1ST SOURCE CORP
Form 10-Q
October 22, 2009

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, 2009

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	35-1068133
(State or other jurisdiction of incorporation or organization)	(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. xYes 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). oYes 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 (Do not check if a smaller reporting company) o 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 16, 2009 – 24,141,456 shares

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PART II. OTHER INFORMATION

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1st SOURCE CORPORATION

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Unaudited - Dollars in thousands, except share amounts)

	September 30, 2009	December 31, 2008
ASSETS		
Cash and due from banks	$ 56,408	$ 119,771
Federal funds sold and		
interest bearing deposits with other banks	65,307	6,951
Investment securities available-for-sale		
(amortized cost of $871,266 and $715,380		
at September 30, 2009 and December 31, 2008, respectively)	886,777	724,754
Other investments	21,012	18,612
Trading account securities	117	100
Mortgages held for sale	39,364	46,686
Loans and leases - net of unearned discount		
Commercial and agricultural loans	567,476	643,440
Auto, light truck and environmental equipment	313,808	353,838
Medium and heavy duty truck	219,762	243,375
Aircraft financing	633,552	632,121
Construction equipment financing	326,858	375,983
Loans secured by real estate	917,754	918,749
Consumer loans	114,820	130,706
Total loans and leases	3,094,030	3,298,212
Reserve for loan and lease losses	(85,504)	(79,776)
Net loans and leases	3,008,526	3,218,436
Equipment owned under operating leases, net	91,538	83,062
Net premises and equipment	38,552	40,491
Goodwill and intangible assets	90,669	91,691
Accrued income and other assets	114,890	113,620
Total assets	$ 4,413,160	$ 4,464,174
LIABILITIES		
Deposits:		
Noninterest bearing	$ 425,742	$ 416,960
Interest bearing	3,060,972	3,097,582
Total deposits	3,486,714	3,514,542
Federal funds purchased and securities		
sold under agreements to repurchase	129,707	272,529
Other short-term borrowings	25,272	23,646
Long-term debt and mandatorily redeemable securities	20,046	29,832
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	87,399	80,269
Total liabilities	3,838,830	4,010,510
SHAREHOLDERS' EQUITY		
Preferred stock; no par value		
Authorized 10,000,000 shares; issued 111,000 at September 30, 2009		

and none at December 31, 2008		104,612	-
Common stock; no par value			
Authorized 40,000,000 shares; issued 25,894,879 at September 30, 2009 and 25,895,505 at December 31, 2008, less unearned shares (251,373 at September 30, 2009 and 251,999 at December 31, 2008)		350,266	342,982
Retained earnings		141,758	136,877
Cost of common stock in treasury (1,502,050 shares at September 30, 2009, and 1,532,576 shares at December 31, 2008)		(31,943)	(32,019)
Accumulated other comprehensive income		9,637	5,824
Total shareholders' equity		574,330	453,664
Total liabilities and shareholders' equity	$	4,413,160	$4,464,174

