1ST SOURCE CORP
Form 10-Q
July 20, 2017
Table of Contents

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 June 30, 2017

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, IN	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. 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, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth 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

Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section13(a) of the Exchange Act. 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 July 14, 2017 — 25,935,324 shares

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Table of Contents

TABLE OF CONTENTS

		Page
PART I. FINANCIAL INFORMATION		
Item 1.	Financial Statements (Unaudited)	
	Consolidated Statements of Financial Condition — June 30, 2017 and December 31, 2016	3
	Consolidated Statements of Income — three and six months ended June 30, 2017 and 2016	4
	Consolidated Statements of Comprehensive Income — three and six months ended June 30, 2017 and 2016	5
	Consolidated Statements of Shareholders' Equity — six months ended June 30, 2017 and 2016	5
	Consolidated Statements of Cash Flows — six months ended June 30, 2017 and 2016	6
	Notes to the Consolidated Financial Statements	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	30
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	39
Item 4.	Controls and Procedures	39
PART II. OTHER INFORMATION		
Item 1.	Legal Proceedings	40
Item 1A.	Risk Factors	40
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	40
Item 3.	Defaults Upon Senior Securities	40
Item 4.	Mine Safety Disclosures	40
Item 5.	Other Information	40
Item 6.	Exhibits	41
SIGNATURES		42
EXHIBITS		
	Exhibit 31.1	
	Exhibit 31.2	
	Exhibit 32.1	
	Exhibit 32.2	

Table of Contents

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

	June 30, 2017	December 31, 2016
ASSETS		
Cash and due from banks	$63,473	$58,578
Federal funds sold and interest bearing deposits with other banks	12,561	49,726
Investment securities available-for-sale	850,314	850,467
Other investments	24,238	22,458
Mortgages held for sale	16,204	15,849
Loans and leases, net of unearned discount:		
Commercial and agricultural	876,404	812,264
Auto and light truck	512,021	411,764
Medium and heavy duty truck	290,687	294,790
Aircraft	787,516	802,414
Construction equipment	539,097	495,925
Commercial real estate	720,078	719,170
Residential real estate and home equity	526,592	521,931
Consumer	128,919	129,813
Total loans and leases	4,381,314	4,188,071
Reserve for loan and lease losses	(91,914)	(88,543)
Net loans and leases	4,289,400	4,099,528
Equipment owned under operating leases, net	144,509	118,793
Net premises and equipment	54,783	56,708
Goodwill and intangible assets	83,848	84,102
Accrued income and other assets	147,900	130,059
Total assets	$5,687,230	$5,486,268
LIABILITIES		
Deposits:		
Noninterest-bearing demand	$979,801	$991,256
Interest-bearing deposits:		
Interest-bearing demand	1,519,419	1,471,526
Savings	832,341	814,326
Time	1,150,475	1,056,652
Total interest-bearing deposits	3,502,235	3,342,504
Total deposits	4,482,036	4,333,760
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	148,109	162,913
Other short-term borrowings	158,474	129,030
Total short-term borrowings	306,583	291,943
Long-term debt and mandatorily redeemable securities	70,438	74,308
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	70,207	54,843
Total liabilities	4,988,028	4,813,618

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 28,205,674 at June 30, 2017 and December 31, 2016	436,538	436,538
Retained earnings	314,889	290,824
Cost of common stock in treasury (2,270,350 shares at June 30, 2017 and 2,329,909 shares at December 31, 2016)	(54,662)	(56,056)
Accumulated other comprehensive income	2,437	1,344
Total shareholders’ equity	699,202	672,650
Total liabilities and shareholders’ equity	$5,687,230	$5,486,268

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

Table of Contents

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Interest income:				
Loans and leases	$48,032	$ 43,891	$92,916	$ 86,627
Investment securities, taxable	3,370	3,040	6,884	6,120
Investment securities, tax-exempt	677	697	1,360	1,389
Other	319	309	610	600
Total interest income	52,398	47,937	101,770	94,736
Interest expense:				
Deposits	4,511	3,790	8,245	7,561
Short-term borrowings	272	119	499	280
Subordinated notes	1,055	1,055	2,110	2,110
Long-term debt and mandatorily redeemable securities	699	680	1,328	1,203
Total interest expense	6,537	5,644	12,182	11,154
Net interest income	45,861	42,293	89,588	83,582
Provision for loan and lease losses	2,738	2,049	3,738	3,024
Net interest income after provision for loan and lease losses	43,123	40,244	85,850	80,558
Noninterest income:				
Trust and wealth advisory	5,627	5,108	10,628	9,731
Service charges on deposit accounts	2,464	2,276	4,703	4,383
Debit card	2,986	2,816	5,736	5,415
Mortgage banking	1,304	1,115	2,251	2,161
Insurance commissions	1,310	1,233	3,077	2,796
Equipment rental	7,586	6,517	14,418	12,590
Gains (losses) on investment securities available-for-sale	465	(209)	1,750	(199)
Other	2,394	3,441	4,880	7,047
Total noninterest income	24,136	22,297	47,443	43,924
Noninterest expense:				
Salaries and employee benefits	20,712	21,194	42,057	42,545
Net occupancy	2,368	2,307	4,962	4,808
Furniture and equipment	5,108	4,811	9,901	9,601
Depreciation – leased equipment	6,296	5,444	11,976	10,545
Professional fees	1,672	1,190	2,749	2,409
Supplies and communication	1,345	1,374	2,595	2,882
FDIC and other insurance	573	911	1,196	1,790
Business development and marketing	1,501	1,025	3,153	2,005
Loan and lease collection and repossession	329	385	965	812
Other	1,201	1,393	2,670	3,342
Total noninterest expense	41,105	40,034	82,224	80,739
Income before income taxes	26,154	22,507	51,069	43,743
Income tax expense	9,485	8,028	18,194	15,446
Net income	$16,669	$ 14,479	$32,875	$ 28,297
Per common share:				
Basic net income per common share	$0.64	$ 0.56	$1.26	$ 1.08

Diluted net income per common share	$0.64	$ 0.56	$1.26	$ 1.08
Cash dividends	$0.19	$ 0.18	$0.37	$ 0.36
Basic weighted average common shares outstanding	25,927,032	25,853,537	25,915,280	25,888,534
Diluted weighted average common shares outstanding	25,927,032	25,853,537	25,915,280	25,888,534

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

Table of Contents

1st SOURCE CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited - Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net income	$16,669	$14,479	$32,875	$28,297
Other comprehensive income:				
Change in unrealized appreciation of available-for-sale securities	2,242	2,244	3,500	6,647
Reclassification adjustment for realized (gains) losses included in net income	(465)	209	(1,750)	199
Income tax effect	(667)	(921)	(657)	(2,570)
Other comprehensive income, net of tax	1,110	1,532	1,093	4,276
Comprehensive income	$17,779	$16,011	$33,968	$32,573

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)

	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net	Total
Balance at January 1, 2016	$ —	$436,538	$251,812	$(50,852)	$ 6,555	$644,053
Net income	—	—	28,297	—	—	28,297
Other comprehensive income	—	—	—	—	4,276	4,276
Issuance of 104,853 common shares under stock based compensation awards, including related tax effects	—	—	4	2,500	—	2,504
Cost of 269,667 shares of common stock acquired for treasury	—	—	—	(8,005)	—	(8,005)
Common stock cash dividend ($0.36 per share)	—	—	(9,369)	—	—	(9,369)
Balance at June 30, 2016	$ —	$436,538	$270,744	$(56,357)	$ 10,831	$661,756
Balance at January 1, 2017	$ —	$436,538	$290,824	$(56,056)	$ 1,344	$672,650
Cumulative-effect adjustment	—	—	(65)	—	—	(65)
Balance at January 1, 2017, adjusted	—	436,538	290,759	(56,056)	1,344	672,585
Net income	—	—	32,875	—	—	32,875
Other comprehensive income	—	—	—	—	1,093	1,093
Issuance of 60,459 common shares under stock based compensation awards	—	—	870	1,435	—	2,305
Cost of 900 shares of common stock acquired for treasury	—	—	—	(41)	—	(41)
Common stock cash dividend ($0.37 per share)	—	—	(9,615)	—	—	(9,615)
Balance at June 30, 2017	$ —	$436,538	$314,889	$(54,662)	$ 2,437	$699,202

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

Table of Contents

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

	Six Months Ended June 30,	
	2017	2016
Operating activities:		
Net income	$32,875	$28,297
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	3,738	3,024
Depreciation of premises and equipment	2,758	2,596
Depreciation of equipment owned and leased to others	11,976	10,545
Stock-based compensation	720	1,399
Amortization of investment securities premiums and accretion of discounts, net	2,402	2,553
Amortization of mortgage servicing rights	551	716
Deferred income taxes	(1,222)	(742)
(Gains) losses on investment securities available-for-sale	(1,750)	199
Originations of loans held for sale, net of principal collected	(44,472)	(50,830)
Proceeds from the sales of loans held for sale	45,420	46,151
Net gain on sale of loans held for sale	(1,303)	(1,420)
Net loss (gain) on sale of other real estate and repossessions	75	(135)
Change in interest receivable	(224)	(173)
Change in interest payable	357	907
Change in other assets	(579)	(4,127)
Change in other liabilities	4,712	8,177
Other	1,695	(857)
Net change in operating activities	57,729	46,280
Investing activities:		
Proceeds from sales of investment securities available-for-sale	1,766	3,956
Proceeds from maturities and paydowns of investment securities available-for-sale	93,098	108,215
Purchases of investment securities available-for-sale	(94,117)	(130,607)
Proceeds from liquidation of partnership investment	—	1,472
Net change in other investments	(1,780)	—
Loans sold or participated to others	6,579	—
Net change in loans and leases	(206,166)	(159,218)
Net change in equipment owned under operating leases	(37,692)	(19,486)
Purchases of premises and equipment	(1,017)	(3,991)
Proceeds from sales of other real estate and repossessions	2,042	714
Net change in investing activities	(237,287)	(198,945)
Financing activities:		
Net change in demand deposits and savings accounts	54,453	117,906
Net change in time deposits	93,823	67,992
Net change in short-term borrowings	14,640	(27,253)
Proceeds from issuance of long-term debt	19,999	10,832
Payments on long-term debt	(25,790)	(5,703)
Stock issued under stock purchase plans	153	116
Acquisition of treasury stock	(41)	(8,005)
Cash dividends paid on common stock	(9,949)	(9,700)
Net change in financing activities	147,288	146,185

Net change in cash and cash equivalents	(32,270)	(6,480)
Cash and cash equivalents, beginning of year	108,304	79,721
Cash and cash equivalents, end of period	$76,034	$73,241
Supplemental Information:		
Non-cash transactions:		
Loans transferred to other real estate and repossessed assets	$5,977	$1,469
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan	1,426	800

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

Table of Contents

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

Note 1. Accounting Policies

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.

