

1ST SOURCE CORP  
Form 10-Q  
October 24, 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 September 30, 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)

**35-1068133**

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

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

(Address of principal executive  
offices)

**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   
(Do not check if a smaller reporting company)

Smaller reporting company

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

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Number of shares of common stock outstanding as of October 11, 2013 24,322,527 shares

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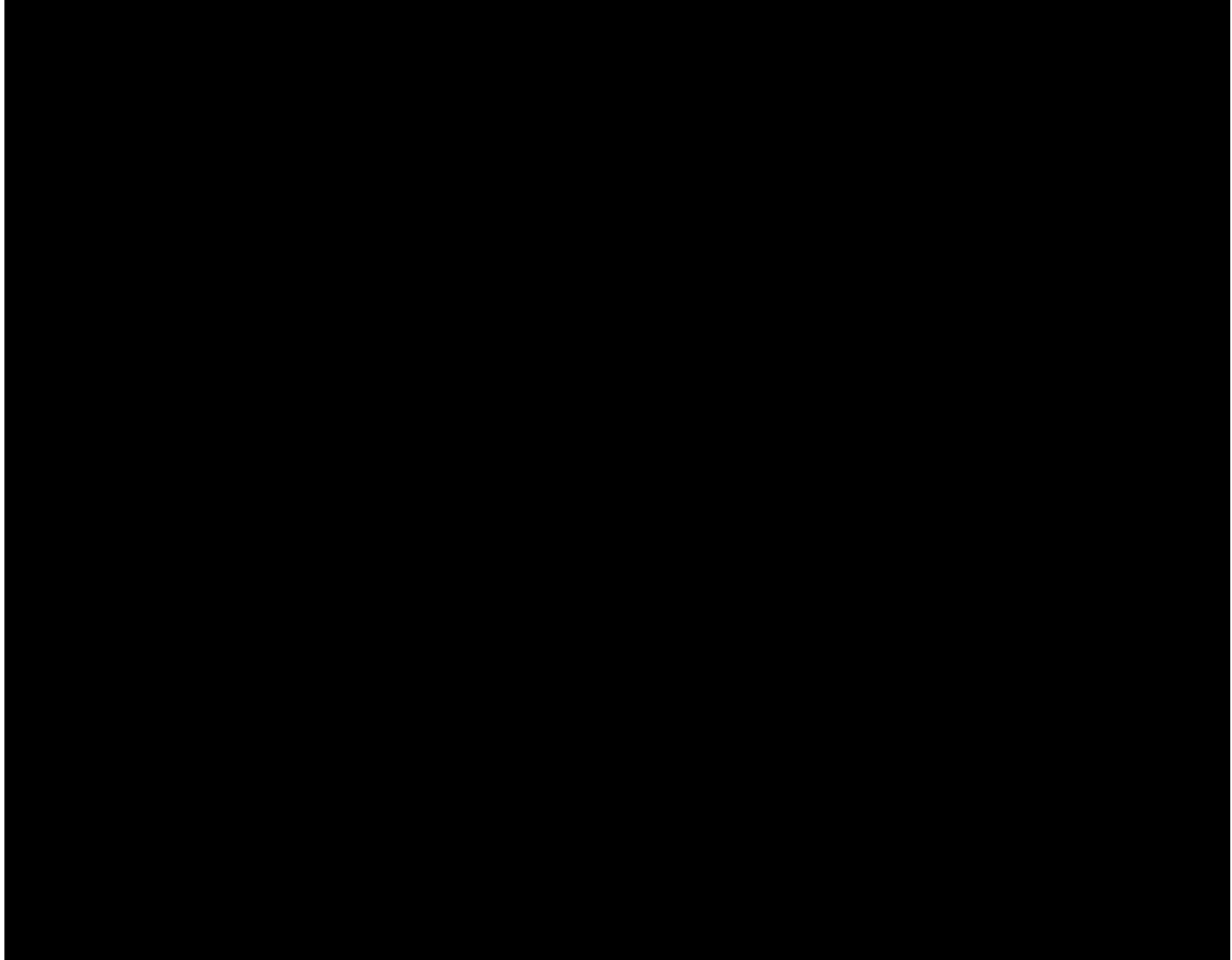


Table of Contents**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION***(Unaudited - Dollars in thousands)*

	September 30, 2013	December 31, 2012
<b><u>ASSETS</u></b>		
Cash and due from banks	\$ 90,090	\$ 83,232
Federal funds sold and interest bearing deposits with other banks	1,676	702
Investment securities available-for-sale (amortized cost of \$819,918 and \$849,139 at September 30, 2013 and December 31, 2012, respectively)	834,348	880,764
Other investments	22,409	22,609
Trading account securities	177	146
Mortgages held for sale	7,157	10,879
Loans and leases - net of unearned discount		
Commercial and agricultural loans	652,180	639,069
Auto, light truck and environmental equipment	452,405	438,147
Medium and heavy duty truck	192,974	172,002
Aircraft financing	704,072	696,479
Construction equipment financing	315,346	278,974
Commercial real estate	574,279	554,968
Residential real estate	455,327	438,641
Consumer loans	121,535	109,273
<b>Total loans and leases</b>	<b>3,468,118</b>	<b>3,327,553</b>
Reserve for loan and lease losses	(84,507)	(83,311)
<b>Net loans and leases</b>	<b>3,383,611</b>	<b>3,244,242</b>
Equipment owned under operating leases, net	61,160	52,173
Net premises and equipment	45,466	45,016
Goodwill and intangible assets	86,629	87,502
Accrued income and other assets	117,238	123,428
<b>Total assets</b>	<b>\$ 4,649,961</b>	<b>\$ 4,550,693</b>
<b><u>LIABILITIES</u></b>		
Deposits:		
Noninterest bearing	\$ 725,263	\$ 646,380
Interest bearing	2,954,153	2,977,967
<b>Total deposits</b>	<b>3,679,416</b>	<b>3,624,347</b>
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	147,991	158,680
Other short-term borrowings	73,451	10,508
<b>Total short-term borrowings</b>	<b>221,442</b>	<b>169,188</b>
Long-term debt and mandatorily redeemable securities	58,440	71,021
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	53,670	68,718
<b>Total liabilities</b>	<b>4,071,732</b>	<b>3,992,038</b>
<b><u>SHAREHOLDERS' EQUITY</u></b>		
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 September 30, 2013 and December 31, 2012	346,535	346,535

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Retained earnings	252,043	223,715
Cost of common stock in treasury (1,319,336 shares at September 30, 2013 and 1,399,261 shares at December 31, 2012)	(29,362)	(31,134)
Accumulated other comprehensive income	9,013	19,539
<b>Total shareholders equity</b>	<b>578,229</b>	<b>558,655</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 4,649,961</b>	<b>\$ 4,550,693</b>

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Interest income:</b>				
Loans and leases	\$ 42,392	\$ 40,610	\$ 121,674	\$ 120,824
Investment securities, taxable	3,581	3,913	10,774	12,574
Investment securities, tax-exempt	764	826	2,295	2,526
Other	229	231	712	688
<b>Total interest income</b>	<b>46,966</b>	<b>45,580</b>	<b>135,455</b>	<b>136,612</b>
<b>Interest expense:</b>				
Deposits	4,089	5,419	13,043	16,868
Short-term borrowings	72	36	149	136
Subordinated notes	1,055	1,647	3,165	4,942
Long-term debt and mandatorily redeemable securities	592	571	1,315	1,399
<b>Total interest expense</b>	<b>5,808</b>	<b>7,673</b>	<b>17,672</b>	<b>23,345</b>
<b>Net interest income</b>	<b>41,158</b>	<b>37,907</b>	<b>117,783</b>	<b>113,267</b>
(Recovery of) provision for loan and lease losses	(419)	650	1,631	4,959
<b>Net interest income after provision for loan and lease losses</b>	<b>41,577</b>	<b>37,257</b>	<b>116,152</b>	<b>108,308</b>
<b>Noninterest income:</b>				
Trust fees	5,260	4,055	13,800	12,407
Service charges on deposit accounts	2,364	2,688	6,928	7,747
Debit card income	2,343	2,020	6,752	6,281
Mortgage banking income	1,103	2,020	4,667	5,464
Insurance commissions	1,292	1,483	4,131	4,051
Equipment rental income	4,000	4,604	12,098	14,620
Investment securities and other investment gains	258	89	469	492
Other income	3,538	3,346	10,382	9,556
<b>Total noninterest income</b>	<b>20,158</b>	<b>20,305</b>	<b>59,227</b>	<b>60,618</b>
<b>Noninterest expense:</b>				
Salaries and employee benefits	20,441	20,982	59,553	61,668
Net occupancy expense	2,126	1,652	6,480	5,660
Furniture and equipment expense	4,477	3,817	12,285	11,155
Depreciation - leased equipment	3,246	3,795	9,745	11,909
Professional fees	1,178	1,385	3,843	4,232
Supplies and communication	1,330	1,387	4,365	4,165
FDIC and other insurance	874	913	2,679	2,716
Business development and marketing expense	1,306	1,008	3,011	2,925
Loan and lease collection and repossession expense	1,530	1,866	3,382	4,346
Other expense	1,922	388	5,381	3,043
<b>Total noninterest expense</b>	<b>38,430</b>	<b>37,193</b>	<b>110,724</b>	<b>111,819</b>
Income before income taxes	23,305	20,369	64,655	57,107
Income tax expense	8,409	7,364	23,413	19,820