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

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Interest income:				
Loans and leases	$43,436	$50,979	$132,507	$154,590
Investment securities, taxable	4,357	4,896	12,600	17,288
Investment securities, tax-exempt	1,651	1,873	5,046	5,904
Other	297	317	894	986
Total interest income	49,741	58,065	151,047	178,768
Interest expense:				
Deposits	15,460	20,347	49,662	67,116
Short-term borrowings	265	2,255	909	6,434
Subordinated notes	1,648	1,648	4,942	5,067
Long-term debt and mandatorily redeemable securities	322	418	853	1,333
Total interest expense	17,695	24,668	56,366	79,950
Net interest income	32,046	33,397	94,681	98,818
Provision for loan and lease losses	6,469	3,571	22,741	9,603
Net interest income after provision for loan and lease losses	25,577	29,826	71,940	89,215
Noninterest income:				
Trust fees	3,782	4,939	11,473	14,155
Service charges on deposit accounts	5,402	5,761	15,367	16,633
Mortgage banking income	965	959	6,874	3,493
Insurance commissions	1,022	1,084	3,614	4,122
Equipment rental income	6,347	6,285	18,896	17,794
Other income	2,022	2,168	6,613	6,836
Investment securities and other investment gains (losses)	716	(8,816)	673	(9,259)
Total noninterest income	20,256	12,380	63,510	53,774
Noninterest expense:				
Salaries and employee benefits	18,425	19,297	55,340	58,996
Net occupancy expense	2,221	2,332	7,095	7,289
Furniture and equipment expense	3,241	3,694	10,487	11,555
Depreciation - leased equipment	5,021	5,041	15,065	14,266
Professional fees	1,020	2,773	2,897	6,453
Supplies and communication	1,473	1,812	4,468	5,163
FDIC and other insurance	1,582	713	6,851	1,396
Other expense	3,587	2,655	10,356	9,495
Total noninterest expense	36,570	38,317	112,559	114,613
Income before income taxes	9,263	3,889	22,891	28,376

Income tax expense (benefit)	2,530	(583)	3,624	7,305
Net income	6,733	4,472	19,267	21,071
Preferred stock dividends and discount accretion	(1,701)	-	(4,710)	-
Net income available to common shareholders	$5,032	$4,472	$14,557	$21,071
Per common share				
Basic net income per common share	$0.21	$0.19	$0.60	$0.87
Diluted net income per common share	$0.21	$0.18	$0.60	$0.86
Dividends	$0.15	$0.14	$0.43	$0.42
Basic weighted average common shares outstanding	24,164,884	24,109,960	24,166,887	24,104,015
Diluted weighted average common shares outstanding	24,212,042	24,381,657	24,215,542	24,374,811

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

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1st SOURCE CORPORATION
STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
(Unaudited - Dollars in thousands, except per share amounts)

	Total	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Net Unrealized Appreciation (Depreciation) of Securities Available-For-Sale
Balance at January 1, 2008	$430,504	$-	$342,840	$117,373	$(32,231)	$ 2,522
Comprehensive Income, net of tax:						
Net Income	21,071	-	-	21,071	-	-
Change in unrealized appreciation of available-for-sale securities, net of tax	(900)	-	-	-	-	(900)
Total Comprehensive Income	20,171	-	-	-	-	-
Issuance of 18,820 common shares under stock based compensation awards, including related tax effects	342	-	-	130	212	-
Stock-based compensation	139	-	139			
Common stock dividend ($0.42 per share)	(10,146)	-	-	(10,146)	-	-
Balance at September 30, 2008	$441,010	$-	$342,979	$128,428	$(32,019)	$ 1,622
Balance at January 1, 2009	$453,664	$-	$342,982	$136,877	$(32,019)	$ 5,824
Comprehensive Income, net of tax:						
Net Income	19,267	-	-	19,267	-	-
Change in unrealized appreciation of available-for-sale securities, net of tax	3,813	-	-	-	-	3,813
Total Comprehensive Income	23,080	-	-	-	-	-
Issuance of 83,402 common shares under stock based compensation awards, including related tax effects	1,663	-	-	725	938	-

Cost of 52,876 shares of common stock acquired for treasury	(862)	-	-	-	(862)	-
Issuance of preferred stock	103,725	103,725	-		-	-
Preferred stock discount accretion	-	887	-	(887)	-	-
Issuance of warrants to purchase common stock	7,275	-	7,275	-	-	-
Preferred stock dividend paid and/or accrued	(3,823)	-	-	(3,823)	-	-
Common stock dividend ($0.43 per share)	(10,401)	-	-	(10,401)	-	-
Stock based compensation	9	-	9	-	-	-
Balance at September 30, 2009	$574,330	$104,612	$350,266	$141,758	$(31,943)	$ 9,637

