

1ST SOURCE CORP
Form 10-Q
July 21, 2016
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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, 2016

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

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. 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

Accelerated filer

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Non-accelerated filer

(Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Number of shares of common stock outstanding as of July 15, 2016 — 25,866,884 shares

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

| | June 30, 2016 | December 31, 2015 |
|--|------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$58,944 | \$ 65,171 |
| Federal funds sold and interest bearing deposits with other banks | 14,297 | 14,550 |
| Investment securities available-for-sale | 814,258 | 791,727 |
| Other investments | 21,973 | 21,973 |
| Mortgages held for sale | 15,924 | 9,825 |
| Loans and leases, net of unearned discount: | | |
| Commercial and agricultural | 759,175 | 744,749 |
| Auto and light truck | 457,586 | 425,236 |
| Medium and heavy duty truck | 273,674 | 278,254 |
| Aircraft | 822,842 | 778,012 |
| Construction equipment | 484,354 | 455,565 |
| Commercial real estate | 715,932 | 700,268 |
| Residential real estate and home equity | 482,979 | 464,129 |
| Consumer | 156,221 | 148,479 |
| Total loans and leases | 4,152,763 | 3,994,692 |
| Reserve for loan and lease losses | (91,458) | (88,112) |
| Net loans and leases | 4,061,305 | 3,906,580 |
| Equipment owned under operating leases, net | 119,312 | 110,371 |
| Net premises and equipment | 54,506 | 53,191 |
| Goodwill and intangible assets | 84,386 | 84,676 |
| Accrued income and other assets | 135,033 | 129,852 |
| Total assets | \$5,379,938 | \$ 5,187,916 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing demand | \$944,626 | \$ 902,364 |
| Interest-bearing deposits: | | |
| Interest-bearing demand | 1,391,823 | 1,350,417 |
| Savings | 779,899 | 745,661 |
| Time | 1,208,736 | 1,140,744 |
| Total interest-bearing deposits | 3,380,458 | 3,236,822 |
| Total deposits | 4,325,084 | 4,139,186 |
| Short-term borrowings: | | |
| Federal funds purchased and securities sold under agreements to repurchase | 161,826 | 130,662 |
| Other short-term borrowings | 44,150 | 102,567 |
| Total short-term borrowings | 205,976 | 233,229 |
| Long-term debt and mandatorily redeemable securities | 64,738 | 57,379 |
| Subordinated notes | 58,764 | 58,764 |
| Accrued expenses and other liabilities | 63,620 | 55,305 |
| Total liabilities | 4,718,182 | 4,543,863 |

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, 2016 and December 31, 2015 | 436,538 | 436,538 |
| Retained earnings | 270,744 | 251,812 |
| Cost of common stock in treasury (2,342,904 shares at June 30, 2016 and 2,178,090 shares at December 31, 2015) | (56,357) | (50,852) |
| Accumulated other comprehensive income | 10,831 | 6,555 |
| Total shareholders' equity | 661,756 | 644,053 |
| Total liabilities and shareholders' equity | \$5,379,938 | \$5,187,916 |