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<b>Net income</b>	\$	14,896	\$	13,005	\$	41,242	\$	37,287
Per common share:								
Basic net income per common share	\$	0.60	\$	0.53	\$	1.67	\$	1.52
Diluted net income per common share	\$	0.60	\$	0.53	\$	1.67	\$	1.51
Dividends	\$	0.17	\$	0.17	\$	0.51	\$	0.49
Basic weighted average common shares outstanding		24,366,220		24,279,178		24,352,073		24,267,535
Diluted weighted average common shares outstanding		24,367,109		24,289,495		24,352,854		24,278,160

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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income	\$ 14,896	\$ 13,005	\$ 41,242	\$ 37,287
Other comprehensive income (loss):				
Change in unrealized appreciation (depreciation) of available-for-sale securities	1,853	3,979	(16,881)	5,673
Reclassification adjustment for realized losses (gains) included in net income	28	2	28	(275)
Income tax effect	(706)	(1,522)	6,327	(2,063)
Other comprehensive income (loss), net of tax	1,175	2,459	(10,526)	3,335
<b>Comprehensive income</b>	<b>\$ 16,071</b>	<b>\$ 15,464</b>	<b>\$ 30,716</b>	<b>\$ 40,622</b>

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	37,287			37,287		
Other comprehensive income	3,335					3,335
Issuance of 169,720 common shares under stock based compensation awards, including related tax effects	3,743			97	3,646	
Cost of 104,471 shares of common stock acquired for treasury	(2,617)				(2,617)	
Common stock dividend (\$0.49 per share)	(11,998)			(11,998)		
Balance at September 30, 2012	\$ 553,668	\$	\$ 346,535	\$ 215,647	\$ (30,360)	\$ 21,846

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Balance at January 1, 2013	\$	558,655	\$		\$	346,535	\$	223,715	\$	(31,134)	\$	19,539
Net income		41,242						41,242				
Other comprehensive loss		(10,526)										(10,526)
Issuance of 169,792 common shares under stock based compensation awards, including related tax effects		3,650					(390)			4,040		
Cost of 89,867 shares of common stock acquired for treasury		(2,268)								(2,268)		
Common stock dividend (\$0.51 per share)		(12,524)						(12,524)				
Balance at September 30, 2013	\$	578,229	\$		\$	346,535	\$	252,043	\$	(29,362)	\$	9,013

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

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	<b>Nine Months Ended September 30,</b>	
	<b>2013</b>	<b>2012</b>
<b>Operating activities:</b>		
Net income	\$ 41,242	\$ 37,287
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	1,631	4,959
Depreciation of premises and equipment	3,515	3,151
Depreciation of equipment owned and leased to others	9,745	11,909
Amortization of investment security premiums and accretion of discounts, net	2,745	3,140
Amortization of mortgage servicing rights	1,265	2,267
Mortgage servicing asset (recoveries) impairments		230
Deferred income taxes	(3,265)	(4,817)
Investment securities and other investment gains	(469)	(492)
Originations of loans held for sale, net of principal collected	(85,010)	(165,577)
Proceeds from the sales of loans held for sale	91,395	160,301
Net gain on sale of loans held for sale	(2,663)	(4,933)
Change in trading account securities	(31)	(13)
Change in interest receivable	(215)	(634)
Change in interest payable	(1,506)	(529)
Change in other assets	13,085	10,993
Change in other liabilities	(3,636)	404
Other	825	990
<b>Net change in operating activities</b>	<b>68,653</b>	<b>58,636</b>
<b>Investing activities:</b>		
Proceeds from sales of investment securities	47,028	40,736
Proceeds from maturities of investment securities	152,706	203,436
Purchases of investment securities	(172,789)	(226,567)
Net change in other investments	200	(3,390)
Loans sold or participated to others	25,054	22,968
Net change in loans and leases	(171,771)	(206,261)
Net change in equipment owned under operating leases	(18,732)	(854)
Purchases of premises and equipment	(4,040)	(6,521)
<b>Net change in investing activities</b>	<b>(142,344)</b>	<b>(176,453)</b>
<b>Financing activities:</b>		
Net change in demand deposits, NOW accounts and savings accounts	79,907	119,128
Net change in certificates of deposit	(24,838)	(70,601)
Net change in short-term borrowings	52,254	11,401
Proceeds from issuance of long-term debt	5,951	26,873
Payments on long-term debt	(20,313)	(360)
Net proceeds from issuance of treasury stock	3,650	3,743
Acquisition of treasury stock	(2,268)	(2,617)
Cash dividends paid on common stock	(12,820)	(12,263)
<b>Net change in financing activities</b>	<b>81,523</b>	<b>75,304</b>
<b>Net change in cash and cash equivalents</b>	<b>7,832</b>	<b>(42,513)</b>

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Cash and cash equivalents, beginning of year	83,934	114,327
Cash and cash equivalents, end of period	\$ 91,766	\$ 71,814

**Supplemental Information:**

Non-cash transactions:

Loans transferred to other real estate and repossessed assets	\$ 5,717	\$ 2,319
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**

Investment Companies: In June 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-08 *Financial Services-Investment Companies (Topic 946) Amendments to the Scope, Measurement and Disclosure Requirements*. ASU 2013-08 changes the approach to the investment company assessment in Topic 946, clarifies the characteristics of an investment company and provides comprehensive guidance for assessing whether an entity is an investment company. ASU 2013-08 is effective for interim and annual reporting periods in fiscal years that begin after December 15, 2013. Early application is prohibited. The Company is assessing the impact of ASU 2013-08 on its disclosures.

Comprehensive Income: In February 2013, the FASB issued 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 effect of applying this standard is reflected in Note 11 Accumulated Other Comprehensive Income.

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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.

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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.

**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
<b>September 30, 2013</b>				
U.S. Treasury and Federal agencies securities	\$ 394,063	\$ 5,698	\$ (3,468)	\$ 396,293
U.S. States and political subdivisions securities	111,843	3,821	(984)	114,680
Mortgage-backed securities Federal agencies	280,255	6,277	(2,172)	284,360
Corporate debt securities	30,890	242	(9)	31,123
Foreign government and other securities	700	7		707
Total debt securities	817,751	16,045	(6,633)	827,163
Marketable equity securities	2,167	5,021	(3)	7,185
Total investment securities available-for-sale	\$ 819,918	\$ 21,066	\$ (6,636)	\$ 834,348
<b>December 31, 2012</b>				
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 September 30, 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).

The contractual maturities of investments in debt securities available-for-sale at September 30, 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.

<b>(Dollars in thousands)</b>	<b>Amortized Cost</b>		<b>Fair Value</b>	
Due in one year or less	\$	128,276	\$	127,885
Due after one year through five years		346,667		352,734
Due after five years through ten years		61,903		61,568
Due after ten years		650		616
Mortgage-backed securities		280,255		284,360
Total debt securities available-for-sale	\$	817,751	\$	827,163



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The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. The gross gains and losses for the three and nine months ended September 30, 2013 primarily reflect the sale of federal agency securities. The trades were done for the purpose of balance sheet realignment and managing reinvestment risk by adjusting the timing of future cash flows. There were no other-than-temporary-impairment (OTTI) write-downs in 2013 or 2012.

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Gross realized gains	\$ 903	\$	\$ 903	\$ 275
Gross realized losses	(931)		(931)	
Net realized (losses) gains	\$ (28)	\$	\$ (28)	\$ 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
September 30, 2013						
U.S. Treasury and Federal agencies securities	\$ 139,539	\$ (3,337)	\$ 15,094	\$ (131)	\$ 154,633	\$ (3,468)
U.S. States and political subdivisions securities	30,490	(671)	2,691	(313)	33,181	(984)
Mortgage-backed securities - Federal agencies	94,174	(2,171)	49	(1)	94,223	(2,172)
Corporate debt securities	7,900	(3)	993	(6)	8,893	(9)
Foreign government and other securities	100				100	
Total debt securities	272,203	(6,182)	18,827	(451)	291,030	(6,633)
Marketable equity securities			4	(3)	4	(3)
Total investment securities available-for-sale	\$ 272,203	\$ (6,182)	\$ 18,831	\$ (454)	\$ 291,034	\$ (6,636)
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

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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 sell any such securities before a recovery of cost.

