

1ST SOURCE CORP
Form 10-Q
October 24, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from _____ to _____

Commission file number 0-6233

(Exact name of registrant as specified in its charter)

INDIANA
(State or other jurisdiction of
incorporation or organization)

35-1068133
(I.R.S. Employer
Identification No.)

100 North Michigan Street South Bend, Indiana 46601
(Address of principal executive offices) (Zip Code)

(574) 235-2000

(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report.)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X 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

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company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ___ Accelerated filer Non-accelerated filer ___ 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

Number of shares of common stock outstanding as of October 22, 2008 - 24,110,930 shares

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

| | September 30, 2008 | December 31, 2007 |
|--|--------------------------|-------------------------|
| ASSETS | | |
| Cash and due from banks | \$ 75,704 | \$ 153,137 |
| Federal funds sold and interest bearing deposits with other banks | 59,090 | 25,817 |
| Investment securities available-for-sale (amortized cost of \$656,294 and \$775,922 at September 30, 2008 and December 31, 2007, respectively) | 658,905 | 779,981 |
| Other investments | 18,612 | 14,937 |
| Mortgages held for sale | 38,700 | 25,921 |
| Loans and leases - net of unearned discount: | | |
| Commercial and agricultural loans | 671,019 | 593,806 |
| Auto, light truck and environmental equipment | 337,248 | 305,238 |
| Medium and heavy duty truck | 253,682 | 300,469 |
| Aircraft financing | 608,881 | 587,022 |
| Construction equipment financing | 383,446 | 377,785 |
| Loans secured by real estate | 924,313 | 881,646 |
| Consumer loans | 136,274 | 145,475 |
| Total loans and leases | 3,314,863 | 3,191,441 |
| Reserve for loan and lease losses | (75,606) | (66,602) |
| Net loans and leases | 3,239,257 | 3,124,839 |
| Equipment owned under operating leases, net of accumulated depreciation | 87,407 | 81,960 |
| Net premises and equipment | 41,194 | 45,048 |
| Goodwill and intangible assets | 92,185 | 93,567 |
| Accrued income and other assets | 98,565 | 101,897 |
| Total assets | \$ 4,409,619 | \$ 4,447,104 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest bearing | \$ 374,290 | \$ 418,529 |
| Interest bearing | 2,976,122 | 3,051,134 |
| Total deposits | 3,350,412 | 3,469,663 |
| Federal funds purchased and securities sold under agreements to repurchase | 244,491 | 303,429 |
| Other short-term borrowings | 190,173 | 34,403 |
| Long-term debt and mandatorily redeemable securities | 34,861 | 34,702 |
| Subordinated notes | 89,692 | 100,002 |
| Accrued expenses and other liabilities | 58,980 | 74,401 |
| Total liabilities | 3,968,609 | 4,016,600 |

SHAREHOLDERS' EQUITY

| | | |
|--|--------------|--------------|
| Preferred stock; no par value | | |
| Authorized 10,000,000 shares; none issued or outstanding | - | - |
| Common stock; no par value | | |
| Authorized 40,000,000 shares; issued 25,911,397 at September 30, 2008 and 25,927,510 at December 31, 2007, less unearned shares (267,891 at September 30, 2008 and 284,004 at December 31, 2007) | 342,979 | 342,840 |
| Retained earnings | 128,428 | 117,373 |
| Cost of common stock in treasury (1,532,576 shares at September 30, 2008, and 1,551,396 shares at December 31, 2007) | (32,019) | (32,231) |
| Accumulated other comprehensive income | 1,622 | 2,522 |
| Total shareholders' equity | 441,010 | 430,504 |
| Total liabilities and shareholders' equity | \$ 4,409,619 | \$ 4,447,104 |

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

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|--|---------------|------------------------------------|----------------|
| | 2008 | 2007 | 2008 | 2007 |
| Interest income: | | | | |
| Loans and leases | \$ 50,979 | \$ 57,970 | \$ 154,590 | \$ 159,322 |
| Investment securities, taxable | 4,896 | 7,221 | 17,288 | 18,660 |
| Investment securities, tax-exempt | 1,873 | 2,213 | 5,904 | 5,351 |
| Other | 317 | 926 | 986 | 3,282 |
| Total interest income | 58,065 | 68,330 | 178,768 | 186,615 |
| Interest expense: | | | | |
| Deposits | 20,347 | 31,184 | 67,116 | 85,249 |
| Short-term borrowings | 2,255 | 2,978 | 6,434 | 8,240 |
| Subordinated notes | 1,648 | 1,846 | 5,067 | 4,236 |
| Long-term debt and mandatorily redeemable securities | 418 | 624 | 1,333 | 2,049 |
| Total interest expense | 24,668 | 36,632 | 79,950 | 99,774 |
| Net interest income | 33,397 | 31,698 | 98,818 | 86,841 |
| Provision for loan and lease losses | 3,571 | 3,660 | 9,603 | 4,284 |
| Net interest income after provision for loan and lease losses | 29,826 | 28,038 | 89,215 | 82,557 |
| Noninterest income: | | | | |
| Trust fees | 4,939 | 3,853 | 14,155 | 11,367 |
| Service charges on deposit accounts | 5,761 | 5,278 | 16,633 | 15,074 |
| Mortgage banking income | 959 | 770 | 3,493 | 2,400 |
| Insurance commissions | 1,084 | 964 | 4,122 | 3,540 |
| Equipment rental income | 6,285 | 5,345 | 17,794 | 15,730 |
| Other income | 2,168 | 1,841 | 6,836 | 6,042 |
| Investment securities and other investment (losses) gains | (8,816) | (154) | (9,259) | 300 |
| Total noninterest income | 12,380 | 17,897 | 53,774 | 54,453 |

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| | | | | |
|--|------------|------------|------------|------------|
| Noninterest expense: | | | | |
| Salaries and employee benefits | 19,297 | 20,035 | 58,996 | 55,754 |
| Net occupancy expense | 2,332 | 2,467 | 7,289 | 6,552 |
| Furniture and equipment expense | 3,694 | 3,996 | 11,555 | 10,838 |
| Depreciation - leased equipment | 5,041 | 4,284 | 14,266 | 12,603 |
| Professional fees | 2,773 | 922 | 6,453 | 3,089 |
| Supplies and communication | 1,812 | 1,666 | 5,163 | 4,450 |
| Business development and marketing expense | 881 | 1,027 | 2,524 | 3,302 |
| Other expense | 2,487 | 3,043 | 8,367 | 7,098 |
| Total noninterest expense | 38,317 | 37,440 | 114,613 | 103,686 |
| Income before income taxes | 3,889 | 8,495 | 28,376 | 33,324 |
| Income tax (benefit) expense | (583) | 2,365 | 7,305 | 10,611 |
| Net income | \$ 4,472 | \$ 6,130 | \$ 21,071 | \$ 22,713 |
| Per common share: | | | | |
| Basic net income per common share | \$ 0.19 | \$ 0.25 | \$ 0.87 | \$ 0.97 |
| Diluted net income per common share | \$ 0.18 | \$ 0.25 | \$ 0.86 | \$ 0.96 |
| Dividends | \$ 0.14 | \$ 0.14 | \$ 0.43 | \$ 0.42 |
| Basic weighted average common shares outstanding | 24,109,960 | 24,275,794 | 24,104,015 | 23,309,281 |
| Diluted weighted average common shares outstanding | 24,393,603 | 24,567,404 | 24,386,756 | 23,603,676 |

