------------|----------------------------------|------------------------|-------------------------|----------------|--------------|
| March 31, 2013 | | | | | | | | | |
| <i>Reserve for loan and lease losses</i> | | | | | | | | | |
| Balance, beginning of period | \$ 12,326 | \$ 9,584 | \$ 3,001 | \$ 34,205 | \$ 5,390 | \$ 13,778 | \$ 3,652 | \$ 1,375 | \$ 83,311 |
| Charge-offs | 285 | 1 | | 31 | 83 | 62 | 77 | 423 | 962 |
| Recoveries | 109 | 123 | 14 | 178 | 35 | 329 | 6 | 111 | 905 |
| Net charge-offs (recoveries) | 176 | (122) | (14) | (147) | 48 | (267) | 71 | 312 | 57 |
| Provision (recovery of provision) | 1,077 | (376) | (176) | (520) | 383 | (124) | 125 | 368 | 757 |
| Balance, end of period | \$ 13,227 | \$ 9,330 | \$ 2,839 | \$ 33,832 | \$ 5,725 | \$ 13,921 | \$ 3,706 | \$ 1,431 | \$ 84,011 |
| Ending balance, individually evaluated for impairment | \$ 434 | \$ | \$ | \$ 1,639 | \$ | \$ | \$ | \$ | \$ 2,073 |
| Ending balance, collectively evaluated for impairment | 12,793 | 9,330 | 2,839 | 32,193 | 5,725 | 13,921 | 3,706 | 1,431 | 81,938 |
| Total reserve for loan and lease losses | \$ 13,227 | \$ 9,330 | \$ 2,839 | \$ 33,832 | \$ 5,725 | \$ 13,921 | \$ 3,706 | \$ 1,431 | \$ 84,011 |
| <i>Recorded investment in loans</i> | | | | | | | | | |
| Ending balance, individually evaluated for impairment | \$ 7,072 | \$ 464 | \$ | \$ 14,762 | \$ 4,154 | \$ 20,203 | \$ | \$ | \$ 46,655 |
| Ending balance, collectively evaluated for impairment | 640,589 | 449,182 | 166,590 | 684,479 | 281,762 | 546,152 | 445,160 | 112,649 | 3,326,563 |
| Total recorded investment in loans | \$ 647,661 | \$ 449,646 | \$ 166,590 | \$ 699,241 | \$ 285,916 | \$ 566,355 | \$ 445,160 | \$ 112,649 | \$ 3,373,218 |
| March 31, 2012 | | | | | | | | | |
| <i>Reserve for loan and lease losses</i> | | | | | | | | | |
| Balance, beginning of period | \$ 13,091 | \$ 8,469 | \$ 3,742 | \$ 28,626 | \$ 6,295 | \$ 16,772 | \$ 3,362 | \$ 1,287 | \$ 81,644 |
| Charge-offs | 146 | 2,033 | | 139 | 119 | 33 | 41 | 256 | 2,767 |
| Recoveries | 96 | 783 | 21 | 125 | 34 | 34 | 32 | 138 | 1,263 |
| Net charge-offs (recoveries) | 50 | 1,250 | (21) | 14 | 85 | (1) | 9 | 118 | 1,504 |
| Provision (recovery of provision) | (516) | 2,550 | (96) | (14) | 641 | (447) | 25 | 111 | 2,254 |
| Balance, end of period | \$ 12,525 | \$ 9,769 | \$ 3,667 | \$ 28,598 | \$ 6,851 | \$ 16,326 | \$ 3,378 | \$ 1,280 | \$ 82,394 |
| Ending balance, individually evaluated for impairment | \$ 1,187 | \$ 1,200 | \$ | \$ 557 | \$ | \$ 277 | \$ | \$ | \$ 3,221 |
| Ending balance, collectively evaluated for impairment | 11,338 | 8,569 | 3,667 | 28,041 | 6,851 | 16,049 | 3,378 | 1,280 | 79,173 |
| Total reserve for loan and lease losses | \$ 12,525 | \$ 9,769 | \$ 3,667 | \$ 28,598 | \$ 6,851 | \$ 16,326 | \$ 3,378 | \$ 1,280 | \$ 82,394 |

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Recorded investment in loans

| | | | | | | | | | | | | | | | | | | |
|---|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|---------|----|--------|-----------|-----------|
| Ending balance, individually evaluated for impairment | \$ | 9,554 | \$ | 3,529 | \$ | 1,227 | \$ | 12,022 | \$ | 3,431 | \$ | 19,740 | \$ | 108 | \$ | 49,611 | | |
| Ending balance, collectively evaluated for impairment | | 535,503 | | 452,344 | | 174,244 | | 609,478 | | 268,044 | | 519,372 | | 439,454 | | 98,840 | 3,097,279 | |
| Total recorded investment in loans | \$ | 545,057 | \$ | 455,873 | \$ | 175,471 | \$ | 621,500 | \$ | 271,475 | \$ | 539,112 | \$ | 439,562 | \$ | 98,840 | \$ | 3,146,890 |

Table of Contents**Note 6. Mortgage Servicing Assets**

The Company recognizes the rights to service residential mortgage loans for others as separate assets, whether the servicing rights are acquired through a separate purchase or through the sale of originated loans with servicing rights retained. The Company allocates a portion of the total proceeds of a mortgage loan to servicing rights based on the relative fair value. The unpaid principal balance of residential mortgage loans serviced for third parties was \$888.37 million and \$921.20 million at March 31, 2013 and December 31, 2012, respectively.