At September 30, 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 increases in market rates over the yields available at the time the underlying securities were purchased and market illiquidity on auction rate securities which are reflected in U.S. States and political subdivisions. The fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

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At September 30, 2013 and December 31, 2012, investment securities with carrying values of \$236.58 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
September 30, 2013			
Commercial and agricultural loans	\$ 623,884	\$ 28,296	\$ 652,180
Auto, light truck and environmental equipment	442,616	9,789	452,405
Medium and heavy duty truck	190,921	2,053	192,974
Aircraft financing	662,126	41,946	704,072
Construction equipment financing	299,938	15,408	315,346
Commercial real estate	546,426	27,853	574,279
Total	\$ 2,765,911	\$ 125,345	\$ 2,891,256
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
September 30, 2013			
Residential real estate	\$ 452,561	\$ 2,766	\$ 455,327
Consumer	121,109	426	121,535
Total	\$ 573,670	\$ 3,192	\$ 576,862
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
September 30, 2013							
Commercial and agricultural loans	\$ 643,495	\$ 714	\$ 750	\$	\$ 644,959	\$ 7,221	\$ 652,180
Auto, light truck and environmental equipment	451,659	349	110		452,118	287	452,405
Medium and heavy duty truck	192,380				192,380	594	192,974
Aircraft financing	688,856		3,725		692,581	11,491	704,072
Construction equipment financing	313,532	515			314,047	1,299	315,346
Commercial real estate	566,742		51		566,793	7,486	574,279
Residential real estate	451,005	956	600	220	452,781	2,546	455,327
Consumer	120,260	517	332	25	121,134	401	121,535
Total	\$ 3,427,929	\$ 3,051	\$ 5,568	\$ 245	\$ 3,436,793	\$ 31,325	\$ 3,468,118
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

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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
<b>September 30, 2013</b>			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 6,470	\$ 6,468	\$
Auto, light truck and environmental equipment			
Medium and heavy duty truck	594	594	
Aircraft financing	2,301	2,301	
Construction equipment financing	1,214	1,213	
Commercial real estate	15,339	15,339	
Residential real estate			
Consumer loans			
Total with no related allowance recorded	25,918	25,915	
With an allowance recorded:			
Commercial and agricultural loans	5,189	5,189	49
Auto, light truck and environmental equipment			
Medium and heavy duty truck			
Aircraft financing	9,132	9,132	1,491
Construction equipment financing			
Commercial real estate			
Residential real estate			
Consumer loans			
Total with an allowance recorded	14,321	14,321	1,540
Total impaired loans	\$ 40,239	\$ 40,236	\$ 1,540
<b>December 31, 2012</b>			
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 September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural loans	\$ 11,766	\$ 98	\$ 9,111	\$ 2	\$ 9,645	\$ 133	\$ 9,441	\$ 12
Auto, light truck and environmental equipment	39		2,578		221		2,474	7
Medium and heavy duty truck	638		434	1	292		917	2
Aircraft financing	10,361	79	6,100		8,832	79	8,831	
Construction equipment financing	1,447	1	4,512		3,376	4	4,399	5
Commercial real estate	16,531	155	22,757	138	18,507	459	22,330	302
Residential real estate			104	2			82	4
Consumer								
<b>Total</b>	<b>\$ 40,782</b>	<b>\$ 333</b>	<b>\$ 45,596</b>	<b>\$ 143</b>	<b>\$ 40,873</b>	<b>\$ 675</b>	<b>\$ 48,474</b>	<b>\$ 332</b>

The number of loans and leases classified as troubled debt restructuring (TDR) during the three and nine months ended September 30, 2013 and 2012, segregated by class, are shown in the table below as well as the recorded investment as of September 30. 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 September 30,				Nine Months Ended September 30,			
	2013		2012		2013		2012	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
<i>Performing TDRs:</i>								
Commercial and agricultural loans		\$		\$	1	\$ 750		\$
Auto, light truck and environmental equipment								
Medium and heavy duty truck								
Aircraft financing								
Construction equipment financing								
Commercial real estate							1	7,014
Residential real estate							1	103
Consumer								
<b>Total performing TDR modifications</b>		<b>\$</b>		<b>\$</b>	<b>1</b>	<b>\$ 750</b>	<b>2</b>	<b>\$ 7,117</b>
<i>Nonperforming TDRs:</i>								
Commercial and agricultural loans		\$		\$	1	\$ 299		\$
Auto, light truck and environmental equipment								
Medium and heavy duty truck								



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Aircraft financing	1	4,201			1	4,201		
Construction equipment financing							3	1,467
Commercial real estate			1	1,163			1	1,163
Residential real estate								
Consumer								
Total nonperforming TDR modifications	1	\$ 4,201	1	\$ 1,163	2	\$ 4,500	4	\$ 2,630
Total TDR modifications	1	\$ 4,201	1	\$ 1,163	3	\$ 5,250	6	\$ 9,747

There were no TDRs which had payment defaults within the twelve months following modification during the three months ended September 30, 2013. There was one commercial and agricultural TDR which had payment defaults within the twelve months following modification during the nine months ended September 30, 2013.

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This loan was transferred into Other Real Estate during the three months ended June 30, 2013. There were no TDRs which had payment defaults within twelve months following modification during the three and nine months ended September 30, 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 September 30, 2013 and December 31, 2012.

(Dollars in thousands)	September 30,		December 31,	
	2013		2012	
Performing TDRs	\$	9,205	\$	8,839
Nonperforming TDRs		11,845		12,869
Total TDRs	\$	21,050	\$	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. 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 September 30, 2013 and 2012 are shown below.

	Auto, light truck Commercial and environmental agricultural loans equipment			Construction equipment Commercial financing real estate			Residential real estate	Consumer loans	Total									
September 30, 2013																		
<i>Reserve for loan and lease losses</i>																		
Balance, beginning of period	\$	12,202	\$	11,889	\$	3,178	\$	33,323	\$	6,065	\$	13,529	\$	3,895	\$	1,609	\$	85,690
Charge-offs		49		50		1,277								76		219		1,671
Recoveries		114		98		308		98		64		150		1		74		907
Net charge-offs (recoveries)		(65)		(48)		(308)		1,179		(64)		(150)		75		145		764
Provision (recovery of provision)		(255)		(1,588)		(83)		1,670		448		(801)		70		120		(419)
Balance, end of period	\$	12,012	\$	10,349	\$	3,403	\$	33,814	\$	6,577	\$	12,878	\$	3,890	\$	1,584	\$	84,507
Ending balance, individually evaluated for impairment	\$	49	\$		\$	1,491	\$		\$		\$		\$		\$		\$	1,540
Ending balance, collectively evaluated for impairment		11,963		10,349		3,403		32,323		6,577		12,878		3,890		1,584		82,967
Total reserve for loan and lease losses	\$	12,012	\$	10,349	\$	3,403	\$	33,814	\$	6,577	\$	12,878	\$	3,890	\$	1,584	\$	84,507
<i>Recorded investment in loans</i>																		
Ending balance, individually evaluated for impairment	\$	11,659	\$		\$	594	\$	11,433	\$	1,214	\$	15,339	\$		\$		\$	40,239
Ending balance, collectively evaluated for impairment		640,521		452,405		192,380		692,639		314,132		558,940		455,327		121,535		3,427,879
Total recorded investment in loans	\$	652,180	\$	452,405	\$	192,974	\$	704,072	\$	315,346	\$	574,279	\$	455,327	\$	121,535	\$	3,468,118
September 30, 2012																		
<i>Reserve for loan and lease losses</i>																		
Balance, beginning of period	\$	13,077	\$	10,300	\$	3,618	\$	29,871	\$	6,330	\$	15,172	\$	3,521	\$	1,410	\$	83,299
Charge-offs		214		210		461		1		132		159		311		1,488		
Recoveries		60		356		125		163		149		91		4		90		1,038
Net charge-offs (recoveries)		154		(146)		(125)		298		(148)		41		155		221		450
Provision (recovery of provision)		433		(496)		(377)		1,427		(585)		(99)		74		273		650
Balance, end of period	\$	13,356	\$	9,950	\$	3,366	\$	31,000	\$	5,893	\$	15,032	\$	3,440	\$	1,462	\$	83,499
Ending balance, individually evaluated for impairment	\$	878	\$	500	\$	886	\$		\$	49	\$		\$		\$		\$	2,313
Ending balance, collectively evaluated for impairment		12,478		9,450		3,366		30,114		5,893		14,983		3,440		1,462		81,186
Total reserve for loan and lease losses	\$	13,356	\$	9,950	\$	3,366	\$	31,000	\$	5,893	\$	15,032	\$	3,440	\$	1,462	\$	83,499

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*Recorded investment in loans*

Ending balance, individually evaluated for impairment	\$	9,148	\$	2,233	\$	322	\$	5,734	\$	4,355	\$	22,524	\$	103	\$	44,419		
Ending balance, collectively evaluated for impairment		575,848		454,432		167,387		680,066		271,915		526,397		436,806		111,143	3,223,994	
Total recorded investment in loans	\$	584,996	\$	456,665	\$	167,709	\$	685,800	\$	276,270	\$	548,921	\$	436,909	\$	111,143	\$	3,268,413

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Changes in the reserve for loan and lease losses, segregated by class, for the nine months ended September 30, 2013 and 2012 are shown below.