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

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1st SOURCE CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS'
EQUITY

(Unaudited - Dollars in thousands, except per share amounts)

| | Total | Common Stock | Retained Earnings | Cost of Common Stock in Treasury | Accumulated Other Comprehensive Income (Loss), Net |
|---|------------|-----------------|----------------------|---|---|
| Balance at January 1, 2007 | \$ 368,904 | \$ 289,163 | \$ 99,572 | \$ (19,571) | \$ (260) |
| Comprehensive Income, net of tax: | | | | | |
| Net Income | 22,713 | - | 22,713 | - | - |
| Change in unrealized appreciation of available-for-sale securities, net of tax | 2,394 | - | - | - | 2,394 |
| Total Comprehensive Income | 25,107 | - | - | - | - |
| Issuance of 40,349 common shares under stock-based compensation awards, including related tax effects | 544 | - | 384 | 160 | - |
| Cost of 478,083 shares of common stock acquired for treasury | (11,306) | - | - | (11,306) | - |
| Cash dividend (\$0.42 per share) | (9,731) | - | (9,731) | - | - |
| Issuance of 2,124,974 shares of common stock for FINA Bancorp purchase | 53,677 | 53,677 | | | |
| Balance at September 30, 2007 | \$ 427,195 | \$ 342,840 | \$ 112,938 | \$ (30,717) | \$ 2,134 |
| Balance at January 1, 2008 | \$ 430,504 | \$ 342,840 | \$ 117,373 | \$ (32,231) | \$ 2,522 |
| Comprehensive Income, net of tax: | | | | | |
| Net Income | 21,071 | - | 21,071 | - | - |
| Change in unrealized appreciation of available-for-sale securities, net of tax | (900) | - | - | - | (900) |
| | 20,171 | - | - | - | - |

Total Comprehensive
Income

| | | | | | |
|---|------------|------------|------------|-------------|----------|
| Issuance of 18,820 common shares under stock-based compensation awards, including related tax effects | 342 | - | 130 | 212 | - |
| Stock-based compensation | 139 | 139 | | | |
| Cash dividend (\$0.42 per share) | (10,146) | - | (10,146) | - | - |
| Balance at September 30, 2008 | \$ 441,010 | \$ 342,979 | \$ 128,428 | \$ (32,019) | \$ 1,622 |

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited - Dollars in thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|-----------|
| | 2008 | 2007 |
| Operating activities: | | |
| Net income | \$ 21,071 | \$ 22,713 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan and lease losses | 9,603 | 4,284 |
| Depreciation of premises and equipment | 4,088 | 3,905 |
| Depreciation of equipment owned and leased to others | 14,266 | 12,603 |
| Amortization of investment security premiums and accretion of discounts, net | 1,328 | (273) |
| Amortization of mortgage servicing rights | 2,234 | 1,753 |
| Mortgage servicing asset impairment | 56 | - |
| Deferred income taxes | (11,558) | (3,226) |
| Realized investment securities losses (gains) | 9,259 | (300) |
| Change in mortgages held for sale | (12,779) | 25,085 |
| Change in interest receivable | 438 | (3,538) |
| Change in interest payable | (5,853) | 2,816 |
| Change in other assets | 1,984 | (1,303) |
| Change in other liabilities | 2,539 | (867) |
| Other | 2,988 | 1,328 |
| Net change in operating activities | 39,664 | 64,980 |
| Investing activities: | | |
| Cash paid for acquisition, net | - | (55,977) |
| Proceeds from sales of investment securities | 8,237 | 1,070 |
| Proceeds from maturities of investment securities | 390,303 | 445,847 |
| Purchases of investment securities | (289,498) | (360,199) |
| Net change in short-term investments | (36,948) | 217,400 |
| Net change in loans and leases | (124,021) | (261,770) |
| Net change in equipment owned under operating leases | (19,712) | (14,333) |
| Purchases of premises and equipment | (2,403) | (13,600) |
| Net change in investing activities | (74,042) | (41,562) |
| Financing activities: | | |
| Net change in demand deposits, NOW accounts and savings accounts | (96,857) | (230,677) |
| Net change in certificates of deposit | (22,394) | 75,420 |
| Net change in short-term borrowings | 96,832 | 111,331 |
| Proceeds from issuance of long-term debt | 10,024 | - |
| Proceeds from issuance of trust preferred securities | - | 58,764 |
| Payments on subordinated notes | (10,310) | (17,784) |
| Payments on long-term debt | (10,371) | (381) |
| Net proceeds from issuance of treasury stock | 341 | 545 |
| Acquisition of treasury stock | - | (11,306) |
| Cash dividends | (10,320) | (9,897) |

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| | | |
|--|-----------|------------|
| Net change in financing activities | (43,055) | (23,985) |
| Net change in cash and cash equivalents | (77,433) | (567) |
| Cash and cash equivalents, beginning of year | 153,137 | 118,131 |
| Cash and cash equivalents, end of period | \$ 75,704 | \$ 117,564 |

Supplemental non-cash activity:

| | | |
|--|------|-----------|
| Common stock issued for purchase of FNBV | \$ - | \$ 53,667 |
|--|------|-----------|

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

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1ST SOURCE CORPORATION

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) that are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in shareholders' equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U. S. generally accepted accounting principles have been omitted. The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K for 2007 (2007 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The balance sheet at December 31, 2007, has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U. S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform with the current year presentation.

Note 2. Other Activity

On June 7, 2008, First National Bank, Valparaiso (FNBV) was merged into 1st Source Bank; both of which were wholly owned subsidiaries of 1st Source Corporation.

On August 25, 2008, 1st Source Corporation Investment Advisors, Inc. ("1st Source Investment Advisors"), a wholly-owned subsidiary of 1st Source Bank and an affiliate of 1st Source Corporation, entered into a Purchase and Sale Agreement with WA Holdings, Inc. ("Buyer") whereby 1st Source Investment Advisors agreed to sell certain assets to Buyer and to enter into a long-term strategic partnership with Buyer (the "Transaction"). Pursuant to the Purchase and Sale Agreement, Buyer and its wholly-owned subsidiary, Wasatch Advisors, Inc., investment advisor of the Wasatch Funds, Inc., will acquire assets of 1st Source Investment Advisors related to the management of the 1st Source Monogram Mutual Funds - the Income Equity Fund, the Long/Short Fund and the Income Fund. The 1st Source Monogram Mutual Funds will be reorganized into the Wasatch - 1st Source Income Equity Fund, the Wasatch - 1st Source Long/Short Fund, and the Wasatch - 1st Source Income Fund. The closing of the Transaction is subject to the approval of the shareholders of each of the 1st Source Monogram Mutual Funds. Additionally, closing is subject to the completion of certain regulatory filings and subject to customary closing conditions. Assuming satisfaction of all requisite conditions, the Transaction is expected to close by the end of the year.

