1ST SOURCE CORP
Form 10-Q
October 25, 2012
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2012

OR

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

For the transition period from to

Commission file number 0-6233

(Exact name of registrant as specified in its charter)

INDIANA (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. x Yes o No

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

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

Number of shares of common stock outstanding as of October 12, 2012 24,279,271 shares

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1st SOURCE CORPORATION

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Unaudited - Dollars in thousands)

	September 30, 2012	December 31, 2011
ASSETS		
Cash and due from banks	$ 54,635	$ 61,406
Federal funds sold and interest bearing deposits with other banks	17,179	52,921
Investment securities available-for-sale (amortized cost of $832,951 and $853,204 at September 30, 2012 and December 31, 2011, respectively)	868,312	883,000
Other investments	22,364	18,974
Trading account securities	145	132
Mortgages held for sale	22,853	12,644
Loans and leases - net of unearned discount		
Commercial and agricultural loans	584,996	545,570
Auto, light truck and environmental equipment	456,665	435,965
Medium and heavy duty truck	167,709	159,796
Aircraft financing	685,800	620,782
Construction equipment financing	276,270	261,204
Commercial real estate	548,921	545,457
Residential real estate	436,909	423,606
Consumer loans	111,143	98,163
Total loans and leases	3,268,413	3,090,543
Reserve for loan and lease losses	(83,499)	(81,644)
Net loans and leases	3,184,914	3,008,899
Equipment owned under operating leases, net	58,496	69,551
Net premises and equipment	43,172	39,857
Goodwill and intangible assets	87,796	87,675
Accrued income and other assets	128,353	139,012
Total assets	$ 4,488,219	$ 4,374,071
LIABILITIES		
Deposits:		
Noninterest bearing	$ 634,795	$ 580,101
Interest bearing	2,933,873	2,940,040
Total deposits	3,568,668	3,520,141
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	119,749	106,991
Other short-term borrowings	16,886	18,243
Total short-term borrowings	136,635	125,234
Long-term debt and mandatorily redeemable securities	66,964	37,156
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	72,592	77,930
Total liabilities	3,934,551	3,850,153
SHAREHOLDERS EQUITY		
Preferred stock; no par value		
Authorized 10,000,000 shares; none issued or outstanding		
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,643,506 at September 30, 2012 and December 31, 2011	346,535	346,535

Retained earnings		215,647		190,261
Cost of common stock in treasury (1,364,235 shares at September 30, 2012 and 1,429,484 shares at December 31, 2011)		(30,360)		(31,389)
Accumulated other comprehensive income		21,846		18,511
Total shareholders equity		553,668		523,918
Total liabilities and shareholders equity	$	4,488,219	$	4,374,071

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

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1st SOURCE CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

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

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Interest income:				
Loans and leases	$ 40,610	$ 40,741	$ 120,824	$ 123,750
Investment securities, taxable	3,913	4,694	12,574	14,088
Investment securities, tax-exempt	826	934	2,526	3,124
Other	231	217	688	707
Total interest income	45,580	46,586	136,612	141,669
Interest expense:				
Deposits	5,419	7,756	16,868	24,273
Short-term borrowings	36	77	136	240
Subordinated notes	1,647	1,647	4,942	4,942
Long-term debt and mandatorily redeemable securities	571	480	1,399	1,144
Total interest expense	7,673	9,960	23,345	30,599
Net interest income	37,907	36,626	113,267	111,070
Provision for loan and lease losses	650	1,260	4,959	3,525
Net interest income after provision for loan and lease losses	37,257	35,366	108,308	107,545
Noninterest income:				
Trust fees	4,055	3,902	12,407	12,305
Service charges on deposit accounts	4,708	4,748	14,028	13,622
Mortgage banking income	2,020	1,056	5,464	2,335
Insurance commissions	1,483	1,212	4,051	3,416
Equipment rental income	4,604	5,814	14,620	17,861
Other income	3,346	3,084	9,556	9,382
Investment securities and other investment gains	89	414	492	1,686
Total noninterest income	20,305	20,230	60,618	60,607
Noninterest expense:				
Salaries and employee benefits	20,982	19,476	61,668	57,249
Net occupancy expense	1,652	2,237	5,660	6,608
Furniture and equipment expense	3,817	3,519	11,155	10,429
Depreciation - leased equipment	3,795	4,650	11,909	14,250
Professional fees	1,385	1,326	4,232	3,502
Supplies and communication	1,387	1,312	4,165	4,022
FDIC and other insurance	913	874	2,716	3,508
Business development and marketing expense	1,008	968	2,925	2,454
Loan and lease collection and repossession expense	1,866	1,387	4,346	4,211
Other expense	388	1,399	3,043	5,334
Total noninterest expense	37,193	37,148	111,819	111,567
Income before income taxes	20,369	18,448	57,107	56,585
Income tax expense	7,364	6,908	19,820	19,572