(Dollars in thousands)	Auto, light truck			Construction			Commercial real estate	Residential real estate	Consumer loans	Total
	Commercial and agricultural loans	and environmental equipment	Medium and heavy duty truck financing	Aircraft financing	equipment financing	real estate				
September 30, 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	463	51		1,308	88	164	230	820	3,124	
Recoveries	355	236	337	782	138	560	12	269	2,689	
Net charge-offs (recoveries)	108	(185)	(337)	526	(50)	(396)	218	551	435	
Provision (recovery of provision)	(206)	580	65	135	1,137	(1,296)	456	760	1,631	
Balance, end of period	\$ 12,012	\$ 10,349	\$ 3,403	\$ 33,814	\$ 6,577	\$ 12,878	\$ 3,890	\$ 1,584	\$ 84,507	
Ending balance, individually evaluated for impairment	\$ 49	\$	\$	\$ 1,491	\$	\$	\$	\$	\$ 1,540	
Ending balance, collectively evaluated for impairment	11,963	10,349	3,403	32,323	6,577	12,878	3,890	1,584	82,967	
Total reserve for loan and lease losses	\$ 12,012	\$ 10,349	\$ 3,403	\$ 33,814	\$ 6,577	\$ 12,878	\$ 3,890	\$ 1,584	\$ 84,507	
<i>Recorded investment in loans</i>										
Ending balance, individually evaluated for impairment	\$ 11,659	\$	\$ 594	\$ 11,433	\$ 1,214	\$ 15,339	\$	\$	\$ 40,239	
Ending balance, collectively evaluated for impairment	640,521	452,405	192,380	692,639	314,132	558,940	455,327	121,535	3,427,879	
Total recorded investment in loans	\$ 652,180	\$ 452,405	\$ 192,974	\$ 704,072	\$ 315,346	\$ 574,279	\$ 455,327	\$ 121,535	\$ 3,468,118	
September 30, 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	486	3,110		600	120	274	232	1,106	5,928	
Recoveries	224	1,214	147	484	233	170	38	314	2,824	
Net charge-offs (recoveries)	262	1,896	(147)	116	(113)	104	194	792	3,104	
Provision (recovery of provision)	527	3,377	(523)	2,490	(515)	(1,636)	272	967	4,959	
Balance, end of period	\$ 13,356	\$ 9,950	\$ 3,366	\$ 31,000	\$ 5,893	\$ 15,032	\$ 3,440	\$ 1,462	\$ 83,499	
Ending balance, individually evaluated for impairment	\$ 878	\$ 500	\$	\$ 886	\$	\$ 49	\$	\$	\$ 2,313	
Ending balance, collectively evaluated for impairment	12,478	9,450	3,366	30,114	5,893	14,983	3,440	1,462	81,186	
Total reserve for loan and lease losses	\$ 13,356	\$ 9,950	\$ 3,366	\$ 31,000	\$ 5,893	\$ 15,032	\$ 3,440	\$ 1,462	\$ 83,499	
<i>Recorded investment in loans</i>										
Ending balance, individually evaluated for impairment	\$ 9,148	\$ 2,233	\$ 322	\$ 5,734	\$ 4,355	\$ 22,524	\$ 103	\$	\$ 44,419	
Ending balance, collectively evaluated for impairment	575,848	454,432	167,387	680,066	271,915	526,397	436,806	111,143	3,223,994	
Total recorded investment in loans	\$ 584,996	\$ 456,665	\$ 167,709	\$ 685,800	\$ 276,270	\$ 548,921	\$ 436,909	\$ 111,143	\$ 3,268,413	

**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.

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The unpaid principal balance of residential mortgage loans serviced for third parties was \$851.70 million and \$921.20 million at September 30, 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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
<b>Mortgage servicing assets:</b>				
Balance at beginning of period	\$ 4,634	\$ 4,984	\$ 4,645	\$ 5,610
Additions	572	509	1,498	1,411
Amortization	(328)	(739)	(1,265)	(2,267)
Sales				
Carrying value before valuation allowance at end of period	4,878	4,754	4,878	4,754
<b>Valuation allowance:</b>				
Balance at beginning of period		(91)		(238)
Impairment (charges) recoveries		(377)		(230)
Balance at end of period	\$	\$ (468)	\$	\$ (468)
Net carrying value of mortgage servicing assets at end of period	\$ 4,878	\$ 4,286	\$ 4,878	\$ 4,286
Fair value of mortgage servicing assets at end of period	\$ 7,656	\$ 4,478	\$ 7,656	\$ 4,478

During the nine months ended September 30, 2013, the Company determined that it was not necessary to permanently write-down any previously established valuation allowance. At September 30, 2013 and 2012, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by \$2.78 million and \$0.19 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 \$0.79 million and \$0.90 million for the three months ended September 30, 2013 and 2012, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$2.43 million and \$2.72 million for the nine months ended September 30, 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**

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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 \$16.29 million and \$17.29 million at September 30, 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 September 30, 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	
September 30, 2013						
Interest rate swap contracts	\$ 445,258	Other assets	\$ 10,902	Other liabilities	\$ 11,110	
Loan commitments	8,497	Mortgages held for sale	82	N/A		
Forward contracts	12,000	N/A		Mortgages held for sale		179
Total	\$ 465,755		\$ 10,984		\$ 11,289	

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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 and nine months ended September 30, 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	Three Months Ended September 30,		Gain (loss) Nine Months Ended September 30,	
		2013	2012	2013	2012
Interest rate swap contracts	Other expense	\$ (2)	\$ 21	\$ 111	\$ 100
Interest rate swap contracts	Other income	169	333	567	586
Loan commitments	Mortgage banking income	(71)	64	(138)	205
Forward contracts	Mortgage banking income	(943)	(350)	(146)	(448)
Total		\$ (847)	\$ 68	\$ 394	\$ 443

At September 30, 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
September 30, 2013						
Interest rate swaps	\$ 11,586	\$ 684	\$ 10,902	\$	\$	\$ 10,902
December 31, 2012						
Interest rate swaps	\$ 17,422	\$ 1,296	\$ 16,126	\$	\$	\$ 16,126

At September 30, 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
September 30, 2013						
Interest rate swaps	\$ 11,794	\$ 684	\$ 11,110	\$	\$ 9,407	\$ 1,703
Repurchase agreements	110,491		110,491	110,491		
Total	\$ 122,285	\$ 684	\$ 121,601	\$ 110,491	\$ 9,407	\$ 1,703
December 31, 2012						
Interest rate swaps	\$ 17,740	\$ 1,296	\$ 16,444	\$	\$ 15,811	\$ 633
Repurchase agreements	100,180		100,180	100,180		
Total	\$ 117,920	\$ 1,296	\$ 116,624	\$ 100,180	\$ 15,811	\$ 633

If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions.

**Note 9. Earnings Per Share**

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include non-vested restricted stock awards. Non-vested restricted stock awards are considered participating securities to the extent the holders of these securities receive non-forfeitable dividends at the same rate as holders of common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method. Stock options, where the exercise price was greater than the average market price of the common shares, were excluded from the computation of diluted earnings per common share because the result would have been antidilutive.

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There were no stock options outstanding as of September 30, 2013. No stock options were considered antidilutive as of September 30, 2012.

The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the three and nine months ended September 30, 2013 and 2012.

(Dollars in thousands - except per share amounts)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Distributed earnings allocated to common stock	\$ 4,146	\$ 4,127	\$ 12,429	\$ 11,899
Undistributed earnings allocated to common stock	10,552	8,706	28,271	24,872
Net earnings allocated to common stock	14,698	12,833	40,700	36,771
Net earnings allocated to participating securities	198	172	542	516
Net income allocated to common stock and participating securities	\$ 14,896	\$ 13,005	\$ 41,242	\$ 37,287
Weighted average shares outstanding for basic earnings per common share	24,366,220	24,279,178	24,352,073	24,267,535
Dilutive effect of stock compensation	889	10,317	781	10,625
Weighted average shares outstanding for diluted earnings per common share	24,367,109	24,289,495	24,352,854	24,278,160
Basic earnings per common share	\$ 0.60	\$ 0.53	\$ 1.67	\$ 1.52
Diluted earnings per common share	\$ 0.60	\$ 0.53	\$ 1.67	\$ 1.51

### **Note 10. Stock Based Compensation**

As of September 30, 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 September 30, 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.

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The stock-based compensation expense recognized in the consolidated statements of income for the three and nine months ended September 30, 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 nine months ended September 30, 2013 and 2012. As of September 30, 2013 there were no outstanding stock options. There were 7,500 stock options exercised at a weighted average price of \$12.04 during the nine months ended September 30, 2013. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of September 30, 2013, there was \$6.69 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 3.25 years.

