

1ST SOURCE CORP  
Form 10-Q  
July 26, 2012  
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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2012

OR

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

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

Commission file number 0-6233

(Exact name of registrant as specified in its charter)

**INDIANA**

(State or other jurisdiction of  
incorporation or organization)

**35-1068133**

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

**100 North Michigan Street**

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**South Bend, IN**  
(Address of principal executive  
offices)

**46601**  
(Zip Code)

**(574) 235-2000**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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

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

Large accelerated filer <input type="checkbox"/>	Accelerated filer <input checked="" type="checkbox"/>
Non-accelerated filer <input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company <input type="checkbox"/>

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

Number of shares of common stock outstanding as of July 13, 2012 24,276,271 shares

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	<b>June 30, 2012</b>	<b>December 31, 2011</b>
<b>ASSETS</b>		
Cash and due from banks	\$ 88,729	\$ 61,406
Federal funds sold and interest bearing deposits with other banks	1,351	52,921
Investment securities available-for-sale (amortized cost of \$821,323 and \$853,204 at June 30, 2012 and December 31, 2011, respectively)	852,704	883,000
Other investments	19,934	18,974
Trading account securities	138	132
Mortgages held for sale	17,837	12,644
Loans and leases - net of unearned discount		
Commercial and agricultural loans	555,986	545,570
Auto, light truck and environmental equipment	508,493	435,965
Medium and heavy duty truck	172,305	159,796
Aircraft financing	662,184	620,782
Construction equipment financing	280,715	261,204
Commercial real estate	543,692	545,457
Residential real estate	441,587	423,606
Consumer loans	105,630	98,163
Total loans and leases	3,270,592	3,090,543
Reserve for loan and lease losses	(83,299)	(81,644)
Net loans and leases	3,187,293	3,008,899
Equipment owned under operating leases, net	58,264	69,551
Net premises and equipment	40,820	39,857
Goodwill and intangible assets	88,135	87,675
Accrued income and other assets	131,379	139,012
Total assets	\$ 4,486,584	\$ 4,374,071
<b>LIABILITIES</b>		
Deposits:		
Noninterest bearing	\$ 608,357	\$ 580,101
Interest bearing	2,977,660	2,940,040
Total deposits	3,586,017	3,520,141
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	117,461	106,991
Other short-term borrowings	16,467	18,243
Total short-term borrowings	133,928	125,234
Long-term debt and mandatorily redeemable securities	65,506	37,156
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	69,177	77,930
Total liabilities	3,944,320	3,850,153
<b>SHAREHOLDERS EQUITY</b>		
Preferred stock; no par value		
Authorized 10,000,000 shares; none issued or outstanding		
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,643,506 at June 30, 2012 and December 31, 2011	346,535	346,535
Retained earnings	206,789	190,261

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Cost of common stock in treasury (1,368,495 shares at June 30, 2012 and 1,429,484 shares at December 31, 2011)	(30,447)	(31,389)
Accumulated other comprehensive income	19,387	18,511
Total shareholders' equity	542,264	523,918
Total liabilities and shareholders' equity	\$ 4,486,584	\$ 4,374,071