Net income	$	13,005	$	11,540	$	37,287	$	37,013
Per common share								
Basic net income per common share	$	0.53	$	0.47	$	1.52	$	1.51
Diluted net income per common share	$	0.53	$	0.47	$	1.51	$	1.51
Dividends	$	0.17	$	0.16	$	0.49	$	0.48
Basic weighted average common shares outstanding		24,279,178		24,213,063		24,267,535		24,246,041
Diluted weighted average common shares outstanding		24,289,495		24,223,432		24,278,160		24,255,357

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

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1st SOURCE CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(Unaudited - Dollars in thousands)

	Three Months Ended September 30, 2012	Three Months Ended September 30, 2011	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2011
Net income	$ 13,005	$ 11,540	$ 37,287	$ 37,013
Other comprehensive income, net of tax:				
Change in unrealized appreciation of available-for-sale securities, net of tax	2,458	3,634	3,505	9,091
Reclassification adjustment for losses/(gains) included in net income, net of tax	1	(11)	(170)	(856)
Other comprehensive income	2,459	3,623	3,335	8,235
Comprehensive income	$ 15,464	$ 15,163	$ 40,622	$ 45,248

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, 2011	$ 486,383	$	$ 350,282	$ 157,875	$ (32,284)	$ 10,510
Net income	37,013			37,013		
Other comprehensive income	8,235					8,235
Issuance of 149,731 common shares under stock based compensation awards, including related tax effects	2,853			(165)	3,018	
Cost of 109,525 shares of common stock acquired for treasury	(2,142)				(2,142)	
Repurchase of common stock warrant	(3,750)		(3,750)			
Common stock dividend ($0.48 per share)	(11,716)			(11,716)		
Stock based compensation	3		3			

Balance at September 30, 2011	$ 516,879	$	$ 346,535	$ 183,007	$ (31,408)	$ 18,745
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

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

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1st SOURCE CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited - Dollars in thousands)

	Nine Months Ended September 30, 2012	2011
Operating activities:		
Net income	$ 37,287	$ 37,013
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	4,959	3,525
Depreciation of premises and equipment	3,151	2,698
Depreciation of equipment owned and leased to others	11,909	14,250
Amortization of investment security premiums and accretion of discounts, net	3,140	1,610
Amortization of mortgage servicing rights	2,267	2,125
Mortgage servicing asset impairment	230	230
Deferred income taxes	(4,817)	3,015
Investment securities and other investment gains	(492)	(1,686)
Originations of loans held for sale, net of principal collected	(165,577)	(67,655)
Proceeds from the sales of loans held for sale	160,301	88,372
Net gain on sale of loans held for sale	(4,933)	(1,337)
Change in trading account securities	(13)	19
Change in interest receivable	(634)	1,002
Change in interest payable	(529)	424
Change in other assets	10,993	1,251
Change in other liabilities	404	(331)
Other	990	2,901
Net change in operating activities	58,636	87,426
Investing activities:		
Proceeds from sales of investment securities	40,736	133,241
Proceeds from maturities of investment securities	203,436	269,416
Purchases of investment securities	(226,567)	(270,817)
Net change in other investments	(3,390)	2,370
Loans sold or participated to others	22,968	15,039
Net change in loans and leases	(206,261)	(33,899)
Net change in equipment owned under operating leases	(854)	(11,208)
Purchases of premises and equipment	(6,521)	(10,587)
Net change in investing activities	(176,453)	93,555
Financing activities:		
Net change in demand deposits, NOW accounts and savings accounts	119,128	(129,250)
Net change in certificates of deposit	(70,601)	(45,910)
Net change in short-term borrowings	11,401	(15,051)
Proceeds from issuance of long-term debt	26,873	10,710
Payments on long-term debt	(360)	(328)
Net proceeds from issuance of treasury stock	3,743	2,853
Acquisition of treasury stock	(2,617)	(2,142)
Repurchase of common stock warrant		(3,750)
Cash dividends paid on common stock	(12,263)	(11,935)
Net change in financing activities	75,304	(194,803)
Net change in cash and cash equivalents	(42,513)	(13,822)

Cash and cash equivalents, beginning of year		114,327		96,872
Cash and cash equivalents, end of period	$	71,814	$	83,050
Non-cash transactions:				
Loans transferred to other real estate and repossessed assets	$	2,319	$	11,993
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan		2,643		2,420

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 (2011 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The balance sheet at December 31, 2011 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

Offsetting Assets and Liabilities: In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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 Company is assessing the impact of ASU 2011-11 on its disclosures.