Note 3. Recent Accounting Pronouncements

FASB Clarifies Application of Fair Value Accounting: On October 10, 2008, the Financial Accounting Standards Board (FASB) issued FASB Staff Position (FSP) FAS 157-3, "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active." The FSP clarifies the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective upon issuance, including prior periods for which financial statements have not been issued. The provisions of FSP FAS 157-3 did not have an impact on our financial condition or results of operations.

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GAAP Hierarchy: In May 2008, the FASB issued Statement No. 162, "The Hierarchy of Generally Accepted Accounting Principles" (SFAS No. 162). This standard identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (GAAP) in the United States (the GAAP hierarchy). The provisions of SFAS No. 162 did not have a material impact on our financial condition and results of operations.

Disclosures About Derivative Instruments and Hedging Activities: In March 2008, the FASB issued Statement No. 161, "Disclosures About Derivative Instruments and Hedging Activities – an amendment of FASB Statement No. 133" (SFAS No. 161). SFAS No. 161 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. We are assessing the potential disclosure effects of SFAS No. 161.

Business Combinations: In December 2007, the FASB issued SFAS No. 141R, "Business Combinations." SFAS No. 141R broadens the guidance of SFAS No. 141, extending its applicability to all transactions and other events in which one entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed, and interests transferred as a result of business combinations. SFAS No. 141R expands on required disclosures to improve the statement users' abilities to evaluate the nature and financial effects of business combinations. SFAS No. 141R is effective for the first annual reporting period beginning on or after December 15, 2008. The provisions of SFAS No. 141R will only impact us if we are party to a business combination closing on or after January 1, 2009.

Written Loan Commitments Recorded at Fair Value Through Earnings: In November 2007, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 109 (SAB 109), "Written Loan Commitments Recorded at Fair Value through Earnings," an amendment of SAB 105, "Application of Accounting Principles to Loan Commitments." Under SAB 109, the expected net future cash flows of associated loan servicing activities should be included in the measurement of written loan commitments accounted for at fair value through earnings. The guidance in SAB 109 is applied on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. We adopted the provisions of SAB 109 on January 1, 2008. Details related to the adoption of SAB 109 and the impact on our financial statements are more fully discussed in Note 7 – Fair Value.

Fair Value Option: In February 2007, the Financial Accounting Standards Board (FASB) issued Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB No. 115" (SFAS No. 159). The fair value option permits companies to choose to measure eligible items at fair value at specified election dates. Companies will report unrealized gains and losses on items for which the fair value option has been elected in earnings after adoption. SFAS No. 159 requires additional disclosures related to the fair value measurements included in the companies' financial statements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. We adopted the provisions of SFAS No. 159 on January 1, 2008. Details related to the adoption of SFAS No. 159 and the impact on our financial statements are more fully discussed in Note 7 – Fair Value.

Fair Value Measurements: In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements." This standard clarifies the principle that fair value should be based on the assumptions that market participants would use when pricing an asset or liability. Additionally, it establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. We adopted the provisions of SFAS No. 157 on January 1, 2008. Details related to the adoption of SFAS No. 157 and the impact on our financial statements are more fully discussed in Note 7 – Fair Value.

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Note 4. Reserve for Loan and Lease Losses

The reserve for loan and lease losses is maintained at a level believed to be adequate by management to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting management's best estimate of probable loan and lease losses related to specifically identified loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for identified special attention loans and leases (classified loans and leases and internal watch list credits), percentage allocations for special attention loans and leases without specific reserves, formula reserves for each business lending division portfolio, and reserves for pooled homogeneous loans and leases. Management's evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

Note 5. Financial Instruments with Off-Balance-Sheet Risk and Derivative Transactions

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

We have certain interest rate derivative positions that are not designated as hedging instruments. These derivative positions relate to transactions in which we enter into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. In connection with each transaction, we agree to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, we agree to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows our client to effectively convert a variable rate loan to a fixed rate. Because we act as an intermediary for our client, changes in the fair value of the underlying derivative contracts essentially offset. As of September 30, 2008, the notional amount of non-hedging interest rate swaps was \$399.00 million.

1st Source 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.

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We issue letters of credit that are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

As of September 30, 2008 and December 31, 2007, 1st Source Bank had commitments outstanding to originate and purchase mortgage loans aggregating \$38.86 million and \$29.53 million, respectively. Outstanding commitments to sell mortgage loans aggregated \$58.00 million at September 30, 2008, and \$45.53 million at December 31, 2007. Standby letters of credit totaled \$79.55 million and \$61.79 million at September 30, 2008, and December 31, 2007, respectively. Standby letters of credit have terms ranging from six months to one year.

Note 6. Stock-Based Compensation

As of September 30, 2008, we had five stock-based employee compensation plans, which are more fully described in Note L of the Consolidated Financial Statements in 1st Source's Annual Report on Form 10-K for the year ended December 31, 2007. These plans include two stock option plans, the Employee Stock Purchase Plan, the Executive Incentive Plan, and the Restricted Stock Award Plan.

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

The stock-based compensation expense recognized in the condensed consolidated statement of operations for the nine months ended September 30, 2008 and 2007 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

The aggregate intrinsic value in the table below represents the total pretax intrinsic value (the difference between 1st Source's closing stock price on the last trading day of the third quarter of 2008 (September 30, 2008) and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2008. This amount changes based on the fair market value of 1st Source's stock. Total fair value of options vested and expensed was \$12 thousand and \$57 thousand, net of tax, for the nine months ended September 30, 2008 and 2007, respectively.

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| | September 30, 2008 | | | |
|---|---------------------|---|---|---|
| | Number of Shares | Weighted Average Grant-date Fair Value | Average Remaining Contractual Term (in years) | Total Intrinsic Value (in 000's) |
| Options outstanding, beginning of year | 471,517 | \$ 26.51 | | |
| Granted | - | - | | |
| Exercised | - | - | | |
| Forfeited | (387,537) | 28.24 | | |
| Options outstanding, September 30, 2008 | 83,980 | \$ 18.53 | 3.02 | \$ 447 |
| Vested and expected to vest at September 30, 2008 | 83,980 | \$ 18.53 | 3.02 | \$ 447 |
| Exercisable at September 30, 2008 | 75,730 | \$ 19.24 | 2.85 | \$ 353 |

No options were granted during the nine months ended September 30, 2008.

As of September 30, 2008, there was \$2.52 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 4.24 years.

The following table summarizes information about stock options outstanding at September 30, 2008:

| Range of Exercise Prices | Number of shares Outstanding | Options Outstanding | | Options Exercisable | |
|--------------------------------|------------------------------------|---|--|------------------------------------|--|
| | | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number of shares Exercisable | Weighted Average Exercise Price |
| 12.04 to \$ 17.99 | 29,508 | 3.99 | \$ 13.38 | 21,258 | \$ 13.90 |
| 18.00 to \$ 26.99 | 48,917 | 2.43 | 20.46 | 48,917 | 20.46 |
| 27.00 to \$ 29.46 | 5,555 | 3.06 | 28.95 | 5,555 | 28.95 |

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

Note 7. Fair Value

As of January 1, 2008, we adopted SFAS No. 157, "Fair Value Measurements" and SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," including an amendment of SFAS No. 115. SFAS No. 157 does not change existing guidance as to whether or not an asset or liability is carried at fair value. It defines fair value 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, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 159 generally permits the measurement of selected eligible financial instruments at fair value at specified election dates, subject to the conditions set forth in the standard.