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Interest income: | | | | |
| Loans and leases | \$43,891 | \$ 42,583 | \$86,627 | \$ 82,187 |
| Investment securities, taxable | 3,040 | 2,648 | 6,120 | 5,652 |
| Investment securities, tax-exempt | 697 | 754 | 1,389 | 1,523 |
| Other | 309 | 229 | 600 | 484 |
| Total interest income | 47,937 | 46,214 | 94,736 | 89,846 |
| Interest expense: | | | | |
| Deposits | 3,790 | 2,838 | 7,561 | 5,397 |
| Short-term borrowings | 119 | 131 | 280 | 234 |
| Subordinated notes | 1,055 | 1,055 | 2,110 | 2,110 |
| Long-term debt and mandatorily redeemable securities | 680 | 525 | 1,203 | 1,004 |
| Total interest expense | 5,644 | 4,549 | 11,154 | 8,745 |
| Net interest income | 42,293 | 41,665 | 83,582 | 81,101 |
| Provision for loan and lease losses | 2,049 | 811 | 3,024 | 1,168 |
| Net interest income after provision for loan and lease losses | 40,244 | 40,854 | 80,558 | 79,933 |
| Noninterest income: | | | | |
| Trust fees | 5,108 | 5,247 | 9,731 | 9,804 |
| Service charges on deposit accounts | 2,276 | 2,367 | 4,383 | 4,564 |
| Debit card | 2,816 | 2,628 | 5,415 | 5,027 |
| Mortgage banking | 1,115 | 1,239 | 2,161 | 2,490 |
| Insurance commissions | 1,233 | 1,382 | 2,796 | 2,687 |
| Equipment rental | 6,517 | 5,342 | 12,590 | 10,421 |
| (Losses) gains on investment securities available-for-sale | (209) |) 4 | (199) |) 4 |
| Other | 3,441 | 3,322 | 7,047 | 6,285 |
| Total noninterest income | 22,297 | 21,531 | 43,924 | 41,282 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 21,194 | 20,794 | 42,545 | 41,719 |
| Net occupancy | 2,307 | 2,345 | 4,808 | 4,806 |
| Furniture and equipment | 4,811 | 4,531 | 9,601 | 8,867 |
| Depreciation - leased equipment | 5,444 | 4,396 | 10,545 | 8,484 |
| Professional fees | 1,190 | 1,108 | 2,409 | 1,978 |
| Supplies and communication | 1,374 | 1,409 | 2,882 | 2,815 |
| FDIC and other insurance | 911 | 847 | 1,790 | 1,696 |
| Business development and marketing | 1,025 | 1,214 | 2,005 | 2,263 |
| Loan and lease collection and repossession | 385 | (294) |) 812 | 69 |
| Other | 1,393 | 1,891 | 3,342 | 3,605 |
| Total noninterest expense | 40,034 | 38,241 | 80,739 | 76,302 |
| Income before income taxes | 22,507 | 24,144 | 43,743 | 44,913 |
| Income tax expense | 8,028 | 8,514 | 15,446 | 15,772 |
| Net income | \$14,479 | \$ 15,630 | \$28,297 | \$ 29,141 |
| Per common share*: | | | | |
| Basic net income per common share | \$0.56 | \$ 0.59 | \$1.08 | \$ 1.10 |
| Diluted net income per common share | \$0.56 | \$ 0.59 | \$1.08 | \$ 1.10 |

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|---|------------|------------|------------|------------|
| Cash dividends | \$0.180 | \$ 0.164 | \$0.360 | \$ 0.327 |
| Basic weighted average common shares outstanding* | 25,853,537 | 26,212,999 | 25,888,534 | 26,235,511 |
| Diluted weighted average common shares outstanding* | 25,853,537 | 26,212,999 | 25,888,534 | 26,235,511 |

*The computation of the three and six months ended June 30, 2015 per common share data and shares outstanding gives retrospective recognition to a 10% stock dividend declared on July 22, 2015 and issued on August 14, 2015. The accompanying notes are a part of the consolidated financial statements.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|-----------------------------|-----------|---------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Net income | \$ 14,479 | \$ 15,630 | \$ 28,297 | \$ 29,141 |
| Other comprehensive income (loss): | | | | |
| Change in unrealized appreciation (depreciation) of available-for-sale securities | 2,244 | (4,727) | 6,647 | (1,781) |
| Reclassification adjustment for realized losses (gains) included in net income | 209 | (4) | 199 | (4) |
| Income tax effect | (921) | 1,776 | (2,570) | 670 |
| Other comprehensive income (loss), net of tax | 1,532 | (2,955) | 4,276 | (1,115) |
| Comprehensive income | \$ 16,011 | \$ 12,675 | \$ 32,573 | \$ 28,026 |

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, 2015 | \$ — | —\$346,535 | \$ 302,242 | \$(43,711) | \$ 9,407 | \$ 614,473 |
| Net income | — | — | 29,141 | — | — | 29,141 |
| Other comprehensive loss | — | — | — | — | (1,115) | (1,115) |
| Issuance of 112,483 common shares under stock based compensation awards, including related tax effects* | — | — | (237) | 2,683 | — | 2,446 |
| Cost of 164,829 shares of common stock acquired for treasury* | — | — | — | (4,678) | — | (4,678) |
| Common stock cash dividend (\$0.327 per share)* | — | — | (8,636) | — | — | (8,636) |
| 10% common stock dividend | — | 90,003 | (90,003) | — | — | — |
| Balance at June 30, 2015 | \$ — | —\$436,538 | \$ 232,507 | \$(45,706) | \$ 8,292 | \$ 631,631 |
| 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 (\$0.360 per share) | — | — | (9,369) | — | — | (9,369) |
| Balance at June 30, 2016 | \$ — | —\$436,538 | \$ 270,744 | \$(56,357) | \$ 10,831 | \$ 661,756 |