Goodwill: In September 2011, the FASB issued ASU No. 2011-08 *Intangibles Goodwill and Other (Topic 350) - Testing Goodwill for Impairment.* ASU 2011-08 allows an entity the option to make a qualitative evaluation about the likelihood of goodwill impairment to determine whether it should calculate the fair value of the reporting unit. ASU 2011-08 was effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. Early adoption was permitted. The Company does not expect an impact on its financial condition or results of operations.

Comprehensive Income: In June 2011, the FASB issued ASU No. 2011-05 *Comprehensive Income (Topic 220) - Presentation of Comprehensive Income.* ASU 2011-05 requires that all nonowner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both cases, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. In December 2011, FASB issued ASU No. 2011-12 which defers the effective date of the requirement in ASU 2011-05 to present items that are

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reclassified from accumulated other comprehensive income to net income alongside their respective components of net income and other comprehensive income. ASU 2011-05 was effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. The effect of applying this standard is reflected in the Consolidated Statements of Comprehensive Income and Consolidated Statements of Shareholders Equity.

Fair Value Measurements: In May 2011, the FASB issued ASU No. 2011-04 *Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* ASU 2011-04 changed the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs (International Financial Reporting Standards). ASU 2011-04 was effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early application by public entities was not permitted. The effect of applying this standard is reflected in Note 12 Fair Value Measurements.

Transfers and Servicing: In April 2011, the FASB issued ASU No. 2011-03 *Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement.* ASU 2011-03 removed from the assessment of effective control the criterion relating to the transferor s ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 was effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date. Early adoption was not permitted. ASU 2011-03 did not have an impact on the Company s financial condition, results of operations, or disclosures.

Note 3. Investment Securities

Investment securities available-for-sale were as follows:

(Dollars in thousands)	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
September 30, 2012				
U.S. Treasury and Federal agencies securities	$ 370,394	$ 12,002	$ (52)	$ 382,344
U.S. States and political subdivisions securities	100,702	6,454	(443)	106,713
Mortgage-backed securities Federal agencies	318,775	13,381	(1)	332,155
Corporate debt securities	36,010	471	(234)	36,247
Foreign government and other securities	4,703	33		4,736
Total debt securities	830,584	32,341	(730)	862,195
Marketable equity securities	2,367	3,753	(3)	6,117
Total investment securities available-for-sale	$ 832,951	$ 36,094	$ (733)	$ 868,312
December 31, 2011				
U.S. Treasury and Federal agencies securities	$ 390,819	$ 10,356	$ (50)	$ 401,125
U.S. States and political subdivisions securities	101,587	6,433	(660)	107,360
Mortgage-backed securities Federal agencies	317,392	11,565	(9)	328,948
Corporate debt securities	36,349	325	(364)	36,310
Foreign government and other securities	4,690	24	(1)	4,713
Total debt securities	850,837	28,703	(1,084)	878,456
Marketable equity securities	2,367	2,673	(496)	4,544

Total investment securities available-for-sale	$	853,204	$	31,376	$	(1,580)	$	883,000

At September 30, 2012 and December 31, 2011, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).

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The contractual maturities of debt securities available-for-sale at September 30, 2012 are shown below. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 50,631	$ 50,940
Due after one year through five years	349,881	360,131
Due after five years through ten years	104,113	112,138
Due after ten years	7,184	6,831
Mortgage-backed securities	318,775	332,155
Total debt securities available-for-sale	$ 830,584	$ 862,195

The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. There were no other-than-temporary-impairment (OTTI) write-downs in 2012 or 2011.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	2012	2011	2012	2011
Gross realized gains	$	$ 63	$ 275	$ 1,662
Gross realized losses		(46)		(284)
Net realized gains (losses)	$	$ 17	$ 275	$ 1,378