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,	
	2012	2011	2012	2011
<b>Interest income:</b>				
Loans and leases	\$ 40,318	\$ 41,710	\$ 80,214	\$ 83,009
Investment securities, taxable	4,334	4,912	8,661	9,394
Investment securities, tax-exempt	848	1,004	1,700	2,190
Other	231	247	457	490
<b>Total interest income</b>	<b>45,731</b>	<b>47,873</b>	<b>91,032</b>	<b>95,083</b>
<b>Interest expense:</b>				
Deposits	5,704	8,162	11,449	16,517
Short-term borrowings	47	74	100	163
Subordinated notes	1,648	1,648	3,295	3,295
Long-term debt and mandatorily redeemable securities	357	405	828	664
<b>Total interest expense</b>	<b>7,756</b>	<b>10,289</b>	<b>15,672</b>	<b>20,639</b>
<b>Net interest income</b>	<b>37,975</b>	<b>37,584</b>	<b>75,360</b>	<b>74,444</b>
Provision for loan and lease losses	2,055	67	4,309	2,265
<b>Net interest income after provision for loan and lease losses</b>	<b>35,920</b>	<b>37,517</b>	<b>71,051</b>	<b>72,179</b>
<b>Noninterest income:</b>				
Trust fees	4,379	4,411	8,352	8,403
Service charges on deposit accounts	4,815	4,638	9,320	8,874
Mortgage banking income	1,502	835	3,444	1,279
Insurance commissions	1,211	1,062	2,568	2,204
Equipment rental income	4,666	6,009	10,016	12,047
Other income	3,209	3,327	6,210	6,298
Investment securities and other investment gains	8	1,142	403	1,272
<b>Total noninterest income</b>	<b>19,790</b>	<b>21,424</b>	<b>40,313</b>	<b>40,377</b>
<b>Noninterest expense:</b>				
Salaries and employee benefits	20,370	19,135	40,686	37,773
Net occupancy expense	1,848	2,051	4,008	4,371
Furniture and equipment expense	3,831	3,561	7,338	6,910
Depreciation - leased equipment	3,803	4,795	8,114	9,600
Professional fees	1,449	1,080	2,847	2,176
Supplies and communication	1,385	1,316	2,778	2,710
FDIC and other insurance	854	958	1,803	2,634
Business development and marketing expense	1,050	864	1,917	1,486
Loan and lease collection and repossession expense	979	1,500	2,480	2,824
Other expense	1,009	683	2,655	3,935
<b>Total noninterest expense</b>	<b>36,578</b>	<b>35,943</b>	<b>74,626</b>	<b>74,419</b>
Income before income taxes	19,132	22,998	36,738	38,137
Income tax expense	6,565	8,133	12,456	12,664

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<b>Net income</b>	\$	12,567	\$	14,865	\$	24,282	\$	25,473
<b>Per common share</b>								
Basic net income per common share	\$	0.51	\$	0.61	\$	0.99	\$	1.04
Diluted net income per common share	\$	0.51	\$	0.61	\$	0.99	\$	1.04
Dividends	\$	0.16	\$	0.16	\$	0.32	\$	0.32
Basic weighted average common shares outstanding		24,263,881		24,254,334		24,261,649		24,262,803
Diluted weighted average common shares outstanding		24,273,898		24,263,596		24,272,423		24,271,527

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,	
	2012	2011	2012	2011
Net income	\$ 12,567	\$ 14,865	\$ 24,282	\$ 25,473
Other comprehensive income, net of tax:				
Change in unrealized appreciation of available-for-sale securities, net of tax	1,449	6,707	1,047	5,457
Reclassification adjustment for gains included in net income, net of tax		(717)	(171)	(845)
Other comprehensive income	1,449	5,990	876	4,612
Comprehensive income	\$ 14,016	\$ 20,855	\$ 25,158	\$ 30,085

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

**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

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

	Total	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net
Balance at January 1, 2011	\$ 486,383	\$	\$ 350,282	\$ 157,875	\$ (32,284)	\$ 10,510
Net income	25,473			25,473		
Other comprehensive income	4,612					4,612
Issuance of 148,291 common shares under stock based compensation awards, including related tax effects	2,818			(168)	2,986	
Cost of 109,399 shares of common stock acquired for treasury	(2,139)				(2,139)	
Repurchase of common stock warrant	(3,750)		(3,750)			
Common stock dividend (\$0.32 per share)	(7,806)			(7,806)		
Stock based compensation	3		3			
Balance at June 30, 2011	\$ 505,594	\$	\$ 346,535	\$ 175,374	\$ (31,437)	\$ 15,122



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Balance at January 1, 2012	\$	523,918	\$	\$	346,535	\$	190,261	\$	(31,389)	\$	18,511
Net income		24,282					24,282				
Other comprehensive income		876									876
Issuance of 165,460 common shares under stock based compensation awards, including related tax effects		3,644				85			3,559		
Cost of 104,471 shares of common stock acquired for treasury		(2,617)							(2,617)		
Common stock dividend (\$0.32 per share)		(7,839)					(7,839)				
Balance at June 30, 2012	\$	542,264	\$	\$	346,535	\$	206,789	\$	(30,447)	\$	19,387