*Share and per share data gives retrospective recognition to a 10% stock dividend declared on July 22, 2015 and issued on August 14, 2015.

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

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

| | Six Months Ended June 30, | |
|---|------------------------------|-----------|
| | 2016 | 2015 |
| Operating activities: | | |
| Net income | \$28,297 | \$29,141 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan and lease losses | 3,024 | 1,168 |
| Depreciation of premises and equipment | 2,596 | 2,302 |
| Depreciation of equipment owned and leased to others | 10,545 | 8,484 |
| Stock-based compensation | 1,399 | 2,079 |
| Amortization of investment securities premiums and accretion of discounts, net | 2,553 | 2,597 |
| Amortization of mortgage servicing rights | 716 | 778 |
| Deferred income taxes | (742) | (2,159) |
| Losses (gains) on investment securities available-for-sale | 199 | (4) |
| Originations of loans held for sale, net of principal collected | (50,830) | (66,312) |
| Proceeds from the sales of loans held for sale | 46,151 | 67,143 |
| Net gain on sale of loans held for sale | (1,420) | (2,009) |
| Net gain on sale of other real estate and repossessions | (135) | (772) |
| Change in trading account securities | — | (6) |
| Change in interest receivable | (173) | 117 |
| Change in interest payable | 907 | 289 |
| Change in other assets | (2,655) | 987 |
| Change in other liabilities | 8,177 | (1,032) |
| Other | (857) | 690 |
| Net change in operating activities | 47,752 | 43,481 |
| Investing activities: | | |
| Proceeds from sales of investment securities available-for-sale | 3,956 | 1,299 |
| Proceeds from maturities and paydowns of investment securities available-for-sale | 108,215 | 47,314 |
| Purchases of investment securities available-for-sale | (130,607) | (48,344) |
| Net change in other investments | — | 58 |
| Loans sold or participated to others | — | 1,962 |
| Net change in loans and leases | (159,218) | (171,601) |
| Net change in equipment owned under operating leases | (19,486) | (28,216) |
| Purchases of premises and equipment | (3,991) | (2,934) |
| Proceeds from sales of other real estate and repossessions | 714 | 6,536 |
| Net change in investing activities | (200,417) | (193,926) |
| Financing activities: | | |
| Net change in demand deposits and savings accounts | 117,906 | 104,266 |
| Net change in time deposits | 67,992 | 55,459 |
| Net change in short-term borrowings | (27,253) | 16,365 |
| Proceeds from issuance of long-term debt | 10,832 | — |
| Payments on long-term debt | (5,703) | (743) |
| Stock issued under stock purchase plans | 116 | 149 |
| Acquisition of treasury stock | (8,005) | (4,678) |
| Cash dividends paid on common stock | (9,700) | (8,865) |
| Net change in financing activities | 146,185 | 161,953 |

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| | | |
|--|----------|----------|
| Net change in cash and cash equivalents | (6,480) | 11,508 |
| Cash and cash equivalents, beginning of year | 79,721 | 66,190 |
| Cash and cash equivalents, end of period | \$73,241 | \$77,698 |
| Supplemental Information: | | |
| Non-cash transactions: | | |
| Loans transferred to other real estate and repossessed assets | \$1,469 | \$5,866 |
| Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan | 800 | 500 |

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. 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 (2015 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, 2015 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.

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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

Measurement of Credit Losses on Financial Instruments: In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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 is currently evaluating the impact of ASU 2016-13 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 continues to assess ASU 2016-09 but does not expect a significant impact on its accounting and disclosures.

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 is assessing the impact of ASU 2016-02 on its accounting and disclosures.

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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 assessing the impact of ASU 2016-01 on its accounting and disclosures.