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

	Less than 12 Months		12 months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2012						
U.S. Treasury and Federal agencies securities	$ 15,236	$ (52)	$	$	$ 15,236	$ (52)
U.S. States and political subdivisions securities	2,963	(14)	3,371	(429)	6,334	(443)
Mortgage-backed securities - Federal agencies			63	(1)	63	(1)
Corporate debt securities	5,144	(8)	4,299	(226)	9,443	(234)
Foreign government and other securities	200				200	
Total debt securities	23,543	(74)	7,733	(656)	31,276	(730)
Marketable equity securities			5	(3)	5	(3)
Total investment securities available-for-sale	$ 23,543	$ (74)	$ 7,738	$ (659)	$ 31,281	$ (733)
December 31, 2011						
U.S. Treasury and Federal agencies securities	$ 42,536	$ (50)	$	$	$ 42,536	$ (50)
U.S. States and political subdivisions securities	423	(9)	5,149	(651)	5,572	(660)
Mortgage-backed securities - Federal agencies	5,071	(1)	13,099	(8)	18,170	(9)
Corporate debt securities	4,858	(142)	8,579	(222)	13,437	(364)
Foreign government and other securities	1,011	(1)			1,011	(1)
Total debt securities	53,899	(203)	26,827	(881)	80,726	(1,084)
Marketable equity securities	622	(492)	4	(4)	626	(496)
Total investment securities available-for-sale	$ 54,521	$ (695)	$ 26,831	$ (885)	$ 81,352	$ (1,580)

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-

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temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In estimating OTTI impairment losses, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

At September 30, 2012, 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. The unrealized losses on debt securities are due to increases in market interest rates over the yields available at the time the underlying securities were purchased and market illiquidity on auction rate securities which are reflected in U.S. States and Political subdivisions securities. The fair value is expected to recover on all debt securities as they approach their maturity date or repricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

At September 30, 2012 and December 31, 2011, investment securities with carrying values of $246.05 million and $250.36 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).

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

	Credit Quality Grades		
(Dollars in thousands)	1-6	7-12	Total
September 30, 2012			
Commercial and agricultural loans	$ 552,188	$ 32,808	$ 584,996
Auto, light truck and environmental equipment	443,163	13,502	456,665
Medium and heavy duty truck	165,196	2,513	167,709
Aircraft financing	654,971	30,829	685,800
Construction equipment financing	259,822	16,448	276,270
Commercial real estate	495,987	52,934	548,921
Total	$ 2,571,327	$ 149,034	$ 2,720,361
December 31, 2011			
Commercial and agricultural loans	$ 513,011	$ 32,559	$ 545,570
Auto, light truck and environmental equipment	432,288	3,677	435,965
Medium and heavy duty truck	154,261	5,535	159,796
Aircraft financing	580,004	40,778	620,782
Construction equipment financing	239,643	21,561	261,204
Commercial real estate	487,576	57,881	545,457
Total	$ 2,406,783	$ 161,991	$ 2,568,774

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, 2012			
Residential real estate	$ 434,005	$ 2,904	$ 436,909
Consumer	109,389	1,754	111,143
Total	$ 543,394	$ 4,658	$ 548,052
December 31, 2011			
Residential real estate	$ 418,810	$ 4,796	$ 423,606
Consumer	97,857	306	98,163
Total	$ 516,667	$ 5,102	$ 521,769

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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, 2012							
Commercial and agricultural loans	$ 573,728	$ 849	$ 181	$	$ 574,758	$ 10,238	$ 584,996
Auto, light truck and environmental equipment	453,348	489	41		453,878	2,787	456,665
Medium and heavy duty truck	166,916	452			167,368	341	167,709
Aircraft financing	672,947	7,012			679,959	5,841	685,800
Construction equipment financing	269,871	1,773			271,644	4,626	276,270
Commercial real estate	533,612	567			534,179	14,742	548,921
Residential real estate	429,365	3,762	878	212	434,217	2,692	436,909
Consumer	108,375	683	331	265	109,654	1,489	111,143
Total	$ 3,208,162	$ 15,587	$ 1,431	$ 477	$ 3,225,657	$ 42,756	$ 3,268,413
December 31, 2011							
Commercial and agricultural loans	$ 534,053	$ 550	$ 1	$	$ 534,604	$ 10,966	$ 545,570
Auto, light truck and environmental equipment	433,048	674	241		433,963	2,002	435,965
Medium and heavy duty truck	158,192	5			158,197	1,599	159,796
Aircraft financing	608,032	224			608,256	12,526	620,782
Construction equipment financing	256,691	376			257,067	4,137	261,204
Commercial real estate	522,883	2,005			524,888	20,569	545,457
Residential real estate	415,177	2,894	739	416	419,226	4,380	423,606
Consumer	96,824	762	271	45	97,902	261	98,163
Total	$ 3,024,900	$ 7,490	$ 1,252	$ 461	$ 3,034,103	$ 56,440	$ 3,090,543