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 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 (2016 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The Consolidated Statement of Financial Condition at December 31, 2016 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by GAAP for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current year presentation.

Use of Estimates in the Preparation of Financial Statements – Financial statements prepared in accordance with GAAP require the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expense during the reporting period. Actual results could differ from those estimates.

Loans and Leases – Loans are stated at the principal amount outstanding, net of unamortized deferred loan origination fees and costs and net of unearned income. Interest income is accrued as earned based on unpaid principal balances. Origination fees and direct loan and lease origination costs are deferred and the net amount amortized to interest income over the estimated life of the related loan or lease. Loan commitment fees are deferred and amortized into other income over the commitment period.

Direct financing leases are carried at the aggregate of lease payments plus estimated residual value of the leased property, net of unamortized deferred lease origination fees and costs and unearned income. Interest income on direct financing leases is recognized over the term of the lease to achieve a constant periodic rate of return on the outstanding investment.

The accrual of interest on loans and leases is discontinued when a loan or lease becomes contractually delinquent for 90 days, or when an individual analysis of a borrower's credit worthiness indicates a credit should be placed on nonperforming status, except for residential mortgage loans and consumer loans that are well secured and in the process of collection. Residential mortgage loans are placed on nonaccrual at the time the loan is placed in foreclosure. When interest accruals are discontinued, interest credited to income in the current year is reversed and interest accrued in the prior year is charged to the reserve for loan and lease losses. However, in some cases, the Company may elect to continue the accrual of interest when the net realizable value of collateral is sufficient to cover the principal and accrued interest. When a loan or lease is classified as nonaccrual and the future collectibility of the recorded loan or lease balance is doubtful, collections on interest and principal are applied as a reduction to principal outstanding. Loans are returned to accrual status when all principal and interest amounts contractually due are brought current and future payments are reasonably assured, which is typically evidenced by a sustained repayment performance of at least six months.

A loan or lease is considered impaired, based on current information and events, if it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan or lease agreement. Interest on impaired loans and leases, which are not classified as nonaccrual, is recognized on the accrual basis. The Company evaluates loans and leases exceeding $100,000 for impairment and establishes a specific reserve as a component of the reserve for loan and lease losses when it is probable all amounts

due will not be collected pursuant to the contractual terms of the loan or lease and the recorded investment in the loan or lease exceeds its fair value.

Loans and leases that have been modified and economic concessions have been granted to borrowers who have experienced financial difficulties are considered a troubled debt restructuring (TDR) and, by definition, are deemed an impaired loan. These concessions typically result from the Company's loss mitigation activities and may include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Certain TDRs are classified as nonperforming at the time of restructuring and typically are returned to performing status after considering the borrower's sustained repayment performance for a reasonable period of at least six months.

Table of Contents

When the Company modifies loans and leases in a TDR, it evaluates any possible impairment similar to other impaired loans based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan or lease agreement, or uses the current fair value of the collateral, less selling costs for collateral dependent loans. If the Company determines that the value of the modified loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through a reserve for loan and lease losses estimate or a charge-off to the reserve for loan and lease losses. In periods subsequent to modification, the Company evaluates all TDRs, including those that have payment defaults, for possible impairment and recognizes impairment through the reserve for loan and lease losses.

Note 2 — Recent Accounting Pronouncements

Share Based Payment Awards: In May 2017, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2017-09 “Compensation - Stock Compensation (Topic 718), Scope of Modification Accounting.” These amendments provide guidance on determining which changes to the terms and conditions of share-based payment awards require an entity to apply modification accounting under Topic 718. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early adoption is permitted, including adoption in an interim period. The amendments should be applied on a prospective basis to an award modified on or after the adoption date. The Company is assessing the impact of ASU 2017-09 and does not expect it to have a material impact on its accounting and disclosures.

Premium Amortization: In March 2017, the FASB issued ASU No. 2017-08 “Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities.” These amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company is assessing the impact of ASU 2017-08 on its accounting and disclosures.

Sale of Nonfinancial Assets: In February 2017, the FASB issued ASU No. 2017-05 “Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets.” 'The amendments clarify that a financial asset is within the scope of Subtopic 610-20 if it meets the definition of an in substance nonfinancial asset. The amendments also define the term in substance nonfinancial asset. The amendments clarify that nonfinancial assets within the scope of Subtopic 610-20 may include nonfinancial assets transferred within a legal entity to a counterparty. For example, a parent may transfer control of nonfinancial assets by transferring ownership interests in a consolidated subsidiary. A contract that includes the transfer of ownership interests in one or more consolidated subsidiaries is within the scope of Subtopic 610-20 if substantially all of the fair value of the assets that are promised to the counterparty in a contract is concentrated in nonfinancial assets. The amendments clarify that an entity should identify each distinct nonfinancial asset or in substance nonfinancial asset promised to a counterparty and derecognize each asset when a counterparty obtains control of it. The guidance is effective for public business entities for annual periods beginning after December 15, 2017 and interim periods therein. Entities may use either a full or modified approach to adopt the ASU. The Company is assessing ASU 2017-05 and does not expect it to have a material impact on its accounting and disclosures.

Simplifying the Test for Goodwill Impairment: In January 2017, the FASB issued ASU No. 2017-04 “Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment.” These amendments eliminate Step 2 from the goodwill impairment test. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The guidance is effective for annual or any interim

goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. ASU 2017-04 should be adopted on a prospective basis. The Company has assessed ASU 2017-04 and does not expect it to have a material impact on its accounting and disclosures.

Business Combinations: In January 2017, the FASB issued ASU No. 2017-01 “Business Combinations (Topic 805) - Clarifying the Definition of a Business.” ASU 2017-01 provides amendments to clarify the definition of a business and affect all companies and other reporting organizations that must determine whether they have acquired or sold a business. The amendments are intended to help companies and other organizations evaluate whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and should be applied prospectively as of the beginning of the period of adoption. Early adoption is permitted under certain circumstances. The Company has assessed ASU 2017-01 and does not expect it to have a material impact on its accounting and disclosures.

Table of Contents

Restricted Cash: In November 2016, the FASB issued ASU No. 2016-18 “Statement of Cash Flows (Topic 230) - Restricted Cash.” ASU 2016-18 provides amendments to cash flow statement classification and presentation to explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and should be applied using a retrospective transition method to each period presented. Early adoption is permitted, including adoption in an interim period. The Company has assessed ASU 2016-18 and does not expect a material impact on its accounting and disclosures.

Intra-Entity Transfers of Assets Other Than Inventory: In October 2016, the FASB issued ASU No. 2016-16 “Income Taxes (Topic 740) - Intra-Entity Transfers of Assets Other Than Inventory.” The amendments in ASU 2016-16 require an entity to recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. The amendments eliminate the exception for an intra-entity transfer of an asset other than inventory. The amendments do not include new disclosure requirements; however existing disclosure requirements might be applicable when accounting for the current and deferred income taxes for an intra-entity transfer of an asset other than inventory. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years and should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The Company has assessed ASU 2016-16 and does not expect a material impact on its accounting and disclosures.

Classification of Certain Cash Receipts and Cash Payments: In August 2016, the FASB issued ASU No. 2016-15 “Statement of Cash Flows (Topic 230) - Classification of Certain Cash Receipts and Cash Payments.” ASU 2016-15 provides cash flow statement classification guidance for certain transactions including how the predominance principle should be applied when cash receipts and cash payments have aspects of more than one class of cash flows. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years and should be applied retrospectively. Early adoption is permitted, including adoption in an interim period. The Company has assessed ASU 2016-15 and does not expect a material impact on its accounting and disclosures.

Measurement of Credit Losses on Financial Instruments: In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments-Credit Losses (Topic 326) - Measurement of Credit Losses on Financial Instruments.” The provisions of ASU 2016-13 were issued to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments that are not accounted for at fair value through net income, including loans held for investment, held-to-maturity debt securities, trade and other receivables, net investment in leases and other commitments to extend credit held by a reporting entity at each reporting date. ASU 2016-13 requires that financial assets measured at amortized cost be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The amendments in ASU 2016-13 eliminate the probable incurred loss recognition in current GAAP and reflect an entity’s current estimate of all expected credit losses. The measurement of expected credit losses is based upon historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the financial assets.

For purchased financial assets with a more-than-insignificant amount of credit deterioration since origination (“PCD assets”) that are measured at amortized cost, the initial allowance for credit losses is added to the purchase price rather than being reported as a credit loss expense. Subsequent changes in the allowance for credit losses on PCD assets are recognized through the statement of income as a credit loss expense.

Credit losses relating to available-for-sale debt securities will be recorded through an allowance for credit losses rather than as a direct write-down to the security.

ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company has an implementation team working through the provisions of ASU 2016-13 including assessing the impact on its accounting and disclosures.