Short Duration Contracts: In May 2015, the FASB issued ASU No. 2015-09 “Financial Services - Insurance (Topic 944) - Disclosures about Short Duration Contracts.” ASU 2015-09 includes amendments that require insurance entities to disclose for annual reporting periods information about the liability for unpaid claims and claim adjustment expenses as well as significant changes in methodologies and assumptions used to calculate the liability for unpaid claims and claim adjustment expenses. In addition, the amendments require a roll-forward of the liability for unpaid claims and claim adjustment expenses on an annual and interim basis. The amendments are effective for annual periods beginning after December 15, 2015, and interim periods within annual periods beginning after December 15, 2016 and should be applied retrospectively. Early adoption is permitted. The Company has determined that ASU 2015-09 applies to certain insurance lines of business and is assessing the impact on its disclosures.

Consolidations: In February 2015, the FASB issued ASU No. 2015-02 “Consolidation (Topic 810) - Amendments to the Consolidation Analysis.” ASU 2015-02 includes amendments that are intended to improve targeted areas of consolidation for legal entities including reducing the number of consolidation models from four to two and simplifying the FASB Accounting Standards Codification. ASU 2015-02 is effective for annual and interim periods within those annual periods, beginning after December 15, 2015. The amendments may be applied retrospectively in previously issued financial statements for one or more years with a cumulative effect adjustment to retained earnings as of the beginning of the first year restated. Early adoption is permitted, including adoption in an interim period. The Company adopted ASU 2015-02 on January 1, 2016 and it did not have an impact on its accounting and disclosures.

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. These amendments are effective upon the adoption of ASU 2014-09. The Company continues to assess the impact of ASU 2014-09 on its accounting and disclosures.

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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, 2016 | | | | |
| U.S. Treasury and Federal agencies securities | \$ 396,740 | \$ 3,396 | \$ (5) |) \$ 400,131 |
| U.S. States and political subdivisions securities | 125,917 | 3,364 | (63) |) 129,218 |
| Mortgage-backed securities — Federal agencies | 239,829 | 4,982 | (272) |) 244,539 |
| Corporate debt securities | 32,032 | 398 | — | 32,430 |
| Foreign government and other securities | 800 | 10 | — | 810 |
| Total debt securities | 795,318 | 12,150 | (340) |) 807,128 |
| Marketable equity securities | 1,599 | 5,533 | (2) |) 7,130 |
| Total investment securities available-for-sale | \$ 796,917 | \$ 17,683 | \$ (342) |) \$ 814,258 |

December 31, 2015

| | | | | |
|---|------------|-----------|------------|--------------|
| U.S. Treasury and Federal agencies securities | \$ 389,457 | \$ 1,718 | \$ (1,506) |) \$ 389,669 |
| U.S. States and political subdivisions securities | 120,441 | 2,692 | (143) |) 122,990 |
| Mortgage-backed securities — Federal agencies | 234,400 | 3,430 | (1,533) |) 236,297 |
| Corporate debt securities | 34,241 | 199 | (57) |) 34,383 |
| Foreign government and other securities | 800 | 10 | (1) |) 809 |
| Total debt securities | 779,339 | 8,049 | (3,240) |) 784,148 |
| Marketable equity securities | 1,893 | 5,906 | (220) |) 7,579 |
| Total investment securities available-for-sale | \$ 781,232 | \$ 13,955 | \$ (3,460) |) \$ 791,727 |

At June 30, 2016 and December 31, 2015, 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, 2016. 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 | \$ 214,503 | \$ 215,323 |
| Due after one year through five years | 318,873 | 324,549 |
| Due after five years through ten years | 22,113 | 22,717 |
| Due after ten years | — | — |
| Mortgage-backed securities | 239,829 | 244,539 |
| Total debt securities available-for-sale | \$ 795,318 | \$ 807,128 |