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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
September 30, 2012			
With no related allowance recorded:			
Commercial and agricultural loans	$ 3,112	$ 3,112	$
Auto, light truck and environmental equipment	740	740	
Medium and heavy duty truck	322	322	
Aircraft financing	3,544	3,544	
Construction equipment financing	4,355	4,355	
Commercial real estate	20,020	20,019	
Residential real estate	103	103	
Consumer loans			
Total with no related allowance recorded	32,196	32,195	
With an allowance recorded:			
Commercial and agricultural loans	6,036	6,036	878
Auto, light truck and environmental equipment	1,493	1,493	500
Medium and heavy duty truck			
Aircraft financing	2,190	2,190	886
Construction equipment financing			
Commercial real estate	2,504	2,504	49
Residential real estate			
Consumer loans			
Total with an allowance recorded	12,223	12,223	2,313
Total impaired loans	$ 44,419	$ 44,418	$ 2,313
December 31, 2011			
With no related allowance recorded:			
Commercial and agricultural loans	$ 2,002	$ 2,002	$
Auto, light truck and environmental equipment	770	770	
Medium and heavy duty truck	959	959	
Aircraft financing	11,206	11,206	
Construction equipment financing	3,949	3,949	
Commercial real estate	17,088	17,091	
Residential real estate			
Consumer loans	211	210	
Total with no related allowance recorded	36,185	36,187	
With an allowance recorded:			
Commercial and agricultural loans	8,406	8,406	1,461
Auto, light truck and environmental equipment	113	113	35
Medium and heavy duty truck	645	645	165
Aircraft financing	1,118	1,118	534
Construction equipment financing			
Commercial real estate	6,029	6,029	294
Residential real estate			
Consumer loans			
Total with an allowance recorded	16,311	16,311	2,489
Total impaired loans	$ 52,496	$ 52,498	$ 2,489

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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.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
(Dollars in thousands)	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural loans	$ 9,111	$ 2	$ 10,437	$ 101	$ 9,441	$ 12	$ 11,583	$ 331
Auto, light truck and environmental equipment	2,578		1,378		2,474	7	1,796	1
Medium and heavy duty truck	434	1	3,770	15	917	2	4,310	18
Aircraft financing	6,100		14,882		8,831		16,076	15
Construction equipment financing	4,512		3,922	7	4,399	5	6,174	23
Commercial real estate	22,757	138	24,481	39	22,330	302	28,264	153
Residential real estate	104	2			82	4		
Consumer			141	1			47	1
Total	$ 45,596	$ 143	$ 59,011	$ 163	$ 48,474	$ 332	$ 68,250	$ 542

Performing loans and leases classified as troubled debt restructuring (TDR) during the three and nine months ended September 30, 2012 and 2011, segregated by class, are shown in the table below. Nonperforming TDRs are shown as nonperforming assets. During 2012 and 2011, 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.

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
(Dollars in thousands)	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
Commercial and agricultural loans		$	6	$ 356		$	7	$ 504
Auto, light truck and environmental equipment								
Medium and heavy duty truck								
Aircraft financing							1	
Construction equipment financing							1	224
Commercial real estate			3	196	1	7,014	4	262
Residential real estate					1	106		
Consumer			2	212			2	212
Total		$	11	$ 764	2	$ 7,120	15	$ 1,202

Troubled debt restructured loans and leases which had payment defaults within twelve months following modification during the three and nine months ended September 30, 2012 and 2011, segregated by class, are shown in the table below. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.

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	Three Months Ended September 30,				Nine Months Ended September 30,			
	2012		2011		2012		2011	
(Dollars in thousands)	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment	Number of Defaults	Recorded Investment
Commercial and agricultural loans		$	2	$ 6,140		$	2	$ 6,140
Auto, light truck and environmental equipment								
Medium and heavy duty truck								
Aircraft financing							2	552
Construction equipment financing								
Commercial real estate							2	90
Residential real estate								
Consumer								
Total		$	2	$ 6,140		$	6	$ 6,782

As of September 30, 2012 and December 31, 2011, the Company had $8.81 million and $3.29 million, respectively of performing loans and leases classified as troubled debt restructurings.

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, national and international economic volatility, global debt and capital markets and political stability or lack thereof. 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 management to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting management s best estimate of probable loan and lease losses related to specifically identified loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. For purposes of determining the reserve, the Company has segmented loans and leases into classes based on the associated risks 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. Management s evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

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Changes in the reserve for loan and lease losses, segregated by class, for the three months ended September 30, 2012 and 2011 are shown below.