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We also adopted the provisions of FASB Staff Position (FSP) No. 157-2, which defers until January 1, 2009, the application of SFAS 157 to nonfinancial assets and nonfinancial liabilities not recognized or disclosed at least annually at fair value. Items affected by this deferral include goodwill, repossessions and other real estate, all for which any necessary impairment analyses are performed using fair value measurements. We do not expect the adoption of FSP No. 157-2 will have a material impact on our financial condition, results of operations, or liquidity.

We elected to adopt SFAS No. 159 for mortgages held for sale (MHFS) at fair value prospectively for new MHFS originations starting on January 1, 2008. We believe the election for MHFS (which are now hedged with free-standing derivatives (economic hedges)) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as economic hedges for these assets. There was no transition adjustment required upon adoption of SFAS No. 159 for MHFS because we continued to account for MHFS originated prior to January 1, 2008 at the lower of cost or fair value. At September 30, 2008, MHFS carried at fair value totaled \$38.70 million. At September 30, 2008, there were no MHFS that were originated prior to January 1, 2008.

In accordance with SFAS No. 157, we group our financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

§ Level 1 – Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

§ Level 2 – Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

§ Level 3 – Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value 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.

Certain assets and liabilities are measured at fair value on a recurring basis. The following is a discussion of these assets and liabilities and valuation techniques applied to each for fair value measurement:

§ Investment securities available for sale are valued primarily by a third party pricing agent and both the market and income valuation approaches are implemented using the following types of inputs:

§ U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.

§ Government-sponsored agency debt securities and corporate bonds are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.

§ Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMO's, are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.

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- § Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.
- § State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Since some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities. Local tax anticipation warrants, with very little market activity, are priced using an appropriate market yield curve.
- § Marketable equity (common) securities are primarily priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.
- § Marketable equity (preferred) securities are primarily priced using available market information through processes such as benchmark curves, benchmarking of like securities, sector groupings and matrix pricing.
- § Other non-marketable securities are primarily priced using cost or book values due to an absence of market activity and market data.
- § Mortgages held for sale and the related loan commitments and forward contracts (hedges) are valued using an income approach and utilizing an appropriate current market yield and a loan commitment closing rate based on historical analysis.
- § Interest rate swap positions, both assets and liabilities, are valued by a third-party pricing agent using an income approach and utilizing models that use as their basis readily observable market parameters. This valuation process considers various factors including interest rate yield curves, time value and volatility factors.

The table below presents the balance of assets and liabilities at September 30, 2008 measured at fair value on a recurring basis:

Assets and Liabilities Measured at Fair Value on a recurring basis:

| (Dollars in thousands) | Level 1 | Level 2 | Level 3 | September 30, 2008 Total |
|--|------------------|-------------------|------------------|--------------------------------|
| Assets: | | | | |
| Investment securities available for sale | \$ 73,265 | \$ 564,886 | \$ 20,754 | \$ 658,905 |
| Mortgages held for sale | - | 38,700 | - | 38,700 |
| Accrued income and other assets (Interest rate swap agreements) | - | 6,511 | - | 6,511 |
| Total | \$ 73,265 | \$ 610,097 | \$ 20,754 | \$ 704,116 |
| Liabilities | | | | |
| Accrued expenses and other liabilities (Interest rate swap agreements) | \$ - | \$ 6,511 | \$ - | \$ 6,511 |
| Total | \$ - | \$ 6,511 | \$ - | \$ 6,511 |

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The changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows:

| (Dollars in thousands) | Quarter ended September 30, 2008 Investment securities available for sale |
|--|--|
| Beginning balance July 1, 2008 | \$ 19,376 |
| Total gains or losses (realized/unrealized): | |
| Included in earnings | - |
| Included in other comprehensive income | (249) |
| Purchases and issuances | 1,411 |
| Settlements | - |
| Maturities | (4,550) |
| Transfers in and/or out of Level 3 | 4,766 |
| Ending balance September 30, 2008 | \$ 20,754 |

| | |
|---|------|
| The amount of total gains or (losses) for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at September 30, 2008. | \$ - |
|---|------|

We may be required, from time to time, to measure certain other financial assets at fair value on a nonrecurring basis in accordance with GAAP. These other financial assets include loans measured for impairment under SFAS 114, venture capital partnership investments and mortgage servicing rights. Impaired loans and related write-downs are based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using customized discounting criteria, appraisals and dealer and trade magazine quotes which are used in a market valuation approach. Venture capital partnership investments and the adjustments to fair value primarily result from application of lower-of-cost-or-fair value accounting. The partnership investments are priced using financial statements provided by the partnerships. Mortgage servicing rights (MSRs) and related adjustments to fair value result from application of lower-of-cost-or-fair value accounting. Fair value measurements for mortgage servicing rights are derived based on a variety of inputs including prepayment speeds, discount rates, scheduled servicing cash flows, delinquency rates and other assumptions. 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. For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended September 30, 2008: impaired loans \$0.04 million; venture capital partnership investments \$(0.11) million; mortgage servicing rights \$(0.13) million. For assets measured at fair value on a nonrecurring basis on hand at September 30, 2008, the following table provides the level of valuation assumptions used to determine each valuation and the fair value measurement of the related assets:

Assets and Liabilities Measured at Fair Value
on a non-recurring basis:

| (Dollars in thousands) | September 30, 2008 | | | |
|---|--------------------|---------|-----------|-----------|
| | Level 1 | Level 2 | Level 3 | Total |
| Loans | \$ - | \$ - | \$ 19,275 | \$ 19,275 |
| Accrued income and other assets (venture capital partnership investments) | - | - | 2,464 | 2,464 |
| Accrued income and other assets (mortgage servicing rights) | - | - | 10,775 | 10,775 |
| | \$ - | \$ - | \$ 32,514 | \$ 32,514 |

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Fair Value Option

The following table reflects the differences between fair value carrying amount of mortgages held for sale measured at fair value under SFAS No. 159 and the aggregate unpaid principal amount we are contractually entitled to receive at maturity on September 30, 2008:

| (Dollars in thousands) | Fair value carrying amount | Aggregate unpaid principal | Excess of fair value carrying amount over (under) unpaid principal | |
|--|----------------------------------|----------------------------------|---|-----|
| Mortgages held for sale reported at fair value: | | | | |
| Total loans | \$ 38,700 | \$ 37,953 | \$ 747 | (1) |
| Nonaccrual loans | - | - | - | |
| Loans 90 days or more past due and still accruing | - | - | - | |

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

ITEM 2.
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Except for historical information contained herein, the matters discussed in this document express "forward-looking statements." Generally, the words "believe," "expect," "intend," "estimate," "anticipate," "project," "will," "should," and similar expressions indicate forward-looking statements. Those statements, including statements, projections, estimates or assumptions concerning future events or performance, and other statements that are other than statements of historical fact, are subject to material risks and uncertainties. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. We may make other written or oral forward-looking statements from time to time. Readers are advised that various important factors could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected in such forward-looking statements. Such factors include, but are not limited to, changes in law, regulations or U. S. generally accepted accounting principles; our competitive position within the markets we serve; increasing consolidation within the banking industry; unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2007, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

The following management's discussion and analysis is presented to provide information concerning our financial condition as of September 30, 2008, as compared to December 31, 2007, and the results of operations for the three and

nine month periods ended September 30, 2008 and 2007. 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 2007 Annual Report.