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

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

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

During the three months ended March 31, 2012, the Company determined that it was not necessary to permanently write-down any previously established valuation allowance. At March 31, 2013 and 2012, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by \$1.61 million and \$2.25 million, respectively. This difference represents increases in the fair value of certain mortgage servicing assets that could not be recorded above cost basis.

Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$0.82 million and \$0.94 million for the three months ended March 31, 2013 and 2012, respectively. Mortgage loan contractual servicing fees are included in mortgage banking income in the consolidated statements of income.

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

1st Source and its subsidiaries are parties to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition. The exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan commitments and standby letters of credit is represented by the dollar amount of those instruments. The Company uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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

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

Note 8. Derivative Financial Instruments

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

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

At March 31, 2013 and December 31, 2012, the amounts of non-hedging derivative financial instruments are shown in the chart below:

| (Dollars in thousands) | Notional or contractual amount | Asset derivatives | | Liability derivatives | |
|------------------------------|--------------------------------|---|------------|---|------------|
| | | Statement of Financial Condition classification | Fair value | Statement of Financial Condition classification | Fair value |
| March 31, 2013 | | | | | |
| Interest rate swap contracts | \$ 444,440 | Other assets | \$ 14,649 | Other liabilities | \$ 14,937 |
| Loan commitments | 18,911 | Mortgages held for sale | 264 | N/A | |
| Forward contracts | 21,500 | N/A | | Mortgages held for sale | 16 |
| Total | \$ 484,851 | | \$ 14,913 | | \$ 14,953 |

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

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For the three months ended March 31, 2013 and 2012, the amounts included in the consolidated statements of income for non-hedging derivative financial instruments are shown in the chart below:

| (Dollars in thousands) | Statement of Income classification | Gain (loss) Three Months Ended March 31, | |
|------------------------------|---------------------------------------|--|--------|
| | | 2013 | 2012 |
| Interest rate swap contracts | Other expense | \$ 30 | \$ 75 |
| Interest rate swap contracts | Other income | 194 | 39 |
| Loan commitments | Mortgage banking income | 44 | 213 |
| Forward contracts | Mortgage banking income | 17 | 276 |
| Total | | \$ 285 | \$ 603 |

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

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

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

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

Note 9. Earnings Per Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the applicable period, excluding

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outstanding participating securities. Participating securities include non-vested restricted stock awards. Non-vested restricted stock awards are considered participating securities to the extent the holders of these securities receive non-forfeitable dividends at the same rate as holders of common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method. Stock options, where the exercise price was greater than the average market price of the common shares, were excluded from the computation of diluted earnings per common share because the result would have been antidilutive. There were no stock options outstanding as of March 31, 2013. No stock options were considered antidilutive as of March 31, 2012.

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The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the three months ended March 31, 2013 and 2012.

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

Note 10. Stock Based Compensation

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

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

The stock-based compensation expense recognized in the consolidated statements of income for the three months ended March 31, 2013 and 2012 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

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

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

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

Note 11. Income Taxes

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

Tax years that remain open and subject to audit include the federal 2009-2012 years and the Indiana 2009-2012 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

Note 12. Fair Value Measurements

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

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

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

observable in the market.

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

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

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

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

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

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

Financial Instruments on Recurring Basis:

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

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

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

adjustments.

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

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

Trading account securities are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

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

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

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

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

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The changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended March 31, 2013 and 2012 are summarized as follows:

| (Dollars in thousands) | U.S. States and political subdivisions securities | Foreign government and other securities | Investment securities available- for-sale |
|--|--|--|--|
| Beginning balance January 1, 2013 | \$ 7,701 | \$ | \$ 7,701 |
| Total gains or losses (realized/unrealized): | | | |
| Included in earnings | | | |
| Included in other comprehensive income | (93) | | (93) |
| Purchases | | | |
| Issuances | | | |
| Settlements | | | |
| Maturities | (538) | | (538) |
| Transfers into Level 3 | | | |
| Transfers out of Level 3 | | | |
| Ending balance March 31, 2013 | \$ 7,070 | \$ | \$ 7,070 |
| Beginning balance January 1, 2012 | \$ 10,493 | \$ 675 | \$ 11,168 |
| Total gains or losses (realized/unrealized): | | | |
| Included in earnings | | | |
| Included in other comprehensive income | 17 | | 17 |
| Purchases | | | |
| Issuances | | | |
| Settlements | | | |
| Maturities | (576) | | (576) |
| Transfers into Level 3 | | | |
| Transfers out of Level 3 | | (675) | (675) |
| Ending balance March 31, 2012 | \$ 9,934 | \$ | \$ 9,934 |

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at March 31, 2013 or 2012. No transfers between levels occurred during the three months ended March 31, 2013. One transfer between levels occurred during the three months ended March, 31, 2012. No transfers between Level 1 and 2 occurred during the period ended March 31, 2013. A foreign government debt security was transferred from Level 3 to Level 2 as of March 31, 2012 due to the Company's periodic review of valuation methodologies and inputs. The Company determined that the observable inputs used in determining fair value warranted a transfer to Level 2 as the unobservable inputs were deemed to be insignificant to the overall fair value measurement.