(Dollars in thousands)	Commercial and agricultural loans	Auto, light truck and environmental equipment	Medium and heavy duty truck	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
September 30, 2012									
Reserve for loan and lease losses									
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
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 investement in loans	$ 584,996	$ 456,665	$ 167,709	$ 685,800	$ 276,270	$ 548,921	$ 436,909	$ 111,143	$ 3,268,413
September 30, 2011									
Reserve for loan and lease losses									
Balance, beginning of period	$ 16,814	$ 9,041	$ 4,584	$ 28,561	$ 6,802	$ 15,400	$ 2,657	$ 1,151	$ 85,010
Charge-offs	152	10		2,073		72	37	341	2,685
Recoveries	118	78	1	96	144	50	19	119	625
Net charge-offs (recoveries)	34	(68)	(1)	1,977	(144)	22	18	222	2,060
Provision (recovery of provision)	(2,056)	(908)	(1,217)	4,482	(691)	1,397	44	209	1,260
Balance, end of period	$ 14,724	$ 8,201	$ 3,368	$ 31,066	$ 6,255	$ 16,775	$ 2,683	$ 1,138	$ 84,210
Ending balance, individually evaluated for impairment	$ 1,488	$ 5	$ 161	$ 3,120	$	$ 1,060	$	$	$ 5,834
Ending balance, collectively evaluated for impairment	13,236	8,196	3,207	27,946	6,255	15,715	2,683	1,138	78,376
Total reserve for loan and lease losses	$ 14,724	$ 8,201	$ 3,368	$ 31,066	$ 6,255	$ 16,775	$ 2,683	$ 1,138	$ 84,210

Recorded investment in loans									
Ending balance, individually evaluated for impairment	$ 10,491	$ 1,109	$ 3,584	$ 13,241	$ 3,780	$ 23,814	$	$	$ 56,019
Ending balance, collectively evaluated for impairment	546,901	441,018	149,119	600,465	256,461	532,473	404,063	96,775	3,027,275
Total recorded investement in loans	$ 557,392	$ 442,127	$ 152,703	$ 613,706	$ 260,241	$ 556,287	$ 404,063	$ 96,775	$ 3,083,294

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Changes in the reserve for loan and lease losses, segregated by class, for the nine months ended September 30, 2012 and 2011 are shown below.

(Dollars in thousands)	Commercial and agricultural loans	Auto, light truck and environmental equipment	Medium and heavy duty truck	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
September 30, 2012									
Reserve for loan and lease losses									
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
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 investement in loans	$ 584,996	$ 456,665	$ 167,709	$ 685,800	$ 276,270	$ 548,921	$ 436,909	$ 111,143	$ 3,268,413
September 30, 2011									
Reserve for loan and lease losses									
Balance, beginning of period	$ 20,544	$ 7,542	$ 5,768	$ 29,811	$ 8,439	$ 11,177	$ 2,518	$ 1,075	$ 86,874
Charge-offs	1,109	335		3,701	853	2,537	191	1,193	9,919
Recoveries	1,734	148	2	860	242	336	53	355	3,730
Net charge-offs (recoveries)	(625)	187	(2)	2,841	611	2,201	138	838	6,189
Provision (recovery of provision)	(6,445)	846	(2,402)	4,096	(1,573)	7,799	303	901	3,525
Balance, end of period	$ 14,724	$ 8,201	$ 3,368	$ 31,066	$ 6,255	$ 16,775	$ 2,683	$ 1,138	$ 84,210
Ending balance, individually evaluated for impairment	$ 1,488	$ 5	$ 161	$ 3,120	$	$ 1,060	$	$	$ 5,834
Ending balance, collectively evaluated for impairment	13,236	8,196	3,207	27,946	6,255	15,715	2,683	1,138	78,376
	$ 14,724	$ 8,201	$ 3,368	$ 31,066	$ 6,255	$ 16,775	$ 2,683	$ 1,138	$ 84,210

Total reserve for loan and lease losses									
Recorded investment in loans									
Ending balance, individually evaluated for impairment	$ 10,491	$ 1,109	$ 3,584	$ 13,241	$ 3,780	$ 23,814	$	$	$ 56,019
Ending balance, collectively evaluated for impairment	546,901	441,018	149,119	600,465	256,461	532,473	404,063	96,775	3,027,275
Total recorded investement in loans	$ 557,392	$ 442,127	$ 152,703	$ 613,706	$ 260,241	$ 556,287	$ 404,063	$ 96,775	$ 3,083,294

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 fair value. The unpaid principal balance of residential mortgage loans serviced for third parties was $940.23 million and $995.09 million at September 30, 2012 and December 31, 2011, respectively.