Share Based Payment Accounting: In March 2016, the FASB issued ASU No. 2016-09 "Compensation - Stock Compensation (Topic 718) - Improvements to Employee Share-Based Payment Accounting." ASU 2016-09 requires all income tax effects of awards to be recognized in the income statement when the awards vest or are settled. It also allows an employer to repurchase more of an employee's shares than it can today for tax withholding purposes without triggering liability accounting and to make a policy election for forfeitures as they occur. The guidance is effective for public business entities for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted. The Company adopted ASU 2016-09 on January 1, 2017 on a modified retrospective method through a cumulative adjustment to retained earnings related to the policy election to account for forfeitures as they occur. The adoption of ASU 2016-09 did not have a material impact on its accounting and disclosures.

Table of Contents

Leases: In February 2016, the FASB issued ASU No. 2016-02 “Leases (Topic 842).” ASU 2016-02 establishes a right of use model that requires a lessee to record a right of use asset and a lease liability for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement. For lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. A lease will be treated as sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn’t convey risks and rewards or control, an operating lease results. The amendments are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years for public business entities. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements, with certain practical expedients available. Early adoption is permitted. The Company has an implementation team working through the provisions of ASU 2016-02 including reviewing all leases to assess the impact on its accounting and disclosures. The Company does not anticipate a significant increase in lessee activity between now and the date of adoption. It is expected that the Company will recognize discounted right of use assets and lease liabilities (estimated between $12 and $15 million).

Recognition and Measurement of Financial Instruments: In January 2016, the FASB issued ASU No. 2016-01 “Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income; requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured and amortized at cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. The Company is continuing to assess the impact of ASU 2016-01 on its accounting for equity investments, fair value disclosures and other disclosure requirements.

Revenue from Contracts with Customers: In May 2014, the FASB issued ASU No. 2014-09 “Revenue from Contracts with Customers (Topic 606).” The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. On July 9, 2015, the FASB approved amendments deferring the effective date by one year. ASU 2014-09 is now effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. Early application is permitted but not before the original public entity effective date, i.e., annual periods beginning after December 15, 2016. In March 2016, the FASB issued final amendments (ASU No. 2016-08 and ASU No. 2016-10) to clarify the implementation guidance for principal versus agent considerations, identifying performance obligations and the accounting for licenses of intellectual property. The amendments can be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this Update recognized at the date of initial application. In May 2016, the FASB issued final amendments (ASU No. 2016-12 and ASU 2016-11) to address narrow-scope improvements to the guidance on collectibility, non-cash consideration, completed contracts at transition and to provide a practical expedient for contract modifications at transition and an accounting policy election related to the presentation of sales taxes and other similar taxes collected from customers. Additionally, the amendments included a rescission of SEC guidance because of ASU 2014-09 related to revenue and expense recognition for freight services in process,

accounting for shipping and handling fees and costs, and accounting for consideration given by a vendor to a customer. In December 2016, the FASB issued final guidance (ASU 2016-20) that allows entities not to make quantitative disclosures about performance obligations in certain cases and requires entities that use any of the new or previously existing optional exemptions to expand their qualitative disclosures. It also makes 12 additional technical corrections and improvements to the new revenue standard. These amendments are effective upon the adoption of ASU 2014-09. The Company's revenue is comprised of net interest income, which is explicitly excluded from the scope of ASU 2014-09, and noninterest income. ASU 2014-09 may require the Company to change how it recognizes certain recurring revenue streams related to noninterest income; however it is not expected to have a material impact on its accounting and disclosures. The Company continues to follow the guidance from the FASB and the Transition Resource Group for Revenue Recognition in determining the impact of ASU 2014-09 on other areas of noninterest income and expects to adopt ASU 2014-09 on January 1, 2018.

Table of Contents

Note 3. Investment Securities Available-For-Sale

The following table shows investment securities available-for-sale.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2017				
U.S. Treasury and Federal agencies securities	$430,782	$ 725	$ (2,610)	$428,897
U.S. States and political subdivisions securities	127,214	1,559	(489)	128,284
Mortgage-backed securities — Federal agencies	255,747	2,110	(2,159)	255,698
Corporate debt securities	31,621	64	(159)	31,526
Foreign government and other securities	300	2	—	302
Total debt securities	845,664	4,460	(5,417)	844,707
Marketable equity securities	749	4,859	(1)	5,607
Total investment securities available-for-sale	$846,413	$ 9,319	$ (5,418)	$850,314
December 31, 2016				
U.S. Treasury and Federal agencies securities	$424,495	$ 809	$ (4,471)	$420,833
U.S. States and political subdivisions securities	133,509	1,036	(1,570)	132,975
Mortgage-backed securities — Federal agencies	252,981	2,175	(2,582)	252,574
Corporate debt securities	35,266	111	(301)	35,076
Foreign government and other securities	800	7	—	807
Total debt securities	847,051	4,138	(8,924)	842,265
Marketable equity securities	1,265	7,007	(70)	8,202
Total investment securities available-for-sale	$848,316	$ 11,145	$ (8,994)	$850,467

At June 30, 2017 and December 31, 2016, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).

The following table shows the contractual maturities of investments in debt securities available-for-sale at June 30, 2017. 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	$ 113,082	$113,466
Due after one year through five years	423,816	422,703
Due after five years through ten years	53,019	52,840
Due after ten years	—	—
Mortgage-backed securities	255,747	255,698
Total debt securities available-for-sale	$ 845,664	$844,707

Table of Contents

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

(Dollars in thousands)	Less than 12 Months Fair Value	Less than 12 Months Unrealized Losses	12 months or Longer Fair Value	12 months or Longer Unrealized Losses	Total Fair Value	Total Unrealized Losses
June 30, 2017						
U.S. Treasury and Federal agencies securities	$267,261	$(2,229)	$22,015	$(381)	$289,276	$(2,610)
U.S. States and political subdivisions securities	35,592	(323)	7,493	(166)	43,085	(489)
Mortgage-backed securities - Federal agencies	125,053	(1,656)	30,536	(503)	155,589	(2,159)
Corporate debt securities	11,910	(159)	—	—	11,910	(159)
Foreign government and other securities	—	—	—	—	—	—
Total debt securities	439,816	(4,367)	60,044	(1,050)	499,860	(5,417)
Marketable equity securities	—	—	3	(1)	3	(1)
Total investment securities available-for-sale	$439,816	$(4,367)	$60,047	$(1,051)	$499,863	$(5,418)
December 31, 2016						
U.S. Treasury and Federal agencies securities	$263,680	$(4,471)	$—	$—	$263,680	$(4,471)
U.S. States and political subdivisions securities	74,129	(1,515)	3,337	(55)	77,466	(1,570)
Mortgage-backed securities - Federal agencies	168,554	(2,341)	5,102	(241)	173,656	(2,582)
Corporate debt securities	13,312	(301)	—	—	13,312	(301)
Foreign government and other securities	—	—	—	—	—	—
Total debt securities	519,675	(8,628)	8,439	(296)	528,114	(8,924)
Marketable equity securities	280	(70)	4	—	284	(70)
Total investment securities available-for-sale	$519,955	$(8,698)	$8,443	$(296)	$528,398	$(8,994)

The initial indication of potential other-than-temporary-impairment (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 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 June 30, 2017, the Company does not have the intent to sell any of the available-for-sale securities in the table above and believes that it is more likely than not, that it will not have to sell any such securities before an anticipated recovery of cost. Primarily the unrealized losses on debt securities are due to increases in market rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

The following table shows the gross realized gains and losses from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses of all securities are computed using the specific identification cost basis.

(Dollars in thousands)	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Gross realized gains	$655	$85	$1,940	$95
Gross realized losses	—	—	—	—
OTTI losses	(190)	(294)	(190)	(294)
Net realized gains (losses)	$465	$(209)	$1,750	$(199)

At June 30, 2017 and December 31, 2016, investment securities available-for-sale with carrying values of $277.31 million and $276.29 million, respectively, were pledged as collateral for security repurchase agreements and for other purposes.

Table of Contents

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 and home equity loans and consumer loans, are assigned credit quality grades on a scale from 1 to 12 with grade 1 representing superior credit quality. The criteria used to assign grades to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on the Company's safety and soundness. Loans or leases graded 7 or weaker are considered "special attention" credits and, as such, relationships in excess of $100,000 are reviewed quarterly as part of management's evaluation of the appropriateness of the reserve for loan and lease losses. Grade 7 credits are defined as "watch" and contain greater than average credit risk and are monitored to limit the exposure to increased risk; grade 8 credits are "special mention" and, following regulatory guidelines, are defined as having potential weaknesses that deserve management's close attention. Credits that exhibit well-defined weaknesses and a distinct possibility of loss are considered "classified" and are graded 9 through 12 corresponding to the regulatory definitions of "substandard" (grades 9 and 10) and the more severe "doubtful" (grade 11) and "loss" (grade 12).