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The table below presents the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a recurring basis at March 31, 2013 and 2012.

| (Dollars in thousands) | Fair Value | Valuation Methodology | Unobservable Inputs | Range of Inputs |
|--|------------|-----------------------|----------------------------|-----------------|
| March 31, 2013 | | | | |
| Investment securities available-for sale | | | | |
| Adjustable rate securities | \$ 3,285 | Discounted cash flows | Illiquidity adjustment | 4.00% - 8.00% |
| | | | Term assumption (1) | 5 yrs |
| | | | Coupon forecast assumption | 0.26% - 0.42% |
| Direct placement municipal securities | 3,785 | Discounted cash flows | Credit spread assumption | 1.26% - 2.04% |
| Total investment securities available-for-sale | \$ 7,070 | | | |
| March 31, 2012 | | | | |
| Investment securities available-for sale | | | | |
| Adjustable rate securities | \$ 5,130 | Discounted cash flows | Illiquidity adjustment | 4.00% - 8.00% |
| | | | Term assumption (1) | 5 yrs |
| | | | Coupon forecast assumption | 0.38% - 0.66% |
| Direct placement municipal securities | 4,804 | Discounted cash flows | Credit spread assumption | 1.56% - 2.75% |
| Total investment securities available-for-sale | \$ 9,934 | | | |

(1) Term assumption is influenced by security call history

The sensitivity to changes in the unobservable inputs and their impact on the fair value measurement can be significant. The significant unobservable inputs for adjustable rate securities are illiquidity, term and coupon forecast assumptions. The illiquidity adjustment is negatively correlated to the fair value measure. An increase (decrease) in the determined illiquidity adjustment will lower (increase) the fair value measure. The term assumption is negatively correlated to the fair value measure. An increase (decrease) in the determined term adjustment will decrease (increase) the fair value measure. The coupon forecast is positively correlated to the fair value measure. An increase (decrease) in the determined coupon forecast will increase (decrease) the fair value measure. A permutation that includes a change in the coupon forecast with a change in either or both of the two variables will mitigate the significance of the change to the fair value measure. The significant unobservable input for direct placement municipal securities is the underlying market level used to determine the fair value measure. An increase (decrease) in the estimated yield level of the market will decrease (increase) the fair value measure of the securities.

Financial Instruments on Non-recurring Basis:

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

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

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

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

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

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

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

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

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For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended March 31, 2013: impaired loans - \$0.03 million; partnership investments - \$(0.17) million; mortgage servicing rights - \$0.00 million; repossessions - \$0.00 million, and other real estate - \$0.02 million.

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

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

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The table below presents the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a non-recurring basis at March 31, 2013 and December 31, 2012.

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

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

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

| (Dollars in thousands) | Carrying or Contract Value | Fair Value | Level 1 | Level 2 | Level 3 |
|---|-------------------------------|--------------|--------------|--------------|-----------|
| March 31, 2013 | | | | | |
| <u>Assets:</u> | | | | | |
| Cash and due from banks | \$ 43,033 | \$ 43,033 | \$ 43,033 | \$ | \$ |
| Federal funds sold and interest bearing deposits with other banks | 21,424 | 21,424 | 21,424 | | |
| Investment securities, available-for-sale | 860,137 | 860,137 | 26,432 | 826,635 | 7,070 |
| Other investments and trading account securities | 22,771 | 22,771 | 22,771 | | |
| Mortgages held for sale | 10,634 | 10,634 | | 10,634 | |
| Loans and leases, net of reserve for loan and lease losses | 3,289,207 | 3,309,349 | | | 3,309,349 |
| Cash surrender value of life insurance policies | 57,058 | 57,058 | 57,058 | | |
| Mortgage servicing rights | 4,528 | 6,137 | | | 6,137 |
| Interest rate swaps | 14,649 | 14,649 | | 14,649 | |
| <u>Liabilities:</u> | | | | | |
| Deposits | \$ 3,680,566 | \$ 3,694,464 | \$ 2,523,044 | \$ 1,171,420 | \$ |
| Short-term borrowings | 114,877 | 114,877 | 107,575 | 7,302 | |
| Long-term debt and mandatorily redeemable securities | 68,258 | 69,485 | | 69,485 | |
| Subordinated notes | 58,764 | 82,135 | | 82,135 | |
| Interest rate swaps | 14,937 | 14,937 | | 14,937 | |
| Off-balance-sheet instruments * | | 190 | | 190 | |
| December 31, 2012 | | | | | |
| <u>Assets:</u> | | | | | |
| Cash and due from banks | \$ 83,232 | \$ 83,232 | \$ 83,232 | \$ | \$ |
| Federal funds sold and interest bearing deposits with other banks | 702 | 702 | 702 | | |
| Investment securities, available-for-sale | 880,764 | 880,764 | 25,756 | 847,307 | 7,701 |
| Other investments and trading account securities | 22,755 | 22,755 | 22,755 | | |
| Mortgages held for sale | 10,879 | 10,879 | | 10,879 | |
| Loans and leases, net of reserve for loan and lease losses | 3,244,242 | 3,287,976 | | | 3,287,976 |
| Cash surrender value of life insurance policies | 56,572 | 56,572 | 56,572 | | |
| Mortgage servicing rights | 4,645 | 5,760 | | | 5,760 |
| Interest rate swaps | 16,126 | 16,126 | | 16,126 | |
| <u>Liabilities:</u> | | | | | |
| Deposits | \$ 3,624,347 | \$ 3,641,280 | \$ 2,556,122 | \$ 1,085,158 | \$ |
| Short-term borrowings | 169,188 | 169,188 | 161,138 | 8,050 | |
| Long-term debt and mandatorily redeemable securities | 71,021 | 71,557 | | 71,557 | |
| Subordinated notes | 58,764 | 72,914 | | 72,914 | |
| Interest rate swaps | 16,444 | 16,444 | | 16,444 | |
| Off-balance-sheet instruments * | | 188 | | 188 | |