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Mortgage servicing assets are evaluated for impairment. For purposes of impairment measurement, mortgage servicing assets are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. 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:

	Three Months Ended September 30,				Nine Months Ended September 30,			
(Dollars in thousands)	**2012**		**2011**		**2012**		**2011**	
Mortgage servicing assets:								
Balance at beginning of period	$	4,984	$	6,419	$	5,610	$	7,556
Additions		509		270		1,411		591
Amortization		(739)		(667)		(2,267)		(2,125)
Sales								
Carrying value before valuation allowance at end of period		4,754		6,022		4,754		6,022
Valuation allowance:								
Balance at beginning of period		(91)		(16)		(238)		
Impairment (charges) recoveries		(377)		(214)		(230)		(230)
Balance at end of period	$	(468)	$	(230)	$	(468)	$	(230)
Net carrying value of mortgage servicing assets at end of period	$	4,286	$	5,792	$	4,286	$	5,792
Fair value of mortgage servicing assets at end of period	$	4,478	$	7,364	$	4,478	$	7,364

During the nine months ended September 30, 2012 and 2011, the Company determined that it was not necessary to permanently write-down any previously established valuation allowance. At September 30, 2012 and 2011, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by $0.19 million and $1.57 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 $0.90 million and $1.02 million for the three months ended September 30, 2012 and 2011, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were $2.72 million and $3.07 million for the nine months ended September 30, 2012 and 2011, respectively. Mortgage loan contractual servicing fees are included in mortgage banking income in the consolidated statements of income.

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

1st Source Corporation and its subsidiaries are parties to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate 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 $16.24 million and $14.66 million at September 30, 2012 and December 31, 2011, respectively. Standby letters of credit generally have terms ranging from six months to one year.

On December 28, 2010, the Company entered into an agreement with the City of South Bend for the sale of the South Bend headquarters building parking garage for $1.95 million. Although the City of South Bend took possession of the parking garage on that date, the proceeds were placed in an escrow account. Under the terms of the agreement, receipt of the proceeds from the escrow were contingent upon the Company investing $5.40 million into its properties within the City of South Bend by December 31, 2013. As of June 30, 2011, the parking garage asset was classified as held for sale and included in accrued income and other assets on the Statement of Financial Condition. In the third quarter of 2012, the proceeds for the parking garage were received from escrow and a gain on sale of $1.61 million (or $1.00 million net of tax) was recognized in Other Expense in the Statement of Income.

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. 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.

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At September 30, 2012 and December 31, 2011, the amounts of non-hedging derivative financial instruments are shown in the chart below:

(Dollars in thousands)	Notional or contractual amount	Asset derivatives Statement of Financial Condition classification	Fair value	Liability derivatives Statement of Financial Condition classification	Fair value
September 30, 2012					
Interest rate swap contracts	$ 460,471	Other assets	$ 17,171	Other liabilities	$ 17,520
Loan commitments	46,402	Mortgages held for sale	394	N/A	
Forward contracts	43,000	N/A		Mortgages held for sale	666
Total	$ 549,873		$ 17,565		$ 18,186
December 31, 2011					
Interest rate swap contracts	$ 453,428	Other assets	$ 17,496	Other liabilities	$ 17,945
Loan commitments	38,209	Mortgages held for sale	189	N/A	
Forward contracts	21,247	N/A		Mortgages held for sale	218
Total	$ 512,884		$ 17,685		$ 18,163

For the three and nine months ended September 30, 2012 and 2011, the amounts included in the consolidated statements of income for non-hedging derivative financial instruments are shown in the chart below:

		Gain (loss)			
	Statement of	Three Months Ended September 30,		Nine Months Ended September 30,	
(Dollars in thousands)	Income classification	2012	2011	2012	2011
Interest rate swap contracts	Other expense	$ 21	$ 230	$ 100	$ 47
Interest rate swap contracts	Other income	333	182	586	351
Loan commitments	Mortgage banking income	64	191	205	240
Forward contracts	Mortgage banking income	(350)	(259)	(448)	(718)
Total		$ 68	$ 344	$ 443	$ (80)

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. No stock options were considered antidilutive as of September 30, 2012 or 2011.

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The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the three and nine months ended September 30, 2012 and 2011.