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

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	<b>Six Months Ended June 30,</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating activities:</b>		
Net income	\$ 24,282	\$ 25,473
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	4,309	2,265
Depreciation of premises and equipment	2,094	1,780
Depreciation of equipment owned and leased to others	8,114	9,600
Amortization of investment security premiums and accretion of discounts, net	1,999	965
Amortization of mortgage servicing rights	1,528	1,458
Mortgage servicing asset (recovery) impairment	(147)	16
Deferred income taxes	(3,996)	(755)
Investment securities and other investment gains	(403)	(1,272)
Originations of loans held for sale, net of principal collected	(96,948)	(40,963)
Proceeds from the sales of loans held for sale	94,491	66,258
Net gain on sale of loans held for sale	(2,736)	(500)
Change in trading account securities	(6)	(5)
Change in interest receivable	(312)	918
Change in interest payable	1,702	2,462
Change in other assets	7,894	8,347
Change in other liabilities	(4,542)	(734)
Other	586	2,620
Net change in operating activities	37,909	77,933
<b>Investing activities:</b>		
Proceeds from sales of investment securities	40,236	126,805
Proceeds from maturities of investment securities	159,553	107,843
Purchases of investment securities	(169,504)	(160,641)
Net change in other investments	(960)	2,370
Loans sold or participated to others	15,494	11,010
Net change in loans and leases	(199,988)	(62,674)
Net change in equipment owned under operating leases	3,173	(8,564)
Purchases of premises and equipment	(3,082)	(5,589)
Net change in investing activities	(155,078)	10,560
<b>Financing activities:</b>		
Net change in demand deposits, NOW accounts and savings accounts	92,814	(108,064)
Net change in certificates of deposit	(26,938)	8,635
Net change in short-term borrowings	8,694	(25,866)
Proceeds from issuance of long-term debt	25,600	10,554
Payments on long-term debt	(268)	(256)
Net proceeds from issuance of treasury stock	3,644	2,818
Acquisition of treasury stock	(2,617)	(2,139)
Repurchase of common stock warrant		(3,750)
Cash dividends paid on common stock	(8,007)	(7,948)
Net change in financing activities	92,922	(126,016)
Net change in cash and cash equivalents	(24,247)	(37,523)

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Cash and cash equivalents, beginning of year		114,327		96,872
Cash and cash equivalents, end of period	\$	90,080	\$	59,349
<u>Non-cash transactions:</u>				
Loans transferred to other real estate and repossessed assets	\$	1,791	\$	6,721
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan		2,643		2,420

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

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**1ST SOURCE CORPORATION**

**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**Note 1. Basis of Presentation**

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as 1st Source or the Company), a broad array of financial products and services. The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in shareholders' equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted.

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K (2011 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The balance sheet at December 31, 2011 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current year presentation.

**Note 2. Recent Accounting Pronouncements**

**Offsetting Assets and Liabilities:** In December 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-11 *Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities*. ASU 2011-11 requires an entity to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Retrospective disclosure is required for all comparative periods presented. The Company is assessing the impact of ASU 2011-11 on its disclosures.

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

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

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

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

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

**Note 3. Investment Securities**

Investment securities available-for-sale were as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>June 30, 2012</b>				
U.S. Treasury and Federal agencies securities	\$ 355,419	\$ 10,797	\$ (129)	\$ 366,087
U.S. States and political subdivisions securities	101,634	6,231	(561)	107,304
Mortgage-backed securities - Federal agencies	321,297	11,749	(38)	333,008
Corporate debt securities	36,123	456	(314)	36,265
Foreign government and other securities	4,483	36	(1)	4,518
Total debt securities	818,956	29,269	(1,043)	847,182
Marketable equity securities	2,367	3,158	(3)	5,522
Total investment securities available-for-sale	\$ 821,323	\$ 32,427	\$ (1,046)	\$ 852,704
<b>December 31, 2011</b>				
U.S. Treasury and Federal agencies securities	\$ 390,819	\$ 10,356	\$ (50)	\$ 401,125
U.S. States and political subdivisions securities	101,587	6,433	(660)	107,360
Mortgage-backed securities - Federal agencies	317,392	11,565	(9)	328,948
Corporate debt securities	36,349	325	(364)	36,310
Foreign government and other securities	4,690	24	(1)	4,713

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Total debt securities	850,837	28,703	(1,084)	878,456
Marketable equity securities	2,367	2,673	(496)	4,544
Total investment securities available-for-sale	\$ 853,204	\$ 31,376	\$ (1,580)	\$ 883,000

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

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

(Dollars in thousands)	Amortized Cost		Fair Value	
Due in one year or less	\$	26,723	\$	27,027
Due after one year through five years		357,768		367,241
Due after five years through ten years		105,227		112,429
Due after ten years		7,941		7,477
Mortgage-backed securities		321,297		333,008
Total debt securities available-for-sale	\$	818,956	\$	847,182