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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, 2016 | | | | | | |
| U.S. Treasury and Federal agencies securities | \$5,974 | \$ (5) | \$ — | \$ — | \$5,974 | \$ (5) |
| U.S. States and political subdivisions securities | 7,237 | (22) | 4,474 | (41) | 11,711 | (63) |
| Mortgage-backed securities - Federal agencies | 23,770 | (78) | 15,147 | (194) | 38,917 | (272) |
| Corporate debt securities | — | — | — | — | — | — |
| Foreign government and other securities | — | — | — | — | — | — |
| Total debt securities | 36,981 | (105) | 19,621 | (235) | 56,602 | (340) |
| Marketable equity securities | 1 | — | 3 | (2) | 4 | (2) |
| Total investment securities available-for-sale | \$36,982 | \$ (105) | \$ 19,624 | \$ (237) | \$56,606 | \$ (342) |

December 31, 2015

| | | | | | | |
|---|-----------|-------------|-----------|-------------|-----------|-------------|
| U.S. Treasury and Federal agencies securities | \$151,581 | \$ (928) | \$43,372 | \$ (578) | \$194,953 | \$ (1,506) |
| U.S. States and political subdivisions securities | 17,040 | (79) | 3,795 | (64) | 20,835 | (143) |
| Mortgage-backed securities - Federal agencies | 78,731 | (777) | 20,592 | (756) | 99,323 | (1,533) |
| Corporate debt securities | 9,340 | (57) | — | — | 9,340 | (57) |
| Foreign government and other securities | 99 | (1) | — | — | 99 | (1) |
| Total debt securities | 256,791 | (1,842) | 67,759 | (1,398) | 324,550 | (3,240) |
| Marketable equity securities | 427 | (218) | 3 | (2) | 430 | (220) |
| Total investment securities available-for-sale | \$257,218 | \$ (2,060) | \$ 67,762 | \$ (1,400) | \$324,980 | \$ (3,460) |

The initial indication of 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, 2016, 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, | | Six Months Ended June 30, | |
|-----------------------------|-----------------------------|------|---------------------------|------|
| | 2016 | 2015 | 2016 | 2015 |
| Gross realized gains | \$85 | \$ 4 | \$95 | \$ 4 |
| Gross realized losses | — | — | — | — |
| OTTI losses | (294) | — | (294) | — |
| Net realized (losses) gains | \$(209) | \$ 4 | \$(199) | \$ 4 |

At June 30, 2016 and December 31, 2015, investment securities available-for-sale with carrying values of \$249.00 million and \$233.14 million, respectively, were pledged as collateral for security repurchase agreements and for other purposes.

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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.

| (Dollars in thousands) | Credit Quality Grades | | |
|-----------------------------|-----------------------|-----------|-------------|
| | 1-6 | 7-12 | Total |
| June 30, 2016 | | | |
| Commercial and agricultural | \$725,345 | \$33,830 | \$759,175 |
| Auto and light truck | 427,067 | 30,519 | 457,586 |
| Medium and heavy duty truck | 271,809 | 1,865 | 273,674 |
| Aircraft | 792,536 | 30,306 | 822,842 |
| Construction equipment | 479,698 | 4,656 | 484,354 |
| Commercial real estate | 704,188 | 11,744 | 715,932 |
| Total | \$3,400,643 | \$112,920 | \$3,513,563 |

December 31, 2015

| | | | |
|-----------------------------|-------------|-----------|-------------|
| Commercial and agricultural | \$710,030 | \$34,719 | \$744,749 |
| Auto and light truck | 413,836 | 11,400 | 425,236 |
| Medium and heavy duty truck | 275,367 | 2,887 | 278,254 |
| Aircraft | 750,264 | 27,748 | 778,012 |
| Construction equipment | 448,683 | 6,882 | 455,565 |
| Commercial real estate | 680,304 | 19,964 | 700,268 |
| Total | \$3,278,484 | \$103,600 | \$3,382,084 |

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, 2016 | | | |
| Residential real estate and home equity | \$481,128 | \$1,851 | \$482,979 |
| Consumer | 155,533 | 688 | 156,221 |

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| | | | |
|---|------------|----------|------------|
| Total | \$ 636,661 | \$ 2,539 | \$ 639,200 |
| December 31, 2015 | | | |
| Residential real estate and home equity | \$ 462,236 | \$ 1,893 | \$ 464,129 |
| Consumer | 148,180 | 299 | 148,479 |
| Total | \$ 610,416 | \$ 2,192 | \$ 612,608 |