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

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The methodologies for estimating fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The estimated fair value approximates carrying value for cash and due from banks, federal funds sold and interest bearing deposits with other banks, other investments, and cash surrender value of life insurance policies. The methodologies for other financial assets and financial liabilities are discussed below:

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

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

Short-Term Borrowings The carrying values of Federal funds purchased, securities sold under repurchase agreements, and other short-term borrowings, including the liability related to mortgage loans available for repurchase under GNMA optional repurchase programs, approximate their fair values.

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

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

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

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

These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. These estimates are subjective in nature and require considerable judgment to interpret market data. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange, nor are they intended to represent the fair value of 1st Source as a whole. The use of different market assumptions and/or estimation

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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.

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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, 2013, as compared to December 31, 2012, and the results of operations for the three months ended March 31, 2013 and 2012. 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 2012 Annual Report.

Except for historical information contained herein, the matters discussed in this document express forward-looking statements. Generally, the words believe, contemplate, seek, plan, possible, assume, expect, intend, targeted, continue, remain, estimate, anticipate, indicate, would, may and other similar expressions are intended 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 U.S. generally accepted accounting principles; our competitive position within the markets we serve; increasing consolidation within the banking industry; unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2012, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

FINANCIAL CONDITION

Our total assets at March 31, 2013 were \$4.56 billion, an increase of \$7.34 million or 0.16% from December 31, 2012. Total loans and leases were \$3.37 billion, an increase of \$45.67 million or 1.37% from December 31, 2012. Fed funds sold and interest bearing deposits with other banks were \$21.42 million, an increase of \$20.72 million from December 31, 2012 as a result of investing excess cash. Total investment securities, available for sale were \$860.14 million which represented a decrease of \$20.63 million or 2.34% and total deposits were \$3.68 billion, an increase of \$56.22 million or 1.55% over the comparable figures at the end of 2012.

Nonperforming assets at March 31, 2013 were \$48.43 million, which was an increase of \$6.17 million or 14.59% from the \$42.27 million reported at December 31, 2012. At March 31, 2013 and December 31, 2012, nonperforming assets were 1.41% and 1.25%, respectively of net

loans and leases.

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Accrued income and other assets were as follows:

| (Dollars in thousands) | March 31, 2013 | December 31, 2012 |
|--|-------------------|----------------------|
| Accrued income and other assets: | | |
| Bank owned life insurance cash surrender value | \$ 57,058 | \$ 56,572 |
| Accrued interest receivable | 14,037 | 12,698 |
| Mortgage servicing assets | 4,528 | 4,645 |
| Other real estate | 4,372 | 4,311 |
| Former bank premises held for sale | 951 | 1,034 |
| Repossessions | 103 | 63 |
| All other assets | 43,489 | 44,105 |
| Total accrued income and other assets | \$ 124,538 | \$ 123,428 |

CAPITAL

As of March 31, 2013, total shareholders' equity was \$568.36 million, up \$9.71 million or 1.74% from the \$558.66 million at December 31, 2012. In addition to net income of \$12.40 million, other significant changes in shareholders' equity during the first three months of 2013 included \$4.17 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$18.33 million at March 31, 2013, compared to \$19.54 million at December 31, 2012. The decrease in accumulated other comprehensive income/(loss) during 2013 was the result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 12.47% as of March 31, 2013, compared to 12.28% at December 31, 2012. Book value per common share rose to \$23.33 at March 31, 2013, from \$23.04 at December 31, 2012.

We declared and paid dividends per common share of \$0.17 during the first quarter of 2013. The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 32.84%. The dividend payout is continually reviewed by management and the Board of Directors subject to the Company's capital and dividend policy.