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

(Dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Gross realized gains	\$	\$ 1,153	\$ 275	\$ 1,598
Gross realized losses				(238)
Net realized gains (losses)	\$	\$ 1,153	\$ 275	\$ 1,360

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

(Dollars in thousands)	Less than 12 Months		12 months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2012						
U.S. Treasury and Federal agencies securities	\$ 35,531	\$ (129)	\$	\$	\$ 35,531	\$ (129)
U.S. States and political subdivisions securities	7,948	(82)	3,321	(479)	11,269	(561)
Mortgage-backed securities - Federal agencies	3,511	(27)	16,279	(11)	19,790	(38)
Corporate debt securities	4,938	(63)	8,467	(251)	13,405	(314)
Foreign government and other securities	99	(1)			99	(1)
Total debt securities	52,027	(302)	28,067	(741)	80,094	(1,043)
Marketable equity securities	1		4	(3)	5	(3)
Total investment securities available-for-sale	\$ 52,028	\$ (302)	\$ 28,071	\$ (744)	\$ 80,099	\$ (1,046)
December 31, 2011						
U.S. Treasury and Federal agencies securities	\$ 42,536	\$ (50)	\$	\$	\$ 42,536	\$ (50)
U.S. States and political subdivisions securities	423	(9)	5,149	(651)	5,572	(660)



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Mortgage-backed securities - Federal agencies	5,071	(1)	13,099	(8)	18,170	(9)
Corporate debt securities	4,858	(142)	8,579	(222)	13,437	(364)
Foreign government and other securities	1,011	(1)			1,011	(1)
Total debt securities	53,899	(203)	26,827	(881)	80,726	(1,084)
Marketable equity securities	622	(492)	4	(4)	626	(496)
Total investment securities available-for-sale	\$ 54,521	\$ (695)	\$ 26,831	\$ (885)	\$ 81,352	\$ (1,580)

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The initial indication of OTTI for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, the impaired securities are analyzed on a qualitative and quantitative basis in determining OTTI. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In estimating OTTI impairment losses, 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, 2012, the Company does not have the intent to sell any of the available-for-sale securities in the table above and believes that it is more likely than not that it will not have to sell any such securities before an anticipated recovery of cost. The unrealized losses on debt securities are due to increases in market interest rates over the yields available at the time the underlying securities were purchased and market illiquidity on auction rate securities which are reflected in U.S. States and Political subdivisions securities. The fair value is expected to recover on all debt securities as they approach their maturity date or repricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

The unrealized losses on marketable equity securities relate primarily to one common stock investment. The Company evaluated the investments near term prospects in relation to the severity and duration of the impairment. Based on the evaluation and the intent to hold the investment for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider the investment other-than-temporarily impaired at June 30, 2012. Accordingly, as of June 30, 2012, the Company believes the impairments detailed in the table above are temporary and no impairment loss has been realized in our consolidated statements of income.

At June 30, 2012 and December 31, 2011, investment securities with carrying values of \$241.92 million and \$250.36 million, respectively, were pledged as collateral to secure government deposits, security repurchase agreements, and for other purposes.

**Note 4. Loan and Lease Financings**

The Company evaluates loans and leases for credit quality at least annually but more frequently if certain circumstances occur (such as material new information which becomes available and indicates a potential change in credit risk). The Company uses two methods to assess credit risk: loan or lease credit quality grades and credit risk classifications. The purpose of the loan or lease credit quality grade is to document the degree of risk associated with individual credits as well as inform management of the degree of risk in the portfolio taken as a whole. Credit risk classifications are used to categorize loans by degree of risk and to designate individual or committee approval authorities for higher risk credits at the time of origination. Credit risk classifications include categories for: Acceptable, Marginal, Special Attention, Special Risk, Restricted by Policy, Regulated and Prohibited by Law.