**Note 11. Accumulated Other Comprehensive Income**

The following table presents reclassifications out of accumulated other comprehensive income for the three and nine months ended September 30, 2013.

(Dollars in thousands)	Amount Reclassified from Accumulated Other Comprehensive Income		Affected Line Item in the Consolidated Statements of Income
	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2013	
Unrealized gains and losses on available-for-sale securities			
Realized losses included in net income	\$ (28)	\$ (28)	Investment securities and other investment gains
	(28)	(28)	Income before income taxes
Tax effect	11	11	Income tax expense
Net of tax	\$ (17)	\$ (17)	Net income

**Note 12. Income Taxes**

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$2.41 million at September 30, 2013 and \$2.02 million at December 31, 2012. Interest and penalties were recognized through the income tax provision. For the nine months ended September 30, 2013 and 2012, the Company recognized approximately \$0.11 million and \$(0.06) million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately \$0.66 million and \$0.55 million were accrued at September 30, 2013 and December 31, 2012, respectively.

Effective January 1, 2014, the Indiana Financial Institutions tax rate decreases from 8.5% to 8.0% and continues to decrease by 0.5% each of the next three years. As a result of the rate change, the Company decreased the carrying value of certain state deferred tax assets. The impact of this change was not material and was recorded in the financial statements during the second quarter of 2013.

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Tax years that remain open and subject to audit include the federal 2010-2012 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.



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**Note 13. Fair Value Measurements**

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

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

- Level 1 The valuation is based on quoted prices in active markets for identical instruments.
  
- Level 2 The valuation is based on observable inputs such as quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
  
- Level 3 The valuation is based on unobservable inputs that are supported by minimal or no market activity and that are significant to the fair value of the instrument. Level 3 valuations are typically performed using pricing models, discounted cash flow methodologies, or similar techniques that incorporate management's own estimates of assumptions that market participants would use in pricing the instrument, or valuations that require significant management judgment or estimation.

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

The Company elected fair value accounting for mortgages held for sale. The Company believes the election for mortgages held for sale (which are economically hedged with free standing derivatives) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as economic hedges for these assets. At September 30, 2013 and December 31, 2012, all mortgages held for sale were carried at fair value.

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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 September 30, 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
September 30, 2013			
Mortgages held for sale reported at fair value			
Total Loans	\$ 7,157	\$ 7,106	\$ 51(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.

***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 September 30, 2013 and December 31, 2012 measured at fair value on a recurring basis:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
<b>September 30, 2013</b>				
<u>Assets:</u>				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	\$ 19,693	\$ 376,600	\$	\$ 396,293
U.S. States and political subdivisions securities		108,163	6,517	114,680
Mortgage-backed securities Federal agencies		284,360		284,360
Corporate debt securities		31,123		31,123
Foreign government and other securities		707		707
Total debt securities	19,693	800,953	6,517	827,163
Marketable equity securities	7,185			7,185
Total investment securities available-for-sale	26,878	800,953	6,517	834,348
Trading account securities	177			177
Mortgages held for sale		7,157		7,157
Accrued income and other assets (Interest rate swap agreements)		10,902		10,902
Total	\$ 27,055	\$ 819,012	\$ 6,517	\$ 852,584
<u>Liabilities:</u>				
Accrued expenses and other liabilities (Interest rate swap agreements)	\$	\$ 11,110	\$	\$ 11,110
Total	\$	\$ 11,110	\$	\$ 11,110
<b>December 31, 2012</b>				
<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 investment securities available-for-sale Level 3 assets measured at fair value on a recurring basis for the quarter ended September 30, 2013 and 2012 are summarized as follows:

<b>(Dollars in thousands)</b>	<b>U.S. States and political subdivisions securities</b>
Beginning balance July 1, 2013	\$ 5,452
Total gains or losses (realized/unrealized):	
Included in earnings	
Included in other comprehensive income	56
Purchases	1,500
Issuances	
Settlements	
Maturities	(491)
Transfers into Level 3	
Transfers out of Level 3	
Ending balance September 30, 2013	\$ 6,517
Beginning balance July 1, 2012	\$ 8,143
Total gains or losses (realized/unrealized):	
Included in earnings	
Included in other comprehensive income	72
Purchases	
Issuances	
Settlements	
Maturities	(474)
Transfers into Level 3	
Transfers out of Level 3	
Ending balance September 30, 2012	\$ 7,741

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at September 30, 2013 or 2012. No transfers between levels occurred during the nine months ended September 30, 2013. One transfer between levels occurred during the nine months ended September 30, 2012. No transfers between Level 1 and 2 occurred during the period ended September 30, 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 September 30, 2013 and December 31, 2012.

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
<b>September 30, 2013</b>				
Investment securities available-for sale				
Adjustable rate securities	\$ 1,708	Discounted cash flows	Illiquidity adjustment	4.00% - 8.00%
			Term assumption (1)	5 yrs
			Coupon forecast assumption	0.37%
Direct placement municipal securities	4,809	Discounted cash flows	Credit spread assumption	1.16% - 1.66%
Total investment securities available-for-sale	\$ 6,517			
<b>December 31, 2012</b>				
Investment securities available-for sale				
Adjustable rate securities	\$ 3,364	Discounted cash flows	Illiquidity adjustment	4.00% - 8.00%
			Term assumption (1)	5 yrs
			Coupon forecast assumption	0.50% - 0.88%
Direct placement municipal securities	4,337	Discounted cash flows	Credit spread assumption	1.22% - 1.95%
Total investment securities available-for-sale	\$ 7,701			

(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 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



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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 vary depending on the nature of the assets and the source of value. Aircraft are generally valued using quarterly trade publications adjusted for engine time, condition, maintenance programs, discounted by 10%. Likewise, autos are valued using current auction values, discounted by 10%; medium and heavy duty trucks are valued using trade publications and auction values, discounted by 15%. Construction equipment 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.

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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.

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, 2013: impaired loans - \$0.00 million; partnership investments - \$(0.07) million; mortgage servicing rights - \$0.00 million; repossessions - \$0.00 million, and other real estate - \$0.10 million.

The table below presents the carrying value of assets at September 30, 2013 and December 31, 2012 measured at fair value on a non-recurring basis:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
<b>September 30, 2013</b>				
Impaired loans - collateral based	\$	\$	\$ 7,608	\$ 7,608
Accrued income and other assets (partnership investments)			2,017	2,017
Accrued income and other assets (mortgage servicing rights)			4,878	4,878
Accrued income and other assets (repossessions)			2,811	2,811
Accrued income and other assets (other real estate)			5,953	5,953
<b>Total</b>	<b>\$</b>	<b>\$</b>	<b>\$ 23,267</b>	<b>\$ 23,267</b>
<b>December 31, 2012</b>				
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
<b>Total</b>	<b>\$</b>	<b>\$</b>	<b>\$ 14,111</b>	<b>\$ 14,111</b>

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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 September 30, 2013 and December 31, 2012.

(Dollars in thousands)	Carrying Value	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
<b>September 30, 2013</b>					
Impaired loans	\$ 7,608	\$ 7,608	Collateral based measurements including appraisals, trade publications, auction values	Discount for lack of marketability and current conditions	10% - 90%
Mortgage servicing rights	4,878	7,656	Discounted cash flows	Constant prepayment rate (CPR) Discount rate	11.1% - 15.7% 9.75% - 12.75%
Repossessions	2,811	2,957	Appraisals, trade publications and auction values	Discount for lack of marketability	0% - 3%
Other real estate	5,953	7,072	Appraisals	Discount for lack of marketability	0% - 74%
<b>December 31, 2012</b>					
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 September 30, 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
<b>September 30, 2013</b>					
<u>Assets:</u>					
Cash and due from banks	\$ 90,090	\$ 90,090	\$ 90,090	\$	\$
Federal funds sold and interest bearing deposits with other banks	1,676	1,676	1,676		
Investment securities, available-for-sale	834,348	834,348	26,878	800,953	6,517
Other investments and trading account securities	22,586	22,586	22,586		
Mortgages held for sale	7,157	7,157		7,157	
Loans and leases, net of reserve for loan and lease losses	3,383,611	3,408,703			3,408,703
Cash surrender value of life insurance policies	58,057	58,057	58,057		
Mortgage servicing rights	4,878	7,656			7,656
Interest rate swaps	10,902	10,902		10,902	
<u>Liabilities:</u>					
Deposits	\$ 3,679,416	\$ 3,686,218	\$ 2,636,029	\$ 1,050,189	\$
Short-term borrowings	221,442	221,442	152,714	68,728	
Long-term debt and mandatorily redeemable securities	58,440	57,837		57,837	
Subordinated notes	58,764	71,707		71,707	
Interest rate swaps	11,110	11,110		11,110	
Off-balance-sheet instruments *		166		166	
<b>December 31, 2012</b>					
<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 September 30, 2013, as compared to December 31, 2012, and the results of operations for the three and nine months ended September 30, 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 September 30, 2013 were \$4.65 billion, an increase of \$99.27 million or 2.18% from December 31, 2012. Total loans and leases were \$3.47 billion, an increase of \$140.57 million or 4.22% from December 31, 2012. Total investment securities, available for sale were \$834.35 million which represented a decrease of \$46.42 million or 5.27% and total deposits were \$3.68 billion, an increase of \$55.07 million or 1.52% over the comparable figures at the end of 2012. Short-term borrowings were \$221.44 million, an increase of \$52.25 million or 30.89% from December 31, 2012.