The following table shows 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
June 30, 2017			
Commercial and agricultural	$850,371	$26,033	$876,404
Auto and light truck	494,001	18,020	512,021
Medium and heavy duty truck	285,768	4,919	290,687
Aircraft	766,054	21,462	787,516
Construction equipment	525,618	13,479	539,097
Commercial real estate	711,755	8,323	720,078
Total	$3,633,567	$92,236	$3,725,803
December 31, 2016			
Commercial and agricultural	$784,811	$27,453	$812,264
Auto and light truck	407,931	3,833	411,764
Medium and heavy duty truck	291,558	3,232	294,790
Aircraft	772,802	29,612	802,414
Construction equipment	486,923	9,002	495,925
Commercial real estate	707,252	11,918	719,170
Total	$3,451,277	$85,050	$3,536,327

For residential real estate and home equity and consumer loans, credit quality is based on the aging status of the loan and by payment activity. The following table shows the recorded investment in residential real estate and home equity 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
June 30, 2017			
Residential real estate and home equity	$ 523,380	$ 3,212	$526,592
Consumer	128,677	242	128,919

Total	$ 652,057	$ 3,454	$ 655,511
December 31, 2016			
Residential real estate and home equity	$ 518,896	$ 3,035	$ 521,931
Consumer	129,585	228	129,813
Total	$ 648,481	$ 3,263	$ 651,744

Table of Contents

The following table shows 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
June 30, 2017							
Commercial and agricultural	$ 869,663	$ 422	$ —	$ —	$ 870,085	$ 6,319	$ 876,404
Auto and light truck	511,506	106	—	—	511,612	409	512,021
Medium and heavy duty truck	289,719	670	298	—	290,687	—	290,687
Aircraft	782,213	2,014	1,305	—	785,532	1,984	787,516
Construction equipment	537,610	281	—	—	537,891	1,206	539,097
Commercial real estate	717,312	37	—	—	717,349	2,729	720,078
Residential real estate and home equity	522,035	762	583	155	523,535	3,057	526,592
Consumer	128,230	365	82	23	128,700	219	128,919
Total	$ 4,358,288	$ 4,657	$ 2,268	$ 178	$ 4,365,391	$ 15,923	$ 4,381,314
December 31, 2016							
Commercial and agricultural	$ 808,283	$ —	$ —	$ —	$ 808,283	$ 3,981	$ 812,264
Auto and light truck	411,300	298	—	—	411,598	166	411,764
Medium and heavy duty truck	294,790	—	—	—	294,790	—	294,790
Aircraft	791,559	1,429	3,316	—	796,304	6,110	802,414
Construction equipment	493,131	1,546	—	—	494,677	1,248	495,925
Commercial real estate	713,482	133	—	—	713,615	5,555	719,170
Residential real estate and home equity	517,212	1,310	374	394	519,290	2,641	521,931
Consumer	129,000	453	132	22	129,607	206	129,813
Total	$ 4,158,757	$ 5,169	$ 3,822	$ 416	$ 4,168,164	$ 19,907	$ 4,188,071

Table of Contents

The following table shows 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 Reserve
June 30, 2017			
With no related reserve recorded:			
Commercial and agricultural	$ 196	$ 196	$ —
Auto and light truck	—	—	—
Medium and heavy duty truck	—	—	—
Aircraft	1,768	1,768	—
Construction equipment	1,132	1,132	—
Commercial real estate	588	588	—
Residential real estate and home equity	—	—	—
Consumer	—	—	—
Total with no related reserve recorded	3,684	3,684	—
With a reserve recorded:			
Commercial and agricultural	5,862	5,862	1,240
Auto and light truck	204	204	21
Medium and heavy duty truck	—	—	—
Aircraft	120	120	120
Construction equipment	—	—	—
Commercial real estate	2,089	2,089	126
Residential real estate and home equity	355	357	137
Consumer	—	—	—
Total with a reserve recorded	8,630	8,632	1,644
Total impaired loans	$ 12,314	$ 12,316	$ 1,644
December 31, 2016			
With no related reserve recorded:			
Commercial and agricultural	$ 1,700	$ 1,700	$ —
Auto and light truck	115	115	—
Medium and heavy duty truck	—	—	—
Aircraft	2,918	2,918	—
Construction equipment	605	605	—
Commercial real estate	2,607	2,607	—
Residential real estate and home equity	—	—	—
Consumer	—	—	—
Total with no related reserve recorded	7,945	7,945	—
With a reserve recorded:			
Commercial and agricultural	1,890	1,890	297
Auto and light truck	—	—	—
Medium and heavy duty truck	—	—	—
Aircraft	3,192	3,192	1,076
Construction equipment	562	562	35
Commercial real estate	2,765	2,765	322
Residential real estate and home equity	674	676	148
Consumer	—	—	—
Total with a reserve recorded	9,083	9,085	1,878

Total impaired loans	$ 17,028	$ 17,030	$ 1,878

15

Table of Contents

The following table shows average recorded investment and interest income recognized on impaired loans and leases, segregated by class.

(Dollars in thousands)	Three Months Ended June 30,				Six Months Ended June 30,			
	2017		2016		2017		2016	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural	$7,067	$ —	$3,449	$ —	$4,886	$ 1	$3,579	$ 4
Auto and light truck	182	—	—	—	133	—	—	—
Medium and heavy duty truck	—	—	—	—	—	—	—	—
Aircraft	6,174	—	4,341	—	7,484	—	4,184	—
Construction equipment	1,143	—	514	—	1,152	—	697	—
Commercial real estate	2,720	—	6,100	—	3,312	—	7,251	123
Residential real estate and home equity	356	4	364	4	357	8	365	8
Consumer	—	—	—	—	—	—	—	—
Total	$17,642	$ 4	$14,768	$ 4	$17,324	$ 9	$16,076	$ 135

There was one nonperforming loan and lease modification classified as a troubled debt restructuring (TDR) during the three and six months ended June 30, 2017 and no loan and lease modifications classified as TDR during the three and six months ended June 30, 2016. The classification between nonperforming and performing is determined at the time of modification. Modification programs focus on extending maturity dates or modifying payment patterns with most TDRs experiencing a combination of concessions. Modifications do not result in the contractual forgiveness of principal or interest. There was one modification during 2017 and no modifications during 2016 that resulted in an interest rate reduction below market rate. Consequently, the financial impact of the modification was immaterial. There was one nonperforming TDR which had a payment default within the twelve months following modification during the three and six months ended June 30, 2017 and no TDRs which had payment defaults within the twelve months following modification during the three and six months ended June 30, 2016. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.
The following table shows the recorded investment of loans and leases classified as troubled debt restructurings as of June 30, 2017 and December 31, 2016.

(Dollars in thousands)	June 30, 2017	December 31, 2016
Performing TDRs	$ 355	$ 360
Nonperforming TDRs	2,184	1,642
Total TDRs	$ 2,539	$ 2,002

Note 5. Reserve for Loan and Lease Losses

The reserve for loan and lease loss methodology has been consistently applied for several years, with enhancements instituted periodically. Reserve ratios are reviewed quarterly and revised periodically to reflect recent loss history and to incorporate current risks and trends which may not be recognized in historical data. As the historical charge-off analysis is updated, the Company reviews the look-back periods for each business loan portfolio. Furthermore, a thorough analysis of charge-offs, non-performing asset levels, special attention outstandings and delinquency is performed in order to review portfolio trends and other factors, including specific industry risks and economic conditions, which may have an impact on the reserves and reserve ratios applied to various portfolios. The Company adjusts the calculated historical based ratio as a result of the analysis of environmental factors, principally economic risk and concentration risk. Key economic factors affecting the portfolios are growth in gross domestic product, unemployment rates, housing market trends, commodity prices, inflation and global economic and political issues. Concentration risk is impacted primarily by geographic concentration in Northern Indiana and Southwestern Lower Michigan in the business banking and commercial real estate portfolios and by collateral concentration in the specialty

finance portfolios and exposure to foreign markets by geographic risk.

Table of Contents

The reserve for loan and lease losses is maintained at a level believed to be appropriate by the Company to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting the Company’s best estimate of probable loan and lease losses related to specifically identified impaired loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. For purposes of determining the reserve, the Company has segmented loans and leases into classes based on the associated risk within these segments. The Company has determined that eight classes exist within the loan and lease portfolio. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for impaired loans, formula reserves for each business lending division portfolio including percentage allocations for special attention loans and leases not deemed impaired, and reserves for pooled homogeneous loans and leases. The Company’s evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the three months ended June 30, 2017 and 2016.

(Dollars in thousands)	Commercial and agricultural	Auto and light truck	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer	Total
June 30, 2017									
Balance, beginning of period	$ 15,989	$ 9,772	$ 4,676	$ 32,008	$ 8,932	$ 13,868	$ 3,592	$ 1,281	$ 90,118
Charge-offs	261	61	—	654	27	—	33	150	1,186
Recoveries	89	5	—	15	7	48	16	64	244
Net charge-offs (recoveries)	172	56	—	639	20	(48)	17	86	942
Provision (recovery of provision)	382	1,727	164	453	337	(441)	32	84	2,738
Balance, end of period	$ 16,199	$ 11,443	$ 4,840	$ 31,822	$ 9,249	$ 13,475	$ 3,607	$ 1,279	$ 91,914
June 30, 2016									
Balance, beginning of period	$ 14,735	$ 9,582	$ 4,511	$ 34,240	$ 7,462	$ 13,835	$ 3,643	$ 1,288	$ 89,296
Charge-offs	16	—	—	—	—	—	75	240	331
Recoveries	109	64	2	89	70	34	13	63	444
Net charge-offs (recoveries)	(93)	(64)	(2)	(89)	(70)	(34)	62	177	(113)
Provision (recovery of provision)	7	2,021	(163)	332	(20)	(407)	35	244	2,049
Balance, end of period	$ 14,835	$ 11,667	$ 4,350	$ 34,661	$ 7,512	$ 13,462	$ 3,616	$ 1,355	$ 91,458

The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Commercial and agricultural	Auto and light truck	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer loans	Total
June 30, 2017									
	$ 14,668	$ 8,064	$ 4,740	$ 34,352	$ 8,207	$ 13,677	$ 3,550	$ 1,285	$ 88,543

Balance, beginning of period									
Charge-offs	469	82	—	1,757	27	2	37	370	2,744
Recoveries	684	1,132	—	198	29	98	87	149	2,377
Net charge-offs (recoveries)	(215)	(1,050)	—	1,559	(2)	(96)	(50)	221	367
Provision (recovery of provision)	1,316	2,329	100	(971)	1,040	(298)	7	215	3,738
Balance, end of period	$ 16,199	$ 11,443	$ 4,840	$ 31,822	$ 9,249	$ 13,475	$ 3,607	$ 1,279	$ 91,914
June 30, 2016									
Balance, beginning of period	$ 15,456	$ 9,269	$ 4,699	$ 32,373	$ 7,592	$ 13,762	$ 3,662	$ 1,299	$ 88,112
Charge-offs	216	3	—	—	92	1	129	454	895
Recoveries	200	126	10	227	148	339	16	151	1,217
Net charge-offs (recoveries)	16	(123)	(10)	(227)	(56)	(338)	113	303	(322)
Provision (recovery of provision)	(605)	2,275	(359)	2,061	(136)	(638)	67	359	3,024
Balance, end of period	$ 14,835	$ 11,667	$ 4,350	$ 34,661	$ 7,512	$ 13,462	$ 3,616	$ 1,355	$ 91,458

Table of Contents

The following table shows the reserve for loan and lease losses and recorded investment in loans and leases, segregated by class, separated between individually and collectively evaluated for impairment as of June 30, 2017 and December 31, 2016.