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, 2009	2008
Operating activities:		
Net income	$19,267	$21,071
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	22,741	9,603
Depreciation of premises and equipment	3,515	4,088
Depreciation of equipment owned and leased to others	15,065	14,266
Amortization of investment security premiums and accretion of discounts, net	4,477	1,328
Amortization of mortgage servicing rights	2,517	2,234
Mortgage servicing asset impairment (recovery) charges	(1,793)	56
Deferred income taxes	3,460	(11,558)
Realized investment securities (gains) losses	(673)	9,259
Originations/purchases of loans held for sale, net of principal collected	(512,286)	(300,404)
Proceeds from the sales of loans held for sale	522,780	288,878
Net gain on sale of loans held for sale	(3,170)	(1,253)
Change in trading account securities	(17)	-
Change in interest receivable	1,352	438
Change in interest payable	2,173	(5,853)
Change in other assets	(8,109)	1,984
Change in other liabilities	4,249	2,539
Other	754	2,988
Net change in operating activities	76,302	39,664
Investing activities:		
Proceeds from sales of investment securities	147,658	8,237
Proceeds from maturities of investment securities	323,295	390,303
Purchases of investment securities	(630,642)	(289,498)
Net change in short-term investments	(60,757)	(36,948)
Loans sold or participated to others	13,482	-
Net change in loans and leases	173,687	(124,021)
Net change in equipment owned under operating leases	(23,541)	(19,712)
Purchases of premises and equipment	(1,772)	(2,403)
Net change in investing activities	(58,590)	(74,042)
Financing activities:		
Net change in demand deposits, NOW accounts and savings accounts	74,639	(96,857)
Net change in certificates of deposit	(102,468)	(22,394)
Net change in short-term borrowings	(141,197)	96,832
Proceeds from issuance of long-term debt	240	10,024
Payments on subordinated notes	-	(10,310)

Payments on long-term debt	(10,392)	(10,371)
Net proceeds from issuance of treasury stock	1,663	341
Acquisition of treasury stock	(862)	-
Proceeds from issuance of preferred stock & common stock warrants	111,000	-
Cash dividends	(13,698)	(10,320)
Net change in financing activities	(81,075)	(43,055)
Net change in cash and cash equivalents	(63,363)	(77,433)
Cash and cash equivalents, beginning of year	119,771	153,137
Cash and cash equivalents, end of period	$56,408	$75,704

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 (2008 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, 2008 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U. S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform with the current year presentation.

Note 2. Other Activity

On January 23, 2009, we entered into a Letter Agreement with the United States Department of the Treasury ("Treasury"), pursuant to which we issued and sold (i) 111,000 shares of our Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the "Series A Preferred Stock") and (ii) a warrant (the "Warrant") to purchase 837,947 shares of our common stock, without par value (the "Common Stock"), for an aggregate purchase price of $111,000,000 in cash.

The Series A Preferred Stock qualifies as Tier 1 capital and pays cumulative dividends at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Series A Preferred Stock is non-voting except with respect to certain matters affecting the rights of the holders thereof, and may be redeemed by us after notice to the Treasury and our primary federal regulator, the Board of Governors of the Federal Reserve System ("Federal Reserve Bank") and subject to consultation between the Treasury and Federal Reserve Bank. At the time of redemption, if we do not choose to exercise our option to repurchase the warrants, the Secretary of Treasury intends to sell the warrants through an auction process.

The Warrant has a 10-year term and is immediately exercisable upon its issuance, with an exercise price, subject to anti-dilution adjustments, equal to $19.87 per share of the Common Stock.

In addition, we may not increase the quarterly dividend we pay on our common stock above $0.16 per share during the three-year period ending January 23, 2012, without consent of the Treasury, unless the Treasury no longer holds shares of the Series A Preferred Stock.