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FINANCIAL CONDITION

Our total assets at September 30, 2008, were \$4.41 billion, relatively unchanged from December 31, 2007. Total loans and leases were \$3.31 billion at September 30, 2008, an increase of \$123.42 million or 3.87% from December 31, 2007. Total deposits at September 30, 2008, were \$3.35 billion, down \$119.25 million or 3.44% from the comparable figures at the end of 2007. Total investment securities, available for sale were \$658.91 million at September 30, 2008, a decrease of \$121.08 million or 15.52% from December 31, 2007.

Nonperforming assets at September 30, 2008, were \$30.00 million compared to \$18.48 million at December 31, 2007, an increase of 62.34%. The majority of the increase was in nonaccrual loans in the medium and heavy duty truck financing portfolio. At September 30, 2008, nonperforming assets were 0.88% of net loans and leases compared to 0.56% at December 31, 2007.

Accrued income and other assets were as follows:

(Dollars in Thousands)

| | September 30, 2008 | December 31, 2007 |
|--|--------------------------|-------------------------|
| Accrued income and other assets: | | |
| Bank owned life insurance cash surrender value | \$ 38,453 | \$ 38,871 |
| Accrued interest receivable | 18,855 | 19,293 |
| Mortgage servicing assets | 6,549 | 7,279 |
| Other real estate | 1,615 | 781 |
| Former bank premises held for sale | 3,821 | 4,040 |
| Repossessions | 234 | 2,291 |
| All other assets | 29,038 | 29,342 |
| Total accrued income and other assets | \$ 98,565 | \$ 101,897 |

CAPITAL

As of September 30, 2008, total shareholders' equity was \$441.01 million, up \$10.51 million or 2.44% from the \$430.50 million at December 31, 2007. In addition to net income of \$21.07 million, other significant changes in shareholders' equity during the first nine months of 2008 included \$10.15 million of dividends paid. The accumulated other comprehensive income component of shareholders' equity totaled \$1.62 million at September 30, 2008, compared to \$2.52 million at December 31, 2007. The decrease in accumulated other comprehensive income was a result of changes in unrealized gain or loss on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 10.00% as of September 30, 2008, compared to 9.68% at December 31, 2007. Book value per common share rose to \$18.29 at September 30, 2008, up from \$17.87 at December 31, 2007. Tangible book value per common share was \$14.47 at September 30, 2008, up from \$13.99 at December 31, 2007.

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We declared and paid dividends per common share of \$0.14 during the third quarter of 2008. The trailing four quarters dividend payout ratio, representing dividends per share divided by diluted earnings per share, was 48.31%. The dividend payout is continually reviewed by management and the Board of Directors.

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 and required capital amounts and ratios of 1st Source Corporation and 1st Source Bank, as of September 30, 2008, 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 | \$ 481,743 | 12.98% | \$ 296,816 | 8.00% | \$ 371,021 | 10.00% |
| 1st Source Bank | 477,018 | 12.91 | 295,561 | 8.00 | 369,452 | 10.00 |
| Tier 1 Capital (to Risk-Weighted Assets): | | | | | | |
| 1st Source Corporation | 434,049 | 11.70 | 148,408 | 4.00 | 222,612 | 6.00 |
| 1st Source Bank | 430,472 | 11.65 | 147,781 | 4.00 | 221,671 | 6.00 |
| Tier 1 Capital (to Average Assets): | | | | | | |
| 1st Source Corporation | 434,049 | 10.08 | 172,313 | 4.00 | 215,391 | 5.00 |
| 1st Source Bank | 430,472 | 10.04 | 171,532 | 4.00 | 214,415 | 5.00 |

LIQUIDITY AND INTEREST RATE SENSITIVITY

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as the operating cash needs of 1st Source Corporation, are met. Funds are available from a number of sources, including the securities portfolio, the core deposit base, Federal Home Loan Bank borrowings, and the capability to package loans for sale. Our loan to asset ratio was 75.17% at September 30, 2008 compared to 71.76% at December 31, 2007 and 72.55% at September 30, 2007. Cash and cash equivalents totaled \$75.70 million at September 30, 2008 compared to \$153.14 million at December 31, 2007 and \$117.56 million at September 30, 2007. At September 30, 2008, the consolidated statement of financial condition was rate sensitive by \$516.90 million more liabilities than assets scheduled to reprice within one year, or approximately 0.83%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

SUBORDINATED DEBT

During the first quarter of 2008, we redeemed \$10.31 million in floating-rate trust preferred securities issued by 1st Source Capital Trust III and \$0.43 million of pre-tax capitalized debt issuance costs were written off. 1st Source Capital Trust III was dissolved during the third quarter of 2008.

RESULTS OF OPERATIONS

Net income for the three and nine month periods ended September 30, 2008, was \$4.47 million and \$21.07 million respectively, compared to \$6.13 million and \$22.71 million for the same periods in 2007. Diluted net income per common share was \$0.18 and \$0.86 respectively, for the three and nine month periods ended September 30, 2008, compared to \$0.25 and \$0.96 for the same periods in 2007. Return on average common shareholders' equity was 6.35% for the nine months ended September 30, 2008, compared to 7.58% in 2007. The return on total average assets was 0.64% for the nine months ended September 30, 2008, compared to 0.75% in 2007.

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The change in net income for the nine months ended September 30, 2008, over the first nine months of 2007, was primarily the result of an increase of \$5.32 million to our provision for loan and lease losses, \$10.26 million of other than temporary impairment on investment securities, and a \$10.93 million increase in noninterest expense, which were offset by a \$11.98 million increase in net interest income, a \$9.58 million increase in noninterest income and a \$3.31 million reduction in income tax expense. Details of the changes in the various components of net income are further discussed below.

NET INTEREST INCOME

The taxable equivalent net interest income for the three months ended September 30, 2008, was \$34.26 million, an increase of 4.65% over the same period in 2007. The net interest margin on a fully taxable equivalent basis was 3.34% for the three months ended September 30, 2008, compared to 3.16% for the three months ended September 30, 2007. The taxable equivalent net interest income for the nine month period ended September 30, 2008 was \$101.51 million, an increase of 13.55% over 2007, resulting in a net yield of 3.35%, compared to a net yield of 3.17% for the same period in 2007.