(Dollars in thousands)	Commercial and agricultural	Auto and light truck	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer loans	Total
June 30, 2017									
Reserve for loan and lease losses									
Ending balance, individually evaluated for impairment	$1,240	$21	$—	$120	$—	$126	$137	$—	$1,644
Ending balance, collectively evaluated for impairment	14,959	11,422	4,840	31,702	9,249	13,349	3,470	1,279	90,270
Total reserve for loan and lease losses	$16,199	$11,443	$4,840	$31,822	$9,249	$13,475	$3,607	$1,279	$91,914
Recorded investment in loans									
Ending balance, individually evaluated for impairment	$6,058	$204	$—	$1,888	$1,132	$2,677	$355	$—	$12,314
Ending balance, collectively evaluated for impairment	870,346	511,817	290,687	785,628	537,965	717,401	526,237	128,919	4,369,000
Total recorded investment in loans	$876,404	$512,021	$290,687	$787,516	$539,097	$720,078	$526,592	$128,919	$4,381,314
December 31, 2016									
Reserve for loan and lease losses									
Ending balance, individually evaluated for impairment	$297	$—	$—	$1,076	$35	$322	$148	$—	$1,878
Ending balance, collectively evaluated for impairment	14,371	8,064	4,740	33,276	8,172	13,355	3,402	1,285	86,665
Total reserve for loan and lease losses	$14,668	$8,064	$4,740	$34,352	$8,207	$13,677	$3,550	$1,285	$88,543
Recorded investment in loans									
Ending balance, individually evaluated for impairment	$3,590	$115	$—	$6,110	$1,167	$5,372	$674	$—	$17,028
Ending balance, collectively evaluated	808,674	411,649	294,790	796,304	494,758	713,798	521,257	129,813	4,171,043

for impairment									
Total recorded investment in loans	$812,264	$411,764	$294,790	$802,414	$495,925	$719,170	$521,931	$129,813	$4,188,071

Note 6. Mortgage Servicing Rights

The Company recognizes the rights to service residential mortgage loans for others as separate assets, whether the servicing rights are acquired through a separate purchase or through the sale of originated loans with servicing rights retained. The Company allocates a portion of the total proceeds of a mortgage loan to servicing rights based on the relative fair value. The unpaid principal balance of residential mortgage loans serviced for third parties was $751.14 million and $761.85 million at June 30, 2017 and December 31, 2016, respectively.

Mortgage servicing rights (MSRs) are evaluated for impairment at each reporting date. For purposes of impairment measurement, MSRs 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.

Table of Contents

The following table shows changes in the carrying value of MSRs and the associated valuation allowance.

(Dollars in thousands)	Three Months Ended June 30, 2017	Three Months Ended June 30, 2016	Six Months Ended June 30, 2017	Six Months Ended June 30, 2016
Mortgage servicing rights:				
Balance at beginning of period	$4,281	$4,481	$4,297	$4,608
Additions	246	242	493	447
Amortization	(288)	(384)	(551)	(716)
Sales	—	—	—	—
Carrying value before valuation allowance at end of period	4,239	4,339	4,239	4,339
Valuation allowance:				
Balance at beginning of period	—	—	—	—
Impairment recoveries	—	—	—	—
Balance at end of period	$—	$—	$—	$—
Net carrying value of mortgage servicing rights at end of period	$4,239	$4,339	$4,239	$4,339
Fair value of mortgage servicing rights at end of period	$7,134	$5,553	$7,134	$5,553

At June 30, 2017 and 2016, the fair value of MSRs exceeded the carrying value reported in the Statements of Financial Condition by $2.90 million and $1.21 million, respectively. This difference represents increases in the fair value of certain MSRs that could not be recorded above cost basis.

Mortgage loan contractual servicing fees, including late fees and ancillary income, were $0.69 million and $0.66 million for the three months ended June 30, 2017 and 2016, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were $1.37 million and $1.36 million for the six months ended June 30, 2017 and 2016, respectively. Mortgage loan contractual servicing fees are included in Mortgage Banking on the Statements of Income.

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

Commitments — 1st Source Bank (Bank), a subsidiary of 1st Source Corporation, has made investments directly in various tax-advantaged and other operating partnerships formed by third parties.The Bank’s investments are primarily related to investments promoting affordable housing, community development and renewable energy sources. As a limited partner in these operating partnerships, we are allocated credits and deductions associated with the underlying properties. The Bank has determined that it is not the primary beneficiary of these investments because the general partners have the power to direct the activities that most significantly influence the economic performance of their respective partnerships. At June 30, 2017 and December 31, 2016, investment balances, including all legally binding commitments to fund future investments totaled $27.33 million and $11.14 million, respectively. In addition, the Bank had a liability for all legally binding unfunded commitments of $18.61 million and $4.95 million at June 30, 2017 and December 31, 2016, respectively.

Financial Instruments with Off-Balance-Sheet Risk — 1st Source and its subsidiaries are parties to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Statements of Financial Condition. The following table shows financial instruments whose contract amounts represent credit risk.

(Dollars in thousands)	June 30, 2017	December 31, 2016
Amounts of commitments:		
Loan commitments to extend credit	$893,727	$ 868,267
Standby letters of credit	$27,432	$ 33,397
Commercial and similar letters of credit	$1,594	$ 1,704

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.

Table of Contents

The Bank 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 standby letters of credit which are conditional commitments that guarantee the performance of a client to a third party. The credit risk involved in and collateral obtained when issuing standby letters of credit is essentially the same as that involved in extending loan commitments to clients. Standby letters of credit generally have terms ranging from six months to one year.

Commercial letters of credit are issued specifically to facilitate commerce and typically result in the commitment being drawn on when the underlying transaction is consummated between the customer and the third party. Commercial letters of credit generally have terms ranging from three months to six months.

Note 8. Derivative Financial Instruments

Commitments to originate residential mortgage loans held for sale and forward commitments to sell residential mortgage loans are considered derivative instruments. See Note 7 for further information.

The Company has certain interest rate derivative positions that are not designated as hedging instruments. Derivative assets and liabilities are recorded at fair value on the balance sheet and do take into account the effects of master netting agreements. Master netting agreements allow the Company to settle all derivative contracts held with a single counterparty on a net basis, and to offset net derivative positions with related collateral, where applicable. These derivative positions relate to transactions in which the Company enters into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. In connection with each transaction, the Company agrees to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Company agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to effectively convert a variable rate loan to a fixed rate. Because the terms of the swaps with the customers and the other financial institutions offset each other, with the only difference being counterparty credit risk, changes in the fair value of the underlying derivative contracts are not materially different and do not significantly impact the Company's results of operations.

The following table shows the amounts of non-hedging derivative financial instruments.

		Asset derivatives		Liability derivatives	
(Dollars in thousands)	Notional or contractual amount	Statement of Financial Condition classification	Fair value	Statement of Financial Condition classification	Fair value
June 30, 2017					
Interest rate swap contracts	$ 541,177	Other assets	$ 5,554	Other liabilities	$ 5,657
Loan commitments	16,945	Mortgages held for sale	80	N/A	—
Forward contracts - mortgage loan	30,440	Mortgages held for sale	27	N/A	—
Total	$ 588,562		$ 5,661		$ 5,657
December 31, 2016					
Interest rate swap contracts	$ 570,004	Other assets	$ 6,621	Other liabilities	$ 6,743
Loan commitments	5,527	Mortgages held for sale	43	N/A	—
Forward contracts - mortgage loan	16,525	Mortgages held for sale	222	N/A	—
Total	$ 592,056		$ 6,886		$ 6,743

Table of Contents

The following table shows the amounts included in the Statements of Income for non-hedging derivative financial instruments.

		Gain (loss) Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	Statement of Income classification	2017	2016	2017	2016
Interest rate swap contracts	Other expense	$—	$(43)	$20	$(136)
Interest rate swap contracts	Other income	92	110	211	314
Loan commitments	Mortgage banking	(18)	73	37	121
Forward contracts - mortgage loan	Mortgage banking	117	(175)	(195)	(320)
Total		$191	$(35)	$73	$(21)

The following table shows the offsetting of financial assets and derivative assets.

(Dollars in thousands)	Gross Amounts of Recognized Assets	Gross Amounts Offset in the Statement of Financial Condition	Net Amounts of Assets Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition: Financial Instruments	Gross Amounts Not Offset in the Statement of Financial Condition: Cash Collateral Received	Net Amount
June 30, 2017						
Interest rate swaps	$ 5,590	$ 36	$ 5,554	$ —	$ —	$ 5,554
December 31, 2016						
Interest rate swaps	$ 6,681	$ 60	$ 6,621	$ —	$ —	$ 6,621

The following table shows the offsetting of financial liabilities and derivative liabilities.

(Dollars in thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statement of Financial Condition	Net Amounts of Liabilities Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition: Financial Instruments	Gross Amounts Not Offset in the Statement of Financial Condition: Cash Collateral Pledged	Net Amount
June 30, 2017						
Interest rate swaps	$ 5,693	$ 36	$ 5,657	$ —	$ 4,939	$ 718
Repurchase agreements	148,109	—	148,109	148,109	—	—
Total	$ 153,802	$ 36	$ 153,766	$ 148,109	$ 4,939	$ 718
December 31, 2016						
Interest rate swaps	$ 6,803	$ 60	$ 6,743	$ —	$ 3,794	$ 2,949
Repurchase agreements	162,913	—	162,913	162,913	—	—
Total	$ 169,716	$ 60	$ 169,656	$ 162,913	$ 3,794	$ 2,949

If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions. At June 30, 2017 and December 31, 2016, repurchase agreements had a remaining contractual maturity of $146.45 million and $160.38 million in overnight, $1.66 million and $2.23 million in up to 30 days, and $0.00 million and $0.30 million in greater than 90 days, respectively and were collateralized by U.S. Treasury and Federal agencies securities.