On December 12, 2008, 1st Source Corporation Investment Advisors, Inc. ("1st Source Investment Advisors"), a wholly-owned subsidiary of 1st Source Bank and second tier subsidiary of 1st Source Corporation, finalized a Purchase and Sale Agreement with WA Holdings, Inc. ("Buyer") whereby 1st Source Investment Advisors sold certain assets to Buyer and entered into a long-term strategic partnership with Buyer (the "Transaction"). Under terms of the Purchase and Sale Agreement, we received a one time payment of $11.70 million at closing and will receive performance payments ("earnout fees") over the next ten years based on the

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net growth and investment performance returns of the Funds. Pursuant to the Purchase and Sale Agreement, Buyer and its wholly-owned subsidiary, Wasatch Advisors, Inc., investment advisor of the Wasatch Funds, Inc., acquired assets of 1st Source Investment Advisors related to the management of the 1st Source Monogram Mutual Funds - the Income Equity Fund, the Long/Short Fund and the Income Fund. The 1st Source Monogram Mutual Funds were reorganized into the Wasatch - 1st Source Income Equity Fund, the Wasatch - 1st Source Long/Short Fund, and the Wasatch - 1st Source Income Fund.

Note 3. Recent Accounting Pronouncements

Investments in Certain Entities that Calculate Net Asset Value per Share: In September 2009, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2009-12, "Fair Value Measurements and Disclosures (Topic 820) – Investments in Certain Entities that Calculate Net Asset Value per Share (or its Equivalent)". This ASU permits, as a practical expedient, a reporting entity to measure the fair value of an investment that is within the scope of the amendments in this ASU on the basis of the net asset value per share of the investment (or its equivalent) if the net asset value of the investment (or its equivalent) is calculated in a manner consistent with the measurement principles of Topic 946 as of the reporting entity's measurement date. The ASU also requires disclosures by major category of investment about the attributes of investments within the scope of the Update. ASU 2009-12 is effective for interim and annual periods ending after December 15, 2009. We are assessing the impact of ASU 2009-05 on our financial condition, results of operations, and disclosures.

Measuring Liabilities at Fair Value: In August 2009, the FASB issued ASU No. 2009-05, "Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value". This ASU provides amendments for fair value measurements of liabilities. It provides clarification that in circumstances in which a quoted price in an active market for the identical liability is not available, a reporting entity is required to measure fair value using one or more techniques. ASU 2009-05 also clarifies that when estimating a fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. ASU 2009-05 is effective for the first reporting period (including interim periods) beginning after issuance or fourth quarter 2009. We are assessing the impact of ASU 2009-05 on our financial condition, results of operations, and disclosures.

FASB Accounting Standards Codification™ (ASC or Codification): In June 2009, the FASB issued ASU No. 2009-01 (formerly Statement No. 168), "Topic 105 - Generally Accepted Accounting Principles - FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles." The Codification is the single source of authoritative nongovernmental U.S. generally accepted accounting principles (GAAP). The Codification does not change current GAAP, but is intended to simplify user access to all authoritative GAAP by providing all the authoritative literature related to a particular topic in one place. All existing accounting standard documents are superseded and all other accounting literature not included in the Codification is considered nonauthoritative. The Codification is effective for interim or annual reporting periods ending after September 15, 2009. We have made the appropriate changes to GAAP references in our financial statements.

Amendments to FASB Interpretation No. 46(R): In June 2009, the FASB issued Statement No. 167, "Amendments to FASB Interpretation No. 46(R)" (SFAS 167). SFAS 167 amends the consolidation guidance applicable to variable interest entities. The amendments to the consolidation guidance affect all entities currently within the scope of FIN 46(R), as well as qualifying special-purpose entities (QSPEs) that are currently excluded from the scope of FIN 46(R). SFAS 167 is effective as of the beginning of the first annual reporting period that begins after November 15, 2009. We are assessing the impact of SFAS 167 on our financial condition, results of operations, and disclosures.