The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations. The actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of March 31, 2013, are presented in the table below:

| (Dollars in thousands) | Actual | | Minimum Capital Adequacy | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|------------|--------|--------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (to Risk-Weighted Assets): | | | | | | |
| 1st Source Corporation | \$ 567,168 | 15.73% | \$ 288,490 | 8.00% | \$ 360,613 | 10.00% |
| 1st Source Bank | 542,151 | 15.07 | 287,804 | 8.00 | 359,755 | 10.00 |
| Tier 1 Capital (to Risk-Weighted Assets): | | | | | | |

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| | | | | | | |
|-------------------------------------|---------|-------|---------|------|---------|------|
| Ist Source Corporation | 519,785 | 14.41 | 144,245 | 4.00 | 216,368 | 6.00 |
| Ist Source Bank | 496,081 | 13.79 | 143,902 | 4.00 | 215,853 | 6.00 |
| Tier 1 Capital (to Average Assets): | | | | | | |
| Ist Source Corporation | 519,785 | 11.73 | 177,203 | 4.00 | 221,504 | 5.00 |
| Ist Source Bank | 496,081 | 11.22 | 176,837 | 4.00 | 221,046 | 5.00 |

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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, Federal Home Loan Bank (FHLB) borrowings, Federal Reserve Bank (FRB) borrowings, and the capability to package loans for sale.

We have borrowing sources available to supplement deposits and meet our funding needs. 1st Source Bank has established relationships with several banks to provide short term borrowings in the form of federal funds purchased. While at March 31, 2013 there were no such borrowings outstanding, we could borrow approximately \$235.00 million for a short time from these banks on a collective basis. As of March 31, 2013, we had \$52.65 million outstanding in FHLB advances and could borrow an additional \$143.05 million. We also had \$334.84 million available to borrow from the FRB with no amounts outstanding as of March 31, 2013.

Our loan to asset ratio was 74.01% at March 31, 2013 compared to 73.12% at December 31, 2012 and 71.77% at March 31, 2012. Cash and cash equivalents totaled \$64.46 million at March 31, 2013 compared to \$83.93 million at December 31, 2012 and \$57.61 million at March 31, 2012. At March 31, 2013, the consolidated statement of financial condition was rate sensitive by \$473.87 million more assets than liabilities scheduled to reprice within one year, or approximately 1.25%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs. Additionally, we anticipate receiving approximately \$7 million in refunded prepaid Federal Deposit Insurance Corporation assessments on June 28, 2013.

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 \$582 million.

RESULTS OF OPERATIONS

Net income for the three month period ended March 31, 2013 was \$12.40 million, compared to \$11.72 million for the same period in 2012. Diluted net income per common share was \$0.50 for the three month period ended March 31, 2013, compared to \$0.48 for the same period in 2012. Return on average common shareholders' equity was 8.90% for the three months ended March 31, 2013, compared to 8.84% in 2012. The return on total average assets was 1.11% for the three months ended March 31, 2013, compared to 1.08% in 2012.

The increase in net income for the three months ended March 31, 2013, over the first three months of 2012, was primarily the result of a decrease in provision for loan and lease losses. Details of the changes in the various components of net income are discussed further below.

NET INTEREST INCOME

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The taxable equivalent net interest income for the three months ended March 31, 2013 was \$38.22 million, an increase of 0.79% over the same period in 2012. The net interest margin on a fully taxable equivalent basis was 3.64% for the three months ended March 31, 2013, compared to 3.77% for the three months ended March 31, 2012.

During the three month period ended March 31, 2013, average earning assets increased \$213.57 million or 5.27% over the comparable period in 2012. Average interest-bearing liabilities increased \$86.53 million or 2.72% for the three month period ended March 31, 2013 over the comparable period one year ago. The yield on

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average earning assets decreased 33 basis points to 4.22% for the first quarter of 2013 from 4.55% for the first quarter of 2012. The rate earned on assets decreased due to the reduction in loan and investment yields in the current interest rate environment. Total cost of average interest-bearing liabilities decreased 24 basis points to 0.76% for the first quarter 2013 from 1.00% for the first quarter 2012. The result to the net interest margin, or the ratio of net interest income to average earning assets, was a decrease of 13 basis points for the three month period ended March 31, 2013 from March 31, 2012.

The largest contributor to the decrease in the yield on average earning assets for the three months ended March 31, 2013, compared to the three months ended March 31, 2012, was a reduction in yields on net loans and leases of 44 basis points. Average net loans and leases increased \$252.17 million or 8.16% for the first quarter of 2013 from the first quarter of 2012. Total average investment securities decreased \$32.68 million or 3.67% for the first quarter over one year ago. Tax equivalent yield on investment securities decreased 24 basis points for the first quarter 2013. Average mortgages held for sale decreased \$1.40 million or 13.97% for the three month period ended March 31, 2013, over the comparable period a year ago. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, decreased \$4.52 million or 7.63% for the three month period ended March 31, 2013, over the comparable period a year ago.