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.

Table of Contents

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. There were no stock options outstanding as of June 30, 2017 and 2016.
The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share.

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands - except per share amounts)	2017	2016	2017	2016
Distributed earnings allocated to common stock	$4,923	$ 4,653	$9,586	$ 9,339
Undistributed earnings allocated to common stock	11,618	9,728	23,040	18,745
Net earnings allocated to common stock	16,541	14,381	32,626	28,084
Net earnings allocated to participating securities	128	98	249	213
Net income allocated to common stock and participating securities	$16,669	$ 14,479	$32,875	$ 28,297
Weighted average shares outstanding for basic earnings per common share	25,927,032	25,853,537	25,915,280	25,888,534
Dilutive effect of stock compensation	—	—	—	—
Weighted average shares outstanding for diluted earnings per common share	25,927,032	25,853,537	25,915,280	25,888,534
Basic earnings per common share	$0.64	$ 0.56	$1.26	$ 1.08
Diluted earnings per common share	$0.64	$ 0.56	$1.26	$ 1.08

Note 10. Stock Based Compensation

As of June 30, 2017, the Company had four 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, 2016. These plans include three executive stock award plans, the Executive Incentive Plan, the Restricted Stock Award Plan, the Strategic Deployment Incentive Plan; and the Employee Stock Purchase Plan. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but the Company had not made any grants through June 30, 2017.
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 on a straight-line basis over the requisite service period of the award, for which the Company uses the related vesting term.
The stock based compensation expense recognized in the Statements of Income for the three and six months ended June 30, 2016 was based on awards ultimately expected to vest, and accordingly had been adjusted by the amount of forfeitures. The Company adopted Accounting Standards Update No. 2016-09, on January 1, 2017, that allows for forfeitures to be recorded as they occur. The adoption of this standard required an immaterial cumulative effect adjustment to retained earnings as prior to January 1, 2017 forfeitures had been estimated based partially on historical experience.
Total fair value of options vested and expensed was zero for the six months ended June 30, 2017 and 2016. As of June 30, 2017 and 2016 there were no outstanding stock options. There were no stock options exercised during the six months ended June 30, 2017 and 2016. All shares issued in connection with stock option exercises are issued from available treasury stock.
As of June 30, 2017, there was $6.99 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.45 years.

Table of Contents

Note 11. Accumulated Other Comprehensive Income

The following table presents reclassifications out of accumulated other comprehensive income related to unrealized gains and losses on available-for-sale securities.

	Three Months Ended June 30,		Six Months Ended June 30,		Affected Line Item in the Statements of Income
(Dollars in thousands)	2017	2016	2017	2016	
Realized gains (losses) included in net income	$465	$(209)	$1,750	$(199)	Gains (losses) on investment securities available-for-sale
	465	(209)	1,750	(199)	Income before income taxes
Tax effect	(175)	78	(657)	75	Income tax expense
Net of tax	$290	$(131)	$1,093	$(124)	Net income

Note 12. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was $0.58 million at June 30, 2017 and $0.50 million at December 31, 2016. Interest and penalties are recognized through the income tax provision. For the six months ended June 30, 2017 and 2016, the Company recognized $0.04 million in interest or penalties, respectively. There was $0.08 million and $0.04 million in accrued interest and penalties at June 30, 2017 and December 31, 2016, respectively.

Tax years that remain open and subject to audit include the federal 2013-2016 years and the Indiana 2013-2016 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

Note 13. Fair Value Measurements

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

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

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

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

The Company elected fair value accounting for mortgages held for sale. The Company believes the election for mortgages held for sale (which are economically hedged with free standing derivatives) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as economic hedges for these assets. At June 30, 2017 and December 31, 2016, all mortgages held for sale were carried

at fair value.

Table of Contents

The following table shows 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.

(Dollars in thousands)	Fair value carrying amount	Aggregate unpaid principal	Excess of fair value carrying amount over (under) unpaid principal	
June 30, 2017				
Mortgages held for sale reported at fair value	$ 16,204	$ 15,983	$ 221	(1)
December 31, 2016				
Mortgages held for sale reported at fair value	$ 15,849	$ 15,809	$ 40	(1)

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

Financial Instruments on Recurring Basis:

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

Investment securities available for sale are valued primarily by a third party pricing agent. Prices supplied by the independent pricing agent, as well as their pricing methodologies and assumptions, are reviewed by the Company for reasonableness and to ensure such prices are aligned with market levels. In general, the Company's investment securities do not possess a complex structure that could introduce greater valuation risk. The portfolio mainly consists of traditional investments including U.S. Treasury and Federal agencies securities, federal agency mortgage pass-through securities, and general obligation and revenue municipal bonds. Pricing for such instruments is fairly generic and is easily obtained. On a quarterly basis, prices supplied by the pricing agent are validated by comparison to prices obtained from other third party sources for a material portion of the portfolio.

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

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.
- Inactively traded government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.
- State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Since some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities. Local direct placement municipal securities, with very little market activity, are priced using an appropriate market yield curve, which includes a credit spread

assumption.

- Marketable equity (common) securities are primarily 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.

Table of Contents

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 embedded in these portfolios.

The following table shows the balance of assets and liabilities measured at fair value on a recurring basis.

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
June 30, 2017				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	$20,287	$408,610	$—	$428,897
U.S. States and political subdivisions securities	—	126,483	1,801	128,284
Mortgage-backed securities — Federal agencies	—	255,698	—	255,698
Corporate debt securities	—	31,526	—	31,526
Foreign government and other securities	—	—	302	302
Total debt securities	20,287	822,317	2,103	844,707
Marketable equity securities	5,607	—	—	5,607
Total investment securities available-for-sale	25,894	822,317	2,103	850,314
Mortgages held for sale	—	16,204	—	16,204
Accrued income and other assets (interest rate swap agreements)	—	5,554	—	5,554
Total	$25,894	$844,075	$2,103	$872,072
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	$—	$5,657	$—	$5,657
Total	$—	$5,657	$—	$5,657
December 31, 2016				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	$20,164	$400,669	$—	$420,833
U.S. States and political subdivisions securities	—	130,276	2,699	132,975
Mortgage-backed securities — Federal agencies	—	252,574	—	252,574
Corporate debt securities	—	35,076	—	35,076
Foreign government and other securities	—	—	807	807
Total debt securities	20,164	818,595	3,506	842,265
Marketable equity securities	8,202	—	—	8,202
Total investment securities available-for-sale	28,366	818,595	3,506	850,467
Mortgages held for sale	—	15,849	—	15,849
Accrued income and other assets (interest rate swap agreements)	—	6,621	—	6,621
Total	$28,366	$841,065	$3,506	$872,937
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	$—	$6,743	$—	$6,743
Total	$—	$6,743	$—	$6,743

Table of Contents

The following table shows changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended June 30, 2017 and 2016.

(Dollars in thousands)	U.S. States and political subdivisions securities	Foreign government and other securities	Investment securities available-for-sale
Beginning balance April 1, 2017	$ 2,018	$ 804	$ 2,822
Total gains or losses (realized/unrealized):			
Included in earnings	—	—	—
Included in other comprehensive income	11	(2)	9
Purchases	287	—	287
Issuances	—	—	—
Sales	—	—	—
Settlements	—	—	—
Maturities	(515)	(500)	(1,015)
Transfers into Level 3	—	—	—
Transfers out of Level 3	—	—	—
Ending balance June 30, 2017	$ 1,801	$ 302	$ 2,103
Beginning balance April 1, 2016	$ 4,810	$ 809	$ 5,619
Total gains or losses (realized/unrealized):			
Included in earnings	—	—	—
Included in other comprehensive income	(4)	1	(3)
Purchases	—	—	—
Issuances	—	—	—
Sales	—	—	—
Settlements	—	—	—
Maturities	(145)	—	(145)
Transfers into Level 3	—	—	—
Transfers out of Level 3	—	—	—
Ending balance June 30, 2016	$ 4,661	$ 810	$ 5,471

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at June 30, 2017 or 2016. No transfers between levels occurred during the three months ended June 30, 2017 or 2016.

The following table shows the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a recurring basis.

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
June 30, 2017				
Investment securities available-for sale				
Direct placement municipal securities	$ 1,801	Discounted cash flows	Credit spread assumption	2.14% - 2.38%
Foreign government	$ 302	Discounted cash flows	Market yield assumption	0.00% - 0.79%
December 31, 2016				
Investment securities available-for sale				
Direct placement municipal securities	$ 2,699	Discounted cash flows	Credit spread assumption	0.92% - 3.17%

Foreign government	$ 807	Discounted cash flows	Market yield assumption	0.28% - 1.12%

The sensitivity to changes in the unobservable inputs and their impact on the fair value measurement can be significant. The significant unobservable input for direct placement municipal securities are the credit spread assumptions used to determine the fair value measure. An increase (decrease) in the estimated spread assumption of the market will decrease (increase) the fair value measure of the securities. The significant unobservable input for foreign government securities are the market yield assumptions. The market yield assumption is negatively correlated to the fair value measure. An increase (decrease) in the determined market yield assumption will decrease (increase) the fair value measurement.

