

1ST SOURCE CORP  
Form 10-Q  
April 22, 2010

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2010

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-6233

(Exact name of registrant as specified in its charter)

INDIANA  
(State or other jurisdiction of  
incorporation or organization)

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

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

(574) 235-2000  
(Registrant's telephone number, including area code)

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

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

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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	<input type="radio"/>	Accelerated filer	<input checked="" type="radio"/>
Non-accelerated filer	<input type="radio"/>	Smaller reporting company	<input type="radio"/>

(Do not check if a smaller reporting company)

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

Number of shares of common stock outstanding as of April 16, 2010 – 24,286,688 shares

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## CERTIFICATIONS

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

	March 31, 2010	December 31, 2009
<b>ASSETS</b>		
Cash and due from banks	\$53,518	\$72,872
Federal funds sold and interest bearing deposits with other banks	71,139	141,166
Investment securities available-for-sale (amortized cost of \$878,403 and \$893,439 at March 31, 2010 and December 31, 2009, respectively)	888,862	901,638
Other investments	21,012	21,012
Trading account securities	130	125
Mortgages held for sale	23,067	26,649
<b>Loans and leases - net of unearned discount</b>		
Commercial and agricultural loans	546,826	546,222
Auto, light truck and environmental equipment	364,445	349,741
Medium and heavy duty truck	200,228	204,545
Aircraft financing	608,643	617,384
Construction equipment financing	303,866	313,300
Loans secured by real estate	977,667	952,223
Consumer loans	104,440	109,735
Total loans and leases	3,106,115	3,093,150
Reserve for loan and lease losses	(87,827 )	(88,236 )
Net loans and leases	3,018,288	3,004,914
Equipment owned under operating leases, net	92,226	97,004
Net premises and equipment	37,556	37,907
Goodwill and intangible assets	89,949	90,222
Accrued income and other assets	149,365	148,591
Total assets	\$4,445,112	\$4,542,100
<b>LIABILITIES</b>		
<b>Deposits:</b>		
Noninterest bearing	\$457,645	\$450,608
Interest bearing	3,081,485	3,201,856
Total deposits	3,539,130	3,652,464
Federal funds purchased and securities sold under agreements to repurchase	111,788	123,787
Other short-term borrowings	29,358	26,323
Long-term debt and mandatorily redeemable securities	24,847	19,761
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	71,240	59,753
Total liabilities	3,866,055	3,971,780
<b>SHAREHOLDERS' EQUITY</b>		
Preferred stock; no par value		
Authorized 10,000,000 shares; issued 111,000 at March 31, 2010,		

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and at December 31, 2009	105,254	104,930
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,643,506 at March 31, 2010, and at December 31, 2009	350,272	350,269
Retained earnings	147,381	142,407
Cost of common stock in treasury (1,356,818 shares at March 31, 2010, and 1,532,483 shares at December 31, 2009)	(30,348 )	(32,380 )
Accumulated other comprehensive income	6,498	5,094
Total shareholders' equity	579,057	570,320
Total liabilities and shareholders' equity	\$4,445,112	\$4,542,100

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

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

	Three Months Ended March 31,	
	2010	2009
Interest income:		
Loans and leases	\$42,270	\$44,597
Investment securities, taxable	5,401	4,036
Investment securities, tax-exempt	1,467	1,710
Other	274	333
Total interest income	49,412	50,676
Interest expense:		
Deposits	12,405	17,606
Short-term borrowings	188	349
Subordinated notes	1,647	1,647
Long-term debt and mandatorily redeemable securities	270	352
Total interest expense	14,510	19,954
Net interest income	34,902	30,722
Provision for loan and lease losses	4,388	7,785
Net interest income after provision for loan and lease losses	30,514	22,937
Noninterest income:		
Trust fees	3,745	3,804
Service charges on deposit accounts	4,620	4,746
Mortgage banking income	777	2,570
Insurance commissions	1,465	1,516
Equipment rental income	6,745	6,147
Other income	2,689	2,235
Investment securities and other investment gains (losses)	881	(469)
Total noninterest income	20,922	20,549
Noninterest expense:		
Salaries and employee benefits	18,810	20,086
Net occupancy expense	2,487	2,601
Furniture and equipment expense	2,800	3,481
Depreciation - leased equipment	5,364	4,956
Professional fees	1,514	1,062
Supplies and communication	1,369	1,567
FDIC and other insurance	1,674	1,550
Business development and marketing expense	567	485
Loan and lease collection and repossession expense	1,106	559
Other expense	1,419	2,293
Total noninterest expense	37,110	38,640