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Nonperforming assets at September 30, 2013 were \$40.33 million, which was a decrease of \$1.94 million or 4.57% from the \$42.27 million reported at December 31, 2012. At September 30, 2013 and December 31, 2012, nonperforming assets were 1.14% and 1.25%, respectively of net loans and leases.

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Accrued income and other assets were as follows:

(Dollars in thousands)	September 30, 2013	December 31, 2012
Accrued income and other assets:		
Bank owned life insurance cash surrender value	\$ 58,057	\$ 56,572
Accrued interest receivable	12,913	12,698
Mortgage servicing assets	4,878	4,645
Other real estate	5,002	4,311
Former bank premises held for sale	951	1,034
Repossessions	2,811	63
All other assets	32,626	44,105
Total accrued income and other assets	\$ 117,238	\$ 123,428

CAPITAL

As of September 30, 2013, total shareholders' equity was \$578.23 million, up \$19.57 million or 3.50% from the \$558.66 million at December 31, 2012. In addition to net income of \$41.24 million, other significant changes in shareholders' equity during the first nine months of 2013 included \$12.52 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$9.01 million at September 30, 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 12.44% as of September 30, 2013, compared to 12.28% at December 31, 2012. Book value per common share rose to \$23.77 at September 30, 2013, from \$23.04 at December 31, 2012.

We declared and paid dividends per common share of \$0.17 during the third quarter of 2013. The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 31.48%. 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 September 30, 2013, are presented in the table below:

(Dollars in thousands)	Actual		Minimum Capital Adequacy		Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-Weighted Assets):						
1st Source Corporation	\$ 588,627	15.89%	\$ 296,294	8.00%	\$ 370,368	10.00%
1st Source Bank	558,869	15.12	295,741	8.00	369,676	10.00
Tier 1 Capital (to Risk-Weighted Assets):						

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Ist Source Corporation	539,572	14.57	148,147	4.00	222,221	6.00
Ist Source Bank	511,491	13.84	147,871	4.00	221,806	6.00
Tier 1 Capital (to Average Assets):						
Ist Source Corporation	539,572	11.91	181,151	4.00	226,439	5.00
Ist Source Bank	511,491	11.31	180,875	4.00	226,093	5.00

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In July of 2013, the Federal Reserve and other federal banking agencies issued the final Basel III rule to help ensure that banks maintain strong capital positions. Under the final rule, minimum requirements increase for both the quantity and quality of capital held by banking organizations. The rule includes a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5% and a common equity tier 1 capital conservation buffer of 2.5% of risk-weighted assets that apply to all supervised financial institutions. The rule also raises the minimum ratio of tier 1 capital to risk-weighted assets from 4.0% to 6.0% and includes a minimum leverage ratio of 4.0% for all banking organizations. These new standards will become effective for us on January 1, 2015.

**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. At September 30, 2013 we had \$37.50 million outstanding and could borrow approximately \$227.50 million for a short time from these banks on a collective basis. As of September 30, 2013, we had \$92.65 million outstanding in FHLB advances and could borrow an additional \$103.04 million. We also had \$344.47 million available to borrow from the FRB with no amounts outstanding as of September 30, 2013.

Our loan to asset ratio was 74.58% at September 30, 2013 compared to 73.12% at December 31, 2012 and 72.82% at September 30, 2012. Cash and cash equivalents totaled \$91.77 million at September 30, 2013 compared to \$83.93 million at December 31, 2012 and \$71.81 million at September 30, 2012. At September 30, 2013, the consolidated statement of financial condition was rate sensitive by \$178.35 million more assets than liabilities scheduled to reprice within one year, or approximately 1.09%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

Under Indiana law governing the collateralization of public fund deposits, the Indiana Board of Depositories determines which financial institutions are required to pledge collateral based on the strength of their financial ratings. We have been informed that no collateral is required for our public fund deposits. However, the Board of Depositories could alter this requirement in the future and adversely impact our liquidity. Our potential liquidity exposure if we must pledge collateral is approximately \$613 million.

**RESULTS OF OPERATIONS**

Net income for the three and nine month periods ended September 30, 2013 was \$14.90 million and \$41.24 million, compared to \$13.01 million and \$37.29 million for the same periods in 2012. Diluted net income per common share was \$0.60 and \$1.67 for the three and nine month periods ended September 30, 2013, compared to \$0.53 and \$1.51 for the same periods in 2012. Return on average common shareholders' equity was 9.65% for the nine months ended September 30, 2013, compared to 9.21% in 2012. The return on total average assets was 1.20% for the nine months ended September 30, 2013, compared to 1.12% in 2012.

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The increase in net income for the nine months ended September 30, 2013, over the first nine months of 2012, was primarily the result of an increase in net interest income and a decrease in provision for loan and lease losses. Details of the changes in the various components of net income are discussed further below.

Table of Contents**NET INTEREST INCOME**

The taxable equivalent net interest income for the three months ended September 30, 2013 was \$41.60 million, an increase of 8.29% over the same period in 2012. The net interest margin on a fully taxable equivalent basis was 3.79% for the three months ended September 30, 2013, compared to 3.63% for the three months ended September 30, 2012. The taxable equivalent net interest income for the nine months ended September 30, 2013 was \$119.15 million, an increase of 3.75% over 2012, resulting in a net yield of 3.69% compared to a net yield of 3.70% for the same period in 2012.

During the three and nine month periods ended September 30, 2013, average earning assets increased \$144.60 million or 3.44% and \$168.24 million or 4.06% respectively, over the comparable periods in 2012. Average interest-bearing liabilities increased \$51.72 million or 1.59% and \$57.47 million or 1.78% respectively, for the three and nine month periods ended September 30, 2013 over the comparable periods one year ago. The yield on average earning assets decreased 4 basis points to 4.32% for the third quarter of 2013 from 4.36% for the third quarter of 2012. The yield on average earning assets for the nine month period ended September 30, 2013 decreased 21 basis points to 4.24% from 4.45% for the nine month period ended September 30, 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 0.70% for the third quarter 2013 from 0.94% for the third quarter 2012. Total cost of average interest-bearing liabilities decreased 25 basis points to 0.72% for the nine months ended September 30, 2013, from 0.97% for the nine months ended September 30, 2012. The result to the net interest margin, or the ratio of net interest income to average earning assets, was an increase of 16 basis points and a decrease of 1 basis point, respectively for the three and nine month periods ended September 30, 2013 from September 30, 2012.

The largest contributor to the decrease in the yield on average earning assets for the three and nine months ended September 30, 2013, compared to the three and nine months ended September 30, 2012, was a reduction in yields on net loans and leases of 10 basis points and 30 basis points, respectively. The yields on net loans and leases would have seen further decreases of 18 basis points and 6 basis points for the three and nine month periods ended September 30, 2013, respectively, were it not for the positive impact of interest recoveries. Average net loans and leases increased \$215.64 million or 6.60% for the third quarter of 2013 from the third quarter of 2012 and \$226.23 million or 7.09% for the nine months ended September 30, 2013 compared to the same period in 2012. Total average investment securities decreased \$29.52 million or 3.45% for the third quarter and decreased \$34.17 million or 3.90% for the nine month period over one year ago. Tax equivalent yield on investment securities decreased 13 basis points for the third quarter 2013. Average mortgages held for sale decreased \$14.49 million or 64.49% and \$8.69 million or 51.07% respectively, for the three and nine month periods ended September 30, 2013, over the comparable periods 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 \$27.03 million or 44.15% and \$15.13 million or 24.10% respectively, for the three and nine month periods ended September 30, 2013, over the comparable periods a year ago.

Average interest-bearing deposits increased \$44.07 million or 1.49% and \$66.84 million or 2.27% respectively, for the third quarter of 2013 and the first nine months of 2013 over the same periods in 2012. The effective rate paid on average interest-bearing deposits decreased 19 basis points to 0.54% for the third quarter 2013 compared to 0.73% for the third quarter 2012. The effective rate paid on average interest-bearing deposits decreased 18 basis points to 0.58% for the first nine months of 2013 compared to 0.76% for the first nine months of 2012. The decline in the average cost of interest-bearing deposits during the third quarter of 2013 and the first nine months of 2013 as compared to the third quarter and first nine months of 2012 was primarily the result of interest rate re-pricing on maturing certificates of deposit and a change in deposit mix.