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

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

(Dollars in thousands)	Credit Quality Grades		
	1-6	7-12	Total
<b>June 30, 2012</b>			
Commercial and agricultural loans	\$ 525,020	\$ 30,966	\$ 555,986
Auto, light truck and environmental equipment	503,588	4,905	508,493
Medium and heavy duty truck	168,355	3,950	172,305
Aircraft financing	630,708	31,476	662,184
Construction equipment financing	261,218	19,497	280,715
Commercial real estate	489,123	54,569	543,692
<b>Total</b>	<b>\$ 2,578,012</b>	<b>\$ 145,363</b>	<b>\$ 2,723,375</b>
<b>December 31, 2011</b>			
Commercial and agricultural loans	\$ 513,011	\$ 32,559	\$ 545,570
Auto, light truck and environmental equipment	432,288	3,677	435,965
Medium and heavy duty truck	154,261	5,535	159,796
Aircraft financing	580,004	40,778	620,782
Construction equipment financing	239,643	21,561	261,204
Commercial real estate	487,576	57,881	545,457
<b>Total</b>	<b>\$ 2,406,783</b>	<b>\$ 161,991</b>	<b>\$ 2,568,774</b>

For residential real estate and consumer loans, credit quality is based on the aging status of the loan and by payment activity. The table below presents the recorded investment in residential real estate and consumer loans by performing or nonperforming status. Nonperforming loans are those loans which are on nonaccrual status or are 90 days or more past due.

(Dollars in thousands)	Performing	Nonperforming	Total
<b>June 30, 2012</b>			
Residential real estate	\$ 437,922	\$ 3,665	\$ 441,587
Consumer	104,050	1,580	105,630
<b>Total</b>	<b>\$ 541,972</b>	<b>\$ 5,245</b>	<b>\$ 547,217</b>
<b>December 31, 2011</b>			
Residential real estate	\$ 418,810	\$ 4,796	\$ 423,606
Consumer	97,857	306	98,163
<b>Total</b>	<b>\$ 516,667</b>	<b>\$ 5,102</b>	<b>\$ 521,769</b>



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The table below presents the recorded investment of loans and leases, segregated by class, with delinquency aging and nonaccrual status.

(Dollars in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Accruing Loans	Nonaccrual	Total Financing Receivables
<b>June 30, 2012</b>							
Commercial and agricultural loans	\$ 545,280	\$ 860	\$ 33	\$	\$ 546,173	\$ 9,813	\$ 555,986
Auto, light truck and environmental equipment	504,535	337	240		505,112	3,381	508,493
Medium and heavy duty truck	171,402	108			171,510	795	172,305
Aircraft financing	654,194	1,297	256		655,747	6,437	662,184
Construction equipment financing	272,959	2,130	319		275,408	5,307	280,715
Commercial real estate	528,392	61			528,453	15,239	543,692
Residential real estate	434,759	2,529	634	346	438,268	3,319	441,587
Consumer	103,152	731	167	94	104,144	1,486	105,630
<b>Total</b>	<b>\$ 3,214,673</b>	<b>\$ 8,053</b>	<b>\$ 1,649</b>	<b>\$ 440</b>	<b>\$ 3,224,815</b>	<b>\$ 45,777</b>	<b>\$ 3,270,592</b>
<b>December 31, 2011</b>							
Commercial and agricultural loans	\$ 534,053	\$ 550	\$ 1	\$	\$ 534,604	\$ 10,966	\$ 545,570
Auto, light truck and environmental equipment	433,048	674	241		433,963	2,002	435,965
Medium and heavy duty truck	158,192	5			158,197	1,599	159,796
Aircraft financing	608,032	224			608,256	12,526	620,782
Construction equipment financing	256,691	376			257,067	4,137	261,204
Commercial real estate	522,883	2,005			524,888	20,569	545,457
Residential real estate	415,177	2,894	739	416	419,226	4,380	423,606
Consumer	96,824	762	271	45	97,902	261	98,163
<b>Total</b>	<b>\$ 3,024,900</b>	<b>\$ 7,490</b>	<b>\$ 1,252</b>	<b>\$ 461</b>	<b>\$ 3,034,103</b>	<b>\$ 56,440</b>	<b>\$ 3,090,543</b>

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The table below presents impaired loans and leases, segregated by class, and the corresponding reserve for impaired loan and lease losses.