Average interest-bearing deposits increased \$99.47 million or 3.41% for the first quarter of 2013 over the same period in 2012. The effective rate paid on average interest-bearing deposits decreased 18 basis points to 0.61% for the first quarter 2013 compared to 0.79% for the first quarter 2012. The decline in the average cost of interest-bearing deposits during the first quarter of 2013 as compared to the first quarter of 2012 was primarily the result of interest rate re-pricing on maturing certificates of deposit and a change in deposit mix.

Average short-term borrowings decreased \$15.55 million or 11.52% for the first quarter of 2013 compared to the same period in 2012. Interest paid on short-term borrowings decreased 5 basis points for the first quarter 2013. Average subordinated notes decreased \$30.93 million for the first quarter of 2013 while the effective rate paid decreased 11 basis points due to the redemption of trust preferred securities in December 2012. Average long-term debt increased \$33.53 million or 87.38% during the first quarter of 2013 as compared to the first quarter of 2012. The increase in long-term borrowings was mainly the result of higher borrowings with the Federal Home Loan Bank. Interest paid on long-term borrowings decreased 215 basis points for the first quarter 2013 due to lower effective rates on Federal Home Loan Bank borrowings.

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

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

| | Three months ended March 31, | | | | | |
|--|------------------------------|--|----------------|---------------------|--|----------------|
| | Average Balance | 2013 Interest Income/ Expense | Yield/ Rate | Average Balance | 2012 Interest Income/ Expense | Yield/ Rate |
| ASSETS: | | | | | | |
| Investment securities: | | | | | | |
| Taxable | \$ 754,029 | \$ 3,695 | 1.99% | \$ 781,982 | \$ 4,327 | 2.23% |
| Tax exempt | 103,022 | 1,137 | 4.48% | 107,745 | 1,260 | 4.70% |
| Mortgages - held for sale | 8,638 | 71 | 3.33% | 10,041 | 98 | 3.93% |
| Net loans and leases | 3,342,033 | 39,199 | 4.76% | 3,089,868 | 39,928 | 5.20% |
| Other investments | 54,678 | 242 | 1.79% | 59,194 | 226 | 1.54% |
| Total Earning Assets | 4,262,400 | 44,344 | 4.22% | 4,048,830 | 45,839 | 4.55% |
| Cash and due from banks | 56,700 | | | 59,558 | | |
| Reserve for loan and lease losses | (84,134) | | | (82,462) | | |
| Other assets | 308,313 | | | 334,736 | | |
| Total | \$ 4,543,279 | | | \$ 4,360,662 | | |
| LIABILITIES AND SHAREHOLDERS EQUITY: | | | | | | |
| Interest-bearing deposits | \$ 3,014,056 | \$ 4,542 | 0.61% | \$ 2,914,588 | \$ 5,745 | 0.79% |
| Short-term borrowings | 119,373 | 32 | 0.11% | 134,919 | 53 | 0.16% |
| Subordinated notes | 58,764 | 1,055 | 7.28% | 89,692 | 1,647 | 7.39% |
| Long-term debt and mandatorily redeemable securities | 71,907 | 495 | 2.79% | 38,375 | 471 | 4.94% |
| Total Interest-Bearing Liabilities | 3,264,100 | 6,124 | 0.76% | 3,177,574 | 7,916 | 1.00% |
| Noninterest-bearing deposits | 650,217 | | | 574,305 | | |
| Other liabilities | 63,440 | | | 76,055 | | |
| Shareholders equity | 565,522 | | | 532,728 | | |

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| | | |
|---|--------------|--------------|
| Total | \$ 4,543,279 | \$ 4,360,662 |
| Net Interest Income | \$ 38,220 | \$ 37,923 |
| Net Yield on Earning Assets on a Taxable Equivalent Basis | 3.64% | 3.77% |

PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES

The provision for loan and lease losses for the three month period ended March 31, 2013 was \$0.76 million compared to a provision for loan and lease losses in the three month period ended March 31, 2012 of \$2.25 million. Net charge-offs of \$0.06 million were recorded for the first quarter 2013, compared to \$1.50 million for the same quarter a year ago.

On March 31, 2013, 30 day and over loan and lease delinquencies were 0.13% as compared to 0.33% on March 31, 2012. The decrease in delinquencies was primarily in residential real estate, aircraft loans, construction equipment financing loans and environmental equipment financing loans. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.49% as compared to 2.62% one year ago. A summary of loan and lease loss experience during the three months ended March 31, 2013 and 2012 is located in Note 5 of the Consolidated Financial Statements.

A loan or lease is considered impaired, based on current information and events, if it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan or lease agreement. We evaluate loans and leases exceeding \$100,000 for impairment and establish an allowance as a component of the reserve for loan and lease losses when it is probable all amounts due will not be collected pursuant to the contractual terms of the loan and lease and the recorded investment in the loan or lease exceeds its fair value. A summary of impaired loans as of March 31, 2013 and December 31, 2012 is reflected in Note 4 of the Consolidated Financial Statements.