Average earning assets decreased \$28.27 million or 0.69% and increased \$275.32 million or 7.30%, respectively, for the three and nine month periods ended September 30, 2008, over the comparable periods in 2007. Average interest-bearing liabilities decreased \$58.87 million or 1.65% and increased \$257.62 million or 7.96%, respectively, for the three and nine month periods ended September 30, 2008, over the comparable period one year ago. The yield on average earning assets decreased 96 basis points to 5.75% for the third quarter of 2008 from 6.71% for the third quarter of 2007. The yield on average earning assets for the nine month period ended September 30, 2008, decreased 72 basis points to 5.99% from 6.71% for the nine month period ended September 30, 2007. The yield earned on assets continued to decrease due to the reduction in short-term market interest rates from a year ago. Total cost of average interest-bearing liabilities decreased 127 basis points to 2.79% for the third quarter of 2008 from 4.06% for the third quarter of 2007. Total cost of average interest-bearing liabilities decreased 106 basis points to 3.06% for the nine month period ended September 30, 2008 from 4.12% for the nine month period ended September 30, 2007. The cost of interest-bearing liabilities was also affected by the decline in short-term market interest rates. The result to the net interest margin, or the difference between interest income on earning assets and expense on interest-bearing liabilities, was an increase of 18 basis points for both the three and the nine month periods ended September 30, 2008 from September 30, 2007.

Average loans and leases grew by \$143.74 million or 4.52% during the third quarter of 2008, compared to the third quarter of 2007. Average loans and leases outstanding increased most notably in commercial loans, construction equipment financing, aircraft financing, and loans secured by real estate for both the third quarter and year-to-date 2008 as compared to 2007.

Total average investment securities decreased 17.47% for the three month period over one year ago, while they remained steady for the nine month period over one year ago. Average mortgages held for sale increased 50.97% and 9.78% respectively, for the three and nine month periods over the same periods one year ago. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, decreased 50.57% for the three month period ended September 30, 2008 from same period one year ago, and 57.41% for the first nine months of 2008 as compared to the first nine months of 2007 as excess funds were used to fund loan and lease growth.

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Average interest-bearing deposits decreased \$169.45 million or 5.41% and increased \$140.37 million or 4.92%, respectively, for the third quarter of 2008 and first nine months of 2008, over the same periods in 2007. The effective rate paid on average interest-bearing deposits decreased 122 basis points to 2.73% for the third quarter of 2008 compared to 3.95% for the third quarter of 2007. The effective rate paid on average interest-bearing deposits decreased 100 basis points to 3.00% for the first nine months of 2008 compared to 4.00% for the first nine months of 2007. The decline in the average cost of interest-bearing deposits during the third quarter and first nine months of 2008 as compared to the third quarter and first nine months of 2007 was primarily the result of decreases in interest rates offered on deposit products due to decreases in market interest rates.

Average short term borrowings increased \$130.35 million or 43.81% and \$111.50 million or 42.44%, respectively, for the third quarter of 2008 and the first nine months of 2008, compared to the same time periods in 2007. Interest paid on short-term borrowings decreased due to the interest rate decrease in adjustable rate borrowings. Average long-term debt decreased \$9.38 million or 21.22% during the third quarter of 2008 as compared to the third quarter of 2007 and decreased \$9.14 million or 20.88% during the first nine months of 2008 as compared to the first nine months of 2007. The majority of the decrease in long-term debt was made up of Federal Home Loan Bank borrowings.

Average demand deposits increased 5.70% and 10.56%, respectively, for the three and nine month period ended September 30, 2008 as compared to the three and nine month periods of 2007. Much of the change in demand deposits was due to the May 31, 2007 acquisition of FNBV.

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

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

| | Three months ended September 30, 2008 | | | 2007 | | | Nine months ended September 30, 2008 | | | Average Balance |
|----------------------------------|--|--------------------------------|----------------|--------------------|--------------------------------|----------------|---|--------------------------------|----------------|--------------------|
| | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate | |
| ASSETS: | | | | | | | | | | |
| Investment securities: | | | | | | | | | | |
| Taxable | \$ 461,448 | \$ 4,896 | 4.22% | \$ 571,174 | \$ 7,221 | 5.02% | \$ 498,066 | \$ 17,288 | 4.64% | \$ 509,000 |
| Tax exempt | 220,524 | 2,573 | 4.64% | 255,200 | 3,150 | 4.90% | 227,235 | 8,156 | 4.79% | 215,000 |
| Mortgages - held for sale | | | | | | | | | | |
| | 32,794 | 523 | 6.34% | 21,722 | 393 | 7.18% | 33,868 | 1,544 | 6.09% | 30,000 |
| Net loans and leases | 3,322,970 | 50,617 | 6.06% | 3,179,234 | 57,677 | 7.20% | 3,251,499 | 153,484 | 6.31% | 2,930,000 |
| Other investments | 37,805 | 317 | 3.34% | 76,477 | 926 | 4.80% | 36,463 | 986 | 3.61% | 85,000 |
| Total Earning Assets | | | | | | | | | | |
| | 4,075,541 | 58,926 | 5.75% | 4,103,807 | 69,367 | 6.71% | 4,047,131 | 181,458 | 5.99% | 3,770,000 |

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| | | | | | | | | | | |
|-----------------------------------|---------------------|--|--|---------------------|--|--|---------------------|--|--|---------------------|
| Cash and due from banks | 79,943 | | | 86,794 | | | 88,126 | | | 78,000 |
| Reserve for loan and lease losses | (73,187) | | | (62,513) | | | (69,490) | | | (60,000) |
| Other assets | 317,712 | | | 318,631 | | | 318,181 | | | 264,000 |
| Total | \$ 4,400,009 | | | \$ 4,446,719 | | | \$ 4,383,948 | | | \$ 4,053,000 |

LIABILITIES AND SHAREHOLDERS' EQUITY:

| | | | | | | | | | | |
|--|---------------------|---------------|--------------|---------------------|---------------|--------------|---------------------|---------------|--------------|---------------------|
| Interest-bearing deposits | \$ 2,964,923 | \$ 20,347 | 2.73% | \$ 3,134,368 | \$ 31,184 | 3.95% | \$ 2,992,747 | \$ 67,116 | 3.00% | \$ 2,852,000 |
| Short-term borrowings | 427,895 | 2,255 | 2.10% | 297,543 | 2,978 | 3.97% | 374,246 | 6,434 | 2.30% | 262,000 |
| Subordinated notes | 89,692 | 1,648 | 7.31% | 100,089 | 1,846 | 7.32% | 91,385 | 5,067 | 7.41% | 70,000 |
| Long-term debt and mandatorily redeemable securities | 34,820 | 418 | 4.78% | 44,200 | 624 | 5.60% | 34,635 | 1,333 | 5.14% | 43,000 |
| Total Interest-Bearing Liabilities | 3,517,330 | 24,668 | 2.79% | 3,576,200 | 36,632 | 4.06% | 3,493,013 | 79,950 | 3.06% | 3,235,000 |
| Noninterest-bearing deposits | 376,112 | | | 355,825 | | | 376,727 | | | 340,000 |
| Other liabilities | 62,348 | | | 83,984 | | | 71,046 | | | 77,000 |
| Shareholders' equity | 444,219 | | | 430,710 | | | 443,162 | | | 400,000 |
| Total | \$ 4,400,009 | | | \$ 4,446,719 | | | \$ 4,383,948 | | | \$ 4,053,000 |

| | | | | | | | | | | |
|---------------------|-----------|--|--|-----------|--|--|------------|--|--|--|
| Net Interest Income | \$ 34,258 | | | \$ 32,735 | | | \$ 101,508 | | | |
|---------------------|-----------|--|--|-----------|--|--|------------|--|--|--|

| | | | | | | | | | | |
|---|--|--|-------|--|--|-------|--|--|-------|--|
| Net Yield on Earning Assets on a Taxable Equivalent Basis | | | 3.34% | | | 3.16% | | | 3.35% | |
|---|--|--|-------|--|--|-------|--|--|-------|--|

PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES

The provision for loan and lease losses for the three and nine month periods ended September 30, 2008, was \$3.57 million and \$9.60 million, respectively, compared to the provision for loan and lease losses of \$3.66 million and \$4.28 million for the three and nine month periods ended September 30, 2007, respectively. Net recoveries of \$0.34 million were recorded for the third quarter 2008, compared to net charge-offs of \$1.84 million for the same quarter a year ago. Year-to-date net charge-offs of \$0.60 million have been recorded in 2008, compared to net charge-offs of \$0.80 million through September 2007.