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Accounting for Transfers of Financial Assets: In June 2009, the FASB issued Statement No. 166, "Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140" (SFAS No. 166). SFAS 166 amends the derecognition accounting and disclosure guidance relating to SFAS 140. SFAS 166 eliminates the exemption from consolidation for QSPEs, it also requires a transferor to evaluate all existing QSPEs to determine whether it must be consolidated in accordance with SFAS 167. SFAS 166 is effective as of the beginning of the first annual reporting period that begins after November 15, 2009. We are assessing the impact of SFAS 166 on our financial condition, results of operations, and disclosures.

Subsequent Events: In May 2009, the FASB issued ASC 855 (formerly Statement No. 165), "Subsequent Events". ASC 855 establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC 855 is effective for interim or annual periods ending after June 15, 2009. We adopted the provisions of ASC 855 and this change is reflected in Note 10 - Subsequent Events.

FASB Amends Disclosures about Fair Value of Financial Instruments: In April 2009, the FASB issued ASC 825 (formerly FASB Staff Position (FSP) 107-1 and APB 28-1), "Interim Disclosures about Fair Value of Financial Instruments." ASC 825 requires a public entity to provide disclosures about fair value of financial instruments in interim financial information. ASC 825 is effective for interim and annual financial periods ending after June 15, 2009. We adopted the provisions of ASC 825 on April 1, 2009 and the impact on our disclosures is more fully discussed in Note 9 – Fair Value.

FASB Clarifies Other-Than-Temporary Impairment: In April 2009, the FASB issued ASC 320 (formerly FSP FAS 115-2, FAS124-2 and EITF 99-20-2), "Recognition and Presentation of Other-Than-Temporary-Impairment." ASC 320 (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC 320, declines in the fair value of held-to-maturity and available-for-sale 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. ASC 320 is effective for interim and annual periods ending after June 15, 2009. We adopted the provisions of ASC 320 on April 1, 2009. Details related to the adoption of ASC 320 and the impact on our disclosures are more fully discussed in Note 4 – Investment Securities. The provisions of ASC 320 did not have an impact on our financial condition and results of operations.

FASB Clarifies Application of Fair Value Accounting: In April 2009, the FASB issued ASC 820 (formerly FSP FAS 157-4), "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly." ASC 820 affirms the objective of fair value when a market is not active, clarifies and includes additional factors for determining whether there has been a significant decrease in market activity, eliminates the presumption that all transactions are distressed unless proven otherwise, and requires an entity to disclose a change in valuation technique. ASC 820 is effective for interim and annual periods ending after June 15, 2009. We adopted the provisions of ASC 820 on April 1, 2009. The provisions of ASC 820 did not have a material impact on our financial condition and results of operations.

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Earnings Per Share (EPS): In June 2008, the FASB issued ASC 260 (formerly FSP EITF 03-6-1), "Determining Whether Instruments Granted in Shared-Based Payment Transaction are Participating Securities." ASC 260 clarifies that unvested share-based payment awards with a right to receive nonforfeitable dividends are participating securities. ASC 260 also provides guidance on how to allocate earnings to participating securities and compute EPS using the two-class method. ASC 260 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those years. All prior-period EPS data presented shall be adjusted retrospectively (including interim financial statements, summaries of earnings, and selected financial data) to conform with the provisions of ASC 260. The provisions of ASC 260 did not have a material impact on our EPS calculation.

Disclosures About Derivative Instruments and Hedging Activities: In March 2008, the FASB issued ASC 815 (formerly Statement No. 161), "Disclosures About Derivative Instruments and Hedging Activities". ASC 815 requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative agreements. ASC 815 is effective for fiscal years beginning after November 15, 2008. We adopted the provisions of ASC 815 on January 1, 2009. The required disclosures are included in Note 6– Financial Instruments with Off-Balance Sheet Risk and Derivative Transactions.