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Income before income taxes	14,326	4,846
Income tax expense (benefit)	4,647	(1,405 )
Net income	9,679	6,251
Preferred stock dividends and discount accretion	(1,711 )	(1,313 )
Net income available to common shareholders	\$7,968	\$4,938
Per common share		
Basic net income per common share	\$0.33	\$0.20
Diluted net income per common share	\$0.33	\$0.20
Dividends	\$0.15	\$0.14
Basic weighted average common shares outstanding	24,210,242	24,150,200
Diluted weighted average common shares outstanding	24,215,506	24,191,610

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

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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, 2009	\$453,664	\$0	\$342,982	\$136,877	\$(32,019 )	\$ 5,824
Comprehensive Income, net of tax:						
Net Income	6,251	-	-	6,251	-	-
Change in unrealized appreciation of available-for-sale securities, net of tax	(853 )	-	-	-	-	(853 )
Total Comprehensive Income	5,398	-	-	-	-	-
Issuance of 78,194 common shares under stock based compensation awards, including related tax effects	1,566	-	-	687	879	-
Issuance of preferred stock	103,725	103,725	-	-	-	-
Preferred stock discount accretion	-	265	-	(265 )	-	-
Issuance of warrants to purchase common stock	7,275	-	7,275	-	-	-
Preferred stock dividend (paid and/or accrued)	(1,048 )	-	-	(1,048 )	-	-
Common stock dividend (\$0.14 per share)	(3,381 )	-	-	(3,381 )	-	-
Stock based compensation	3	-	3	-	-	-
Balance at March 31, 2009	\$567,202	\$103,990	\$350,260	\$139,121	\$(31,140 )	\$ 4,971
Balance at January 1, 2010	\$570,320	\$104,930	\$350,269	\$142,407	\$(32,380 )	\$ 5,094
Comprehensive Income, net of tax:						
Net Income	9,679	-	-	9,679	-	-
Change in unrealized appreciation of available-for-sale securities, net of tax	1,404	-	-	-	-	1,404
Total Comprehensive Income	11,083	-	-	-	-	-

Issuance of 182,934 common shares under stock based compensation awards, including related tax effects	2,778	-	-	632	2,146	-
Cost of 7,269 shares of common stock acquired for treasury	(114 )	-	-	-	(114 )	-
Preferred stock discount accretion	-	324	-	(324 )	-	-
Preferred stock dividend (paid and/or accrued)	(1,387 )	-	-	(1,387 )	-	-
Common stock dividend (\$0.15 per share)	(3,626 )	-	-	(3,626 )	-	-
Stock based compensation	3	-	3	-	-	-
Balance at March 31, 2010	\$579,057	\$105,254	\$350,272	\$147,381	\$(30,348 )	\$ 6,498