Table of Contents

Financial Instruments on Non-recurring Basis:
The Company may be required, from time to time, to measure certain other financial assets at fair value on a non-recurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower of cost or market accounting or impairment charges of individual assets.
The Credit Policy Committee (CPC), a management committee, is responsible for overseeing the valuation processes and procedures for Level 3 measurements of impaired loans, other real estate and repossessions. The CPC reviews these assets on a quarterly basis to determine the accuracy of the observable inputs, generally third party appraisals, auction values, values derived from trade publications and data submitted by the borrower, and the appropriateness of the unobservable inputs, generally discounts due to current market conditions and collection issues. The CPC establishes discounts based on asset type and valuation source; deviations from the standard are documented. The discounts are reviewed periodically, annually at a minimum, to determine they remain appropriate. Consideration is given to current trends in market values for the asset categories and gains and losses on sales of similar assets. The Loan and Funds Management Committee of the Board of Directors is responsible for overseeing the CPC.
Discounts vary depending on the nature of the assets and the source of value. Aircraft are generally valued using quarterly trade publications adjusted for engine time, condition, maintenance programs, discounted by 10%. Likewise, autos are valued using current auction values, discounted by 10%; medium and heavy duty trucks are valued using trade publications and auction values, discounted by 15%. Construction equipment is generally valued using trade publications and auction values, discounted by 20%. Real estate is valued based on appraisals or evaluations, discounted by 20% with higher discounts for property in poor condition or property with characteristics which may make it more difficult to market. Commercial loans subject to borrowing base certificates are generally discounted by 20% for receivables and 40% - 75% for inventory with higher discounts when monthly borrowing base certificates are not required or received.
Impaired loans and related write-downs are based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are reviewed quarterly and estimated using customized discounting criteria, appraisals and dealer and trade magazine quotes which are used in a market valuation approach. In accordance with fair value measurements, only impaired loans for which a reserve for loan loss has been established based on the fair value of collateral require classification in the fair value hierarchy. As a result, only a portion of the Company’s impaired loans are classified in the fair value hierarchy.
Partnership investments and the adjustments to fair value primarily result from application of lower of cost or fair value accounting. The partnership investments are priced using financial statements provided by the partnerships. Quantitative unobservable inputs are not reasonably available for reporting purposes.
The Company has established MSRs valuation policies and procedures based on industry standards and to ensure valuation methodologies are consistent and verifiable. MSRs and related adjustments to fair value result from application of lower of cost or fair value accounting. For purposes of impairment, MSRs are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. The fair value of each tranche of the servicing portfolio is estimated by calculating the present value of estimated future net servicing cash flows, taking into consideration actual and expected mortgage loan prepayment rates, discount rates, servicing costs, and other economic factors. Prepayment rates and discount rates are derived through a third party pricing agent. Changes in the most significant inputs, including prepayment rates and discount rates, are compared to the changes in the fair value measurements and appropriate resolution is made. A fair value analysis is also obtained from an independent third party agent and compared to the internal valuation for reasonableness. MSRs do not trade in an active, open market with readily observable prices and though sales of MSRs do occur, precise terms and conditions typically are not readily available and the characteristics of the Company’s servicing portfolio may differ from those of any servicing portfolios that do trade.
Other real estate is based on the lower of cost or fair value of the underlying collateral less expected selling costs. Collateral values are estimated primarily using appraisals and reflect a market value approach. Fair values are reviewed quarterly and new appraisals are obtained annually. Repossessions are similarly valued.
For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended June 30, 2017: impaired loans - $0.70 million; partnership

investments - $0.00 million; mortgage servicing rights - $0.00 million; repossessions - $0.01 million; and other real estate - $0.00 million.

Table of Contents

The following table shows the carrying value of assets measured at fair value on a non-recurring basis.

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
June 30, 2017				
Impaired loans - collateral based	$ —	$ —	$5,788	$5,788
Accrued income and other assets (partnership investments)	—	—	1,032	1,032
Accrued income and other assets (mortgage servicing rights)	—	—	4,239	4,239
Accrued income and other assets (repossessions)	—	—	13,052	13,052
Accrued income and other assets (other real estate)	—	—	710	710
Total	$ —	$ —	$24,821	$24,821
December 31, 2016				
Impaired loans - collateral based	$ —	$ —	$6,280	$6,280
Accrued income and other assets (partnership investments)	—	—	1,032	1,032
Accrued income and other assets (mortgage servicing rights)	—	—	4,297	4,297
Accrued income and other assets (repossessions)	—	—	9,373	9,373
Accrued income and other assets (other real estate)	—	—	704	704
Total	$ —	$ —	$21,686	$21,686

The following table below shows the valuation methodology and unobservable inputs for Level 3 assets and liabilities measured at fair value on a non-recurring basis.

(Dollars in thousands)	Carrying Value	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
June 30, 2017					
Impaired loans	$ 5,788	$ 5,788	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	10% - 90%
Mortgage servicing rights	4,239	7,134	Discounted cash flows	Constant prepayment rate (CPR)	8.6% - 19.1%
				Discount rate	9.6% - 12.5%
Repossessions	13,052	13,304	Appraisals, trade publications and auction values	Discount for lack of marketability	0% - 5%
Other real estate	710	710	Appraisals	Discount for lack of marketability	0%
December 31, 2016					
Impaired loans	$ 6,280	$ 6,280	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	0% - 100%
Mortgage servicing rights	4,297	7,484	Discounted cash flows	Constant prepayment rate (CPR)	8.6% - 15.0%
				Discount rate	9.6% - 12.5%
Repossessions	9,373	9,452	Appraisals, trade publications and auction values	Discount for lack of marketability	0% - 4%

Other real estate	704	752	Appraisals	Discount for lack of marketability	0% - 16%

GAAP requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring or non-recurring basis.

28

Table of Contents

The following table shows the fair values of the Company's financial instruments.

(Dollars in thousands)	Carrying or Contract Value	Fair Value	Level 1	Level 2	Level 3
June 30, 2017					
Assets:					
Cash and due from banks	$ 63,473	$63,473	$63,473	$—	$ —
Federal funds sold and interest bearing deposits with other banks	12,561	12,561	12,561	—	—
Investment securities, available-for-sale	850,314	850,314	25,894	822,317	2,103
Other investments	24,238	24,238	—	24,238	—
Mortgages held for sale	16,204	16,204	—	16,204	—
Loans and leases, net of reserve for loan and lease losses	4,289,400	4,281,859	—	—	4,281,859
Mortgage servicing rights	4,239	7,134	—	—	7,134
Interest rate swaps	5,554	5,554	—	5,554	—
Liabilities:					
Deposits	$ 4,482,036	$4,480,080	$3,331,561	$1,148,519	$ —
Short-term borrowings	306,583	306,583	148,595	157,988	—
Long-term debt and mandatorily redeemable securities	70,438	68,576	—	68,576	—
Subordinated notes	58,764	57,991	—	57,991	—
Interest rate swaps	5,657	5,657	—	5,657	—
Off-balance-sheet instruments *	—	272	—	272	—
December 31, 2016					
Assets:					
Cash and due from banks	$ 58,578	$58,578	$58,578	$—	$ —
Federal funds sold and interest bearing deposits with other banks	49,726	49,726	49,726	—	—
Investment securities, available-for-sale	850,467	850,467	28,366	818,595	3,506
Other investments	22,458	22,458	22,458	—	—
Mortgages held for sale	15,849	15,849	—	15,849	—
Loans and leases, net of reserve for loan and lease losses	4,099,528	4,107,079	—	—	4,107,079
Mortgage servicing rights	4,297	7,484	—	—	7,484
Interest rate swaps	6,621	6,621	—	6,621	—
Liabilities:					
Deposits	$ 4,333,760	$4,332,744	$3,277,108	$1,055,636	$ —
Short-term borrowings	291,943	291,943	163,652	128,291	—
Long-term debt and mandatorily redeemable securities	74,308	73,149	—	73,149	—
Subordinated notes	58,764	51,031	—	51,031	—
Interest rate swaps	6,743	6,743	—	6,743	—
Off-balance-sheet instruments *	—	382	—	382	—

* Represents estimated cash outflows required to currently settle the obligations at current market rates.

The methodologies for estimating fair value of financial assets and financial liabilities that are measured at fair value on a recurring or non-recurring basis are discussed above. The estimated fair value approximates carrying value for cash and due from banks, federal funds sold and interest bearing deposits with other banks and other investments. The methodologies for other financial assets and financial liabilities are discussed below:

Loans and Leases — For variable rate loans and leases that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values of other loans and leases are estimated using discounted cash flow analyses which use interest rates currently being offered for loans and leases with similar terms to borrowers of similar credit quality.

Deposits — The fair values for all deposits other than time deposits are equal to the amounts payable on demand (the carrying value). Fair values of variable rate time deposits are equal to their carrying values. Fair values for fixed rate time deposits are estimated using discounted cash flow analyses using interest rates currently being offered for deposits with similar remaining maturities.

Table of Contents

Short-Term Borrowings — The carrying values of Federal funds purchased, securities sold under repurchase agreements, and other short-term borrowings, including the liability related to mortgage loans available for repurchase under GNMA optional repurchase programs, approximate their fair values.
Long-Term Debt and Mandatorily Redeemable Securities — The fair values of long-term debt are estimated using discounted cash flow analyses, based on the current estimated incremental borrowing rates for similar types of borrowing arrangements. The carrying values of mandatorily redeemable securities are based on the current estimated cost of redeeming these securities which approximate their fair values.
Subordinated Notes — Fair values are estimated based on calculated market prices of comparable securities.
Off-Balance-Sheet Instruments — Contract and fair values for certain off-balance-sheet financial instruments (guarantees) are estimated based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.
Limitations — Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instruments. Because no market exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other such factors.
These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. These estimates are subjective in nature and require considerable judgment to interpret market data. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange, nor are they intended to represent the fair value of the Company as a whole. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The fair value estimates presented herein are based on pertinent information available to management as of the respective balance sheet date. Although the Company is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.
Other significant assets, such as premises and equipment, other assets, and liabilities not defined as financial instruments, are not included in the above disclosures. Also, the fair value estimates for deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market.