Noncontrolling Interests in Consolidated Financial Statements: In December 2007, the FASB issued ASC 810 (formerly Statement No. 160), "Noncontrolling Interests in Consolidated Financial Statements. ASC 810 requires that a noncontrolling interest in a subsidiary be reported separately within equity and the amount of consolidated net income specifically attributable to the noncontrolling interest be identified in the consolidated financial statements. It also calls for consistency in the manner of reporting changes in the parent's ownership interest and requires fair value measurement of any noncontrolling equity investment retained in a deconsolidation. ASC 810 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. We adopted the provisions of ASC 810 on January 1, 2009. The provisions of ASC 810 did not have an impact on our financial condition and results of operations.

Business Combinations: In December 2007, the FASB issued ASC 805 (formerly Statement No. 141R), "Business Combinations". ASC 805 broadens the guidance and , extends its applicability to all transactions and other events in which one entity obtains control over one or more other businesses. It broadens the fair value measurement and recognition of assets acquired, liabilities assumed, and interests transferred as a result of business combinations. ASC 805 expands on required disclosures to improve the statement users' abilities to evaluate the nature and financial effects of business combinations. ASC 805 is effective for the first annual reporting period beginning on or after December 15, 2008. In April 2009, the FASB amended the guidance in ASC 805 and is effective for the first annual reporting period beginning on or after December 15, 2008. The provisions of ASC 805 will only impact us if we are party to a business combination closing on or after January 1, 2009.

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Note 4. 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, 2009				
U.S. Treasury and Federal agencies securities	$393,345	$2,055	$(20)	$395,380
U.S. State and political subdivisions securities	202,265	7,396	(2,034)	207,627
Mortgage-backed securities - Federal agencies	254,715	6,797	(934)	260,578
Corporate debt securities	18,978	200	-	19,178
Foreign government securities	675	-	-	675
Total debt securities	869,978	16,448	(2,988)	883,438
Marketable equity securities	1,288	2,076	(25)	3,339
Total investment securities available-for-sale	$871,266	$18,524	$(3,013)	$886,777
December 31, 2008				
U.S. Treasury and Federal agencies securities	$293,461	$2,892	$(2)	$296,351
U.S. State and political subdivisions securities	198,640	3,995	(1,686)	200,949
Mortgage-backed securities - Federal agencies	207,954	3,553	(1,499)	210,008
Corporate debt securities	10,000	50	-	10,050
Foreign government and other securities	929	-	-	929
Total debt securities	710,984	10,490	(3,187)	718,287
Marketable equity securities	4,396	2,092	(21)	6,467
Total investment securities available-for-sale	$715,380	$12,582	$(3,208)	$724,754

The contractual maturities of debt securities available-for-sale at September 30, 2009, 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	$120,555	$120,914
Due after one year through five years	334,454	339,827
Due after five years through ten years	141,996	145,527
Due after ten years	18,258	16,592
Mortgage backed securities	254,715	260,578
Total debt securities available-for-sale	$869,978	$883,438

At September 30, 2009, the 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.

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. The gross gains in the third quarter of 2009 reflect gains on the sale of our remaining FHLMC preferred stock. The gross losses in the third quarter and year-to-date 2008 reflect other-than-temporary impairment ("OTTI") writedowns of $9.00 million and $10.26 million, respectively, on FNMA, FHLMC and other corporate preferred stock. There have been no OTTI writedowns in 2009. There were net gains of $27 thousand and $0 recorded on $0.12 million and $0.10 million in trading securities outstanding at September 30, 2009, and December 31, 2008, respectively.