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
<b>June 30, 2012</b>			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 2,067	\$ 2,067	\$
Auto, light truck and environmental equipment	333	333	
Medium and heavy duty truck	787	787	
Aircraft financing	4,333	4,333	
Construction equipment financing	5,022	5,022	
Commercial real estate	20,705	20,705	
Residential real estate	106	106	
Consumer loans			
Total with no related allowance recorded	33,353	33,353	
With an allowance recorded:			
Commercial and agricultural loans	6,879	6,879	1,073
Auto, light truck and environmental equipment	2,310	2,310	500
Medium and heavy duty truck			
Aircraft financing	1,975	1,975	688
Construction equipment financing			
Commercial real estate	2,830	2,830	19
Residential real estate			
Consumer loans			
Total with an allowance recorded	13,994	13,994	2,280
Total impaired loans	\$ 47,347	\$ 47,347	\$ 2,280
<b>December 31, 2011</b>			
With no related allowance recorded:			
Commercial and agricultural loans	\$ 2,002	\$ 2,002	\$
Auto, light truck and environmental equipment	770	770	
Medium and heavy duty truck	959	959	
Aircraft financing	11,206	11,206	
Construction equipment financing	3,949	3,949	
Commercial real estate	17,088	17,091	
Residential real estate			
Consumer loans	211	210	
Total with no related allowance recorded	36,185	36,187	
With an allowance recorded:			
Commercial and agricultural loans	8,406	8,406	1,461
Auto, light truck and environmental equipment	113	113	35
Medium and heavy duty truck	645	645	165
Aircraft financing	1,118	1,118	534
Construction equipment financing			
Commercial real estate	6,029	6,029	294
Residential real estate			
Consumer loans			
Total with an allowance recorded	16,311	16,311	2,489
Total impaired loans	\$ 52,496	\$ 52,498	\$ 2,489

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Average recorded investment and interest income recognized on impaired loans and leases, segregated by class, is shown in the table below.

(Dollars in thousands)	Three Months Ended June 30,				Six Months Ended June 30,			
	2012		2011		2012		2011	
	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural loans	\$ 9,219	\$ 2	\$ 11,342	\$ 114	\$ 9,606	\$ 10	\$ 12,156	\$ 230
Auto, light truck and environmental equipment	3,251		1,774		2,421	7	2,005	1
Medium and heavy duty truck	940	1	4,350	1	1,158	1	4,580	3
Aircraft financing	8,126		17,070	6	10,197		16,673	15
Construction equipment financing	5,019	1	6,289	8	4,342	5	7,300	16
Commercial real estate	23,006	115	30,448	49	22,116	164	30,156	114
Residential real estate	106	2			71	2		
Consumer								
<b>Total</b>	<b>\$ 49,667</b>	<b>\$ 121</b>	<b>\$ 71,273</b>	<b>\$ 178</b>	<b>\$ 49,911</b>	<b>\$ 189</b>	<b>\$ 72,870</b>	<b>\$ 379</b>

Performing loans and leases classified as troubled debt restructuring (TDR) during the three and six months ended June 30, 2012, segregated by class, are shown in the table below. Nonperforming TDRs are shown as nonperforming assets. During 2012, modification programs focused on extending maturity dates or modifying payment patterns with most TDRs experiencing a combination of concessions. The modifications did not result in the contractual forgiveness of principal or interest or interest rate reductions below market rates. Consequently, the financial impact of the modifications is immaterial.

(Dollars in thousands)	Three Months Ended June 30, 2012		Six Months Ended June 30, 2012	
	Number of Modifications	Recorded Investment	Number of Modifications	Recorded Investment
Commercial and agricultural loans		\$		\$
Auto, light truck and environmental equipment				
Medium and heavy duty truck				
Aircraft financing				
Construction equipment financing				
Commercial real estate	1	7,014	1	7,014
Residential real estate			1	106
Consumer				
<b>Total</b>	<b>1</b>	<b>\$ 7,014</b>	<b>2</b>	<b>\$ 7,120</b>

There were no troubled debt restructured loans and leases which had payment defaults within twelve months following modification during the three and six months ended June 30, 2012. Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.

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As of June 30, 2012 and December 31, 2011, the Company had \$9.24 million and \$3.29 million, respectively of performing loans and leases classified as troubled debt restructurings.



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**Note 5. Reserve for Loan and Lease Losses**

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

The reserve for loan and lease losses is maintained at a level believed to be appropriate by management to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting management's best estimate of probable loan and lease losses related to specifically identified loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. For purposes of determining the reserve, the Company has segmented loans and leases into classes based on the associated risks within these segments. The Company has determined that eight classes exist within the loan and lease portfolio. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for impaired loans, percentage allocations for special attention loans and leases without specific reserves, formula reserves for each business lending division portfolio including percentage allocations for special attention loans and leases not deemed impaired, and reserves for pooled homogeneous loans and leases. Management's evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