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

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

	Three Months Ended March 31,	
	2010	2009
Operating activities:		
Net income	\$ 9,679	\$ 6,251
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	4,388	7,785
Depreciation of premises and equipment	1,182	1,226
Depreciation of equipment owned and leased to others	5,364	4,956
Amortization of investment security premiums and accretion of discounts, net	668	1,662
Amortization of mortgage servicing rights	761	724
Mortgage servicing asset (recovery) impairment	(1 )	565
Deferred income taxes	948	(1,944 )
Investment securities and other investment (gains) losses	(881 )	469
Originations/purchases of loans held for sale, net of principal collected	(50,208 )	(195,322 )
Proceeds from the sales of loans held for sale	54,303	117,411
Net gain on sale of loans held for sale	(512 )	(1,888 )
Change in trading account securities	(5 )	1
Change in interest receivable	75	(1,002 )
Change in interest payable	1,110	2,165
Change in other assets	(1,337 )	665
Change in other liabilities	8,573	(7,896 )
Other	15	587
Net change in operating activities	34,122	(63,585 )
Investing activities:		
Proceeds from sales of investment securities	71,579	98,945
Proceeds from maturities of investment securities	123,734	77,103
Purchases of investment securities	(180,063 )	(384,778 )
Net change in short-term investments	70,026	(1,539 )
Loans sold or participated to others	4,586	3,978
Net change in loans and leases	(22,348 )	76,305
Net change in equipment owned under operating leases	(586 )	(2,119 )
Purchases of premises and equipment	(857 )	(542 )
Net change in investing activities	66,071	(132,647 )
Financing activities:		
Net change in demand deposits, NOW accounts and savings accounts	(69,419 )	59,910
Net change in certificates of deposit	(43,915 )	(26,584 )
Net change in short-term borrowings	(8,964 )	4,966
Proceeds from issuance of long-term debt	5,303	12
Payments on long-term debt	(139 )	(10,186 )
Net proceeds from issuance of treasury stock	2,778	1,566
Acquisition of treasury stock	(114 )	-

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Net proceeds from issuance of preferred stock & common stock warrants	-	111,000
Cash dividends paid on preferred stock	(1,387 )	(339 )
Cash dividends paid on common stock	(3,690 )	(3,440 )
Net change in financing activities	(119,547 )	136,905
Net change in cash and cash equivalents	(19,354 )	(59,327 )
Cash and cash equivalents, beginning of year	72,872	119,771
Cash and cash equivalents, end of period	\$ 53,518	\$ 60,444

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

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1ST SOURCE CORPORATION  
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in shareholders' equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U. S. generally accepted accounting principles (GAAP) have been omitted. The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K (2009 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, 2009 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U. S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform with the current year presentation.

Note 2. Recent Accounting Pronouncements

**Subsequent Events:** In February 2010, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2010-09 "Subsequent Events (Topic 855) – Amendments to Certain Recognition and Disclosure Requirements." ASU 2010-09 amends the subsequent events disclosure guidance. The amendments include a definition of an SEC filer, requires an SEC filer or conduit bond obligor to evaluate subsequent events through the date the financial statements are issued, and removes the requirement for an SEC filer to disclose the date through which subsequent events have been evaluated. ASU 2010-09 was effective upon issuance except for the use of the issued date for conduit debt obligors. The impact of ASU 2010-09 on our disclosures is reflected in Note 11 - Subsequent Events.

**Fair Value Measurements and Disclosures:** In January 2010, the FASB issued ASU No. 2010-06 "Fair Value Measurements and Disclosures (Topic 820) – Improving Disclosures about Fair Value Measurements." ASU 2010-06 amends the fair value disclosure guidance. The amendments include new disclosures and changes to clarify existing disclosure requirements. ASU 2010-06 was effective for interim and annual reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances, and settlements of Level 3 fair value measurements. Those disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. The impact of ASU 2010-06 on our disclosures is reflected in Note 10 - Fair Value Measurements.

**Consolidations:** In December 2009, the FASB issued ASU No. 2009-17 (formerly Statement No. 167), "Consolidations (Topic 810) – Improvements to Financial Reporting for Enterprises involved with Variable Interest Entities". ASU 2009-17 amends the consolidation guidance applicable to variable interest entities. The amendments to the consolidation guidance affect all entities, as well as qualifying special-purpose entities (QSPEs) that are currently excluded from previous consolidation guidance. ASU 2009-17 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009. ASU 2009-17 did not have an impact on our financial condition, results of operations, or disclosures.