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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, 2016 | | | | | | | |
| Commercial and agricultural | \$755,391 | \$ 175 | \$ 16 | \$ — | \$755,582 | \$ 3,593 | \$759,175 |
| Auto and light truck | 457,190 | 336 | 13 | — | 457,539 | 47 | 457,586 |
| Medium and heavy duty truck | 273,674 | — | — | — | 273,674 | — | 273,674 |
| Aircraft | 811,062 | 7,500 | — | — | 818,562 | 4,280 | 822,842 |
| Construction equipment | 482,657 | 1,028 | — | — | 483,685 | 669 | 484,354 |
| Commercial real estate | 713,651 | 554 | — | — | 714,205 | 1,727 | 715,932 |
| Residential real estate and home equity | 479,970 | 769 | 389 | 234 | 481,362 | 1,617 | 482,979 |
| Consumer | 155,129 | 356 | 48 | 42 | 155,575 | 646 | 156,221 |
| Total | \$4,128,724 | \$ 10,718 | \$ 466 | \$ 276 | \$4,140,184 | \$ 12,579 | \$4,152,763 |
| December 31, 2015 | | | | | | | |
| Commercial and agricultural | \$740,335 | \$ 52 | \$ 79 | \$ — | \$740,466 | \$ 4,283 | \$744,749 |
| Auto and light truck | 424,997 | 170 | 23 | — | 425,190 | 46 | 425,236 |
| Medium and heavy duty truck | 278,254 | — | — | — | 278,254 | — | 278,254 |
| Aircraft | 764,074 | 9,442 | 108 | — | 773,624 | 4,388 | 778,012 |
| Construction equipment | 454,993 | 33 | — | — | 455,026 | 539 | 455,565 |
| Commercial real estate | 698,514 | 362 | — | — | 698,876 | 1,392 | 700,268 |
| Residential real estate and home equity | 460,771 | 1,038 | 427 | 71 | 462,307 | 1,822 | 464,129 |
| Consumer | 147,419 | 552 | 209 | 51 | 148,231 | 248 | 148,479 |
| Total | \$3,969,357 | \$ 11,649 | \$ 846 | \$ 122 | \$3,981,974 | \$ 12,718 | \$3,994,692 |

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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, 2016 | | | |
| With no related reserve recorded: | | | |
| Commercial and agricultural | \$ 743 | \$ 743 | \$ — |
| Auto and light truck | — | — | — |
| Medium and heavy duty truck | — | — | — |
| Aircraft | 2,450 | 2,450 | — |
| Construction equipment | 577 | 577 | — |
| Commercial real estate | 1,541 | 1,541 | — |
| Residential real estate and home equity | — | — | — |
| Consumer | — | — | — |
| Total with no related reserve recorded | 5,311 | 5,311 | — |
| With a reserve recorded: | | | |
| Commercial and agricultural | 2,441 | 2,441 | 463 |
| Auto and light truck | — | — | — |
| Medium and heavy duty truck | — | — | — |
| Aircraft | 1,830 | 1,830 | 1,296 |
| Construction equipment | — | — | — |
| Commercial real estate | — | — | — |
| Residential real estate and home equity | 363 | 365 | 145 |
| Consumer | — | — | — |
| Total with a reserve recorded | 4,634 | 4,636 | 1,904 |
| Total impaired loans | \$ 9,945 | \$ 9,947 | \$ 1,904 |
| December 31, 2015 | | | |
| With no related reserve recorded: | | | |
| Commercial and agricultural | \$ 1,016 | \$ 1,016 | \$ — |
| Auto and light truck | — | — | — |
| Medium and heavy duty truck | — | — | — |
| Aircraft | 4,384 | 4,384 | — |
| Construction equipment | 539 | 539 | — |
| Commercial real estate | 8,494 | 8,494 | — |
| Residential real estate and home equity | — | — | — |
| Consumer | — | — | — |
| Total with no related reserve recorded | 14,433 | 14,433 | — |
| With a reserve recorded: | | | |
| Commercial and agricultural | 2,884 | 2,884 | 649 |
| Auto and light truck | — | — | — |
| Medium and heavy duty truck | — | — | — |
| Aircraft | — | — | — |
| Construction equipment | — | — | — |
| Commercial real estate | — | — | — |
| Residential real estate and home equity | 366 | 368 | 148 |
| Consumer | — | — | — |
| Total with a reserve recorded | 3,250 | 3,252 | 797 |

| | | | |
|----------------------|-----------|-----------|--------|
| Total impaired loans | \$ 17,683 | \$ 17,685 | \$ 797 |
|----------------------|-----------|-----------|--------|