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

(Dollars in thousands)	Commercial agricultural loans	Auto, light truck and environmental equipment	Medium and heavy duty truck	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
<b>June 30, 2012</b>									
Reserve for loan and lease losses									
Balance, beginning of period	\$ 12,525	\$ 9,769	\$ 3,667	\$ 28,598	\$ 6,851	\$ 16,326	\$ 3,378	\$ 1,280	\$ 82,394
Charge-offs	126	867				109	32	539	1,673
Recoveries	68	75	1	196	50	45	2	86	523
Net charge-offs (recoveries)	58	792	(1)	(196)	(50)	64	30	453	1,150
Provision (recovery of provision)	610	1,323	(50)	1,077	(571)	(1,090)	173	583	2,055
Balance, end of period	\$ 13,077	\$ 10,300	\$ 3,618	\$ 29,871	\$ 6,330	\$ 15,172	\$ 3,521	\$ 1,410	\$ 83,299
Ending balance:									
individually evaluated for impairment	\$ 1,073	\$ 500	\$	\$ 688	\$	\$ 19	\$	\$	\$ 2,280
Ending balance:									
collectively evaluated for impairment	\$ 12,004	\$ 9,800	\$ 3,618	\$ 29,183	\$ 6,330	\$ 15,153	\$ 3,521	\$ 1,410	\$ 81,019
Financing receivables:									
Ending balance	\$ 555,986	\$ 508,493	\$ 172,305	\$ 662,184	\$ 280,715	\$ 543,692	\$ 441,587	\$ 105,630	\$ 3,270,592
Ending balance:									
individually evaluated for impairment	\$ 8,946	\$ 2,643	\$ 787	\$ 6,308	\$ 5,022	\$ 23,535	\$ 106	\$	\$ 47,347
Ending balance:									
collectively evaluated for impairment	\$ 547,040	\$ 505,850	\$ 171,518	\$ 655,876	\$ 275,693	\$ 520,157	\$ 441,481	\$ 105,630	\$ 3,223,245
<b>June 30, 2011</b>									
Reserve for loan and lease losses									
Balance, beginning of period	\$ 16,305	\$ 7,924	\$ 5,065	\$ 30,903	\$ 6,798	\$ 15,535	\$ 2,542	\$ 1,088	\$ 86,160
Charge-offs	535	257		530	268	1,234	120	257	3,201
Recoveries	1,492	25		90	63	181	31	102	1,984
Net charge-offs (recoveries)	(957)	232		440	205	1,053	89	155	1,217
Provision (recovery of provision)	(448)	1,349	(481)	(1,902)	209	918	204	218	67
Balance, end of period	\$ 16,814	\$ 9,041	\$ 4,584	\$ 28,561	\$ 6,802	\$ 15,400	\$ 2,657	\$ 1,151	\$ 85,010
Ending balance:									
individually evaluated for impairment	\$ 3,051	\$ 105	\$ 172	\$ 817	\$ 20	\$ 639	\$	\$	\$ 4,804
Ending balance:									
collectively evaluated for impairment	\$ 13,763	\$ 8,936	\$ 4,412	\$ 27,744	\$ 6,782	\$ 14,761	\$ 2,657	\$ 1,151	\$ 80,206
Financing receivables:									
Ending balance	\$ 551,820	\$ 473,925	\$ 155,423	\$ 607,567	\$ 274,968	\$ 568,226	\$ 390,389	\$ 95,839	\$ 3,118,157
Ending balance:									
individually evaluated for impairment	\$ 10,248	\$ 1,833	\$ 4,233	\$ 16,946	\$ 4,232	\$ 28,797	\$	\$	\$ 66,289
Ending balance:									
collectively evaluated for impairment	\$ 541,572	\$ 472,092	\$ 151,190	\$ 590,621	\$ 270,736	\$ 539,429	\$ 390,389	\$ 95,839	\$ 3,051,868



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

(Dollars in thousands)	Commercial and agricultural loans		Auto, light truck and environmental equipment		Medium and heavy duty truck		Aircraft financing		Construction equipment financing		Commercial real estate	Residential real estate	Consumer loans	Total				
June 30, 2012																		
Reserve for loan and lease losses																		
Balance, beginning of period	\$	13,091	\$	8,469	\$	3,742	\$	28,626	\$	6,295	\$	16,772	\$	3,362	\$	1,287	\$	81,644
Charge-offs		272		2,900				139		119		142		73		795		4,440
Recoveries		164		858		22		321		84		79		34		224		1,786
Net charge-offs (recoveries)		108		2,042		(22)		(182)		35								