Table of Contents**NONPERFORMING ASSETS**

Nonperforming assets were as follows:

| (Dollars in thousands) | March 31 | | December 31, | | March 31 | |
|---|-----------------|--------|---------------------|--------|-----------------|--------|
| | 2013 | | 2012 | | 2012 | |
| Loans and leases past due 90 days or more | \$ | 231 | \$ | 442 | \$ | 393 |
| Nonaccrual loans and leases | | 42,776 | | 36,417 | | 55,027 |
| Other real estate | | 4,372 | | 4,311 | | 7,719 |
| Former bank premises held for sale | | 951 | | 1,034 | | 1,134 |
| Repossessions | | 103 | | 63 | | 6,109 |
| Equipment owned under operating leases | | | | | | 41 |
| Total nonperforming assets | \$ | 48,433 | \$ | 42,267 | \$ | 70,423 |

Nonperforming assets as a percentage of total loans and leases were 1.41% at March 31, 2013, 1.25% at December 31, 2012, and 2.19% at March 31, 2012. Nonperforming assets totaled \$48.43 million at March 31, 2013, an increase of 14.59% from the \$42.27 million reported at December 31, 2012, and a 31.23% decrease from the \$70.42 million reported at March 31, 2012. The decrease during the first three months of 2013 compared to the same period in 2012 was primarily related to decreases in nonaccrual loans and leases and the sale of repossessed assets and other real estate as the economy slowly improves.

The increase in nonaccrual loans and leases at March 31, 2013 from December 31, 2012 occurred primarily in the aircraft portfolio. The decrease in nonaccrual loans and leases at March 31, 2013 from March 31, 2012 occurred in the commercial, commercial real estate, consumer, residential real estate and auto, light truck and environmental equipment portfolios. A summary of nonaccrual loans and leases and past due aging for the period ended March 31, 2013 and December 31, 2012 is located in Note 4 of the Consolidated Financial Statements.

As of March 31, 2013, the industry with the largest dollar exposure was with borrowers whose primary source of income was derived from commercial real estate. These impaired loans totaled approximately \$15.05 million which were comprised of \$12.61 million secured by commercial real estate and included in loans secured by real estate, \$1.23 million secured by construction equipment and included in construction equipment financing and \$1.21 million secured by aircraft and included in aircraft financing. We have limited exposure to commercial real estate. However, our borrowers with commercial real estate exposure have suffered as a result of declining real estate values and minimal sales activity. Furthermore, aircraft values for some models have been declining since 2010, increasing the risk in aircraft secured transactions.

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 decreased over the past year due to sales of existing properties outpacing current foreclosures.

Repossessions consisted mainly of auto, light truck and environmental equipment at March 31, 2013. At the time of repossession, the recorded amount of the loan or lease is written down, if necessary, to the estimated value of the equipment or vehicle by a charge to the reserve for loan and lease losses, unless the equipment is in the process of immediate sale. Any subsequent write-downs are included in noninterest expense.

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

| (Dollars in thousands) | March 31 2013 | December 31, 2012 | March 31 2012 |
|---|------------------|----------------------|------------------|
| Commercial and agricultural loans | \$ | \$ | \$ |
| Auto, light truck and environmental equipment | 83 | 52 | 100 |
| Medium and heavy duty truck | | | |
| Aircraft financing | | | 5,980 |
| Construction equipment financing | | | |
| Commercial real estate | 3,236 | 3,362 | 6,895 |
| Residential real estate | 717 | 545 | 526 |
| Consumer loans | 439 | 415 | 327 |
| Total | \$ 4,475 | \$ 4,374 | \$ 13,828 |

For financial statement purposes, nonaccrual loans and leases are included in loan and lease outstandings, whereas repossessions and other real estate are included in other assets.

Foreign Outstandings Our foreign loan and lease outstandings, all denominated in U.S. dollars were \$266.24 million and \$271.41 million as of March 31, 2013 and December 31, 2012, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were \$164.00 million and \$56.22 million as of March 31, 2013, respectively, compared to \$169.42 million and \$55.12 million as of December 31, 2012, respectively. Outstanding balances to borrowers in other countries were insignificant.

NONINTEREST INCOME

Noninterest income for the three month period ended March 31, 2013 and 2012 was \$18.95 million and \$20.52 million, respectively. Details of noninterest income follow:

| (Dollars in thousands) | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2013 | 2012 |
| Noninterest income: | | |
| Trust fees | \$ 4,101 | \$ 3,973 |
| Service charges on deposit accounts | 2,239 | 2,438 |
| Debit card income | 2,065 | 2,067 |
| Mortgage banking income | 1,628 | 1,942 |
| Insurance commissions | 1,446 | 1,357 |
| Equipment rental income | 4,012 | 5,350 |
| Investment securities and other investment gains | 173 | 395 |
| Other income | 3,284 | 3,001 |
| Total noninterest income | \$ 18,948 | \$ 20,523 |

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Noninterest income decreased \$1.58 million or 7.67% for the first quarter 2013 as compared to the same period in 2012. Debit card income and insurance commissions changed slightly in 2013 over the same period in 2012.