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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, | | | |
|---|-----------------------------|-----------------|-----------------------------|-----------------|-----------------------------|-----------------|-----------------------------|-----------------|
| | 2016 | | 2015 | | 2016 | | 2015 | |
| | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income |
| Commercial and agricultural | \$3,449 | \$ — | \$2,134 | \$ 6 | \$3,579 | \$ 4 | \$5,971 | \$ 16 |
| Auto and light truck | — | — | — | — | — | — | — | — |
| Medium and heavy duty truck | — | — | — | — | — | — | — | — |
| Aircraft | 4,341 | — | 7,269 | — | 4,184 | — | 8,207 | 6 |
| Construction equipment | 514 | — | 731 | — | 697 | — | 735 | — |
| Commercial real estate | 6,100 | — | 10,735 | 142 | 7,251 | 123 | 11,319 | 284 |
| Residential real estate and home equity | 364 | 4 | 371 | 4 | 365 | 8 | 372 | 8 |
| Consumer | — | — | — | — | — | — | — | — |
| Total | \$14,768 | \$ 4 | \$21,240 | \$ 152 | \$16,076 | \$ 135 | \$26,604 | \$ 314 |

There were no loan and lease modifications classified as troubled debt restructurings (TDR) during the three and six months ended June 30, 2016 and 2015. 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 were no TDRs which had payment defaults within the twelve months following modification during the three and six months ended June 30, 2016 and 2015. 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, 2016 and December 31, 2015.

| (Dollars in thousands) | June 30, 2016 | December 31, 2015 |
|------------------------|---------------|-------------------|
| Performing TDRs | \$ 363 | \$ 7,437 |
| Nonperforming TDRs | 1,844 | 1,926 |
| Total TDRs | \$ 2,207 | \$ 9,363 |

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.

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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, 2016 and 2015.

| (Dollars in thousands) | Commercial 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, 2016 | | | | | | | | | |
| Balance, beginning of period | \$ 14,735 | \$ 9,582 | \$ 4,511 | \$ 34,240 | \$ 7,462 | \$ 13,835 | \$ 3,379 | \$ 1,552 | \$ 89,296 |
| Charge-offs | 16 | — | — | — | — | — | 58 | 257 | 331 |
| Recoveries | 109 | 64 | 2 | 89 | 70 | 34 | 4 | 72 | 444 |
| Net charge-offs (recoveries) | (93) | (64) | (2) | (89) | (70) | (34) | 54 | 185 | (113) |
| Provision (recovery of provision) | 7 | 2,021 | (163) | 332 | (20) | (407) | 52 | 227 | 2,049 |
| Balance, end of period | \$ 14,835 | \$ 11,667 | \$ 4,350 | \$ 34,661 | \$ 7,512 | \$ 13,462 | \$ 3,377 | \$ 1,594 | \$ 91,458 |
| June 30, 2015 | | | | | | | | | |
| Balance, beginning of period | \$ 11,620 | \$ 10,793 | \$ 4,364 | \$ 31,301 | \$ 7,740 | \$ 13,186 | \$ 4,115 | \$ 1,979 | \$ 85,098 |
| Charge-offs | 22 | — | — | — | — | — | 25 | 173 | 220 |
| Recoveries | 86 | 191 | 2 | 398 | 123 | 38 | 5 | 56 | 899 |
| Net charge-offs (recoveries) | (64) | (191) | (2) | (398) | (123) | (38) | 20 | 117 | (679) |
| Provision (recovery of provision) | 181 | 461 | (33) | 1,141 | (56) | 2 | (651) | (234) | 811 |
| Balance, end of period | \$ 11,865 | \$ 11,445 | \$ 4,333 | \$ 32,840 | \$ 7,807 | \$ 13,226 | \$ 3,444 | \$ 1,628 | \$ 86,588 |