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Average short-term borrowings increased \$46.11 million or 32.95% and increased \$8.33 million or 5.94%, respectively for the third quarter of 2013 and the first nine months of 2013 compared to the same periods in 2012 in order to fund loan growth. Interest paid on short-term borrowings increased 5 basis points for the third quarter and was flat for the first nine months of 2013. Average subordinated notes decreased \$30.93 million for the third quarter of 2013 and the first nine months of 2013 while the effective rate paid decreased 19 basis points and 16 basis points, respectively due to the redemption of trust preferred securities in December 2012. Average long-term debt decreased \$7.54 million or 11.46% during the third quarter of 2013 as compared to the third quarter of 2012 and increased \$13.22 million or 25.87% during the first nine months of 2013 as compared to the first nine months of 2012. The decrease in long-term borrowings during the third quarter of 2013 as compared to the third quarter of 2012 was the result of decreased borrowings with the Federal Home Loan Bank (FHLB). The increase in long-term borrowings for the nine months ended September 30, 2013 compared to the same period a year ago was mainly the result of higher borrowings with the FHLB. Interest paid on long-term borrowings increased 58 basis points for the third quarter of 2013 compared to the third quarter of 2012 due to higher rates on mandatorily redeemable securities, offset by lower effective rates on FHLB borrowings. Interest paid on long-term borrowings decreased 93 basis points for the first nine months of 2013 compared to the first nine months of 2012 due to lower effective rates on FHLB borrowings.

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

### **DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS EQUITY**

#### **INTEREST RATES AND INTEREST DIFFERENTIAL**

*(Dollars in thousands)*

	Three Months Ended September 30,						Nine Months Ended September 30,					
	2013			2012			2013			2012		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
<b>ASSETS:</b>												
Investment securities:												
Taxable	\$ 717,081	\$ 3,581	1.98%	\$ 750,003	\$ 3,913	2.08%	\$ 736,192	\$ 10,774	1.96%	\$ 768,994	\$ 12,574	2.18%
Tax exempt	108,395	1,126	4.12%	104,991	1,225	4.64%	105,825	3,385	4.28%	107,189	3,739	4.66%
Mortgages - held for sale	7,979	87	4.33%	22,470	193	3.42%	8,329	235	3.77%	17,022	451	3.54%
Net loans and leases	3,483,942	42,389	4.83%	3,268,304	40,531	4.93%	3,415,752	121,714	4.76%	3,189,526	120,733	5.06%
Other investments	34,186	229	2.66%	61,214	231	1.50%	47,644	712	2.00%	62,769	688	1.46%
<b>Total Earning Assets</b>	<b>4,351,583</b>	<b>47,412</b>	<b>4.32%</b>	<b>4,206,982</b>	<b>46,093</b>	<b>4.36%</b>	<b>4,313,742</b>	<b>136,820</b>	<b>4.24%</b>	<b>4,145,500</b>	<b>138,185</b>	<b>4.45%</b>
Cash and due from banks	58,122			58,226			58,648			60,048		
Reserve for loan and lease losses	(86,570)			(84,120)			(85,204)			(83,221)		
Other assets	302,822			318,337			306,846			325,126		
<b>Total</b>	<b>\$ 4,625,957</b>			<b>\$ 4,499,425</b>			<b>\$ 4,594,032</b>			<b>\$ 4,447,453</b>		

### **LIABILITIES AND SHAREHOLDERS EQUITY:**

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Interest-bearing deposits	\$ 2,992,091	\$ 4,089	0.54%	\$ 2,948,022	\$ 5,419	0.73%	\$ 3,016,570	\$ 13,043	0.58%	\$ 2,949,726	\$ 16,868	0.76%
Short-term borrowings	186,064	72	0.15%	139,951	36	0.10%	148,626	149	0.13%	140,294	136	0.13%
Subordinated notes	58,764	1,055	7.12%	89,692	1,647	7.31%	58,764	3,165	7.20%	89,692	4,942	7.36%
Long-term debt and mandatorily redeemable securities	58,244	592	4.03%	65,780	571	3.45%	64,307	1,315	2.73%	51,090	1,399	3.66%
<b>Total Interest-Bearing Liabilities</b>	<b>3,295,163</b>	<b>5,808</b>	<b>0.70%</b>	<b>3,243,445</b>	<b>7,673</b>	<b>0.94%</b>	<b>3,288,267</b>	<b>17,672</b>	<b>0.72%</b>	<b>3,230,802</b>	<b>23,345</b>	<b>0.97%</b>
Noninterest-bearing deposits	705,778			635,152			677,269			603,805		
Other liabilities	50,427			70,865			56,804			71,806		
Shareholders' equity	574,589			549,963			571,692			541,040		
<b>Total</b>	<b>\$ 4,625,957</b>			<b>\$ 4,499,425</b>			<b>\$ 4,594,032</b>			<b>\$ 4,447,453</b>		
Net Interest Income	\$ 41,604			\$ 38,420			\$ 119,148			\$ 114,840		
Net Yield on Earning Assets on a Taxable Equivalent Basis			3.79%			3.63%			3.69%			3.70%



Table of Contents**PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES**

The provision for loan and lease losses for the three and nine month period ended September 30, 2013 was \$(0.42) million and \$1.63 million respectively, compared to a provision for loan and lease losses in the three and nine month periods ended September 30, 2012 of \$0.65 million and \$4.96 million respectively. Net charge-offs of \$0.76 million were recorded for the third quarter 2013, compared to net charge-offs of \$0.45 million for the same quarter a year ago. Year-to-date net charge-offs of \$0.44 million have been recorded in 2013, compared to net charge-offs \$3.10 million through September 30, 2012.

On September 30, 2013, 30 day and over loan and lease delinquencies were 0.26% compared to 0.54% on September 30, 2012. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.44% as compared to 2.55% one year ago. A summary of loan and lease loss experience during the three and nine months ended September 30, 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 September 30, 2013 and December 31, 2012 is reflected in Note 4 of the Consolidated Financial Statements.

**NONPERFORMING ASSETS**

Nonperforming assets were as follows:

<b>(Dollars in thousands)</b>	<b>September 30,</b>		<b>December 31,</b>		<b>September 30,</b>	
	<b>2013</b>		<b>2012</b>		<b>2012</b>	
Loans and leases past due 90 days or more	\$	245	\$	442	\$	477
Nonaccrual loans and leases		31,325		36,417		42,756
Other real estate		5,002		4,311		4,842
Former bank premises held for sale		951		1,034		1,101
Repossessions		2,811		63		1,248
Equipment owned under operating leases						32
Total nonperforming assets	\$	40,334	\$	42,267	\$	50,456

Nonperforming assets as a percentage of total loans and leases were 1.14% at September 30, 2013, 1.25% at December 31, 2012, and 1.51% at September 30, 2012. Nonperforming assets totaled \$40.33 million at September 30, 2013, a decrease of 4.57% from the \$42.27 million reported at December 31, 2012, and a 20.06% decrease from the \$50.46 million reported at September 30, 2012. The decrease during the first nine months of 2013 compared to the same period in 2012 was primarily related to a decrease in nonaccrual loans and leases as the economy slowly improves.

The decrease in nonaccrual loans and leases at September 30, 2013 from December 31, 2012 and the decrease in nonaccrual loans and leases at September 30, 2013 from September 30, 2012 occurred across almost all loan types. A summary of nonaccrual loans and leases and past due aging for the period ended September 30, 2013 and December 31, 2012 is located in Note 4 of the Consolidated Financial Statements.

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As of September 30, 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 \$11.66 million which were comprised of \$10.69 million secured by commercial real estate and included in loans secured by real estate and \$0.97 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 in this economy. Furthermore, aircraft values for some models declined from 2010 to 2012, increasing the risk in aircraft secured transactions; however, values appear to have stabilized in 2013.

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

Repossessions consisted mainly of aircraft financing at September 30, 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.

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

(Dollars in thousands)	September 30, 2013	December 31, 2012	September 30, 2012
Commercial and agricultural loans	\$	\$	\$
Auto, light truck and environmental equipment	162	52	79
Medium and heavy duty truck			
Aircraft financing	2,632		1,165
Construction equipment financing			
Commercial real estate	3,589	3,362	3,589
Residential real estate	1,060	545	1,253
Consumer loans	370	415	4
Total	\$ 7,813	\$ 4,374	\$ 6,090

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 \$268.74 million and \$271.41 million as of September 30, 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 \$153.50 million and \$58.46 million as of September 30, 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.