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In the third quarter 2008, over 30 day loan and lease delinquencies were 0.83%, as compared to 0.42% for the thirdquarter 2007. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.28% as compared to 2.02% for the same period one year ago and 2.09% at December 31, 2007. A summary of loan and lease loss experienced during the three- and nine- month periods ended September 30, 2008 and 2007 is provided below.

| | Summary of Reserve for Loan and Lease Losses (Dollars in Thousands) | | | |
|--|--|--------------|------------------------------------|--------------|
| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
| | 2008 | 2007 | 2008 | 2007 |
| Reserve for loan and lease losses - beginning balance | \$ 71,698 | \$ 62,682 | \$ 66,602 | \$ 58,802 |
| Acquired reserves from acquisitions | - | 165 | - | 2,379 |
| Charge-offs | (1,006) | (2,744) | (3,921) | (5,097) |
| Recoveries | 1,343 | 901 | 3,322 | 4,296 |
| Net (charge-offs)/recoveries | 337 | (1,843) | (599) | (801) |
| Provision for loan and lease losses | 3,571 | 3,660 | 9,603 | 4,284 |
| Reserve for loan and lease losses - ending balance | \$ 75,606 | \$ 64,664 | \$ 75,606 | \$ 64,664 |
| Loans and leases outstanding at end of period | \$ 3,314,863 | \$ 3,201,595 | \$ 3,314,863 | \$ 3,201,595 |
| Average loans and leases outstanding during period | 3,322,970 | 3,179,234 | 3,251,499 | 2,930,077 |
| Reserve for loan and lease losses as a percentage of loans and leases outstanding at end of period | 2.28% | 2.02% | 2.28% | 2.02% |
| Ratio of net charge offs/(recoveries) during period to average loans and leases outstanding | (0.03) % | 0.23% | 0.03% | 0.04% |

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NONPERFORMING ASSETS

Nonperforming assets were as follows:

(Dollars in thousands)

| | September 30, 2008 | December 31, 2007 | September 30, 2007 |
|--|--------------------------|-------------------------|--------------------------|
| Loans and leases past due 90 days or more | \$ 1,476 | \$ 1,105 | \$ 693 |
| Nonaccrual and restructured loans and leases | 22,812 | 10,136 | 10,211 |
| Other real estate | 1,615 | 781 | 824 |
| Former bank premises held for sale | 3,821 | 4,040 | 1,855 |
| Repossessions | 234 | 2,291 | 3,430 |
| Equipment owned under operating leases | 40 | 126 | 114 |
| Total nonperforming assets | \$ 29,998 | \$ 18,479 | \$ 17,127 |

Nonperforming assets totaled \$30.00 million at September 30, 2008, an increase of 62.34% from \$18.48 million at December 31, 2007 and an increase of 75.15% from \$17.13 million at September 30, 2007. The increase during the first nine months of 2008 compared to December 31, 2007 and to September 30, 2007, was primarily related to an increase in nonaccrual loans and leases primarily in the medium and heavy duty truck finance portfolio. The increase in medium and heavy duty truck nonaccrual loans was primarily the result of several customers continuing to experience cash flow difficulties as a result of high fuel prices and weakened demand for services due to overall economic conditions. Nonperforming assets as a percentage of total loans and leases increased to 0.88% at September 30, 2008, from 0.56% at December 31, 2007, and 0.52% at September 30, 2007.

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As of September 30, 2008, repossessions consisted of aircraft, automobiles, medium and heavy duty trucks, and construction equipment. 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.

Supplemental Loan Information as of September 30, 2008

| (Dollars in thousands) | Loans and leases outstanding | Nonaccrual and restructured loans | Other real estate owned and repossessions | Year-to-date net credit losses/ (recoveries) |
|---|------------------------------------|--|--|---|
| Commercial and agricultural loans | \$ 671,019 | \$ 1,337 | \$ 19 | \$ 597 |
| Auto, light truck and environmental equipment | 337,248 | 606 | 143 | (198) |
| Medium and heavy duty truck | 253,682 | 10,961 | - | 411 |
| Aircraft financing | 608,881 | 896 | 16 | (1,784) |
| Construction equipment financing | 383,446 | 1,448 | - | 189 |
| Loans secured by real estate | 924,313 | 7,453 | 1,614 | 334 |
| Consumer loans | 136,274 | 111 | 57 | 523 |
| Total | \$ 3,314,863 | \$ 22,812 | \$ 1,849 | \$ 72 |

NONINTEREST INCOME

Noninterest income for the three month periods ended September 30, 2008 and 2007 was \$12.38 million and \$17.90 million, respectively, and \$53.77 million and \$54.45 million for the nine month periods ended September 30, 2008 and 2007, respectively. Details of noninterest income follow:

| (Dollars in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|----------|------------------------------------|-----------|
| | 2008 | 2007 | 2008 | 2007 |
| Noninterest income: | | | | |
| Trust fees | \$ 4,939 | \$ 3,853 | \$ 14,155 | \$ 11,367 |
| Service charges on deposit accounts | 5,761 | 5,278 | 16,633 | 15,074 |
| Mortgage banking income | 959 | 770 | 3,493 | 2,400 |
| Insurance commissions | 1,084 | 964 | 4,122 | 3,540 |
| Equipment rental income | 6,285 | 5,345 | 17,794 | 15,730 |
| Other income | 2,168 | 1,841 | 6,836 | 6,042 |
| Investment securities and other investment (losses) gains | (8,816) | (154) | (9,259) | 300 |

| | | | | | | | | |
|--------------------------|----|--------|----|--------|----|--------|----|--------|
| Total noninterest income | \$ | 12,380 | \$ | 17,897 | \$ | 53,774 | \$ | 54,453 |
|--------------------------|----|--------|----|--------|----|--------|----|--------|

Noninterest income increased in all categories for the third quarter and year-to-date 2008 as compared to the same periods in 2007 except for investment security losses which offset these increases. Trust fees increased \$1.09 million, or 28.17% during the third quarter of 2008 as compared to the third quarter of 2007, and \$2.79 million, or 24.52% for the first nine months of 2008 as compared to the first nine months of 2007. These increases were primarily due to an increase in assets under management and an increase in our investment advisory management fees received from the 1st Source Monogram Funds. Service charges on deposit accounts increased for the three and nine month periods ended September 30, 2008 as compared to the same periods in 2007 due to growth in the number of deposit accounts and a higher volume of fee-generating transactions, primarily overdrafts, debit card and nonsufficient funds transactions.