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

The following management's discussion and analysis is presented to provide information concerning 1st Source Corporation and its subsidiaries' (collectively referred to as "the Company", "we", and "our") financial condition as of June 30, 2017, as compared to December 31, 2016, and the results of operations for the three and six months ended June 30, 2017 and 2016. This discussion and analysis should be read in conjunction with our consolidated financial statements and the financial and statistical data appearing elsewhere in this report and our 2016 Annual Report.
Except for historical information contained herein, the matters discussed in this document express "forward-looking statements." Generally, the words "believe," "contemplate," "seek," "plan," "possible," "assume," "expect," "intend," "targeted, "remain," "estimate," "anticipate," "project," "will," "should," "indicate," "would," "may" and other similar expressions are in identify forward-looking statements but are not the exclusive means of identifying such statements. Those statements, including statements, projections, estimates or assumptions concerning future events or performance, and other statements that are other than statements of historical fact, are subject to material risks and uncertainties. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. We may make other written or oral forward-looking statements from time to time. Readers are advised that various important factors could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected in such forward-looking statements. Such factors include, but are not limited to, changes in law, regulations or GAAP; our competitive position within the markets we serve; increasing consolidation within the banking industry; unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or

major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2016, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

Table of Contents

FINANCIAL CONDITION

Our total assets at June 30, 2017 were $5.69 billion, an increase of $200.96 million or 3.66% from December 31, 2016. Total loans and leases were $4.38 billion, an increase of $193.24 million, or 4.61% from December 31, 2016. Total investment securities, available-for-sale were $850.31 million which represented a slight decrease and equipment owned under operating leases was $144.51 million, an increase of $25.72 million, or 21.65% from the comparable figures at December 31, 2016. Total deposits were $4.48 billion, an increase of $148.28 million or 3.42% from the end of 2016. Short-term borrowings were $306.58 million, an increase of $14.64 million, or 5.01% from December 31, 2016. Long-term debt and mandatorily redeemable securities were $70.44 million, a decrease of $3.87 million or 5.21% from December 31, 2016.

Nonperforming assets at June 30, 2017 were $29.88 million, a decrease of $0.55 million, or 1.81% from the $30.43 million reported at December 31, 2016. At June 30, 2017 and December 31, 2016, nonperforming assets were 0.66% and 0.70%, respectively of net loans and leases.

The following table shows accrued income and other assets.

(Dollars in thousands)	June 30, 2017	December 31, 2016
Accrued income and other assets:		
Bank owned life insurance cash surrender value	$64,790	$ 63,802
Accrued interest receivable	15,238	15,015
Mortgage servicing rights	4,239	4,297
Other real estate	710	704
Repossessions	13,052	9,373
All other assets	49,871	36,868
Total accrued income and other assets	$147,900	$ 130,059

CAPITAL

As of June 30, 2017, total shareholders’ equity was $699.20 million, up $26.55 million, or 3.95% from the $672.65 million at December 31, 2016. In addition to net income of $32.88 million, other significant changes in shareholders’ equity during the first six months of 2017 included $9.62 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders’ equity totaled $2.44 million at June 30, 2017, compared to $1.34 million at December 31, 2016. Our equity-to-assets ratio was 12.29% as of June 30, 2017, compared to 12.26% at December 31, 2016. Book value per common share rose to $26.96 at June 30, 2017, from $26.00 at December 31, 2016.

We declared and paid cash dividends per common share of $0.19 during the second quarter of 2017. The trailing four quarters dividend payout ratio, representing cash dividends per common share divided by diluted earnings per common share, was 30.54%. The dividend payout is continually reviewed by management and the Board of Directors subject to the Company’s capital and dividend policy.

The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations.

Table of Contents

The actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of June 30, 2017, are presented in the table below.

	Actual		Minimum Capital Adequacy		Minimum Capital Adequacy with Capital Buffer[1]		To Be Well Capitalized Under Prompt Corrective Action Provisions	
(Dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-Weighted Assets):								
1st Source Corporation	$741,489	14.88%	$398,729	8.00%	$461,031	9.25%	$498,412	10.00%
1st Source Bank	681,386	13.68	398,605	8.00	460,887	9.25	498,257	10.00
Tier 1 Capital (to Risk-Weighted Assets):								
1st Source Corporation	676,604	13.58	299,047	6.00	361,348	7.25	398,729	8.00
1st Source Bank	618,432	12.41	298,954	6.00	361,236	7.25	398,605	8.00
Common Equity Tier 1 Capital (to Risk-Weighted Assets):								
1st Source Corporation	619,604	12.43	224,285	4.50	286,587	5.75	323,967	6.50
1st Source Bank	618,432	12.41	224,216	4.50	286,498	5.75	323,867	6.50
Tier 1 Capital (to Average Assets):								
1st Source Corporation	676,604	12.28	220,363	4.00	N/A	N/A	275,454	5.00
1st Source Bank	618,432	11.23	220,207	4.00	N/A	N/A	275,258	5.00

(1) The capital conservation buffer requirement will be phased in over three years beginning in 2016. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis.

LIQUIDITY AND INTEREST RATE SENSITIVITY

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as our operating cash needs are met. Funds are available from a number of sources, including the securities portfolio, the core deposit base, access to the national brokered certificates of deposit market, Federal Home Loan Bank (FHLB) borrowings, Federal Reserve Bank (FRB) borrowings, and the capability to package loans for sale.

We have borrowing sources available to supplement deposits and meet our funding needs. 1st Source Bank has established relationships with several banks to provide short term borrowings in the form of federal funds purchased. At June 30, 2017, we had no outstandings and could borrow approximately $265.00 million for a short time from these banks on a collective basis. As of June 30, 2017, we had $197.75 million outstanding in FHLB advances and could borrow an additional $75.10 million. We also had $505.25 million available to borrow from the FRB with no amounts outstanding as of June 30, 2017.

Our loan to asset ratio was 77.04% at June 30, 2017 compared to 76.34% at December 31, 2016 and 77.19% at June 30, 2016. Cash and cash equivalents totaled $76.03 million at June 30, 2017 compared to $108.30 million at December 31, 2016 and $73.24 million at June 30, 2016. At June 30, 2017, the Statement of Financial Condition was rate sensitive by $470.55 million more assets than liabilities scheduled to reprice within one year, or approximately 1.21%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

Under Indiana law governing the collateralization of public fund deposits, the Indiana Board of Depositories determines which financial institutions are required to pledge collateral based on the strength of their financial ratings. We have been informed that no collateral is required for our public fund deposits. However, the Board of Depositories could alter this requirement in the future and adversely impact our liquidity. Our potential liquidity exposure if we must pledge collateral is approximately $647 million.

RESULTS OF OPERATIONS

Net income for the three and six month periods ended June 30, 2017 was $16.67 million and $32.88 million, compared to $14.48 million and $28.30 million for the same periods in 2016. Diluted net income per common share was $0.64 and $1.26 for the three and six month periods ended June 30, 2017, compared to $0.56 and $1.08 for the

same periods in 2016. Return on average common shareholders' equity was 9.60% for the six months ended June 30, 2017, compared to 8.70% in 2016. The return on total average assets was 1.20% for the six months ended June 30, 2017, compared to 1.08% in 2016.

Net income increased for the six months ended June 30, 2017 compared to the first six months of 2016. Net interest income and noninterest income increased offset by an increase in provision for loan and lease losses, noninterest expense and income tax expense. Details of the changes in the various components of net income are discussed further below.

Table of Contents

NET INTEREST INCOME

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

DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY
INTEREST RATES AND INTEREST DIFFERENTIAL

	Three Months Ended								
	June 30, 2017			March 31, 2017			June 30, 2016		
(Dollars in thousands)	Average Balance	Interest Income/Expense	Yield/ Rate	Average Balance	Interest Income/Expense	Yield/ Rate	Average Balance	Interest Income/Expense	Yield/ Rate
ASSETS									
Investment securities available-for-sale:									
Taxable	$707,373	$3,370	1.91%	$708,249	$3,514	2.01%	$678,849	$3,040	1.80%
Tax exempt[(1)]	129,542	983	3.04%	131,034	994	3.08%	126,007	1,012	3.23%
Mortgages held for sale	11,325	115	4.07%	8,155	81	4.03%	11,100	110	3.99%
Loans and leases, net of unearned discount[(1)]	4,308,276	48,069	4.48%	4,187,231	44,953	4.35%	4,105,111	43,926	4.30%
Other investments	48,992	319	2.61%	40,741	291	2.90%	65,568	309	1.90%
Total earning assets[(1)]	5,205,508	52,856	4.07%	5,075,410	49,833	3.98%	4,986,635	48,397	3.90%
Cash and due from banks	61,801			59,967			60,786		
Reserve for loan and lease losses	(91,044)			(90,222)			(90,107)		
Other assets	409,927			392,092			386,316		
Total assets	$5,586,192			$5,437,247			$5,343,630		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest-bearing deposits	$3,503,444	$4,511	0.52%	$3,345,670	$3,734	0.45%	$3,380,208	$3,790	0.45%
Short-term borrowings	236,716	272	0.46%	267,823	227	0.34%	204,828	119	0.23%
Subordinated notes	58,764	1,055	7.20%	58,764	1,055	7.28%	58,764	1,055	7.22%
Long-term debt and mandatorily redeemable securities	83,991	699	3.34%	75,495	629	3.38%	65,906	680	4.15%
Total interest-bearing liabilities	3,882,915	6,537	0.68%	3,747,752	5,645	0.61%	3,709,706	5,644	0.61%
Noninterest-bearing deposits	951,531			953,294			920,194		
Other liabilities	54,517			52,554			54,638		

Shareholders' equity	697,229		683,647		659,092	
Total liabilities and shareholders' equity	$5,586,192		$5,437,247		$5,343,630	
Less: Fully tax-equivalent adjustments	(458)		(461)		(460)	
Net interest income/margin (GAAP-derived)(1)	$45,861	3.53%	$43,727	3.49%	$42,293	3.41%
Fully tax-equivalent adjustments	458		461		460	
Net interest income/margin - FTE(1)	$46,319	3.57%	$44,188	3.53%	$42,753	3.45%

(1) See "Reconciliation of Non-GAAP Financial Measures" at the end of this section for additional information on this performance measure/ratio.

Quarter Ended June 30, 2017 compared to the Quarter Ended June 30, 2016
The taxable-equivalent net interest income for the three months ended June 30, 2017 was $46.32 million, an increase of 8.34% over the same peri