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(Dollars in thousands)	Three Months Ended September 30, 2009	2008	Nine Months Ended September 30, 2009	2008
Gross realized gains	$356	$-	$1,010	$826
Gross realized losses	-	(8,999)	(707)	(10,456)
Net realized gains (losses)	$356	$(8,999)	$303	$(9,630)

The following tables summarize our 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, 2009						
U.S. Treasury and Federal agencies securities	$30,166	$(20)	$-	$-	$30,166	$(20)
U.S. State and political subdivisions securities	1,717	(29)	17,121	(2,005)	18,838	(2,034)
Mortgage-backed securities - Federal agencies	31,140	(324)	30,388	(610)	61,528	(934)
Total debt securities	63,023	(373)	47,509	(2,615)	110,532	(2,988)
Marketable equity securities	2	(1)	5	(24)	7	(25)
Total investment securities available-for-sale	$63,025	$(374)	$47,514	$(2,639)	$110,539	$(3,013)
December 31, 2008						
U.S. Treasury and Federal agencies securities	$19,998	$(2)	$-	$-	$19,998	$(2)
U.S. State and political subdivisions securities	29,594	(1,686)	-	-	29,594	(1,686)
Mortgage-backed securities - Federal agencies	14,840	(229)	34,721	(1,270)	49,561	(1,499)
Foreign government and other securities	493	(1)	-	-	493	(1)
Total debt securities	64,925	(1,918)	34,721	(1,270)	99,646	(3,188)
Marketable equity securities	11	(18)	2	(2)	13	(20)
Total investment securities available-for-sale	$64,936	$(1,936)	$34,723	$(1,272)	$99,659	$(3,208)

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 September 30, 2009, 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 a 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. 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 September 30, 2009, we believe the impairments detailed in the table above are temporary and no impairment loss has been realized in our consolidated income statement.

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Note 5. 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 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.

We have certain interest rate derivative positions that 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. Changes in the fair value are included in other expense. The fair value of interest rate swap positions is determined 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.

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 and changes in the fair value are recorded to mortgage banking income. Fair value of mortgage loan commitments is determined 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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Fair values of derivative instruments as of September 30, 2009:

(Dollars in thousands)	Notional or contractual amount	Asset derivatives Balance sheet location	Asset derivatives Fair value	Liability derivatives Balance sheet location	Liability derivatives Fair value
Derivatives not designated as hedging instruments					
Interest rate swap contracts	$ 436,801	Other assets	$ 16,507	Other liabilities	$ 16,900
Loan commitments	51,421	Mortgages held for sale	305	N/A	-
Forward contracts	55,119	N/A	-	Mortgages held for sale	671
Total			$ 16,812		$ 17,571

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 $45.89 million and $82.18 million at September 30, 2009, and December 31, 2008, respectively. Standby letters of credit generally have terms ranging from six months to one year.

Note 7. Stock-Based Compensation

As of September 30, 2009, we had five stock-based employee compensation plans, which are more fully described in Note L of the Consolidated Financial Statements in 1st Source's Annual Report on Form 10-K for the year ended December 31, 2008. These plans include two stock option plans, the Employee Stock Purchase Plan, the Executive Incentive Plan, and the Restricted Stock Award Plan.

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

The stock-based compensation expense recognized in the condensed consolidated statement of operations for the nine months ended September 30, 2009 and 2008 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.

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 2009 (September 30, 2009)

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and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on September 30, 2009. This amount changes based on the fair market value of 1st Source's stock. Total fair value of options vested and expensed was $9 thousand and $12 thousand, net of tax, for the nine months ended September 30, 2009 and 2008, respectively.

	September 30, 2009			
	Number of Shares	Weighted Average Exercise Price	Average Remaining Contractual Term (in years)	Total Intrinsic Value (in 000's)
Options outstanding, beginning of year	80,948	$18.51		
Granted	-	-		
Exercised	-	-		
Forfeited	-	-		
Options outstanding, September 30, 2009	80,948	$18.51	2.09	$94
Vested and expected to vest at September 30, 2009	80,948	$18.51	2.09	$94
Exercisable at September 30, 2009	75,448	$18.99	1.98	$70

No options were granted during the nine months ended September 30, 2009.

As of September 30, 2009, there was $2.41 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 3.46 years.

The following table summarizes information about stock options outstanding at September 30, 2009:

	Options Outstanding			Options Exercisable	
		Weighted Average	Weighted		Weighted
Range of	Number				