(Dollars in thousands - except per share amounts)	Three Months Ended September 30, 2012	2011	Nine Months Ended September 30, 2012	2011
Distributed earnings allocated to common stock	$ 4,127	$ 3,874	$ 11,899	$ 11,650
Undistributed earnings allocated to common stock	8,706	7,482	24,872	24,901
Net earnings allocated to common stock	12,833	11,356	36,771	36,551
Net earnings allocated to participating securities	172	184	516	462
Net income allocated to common stock and participating securities	$ 13,005	$ 11,540	$ 37,287	$ 37,013
Weighted average shares outstanding for basic earnings per common share	24,279,178	24,213,063	24,267,535	24,246,041
Dilutive effect of stock compensation	10,317	10,369	10,625	9,316
Weighted average shares outstanding for diluted earnings per common share	24,289,495	24,223,432	24,278,160	24,255,357
Basic earnings per common share	$ 0.53	$ 0.47	$ 1.52	$ 1.51
Diluted earnings per common share	$ 0.53	$ 0.47	$ 1.51	$ 1.51

Note 10. Stock-Based Compensation

As of September 30, 2012, the Company had five active stock-based employee compensation plans, which are more fully described in Note 16 of the Consolidated Financial Statements in 1st Source s Annual Report on Form 10-K for the year ended December 31, 2011. These plans include the 2001 Stock Option Plan, the 1998 Performance Compensation Plan, the Employee Stock Purchase Plan, the Executive Incentive Plan, and the Restricted Stock Award Plan. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but no grants had been made through September 30, 2012.

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

The stock-based compensation expense recognized in the condensed consolidated statement of income for the nine months ended September 30, 2012 and 2011 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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The aggregate intrinsic value in the table below represents the total pretax intrinsic value (the difference between 1st Source s closing stock price on the last trading day of the third quarter of 2012 (September 28, 2012) and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 28, 2012. This amount changes based on the fair market value of 1st Source s stock. Total fair value of options vested and expensed was zero and $4 thousand, net of tax, for the nine months ended September 30, 2012 and 2011, respectively.

	Number of Shares	Weighted Average Exercise Price	Average Remaining Contractual Term (in years)	Total Intrinsic Value (in 000 s)
Options outstanding, beginning of year	22,000	$ 12.04		
Granted				
Exercised				
Forfeited				
Options outstanding at September 30, 2012	22,000	$ 12.04	0.56	$ 225
Vested and expected to vest at September 30, 2012	22,000	$ 12.04	0.56	$ 225
Exercisable at September 30, 2012	22,000	$ 12.04	0.56	$ 225

As of September 30, 2012, there was $6.88 million of total unrecognized compensation cost related to nonvested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.32 years.

Note 11. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was $1.91 million at September 30, 2012 and $1.67 million at December 31, 2011. Interest and penalties were recognized through the income tax provision. For the nine months ended September 30, 2012 and 2011, the Company recognized approximately $(0.06) million and $(0.04) million in interest, net of tax effect, and penalties, respectively. Interest and penalties of approximately $0.51 million and $0.57 million were accrued at September 30, 2012 and December 31, 2011, respectively.

Tax years that remain open and subject to audit include the federal 2009-2011 years and the Indiana 2008-2011 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

Note 12. Fair Value Measurements

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

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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, 2012 and December 31, 2011, all mortgages held for sale are carried at fair value.

The following table reflects the differences between the fair value carrying amount of mortgages held for sale measured at fair value and the aggregate unpaid principal amount the Company is contractually entitled to receive at maturity on September 30, 2012 and December 31, 2011:

(Dollars in thousands)	**Fair value carrying amount**	**Aggregate unpaid principal**	**Excess of fair value carrrying amount over (under) unpaid principal**
September 30, 2012			
Mortgages held for sale reported at fair value	$ 22,853	$ 22,082	$ 771(1)
December 31, 2011			
Mortgages held for sale reported at fair value	$ 12,644	$ 12,265	$ 379(1)

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

Financial Instruments on Recurring Basis:

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

Investment securities available for sale are valued primarily by a third party pricing agent. Prices supplied by the independent pricing agent, as well as their pricing methodologies and assumptions, are reviewed by the Company for reasonableness and to ensure such prices are aligned with traditional pricing matrices. In general, the Company s investment securities do not possess a complex structure that could introduce greater valuation

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risk. The portfolio mainly consists of traditional investments including U.S. Treasury and Federal agencies securities, federal agency mortgage pass-through securities, and general obligation and revenue municipal bonds. Pricing for such instruments is fairly generic and is easily obtained. On a quarterly basis, prices supplied by the pricing agent are validated by comparison to prices obtained from other third party sources for a material portion of the portfolio.

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

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

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

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

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

- Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.

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

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

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

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

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

The table below presents the balance of assets and liabilities at September 30, 2012 and December 31, 2011 measured at fair value on a recurring basis:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
September 30, 2012				
Assets:				
Investment securities available-for-sale:				