Table of Contents**NONINTEREST INCOME**

Noninterest income for the three month period ended September 30, 2013 and 2012 was \$20.16 million and \$20.31 million, respectively. Noninterest income for the nine month period ended September 30, 2013 and 2012 was \$59.23 million and \$60.62 million, respectively. Details of noninterest income follow:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Noninterest income:				
Trust fees	\$ 5,260	\$ 4,055	\$ 13,800	\$ 12,407
Service charges on deposit accounts	2,364	2,688	6,928	7,747
Debit card income	2,343	2,020	6,752	6,281
Mortgage banking income	1,103	2,020	4,667	5,464
Insurance commissions	1,292	1,483	4,131	4,051
Equipment rental income	4,000	4,604	12,098	14,620
Investment securities and other investment gains	258	89	469	492
Other income	3,538	3,346	10,382	9,556
Total noninterest income	\$ 20,158	\$ 20,305	\$ 59,227	\$ 60,618

Noninterest income decreased \$0.15 million or 0.72% for the three months ended September 30, 2013 as compared to the same period in 2012. Noninterest income decreased \$1.39 million or 2.29% for the nine months ended September 30, 2013 compared to the same period one year ago. Investment securities and other investments gains increased slightly during the third quarter of 2013 over the same period in 2012, while decreasing slightly during the first nine months of 2013 versus the first nine months of 2012.

Trust fees increased \$1.21 million or 29.72% and \$1.39 million or 11.23% for the three and nine months ended September 30, 2013 over the same periods a year ago. The increase in trust fees was primarily the result of an increase in market values of investments held in the trust accounts of clients.

Service charges on deposit accounts decreased \$0.32 million or 12.05% and \$0.82 million or 10.57% for the three and nine months ended September 30, 2013, respectively over the comparable periods one year ago. The decrease in service charges on deposit accounts reflects a lower volume of nonsufficient fund transactions.

Debit card income increased \$0.32 million or 15.99% and \$0.47 million or 7.50% in the three and nine months ended September 30, 2013 over the same periods a year ago. The increase in debit card income was the result of increased transaction fees coupled with an increase in amount of debit card transactions in 2013.

Mortgage banking income decreased \$0.92 million or 45.40% in the third quarter of 2013 as compared to the third quarter of 2012. Mortgage banking income decreased \$0.80 million or 14.59% during the first nine months of 2013 versus the first nine months of 2012. This variance was caused by decreased gains on loan sales due to lower production volumes offset by lower mortgage servicing rights amortization expense in

2013.

Insurance commissions decreased \$0.19 million or 12.88% in the three months ended September 30, 2013 over the same period a year ago. The decrease related to lower premium and agency fees. Insurance commissions remained flat for the nine months ended September 30, 2013 versus the first nine months in 2012.

Equipment rental income declined \$0.60 million or 13.12% in the third quarter of 2013 compared to the third quarter 2012. Equipment rental income declined \$2.52 million or 17.25% for year-to-date 2013 compared to the same period in 2012. The average equipment rental portfolio decreased 19.37% 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 and increased competition.

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Other income increased \$0.19 million or 5.74% and \$0.83 million or 8.64% for the three and nine months ended September 30, 2013, respectively as compared to the same periods in 2012 primarily due to higher mutual fund income and dividend income.

**NONINTEREST EXPENSE**

Noninterest expense for the three month period ended September 30, 2013 and 2012 was \$38.43 million and \$37.19 million, respectively. Noninterest expense for the nine month period ended September 30, 2013 and 2012 was \$110.72 million and \$111.82 million, respectively. Details of noninterest expense follow:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Noninterest expense:				
Salaries and employee benefits	\$ 20,441	\$ 20,982	\$ 59,553	\$ 61,668
Net occupancy expense	2,126	1,652	6,480	5,660
Furniture and equipment expense	4,477	3,817	12,285	11,155
Depreciation - leased equipment	3,246	3,795	9,745	11,909
Professional fees	1,178	1,385	3,843	4,232
Supplies and communication	1,330	1,387	4,365	4,165
FDIC and other insurance	874	913	2,679	2,716
Business development and marketing expense	1,306	1,008	3,011	2,925
Loan and lease collection and repossession expense	1,530	1,866	3,382	4,346
Other expense	1,922	388	5,381	3,043
Total noninterest expense	\$ 38,430	\$ 37,193	\$ 110,724	\$ 111,819

Noninterest expense increased \$1.24 million or 3.33% for the third quarter and decreased \$1.10 million or 0.98% for year-to-date 2013 as compared to the same periods in 2012. FDIC and other insurance expense decreased slightly in 2013 over the same periods in 2012. Supplies and communication expense decreased during the third quarter of 2013 over the same period in 2012 while slightly increasing for year-to-date 2013 as compared to the same period in 2012.

Salaries and employee benefits decreased \$0.54 million or 2.58% and \$2.12 million or 3.43% in the three and nine months ended September 30, 2013, respectively versus the three and nine months ended September 30, 2012. Lower base salary expense was primarily due to fewer full time equivalent employees offset by annual performance raises. Loan producer commissions were lower due to decreased residential mortgage loan volumes.

Net occupancy expense was higher by \$0.47 million or 28.69% for the third quarter of 2013 and \$0.82 million or 14.49% for year-to-date 2013 respectively, compared to the same periods one year ago. The increase was primarily a result of higher real estate taxes, depreciation and repairs.

Furniture and equipment expense increased \$0.66 million or 17.29% and \$1.13 million or 10.13% for the third quarter and year-to-date 2013 compared to the same periods in 2012. Furniture and equipment expense was higher mainly due to increased equipment depreciation, computer

processing charges and software maintenance costs.

During the third quarter and first nine months of 2013, depreciation on leased equipment decreased \$0.55 million or 14.47% and \$2.16 million or 18.17%, respectively in conjunction with the decrease in equipment rental income as compared to the same periods one year ago.

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Professional fees decreased \$0.21 million or 14.95% and \$0.39 million or 9.19% for the three and nine month periods ended September 30, 2013 respectively, as compared to the three and nine month periods ended September 30, 2012. The decrease in professional fees in 2013 was primarily the result of reduced utilization of consulting services.

Business development and marketing expense increased \$0.30 million or 29.56% for the three months ended September 30, 2013 versus the three months ended September 30, 2012 and was flat for the nine months ended September 30, 2013 versus the nine months ended September 30, 2012. The third quarter increase was primarily due to higher charitable contributions and institutional marketing.

Loan and lease collection and repossession expense decreased \$0.34 million or 18.01% for the three months ended September 30, 2013 compared to the same period in 2012 primarily due to a reduction in average repossessions outstanding and lower repurchased mortgage loan losses in 2013 compared to 2012. Loan and lease collection and repossession expense decreased \$0.96 million or 22.18% in the nine month period ended September 30, 2013 compared to the same period a year ago mainly due to a reduction in average repossessions outstanding offset by higher repurchased mortgage loan losses in 2013 compared to 2012.

Other expenses increased \$1.53 million or 395.36% and \$2.34 million or 76.83% in the three and nine month periods ended September 30, 2013, respectively as compared to the same periods in 2012 primarily related to a gain on the sale of the corporate headquarters parking garage that occurred during the third quarter of 2012 in addition to a previously reported trustee matter during 2013.

**INCOME TAXES**

The provision for income taxes for the three and nine month periods ended September 30, 2013 was \$8.41 million and \$23.41 million, respectively compared to \$7.36 million and \$19.82 million for the same periods in 2012. The effective tax rates were 36.08% and 36.15% for the third quarter ended September 30, 2013 and 2012, respectively and 36.21% and 34.71% for the nine months ended September 30, 2013 and 2012, respectively. The effective tax rates are higher in 2013 compared to 2012 due to the impact of state refunds for 2009 received in January of 2012.

Effective January 1, 2014, the Indiana Financial Institutions tax rate decreases from 8.5% to 8.0% and continues to decrease by 0.5% each of the next three years. As a result of the rate change, we decreased the carrying value of certain state deferred tax assets. The impact of this change was not material and was recorded in the financial statements during the second quarter of 2013.

**ITEM 3.**

**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**



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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.

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**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, 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.

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 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.

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

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ISSUER PURCHASES OF EQUITY SECURITIES

<b>Period</b>	<b>Total number of shares purchased</b>	<b>Average price paid per share</b>	<b>Total number of shares purchased as part of publicly announced plans or programs*</b>	<b>Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs</b>
July 01 - 31, 2013		\$		942,963
Aug 01 - 31, 2013	22,334	26.16	22,334	920,629
Sept 01 - 30, 2013	40,470	26.28	40,470	880,159

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\* 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 1,119,841 shares.

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ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Mine Safety Disclosures.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits

The following exhibits are filed with this report:

31.1	Certification of Chief Executive Officer required by Rule 13a-14(a).
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a).
32.1	Certification pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer.
32.2	Certification pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer.
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Labels Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document



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SIGNATURES

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

1st Source Corporation

DATE	October 24, 2013	/s/ CHRISTOPHER J. MURPHY III Christopher J. Murphy III Chairman of the Board, President and CEO
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DATE	October 24, 2013	/s/ ANDREA G. SHORT Andrea G. Short Treasurer and Chief Financial Officer Principal Accounting Officer
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