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Mortgage banking income increased due to increased gains on the sales of mortgage loans. Insurance commissions increased mainly due to an October 2007 acquisition of an insurance agency in the Fort Wayne area. Equipment rental income increased during the third quarter of 2008 and the first nine months of 2008 primarily due to an increase in the operating lease portfolio. Other noninterest income remained stable for the three and nine month periods ended September 30, 2008 as compared to the same periods in 2007.

Investment securities and other investment losses increased for the three and nine month periods ended September 30, 2008 as compared to the same periods in 2007 as we recorded \$8.07 million and \$9.00 million, respectively, in impairment charges on investments in the Federal Home Loan Mortgage Corporation (FHLMC) and Federal National Mortgage Association (FNMA) preferred stock. In addition, other than temporary impairment charges of \$0.93 million and \$1.26 million, respectively, were recorded for the third quarter and year-to-date 2008 on other preferred equity holdings. Due to the uncertainty of future market conditions and of financial performance of these entities, we were unable to determine when or if this impairment will be recovered and considered this to be an other than temporary impairment. As of September 30, 2008, the carrying value of our investment in the FHLMC preferred stock was \$0.58 million and the carrying value of our investment in the FNMA preferred stock was \$0.07 million.

NONINTEREST EXPENSE

Noninterest expense for the three month periods ended September 30, 2008 and 2007 was \$38.32 million and \$37.44 million, respectively, and \$114.61 million and \$103.69 million for the nine month periods ended September 30, 2008 and 2007, respectively. Details of noninterest expense follow:

| (Dollars in thousands) | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|-----------|------------------------------------|------------|
| | 2008 | 2007 | 2008 | 2007 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | \$ 19,297 | \$ 20,035 | \$ 58,996 | \$ 55,754 |
| Net occupancy expense | 2,332 | 2,467 | 7,289 | 6,552 |
| Furniture and equipment expense | 3,694 | 3,996 | 11,555 | 10,838 |
| Depreciation - leased equipment | 5,041 | 4,284 | 14,266 | 12,603 |
| Professional fees | 2,773 | 922 | 6,453 | 3,089 |
| Supplies and communication | 1,812 | 1,666 | 5,163 | 4,450 |
| Business development and marketing expense | 881 | 1,027 | 2,524 | 3,302 |
| Intangible asset amortization | 351 | 287 | 1,052 | 524 |
| Loan and lease collection and repossession expense | (130) | 345 | 672 | 670 |
| Other expense | 2,266 | 2,411 | 6,643 | 5,904 |
| Total noninterest expense | \$ 38,317 | \$ 37,440 | \$ 114,613 | \$ 103,686 |

For the third quarter of 2008 salaries and employee benefits expense was \$19.30 million compared to \$20.04 million for the third quarter of 2007. For the first nine months of 2008 salaries and employee benefits expense was \$59.00 million compared to \$55.75 million for the first nine months of 2007. This increase was due to a larger work force following the acquisition of FNBV and increased executive incentive and group insurance provisions.

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The increases for the third quarter year-to-date 2008 as compared to 2007 in net occupancy expense, furniture and equipment expense, supplies and communication, and intangible asset amortization were primarily due to the added expenses of FNBV. For the third quarter 2008, these expense categories all remained relatively stable with third quarter 2007 amounts. Leased equipment depreciation expense increased in conjunction with the increase in equipment rental income from third quarter and year-to-date of 2007 to third quarter and year-to-date of 2008. Professional fees increased in the third quarter and first nine months of 2008, as compared to the third quarter and first nine months of 2007 due to expenses recorded for a systems security breach that occurred in May 2008 and other consulting expenses. Loan and lease collection and repossession expense remained comparable to 2007 levels. Other expenses decreased for the third quarter and increased year-to-date 2008 as compared to 2007 due to increased FDIC Insurance premiums, correspondent banking fees, and debit card losses.

INCOME TAXES

The provision (benefit) for income taxes for the three and nine month periods ended September 30, 2008, was \$(0.58) million and \$7.31 million, respectively, compared to \$2.37 million and \$10.61 million, respectively, for the same periods in 2007. The effective tax rates were 25.74% for the nine month period ended September 30, 2008, compared to 31.84% for the nine month period ended September 30, 2007. The decrease in the effective tax rate in 2008 was mainly due to an increase in tax-exempt interest in relation to taxable income. Taxable income declined due to the other than temporary impairment charge on investment securities. If these investment securities were sold, they would generate capital losses for income tax purposes. Management believes that there will be adequate capital gains available in prior and subsequent tax periods to offset the capital loss which allows us to realize the full tax benefit of the potential capital loss. The provisions for income taxes for the three and nine month periods ended September 30, 2008 and 2007, are at a rate which management believes approximates the expected effective rate for the year.

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, 2007. For information regarding 1st Source's market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2007.

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 September 30, 2008, 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 third fiscal quarter of 2008 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 their businesses. Management does not expect that the outcome of any such proceedings will have a material adverse effect on 1st Source’s consolidated financial position or results of operations.

ITEM Risk Factors.

1A.

Except for the addition of the risk factors detailed below, there have been no material changes in risks previously disclosed under item 1A. of 1st Source’s Annual Report on Form 10-K for the year ended December 31, 2007.

The soundness of other financial institutions could adversely affect us - Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due us. Any such losses could have a material adverse affect on our financial condition and results of operations.

Current levels of market volatility are unprecedented - The capital and credit markets have been experiencing extreme volatility and disruption for more than 12 months. In recent weeks, the volatility and disruption have reached unprecedented levels. In some cases, the markets have exerted downward pressure on stock prices, security prices and credit capacity for certain issuers without regard to those issuers’ underlying financial strength. If the current levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience adverse effects, which may be material, on our ability to access capital and on our results of operations.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

ISSUER PURCHASES OF EQUITY SECURITIES

| Total number of shares purchased | Maximum number (or approximate dollar value) of shares |
|---|--|
|---|--|

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| Period | Total number of shares purchased | Average price paid per share | as part of publicly announced plans or programs (1) | that may yet be purchased under the plans or programs |
|-------------------------|----------------------------------|------------------------------|---|---|
| July 01 - 31, 2008 | | - | - | 1,447,448 |
| August 01 - 31, 2008 | | - | - | 1,447,448 |
| September 01 - 30, 2008 | | - | - | 1,447,448 |

(1) 1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on April 26, 2007. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock when favorable conditions exist on the open market or through private transactions at various prices from time to time. Since the inception of the plan, 1st Source has repurchased a total of 552,552 shares.

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ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Submission of Matters to a Vote of Security Holders.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits.

The following exhibits are filed with this report:

10(k) Purchase and Sale Agreement with WA Holdings, Inc. dated August 25, 2008.

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.

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SIGNATURES

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

1st Source Corporation

DATE October 24 , 2008

/s/CHRISTOPHER J. MURPHY III
Christopher J. Murphy III
Chairman of the Board, President and
CEO

DATE October 24, 2008

/s/LARRY E. LENTYCH
Larry E. Lentych
Treasurer and Chief Financial Officer
Principal Accounting Officer