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Accounting for Transfers of Financial Assets: In December 2009, the FASB issued ASU No. 2009-16 (formerly Statement No. 166), "Transfers and Servicing (Topic 860) – Accounting for Transfers of Financial Assets". ASU 2009-16 amends the derecognition accounting and disclosure guidance. ASU 2009-16 eliminates the exemption from consolidation for QSPEs and also requires a transferor to evaluate all existing QSPEs to determine whether they must be consolidated. ASU 2009-16 was effective as of the beginning of the first annual reporting period that begins after November 15, 2009. ASU 2009-16 did not have an impact on our 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
March 31, 2010				
U.S. Treasury and Federal agencies securities	\$355,055	\$1,319	\$(547)	\$355,827
U.S. States and political subdivisions securities	173,425	5,265	(2,319)	176,371
Mortgage-backed securities - Federal agencies	322,899	6,201	(1,256)	327,844
Corporate debt securities	24,048	185	-	24,233
Foreign government securities	1,688	6	-	1,694
Total debt securities	877,115	12,976	(4,122)	885,969
Marketable equity securities	1,288	1,632	(27)	2,893
Total investment securities available-for-sale	\$878,403	\$14,608	\$(4,149)	\$888,862
December 31, 2009				
U.S. Treasury and Federal agencies securities	\$390,189	\$760	\$(1,780)	\$389,169
U.S. States and political subdivisions securities	188,706	5,450	(2,337)	191,819
Mortgage-backed securities - Federal agencies	286,415	5,996	(1,434)	290,977
Corporate debt securities	26,166	194	(38)	26,322
Foreign government and other securities	675	-	-	675
Total debt securities	892,151	12,400	(5,589)	898,962
Marketable equity securities	1,288	1,417	(29)	2,676
Total investment securities available-for-sale	\$893,439	\$13,817	\$(5,618)	\$901,638

At March 31, 2010, the residential mortgage-backed securities we held consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (or Government Sponsored Enterprise, GSEs).

The contractual maturities of debt securities available-for-sale at March 31, 2010, 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	\$ 41,051	\$ 41,462
Due after one year through five years	332,860	336,779
Due after five years through ten years	163,934	165,574

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Due after ten years	16,371	14,310
Mortgage-backed securities	322,899	327,844
Total debt securities available-for-sale	\$ 877,115	\$ 885,969

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 in the first quarter of 2010 primarily reflect the disposition of FNMA and FHLMC debt securities.

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The gross gains in the first quarter 2009 reflect gains on the sale of FHLB and FNMA debt securities. The gross losses in the first quarter 2009 primarily reflect losses on the sale of preferred equities. There have been no other than temporary impairment (OTTI) writedowns in 2010. There were net gains (losses) of \$5 thousand and \$(1) thousand recorded for the three months ended March 31, 2010 and 2009 on \$0.13 million and \$0.13 million in trading securities outstanding at March 31, 2010, and December 31, 2009, respectively.

(Dollars in thousands)

	Three Months Ended	
	March 31,	
	2010	2009
Gross realized gains	\$ 292	\$ 594
Gross realized losses	(12 )	(707 )
Net realized gains (losses)	\$ 280	\$ (113 )

The following tables summarize our gross unrealized losses and fair value by investment category and age:

(Dollars in thousands)	Less than 12 Months		12 months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
March 31, 2010						
U.S. Treasury and Federal agencies securities	\$199,261	\$(547 )	\$-	\$-	\$199,261	\$(547 )
U.S. States and political subdivisions securities	7,697	(100 )	16,164	(2,219 )	23,861	(2,319 )
Mortgage-backed securities - Federal agencies	70,567	(977 )	26,257	(279 )	96,824	(1,256 )
Corporate debt securities	-	-	-	-	-	-
Total debt securities	277,525	(1,624 )	42,421	(2,498 )	319,946	(4,122 )
Marketable equity securities	-	-	6	(27 )	6	(27 )
Total investment securities available-for-sale	\$277,525	\$(1,624 )	\$42,427	\$(2,525 )	\$319,952	\$(4,149 )
December 31, 2009						
U.S. Treasury and Federal agencies securities	\$245,921	\$(1,780 )	\$-	\$-	\$245,921	\$(1,780 )
U.S. States and political subdivisions securities	9,501	(178 )	16,718	(2,159 )	26,219	(2,337 )
Mortgage-backed securities - Federal agencies	90,592	(1,137 )	22,330	(297 )	112,922	(1,434 )
Corporate debt securities	7,149	(38 )	-	-	7,149	(38 )
Total debt securities	353,163	(3,133 )	39,048	(2,456 )	392,211	(5,589 )
Marketable equity securities	2	(2 )	4	(27 )	6	(29 )
Total investment securities available-for-sale	\$353,165	\$(3,135 )	\$39,052	\$(2,483 )	\$392,217	\$(5,618 )

The initial indication of OTTI for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, the impaired securities are analyzed on a qualitative and quantitative basis in determining OTTI. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In

estimating OTTI impairment losses, we consider 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 we will not have to sell any such securities before a recovery of cost.

At March 31, 2010, we do not have the intent to sell any of the available-for-sale securities in the table above and believe that it is more likely than not that we will not have to sell any such securities before an anticipated recovery of cost. The unrealized losses are due to increases in market interest rates over the yields available at the time the underlying securities were purchased and market illiquidity on adjustable rate coupon securities which are reflected in U.S. States and Political subdivisions securities.

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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. We do not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of March 31, 2010, we believe the impairments detailed in the table above are temporary and no impairment loss has been realized in our consolidated statements of income.

At March 31, 2010 and December 31, 2009, investment securities with carrying values of \$333.59 million and \$351.84 million, respectively, were pledged as collateral to secure government deposits, security repurchase agreements, and for other purposes.

Note 4. Reserve for Loan and Lease Losses

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

Note 5. Mortgage Servicing Assets

We recognize 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. We allocate a portion of the total cost of a mortgage loan to servicing rights based on the fair value.

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 and interest rate. If temporary impairment exists within a tranche, a valuation allowance is established through a charge to income equal to the amount by which the carrying value exceeds the fair value. If it is later determined all or a portion of the temporary impairment no longer exists for a particular tranche, the valuation allowance is reduced through a recovery of income.

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

(Dollars in thousands)	Three Months Ended	
	March 31,	
	2010	2009
Mortgage servicing assets:		
Balance at beginning of period	\$8,749	\$6,708
Additions	571	2,496
Amortization	(761 )	(724 )
Sales	(443 )	(623 )
Carrying value before valuation allowance at end of period	8,116	7,857
Valuation allowance:		
Balance at beginning of period	(1 )	(2,073 )
Impairment recoveries (charges)	1	(565 )
Balance at end of period	\$-	\$(2,638 )
Net carrying value of mortgage servicing assets at end of period	\$8,116	\$5,219
Fair value of mortgage servicing assets at end of period	\$10,575	\$5,397

During the three months ended March 31, 2010 and 2009, management determined that it was not necessary to permanently write-down any previously established valuation allowance. At March 31, 2010, the fair value of mortgage servicing assets exceeded the carrying value reported in the consolidated statement of financial condition by \$2.46 million. This difference represents increases in the fair value of certain mortgage servicing assets that could not be recorded above cost basis.

The key economic assumptions used to estimate the fair value of the mortgage servicing rights follow:

	Three Months Ended	
	March 31,	
	2010	2009
Expected weighted-average life (in years)	3.55	3.21
Weighted-average constant prepayment rate (CPR)	17.64	% 38.34 %
Weighted-average discount rate	8.48	% 8.34 %

Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$1.02 million and \$0.86 million for the three months ended March 31, 2010 and 2009, respectively. Mortgage loan contractual servicing fees are included in mortgage banking income in the consolidated statements of income.