Trust fees increased \$0.13 million or 3.22% for the three months ended March 31, 2013 over the comparable period one year ago. The increase in trust fees for the first quarter was a result of an increase in market values of investment accounts.

Service charges on deposit accounts decreased \$0.20 million or 8.16% for the three months ended March 31, 2013 over the comparable period one year ago. The decrease in service charges on deposit accounts reflects a lower volume of nonsufficient fund transactions.

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Mortgage banking income decreased \$0.31 million or 16.17% in the first quarter of 2013 as compared to the first quarter of 2012. This negative variance was caused by decreased gains on loan sales due to lower production volumes and reduced margins in 2013.

Equipment rental income declined \$1.34 million or 25.01% in the first quarter of 2013 compared to the first quarter 2012. The average equipment rental portfolio decreased 25.63% in 2013 over the same period in 2012 resulting in lower rental income. In addition, new leases are at lower rates due to current market conditions including lower rates and increased competition.

The decrease in investment securities and other investment gains of \$0.22 million or 56.20% in the three months ended March 31, 2013 over the comparable period one year ago was due primarily to gains on sale of agency securities and corporate debt securities in 2012 which were not present in 2013.

Other income increased \$0.28 million or 9.43% for the three month period ended March 31, 2013 as compared to the same period in 2012 primarily due to higher fees on customer swaps.

NONINTEREST EXPENSE

Noninterest expense for the three month period ended March 31, 2013 and 2012 was \$36.55 million and \$38.05 million, respectively. Details of noninterest expense follow:

| (Dollars in thousands) | Three Months Ended | |
|--|--------------------|----------------|
| | 2013 | March 31, 2012 |
| Noninterest expense: | | |
| Salaries and employee benefits | \$ 19,936 | \$ 20,316 |
| Net occupancy expense | 2,207 | 2,160 |
| Furniture and equipment expense | 3,899 | 3,507 |
| Depreciation - leased equipment | 3,225 | 4,311 |
| Professional fees | 1,355 | 1,398 |
| Supplies and communication | 1,536 | 1,393 |
| FDIC and other insurance | 878 | 949 |
| Business development and marketing expense | 773 | 867 |
| Loan and lease collection and repossession expense | 757 | 1,501 |
| Other expense | 1,984 | 1,646 |
| Total noninterest expense | \$ 36,550 | \$ 38,048 |

Noninterest expense decreased \$1.50 million or 3.94% for the first quarter 2013 as compared to the same period in 2012. Net occupancy, professional fees, supplies and communication, FDIC and other insurance and business development and marketing expense all changed slightly in 2013 over the same period in 2012.

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Salaries and employee benefits decreased \$0.38 million or 1.87% in the three months ended March 31, 2013 versus the three months ended March 31, 2012. Salaries were lower mainly due to decreased base salaries, incentives and commissions expense. Benefits increased primarily due to higher group insurance costs.

Furniture and equipment expense increased \$0.39 million or 11.18% for the three months ended March 31, 2013 versus the three months ended March 31, 2012. Furniture and equipment expense was higher mainly due to increased equipment depreciation, computer processing charges and software maintenance costs.

During the first quarter of 2013, depreciation on leased equipment decreased \$1.09 million or 25.19% in conjunction with the decrease in equipment rental income as compared to the same period one year ago.

Loan and lease collection and repossession expense was lower by \$0.74 million or 49.57% in the first quarter of

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2013 as compared to the same period in 2012 mainly due to a decreased amount of repossessions outstanding during the quarter offset by higher repurchased mortgage loan losses in 2013 compared to 2012.

Other expenses increased \$0.34 million or 20.53% in the three months ended March 31, 2013 as compared to the three months ended March 31, 2012 primarily related to a previously reported trustee matter.

INCOME TAXES

The provision for income taxes for the three month period ended March 31, 2013 was \$6.99 million compared to \$5.89 million for the same period in 2012. The effective tax rates were 36.05% and 33.46% for the first quarter ended March 31, 2013 and 2012, respectively. The effective tax rates are higher in 2013 compared to 2012 due to state refunds for 2009 received in January of 2012.

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, 2012. For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2012.

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, 2013, 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.

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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 2013 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, 2012. For information regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2012.

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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 |
|-------------------|---|-------------------------------------|--|---|
| Jan 01 - 31, 2013 | 9,800 | \$ 22.22 | 9,800 | 960,226 |
| Feb 01 - 28, 2013 | 15,000 | 23.15 | 15,000 | 945,226 |
| Mar 01- 31, 2013 | | | | 945,226 |

* 1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on April 26, 2007. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock when favorable conditions exist on the open market or through private transactions at various prices from time to time. Since the inception of the plan, 1st Source has repurchased a total of 1,054,774 shares.

ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Mine Safety Disclosures.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits

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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 25, 2013 | /s/ CHRISTOPHER J. MURPHY III Christopher J. Murphy III Chairman of the Board, President and CEO |
| DATE | April 25, 2013 | /s/ ANDREA G. SHORT Andrea G. Short Treasurer and Chief Financial Officer Principal Accounting Officer |