#### Note 6. Financial Instruments with Off-Balance-Sheet Risk and Derivative Transactions

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



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We have certain interest rate derivative positions that are not designated as hedging instruments. These derivative positions relate to transactions in which we enter into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. In connection with each transaction, we agree to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, we agree to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows our client to effectively convert a variable rate loan to a fixed rate. Because the terms of the swaps with our customers and the other financial institution 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 our results of operations.

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. Commitments to originate or purchase residential mortgage loans held for sale and forward commitments to sell residential mortgage loans are considered derivative instruments.

At March 31, 2010 and December 31, 2009, the amounts of non-hedging derivative financial instruments are shown in the chart below:

	Notional or contractual amount	Asset derivatives		Liability derivatives	
		Statement of Financial Condition location	Fair value	Statement of Financial Condition location	Fair value
March 31, 2010					
Interest rate swap contracts	\$ 466,823	Other assets	\$ 14,740	Other liabilities	\$ 15,247
Loan commitments	44,641	Mortgages held for sale	184	N/A	-
Forward contracts	42,005	Mortgages held for sale	86	N/A	-
<b>Total</b>			<b>\$ 15,010</b>		<b>\$ 15,247</b>
December 31, 2009					
Interest rate swap contracts	\$ 412,717	Other assets	\$ 13,516	Other liabilities	\$ 13,988
Loan commitments	48,821	Mortgages held for sale	77	N/A	-
Forward contracts	38,940	Mortgages held for sale	411	N/A	-
<b>Total</b>			<b>\$ 14,004</b>		<b>\$ 13,988</b>

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For the three months ended March 31, 2010 and 2009, the amounts included in the consolidated statements of income for non-hedging derivative financial instruments are shown in the chart below:

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(Dollars in thousands)	Statement of Income location	Gain (loss) Three Months Ended March 31,	
		2010	2009
Interest rate swap contracts	Other expense	\$(35 )	\$4 )
Loan commitments	Mortgage banking income	107	684
Forward contracts	Mortgage banking income	(325 )	(1,307 )
Total		\$(253 )	\$(619 )

We issue letters of credit which are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers. Standby letters of credit totaled \$22.66 million and \$19.02 million at March 31, 2010 and December 31, 2009, respectively. Standby letters of credit generally have terms ranging from six months to one year.

## Note 7. 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 and warrants, 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. Stock options of 49,763 and 54,472 were considered antidilutive as of March 31, 2010 and 2009. Stock warrants of 837,947 were considered antidilutive as of March 31, 2010 and 2009.

The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share for the three months ended March 31, 2010 and 2009.

(Dollars in thousands - except per share amounts)	Three Months Ended March 31,	
	2010	2009
Distributed earnings allocated to common stock	\$3,616	\$3,375
Undistributed earnings allocated to common stock	4,278	1,534
Net earnings allocated to common stock	7,894	4,909
Net earnings allocated to participating securities	74	29
Net income allocated to common stock and participating securities	\$7,968	\$4,938
Weighted average shares outstanding for basic earnings per common share	24,210,242	24,150,200
Dilutive effect of stock compensation	5,264	41,410
Weighted average shares outstanding for diluted earnings per common share	24,215,506	24,191,610
Basic earnings per common share	\$0.33	\$0.20
Diluted earnings per common share	\$0.33	\$0.20



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Note 8. Stock-Based Compensation

As of March 31, 2010, we had five 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, 2009. These plans include two stock option plans, the Employee Stock Purchase Plan, the Executive Incentive Plan, and the Restricted Stock Award Plan.

Stock-based compensation expense for all stock-based compensation awards granted is based on the grant-date fair value. For all awards except stock option awards, the grant date fair value is either the fair market value per share or book value per share (corresponding to the type of stock awarded) as of the grant date. For stock option awards, the grant date fair value is estimated using the Black-Scholes option pricing model. For all awards we recognize these compensation costs only for th