The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the six months ended June 30, 2016 and 2015.

| (Dollars in thousands) | Commercial 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, 2016 | | | | | | | | | |

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| | | | | | | | | | |
|-----------------------------------|-----------|-----------|----------|-----------|----------|-----------|----------|----------|-----------|
| Balance, beginning of period | \$ 15,456 | \$ 9,269 | \$ 4,699 | \$ 32,373 | \$ 7,592 | \$ 13,762 | \$ 3,382 | \$ 1,579 | \$ 88,112 |
| Charge-offs | 216 | 3 | — | — | 92 | 1 | 81 | 502 | 895 |
| Recoveries | 200 | 126 | 10 | 227 | 148 | 339 | 6 | 161 | 1,217 |
| Net charge-offs (recoveries) | 16 | (123) | (10) | (227) | (56) | (338) | 75 | 341 | (322) |
| Provision (recovery of provision) | (605) | 2,275 | (359) | 2,061 | (136) | (638) | 70 | 356 | 3,024 |
| Balance, end of period | \$ 14,835 | \$ 11,667 | \$ 4,350 | \$ 34,661 | \$ 7,512 | \$ 13,462 | \$ 3,377 | \$ 1,594 | \$ 91,458 |

June 30, 2015

| | | | | | | | | | |
|-----------------------------------|-----------|-----------|----------|-----------|----------|-----------|----------|----------|-----------|
| Balance, beginning of period | \$ 11,760 | \$ 10,326 | \$ 4,500 | \$ 32,234 | \$ 7,008 | \$ 13,270 | \$ 4,102 | \$ 1,868 | \$ 85,068 |
| Charge-offs | 965 | 22 | — | 49 | — | — | 65 | 320 | 1,421 |
| Recoveries | 564 | 251 | 5 | 442 | 245 | 135 | 7 | 124 | 1,773 |
| Net charge-offs (recoveries) | 401 | (229) | (5) | (393) | (245) | (135) | 58 | 196 | (352) |
| Provision (recovery of provision) | 506 | 890 | (172) | 213 | 554 | (179) | (600) | (44) | 1,168 |
| Balance, end of period | \$ 11,865 | \$ 11,445 | \$ 4,333 | \$ 32,840 | \$ 7,807 | \$ 13,226 | \$ 3,444 | \$ 1,628 | \$ 86,588 |

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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, 2016 and December 31, 2015.

| (Dollars in thousands) | Commercial agricultural equipment | Auto and light trucks | Medium and heavy duty truck | Aircraft | Construction equipment | Commercial real estate | Residential real estate and home equity | Consumer loans | Total |
|---|-----------------------------------|-----------------------|-----------------------------|-----------|------------------------|------------------------|---|----------------|-------------|
| June 30, 2016 | | | | | | | | | |
| Reserve for loan and lease losses | | | | | | | | | |
| Ending balance, individually evaluated for impairment | \$463 | \$— | \$— | \$1,296 | \$— | \$— | \$145 | \$— | \$1,904 |
| Ending balance, collectively evaluated for impairment | 14,372 | 11,667 | 4,350 | 33,365 | 7,512 | 13,462 | 3,232 | 1,594 | 89,554 |
| Total reserve for loan and lease losses | \$14,835 | \$11,667 | \$4,350 | \$34,661 | \$7,512 | \$13,462 | \$3,377 | \$1,594 | \$91,458 |
| Recorded investment in loans | | | | | | | | | |
| Ending balance, individually evaluated for impairment | \$3,184 | \$— | \$— | \$4,280 | \$577 | \$1,541 | \$363 | \$— | \$9,945 |
| Ending balance, collectively evaluated for impairment | 755,991 | 457,586 | 273,674 | 818,562 | 483,777 | 714,391 | 482,616 | 156,221 | 4,142,818 |
| Total recorded investment in loans | \$759,175 | \$457,586 | \$273,674 | \$822,842 | \$484,354 | \$715,932 | \$482,979 | \$156,221 | \$4,152,763 |
| December 31, 2015 | | | | | | | | | |
| Reserve for loan and lease losses | | | | | | | | | |
| Ending balance, individually evaluated for impairment | \$649 | \$— | \$— | \$— | \$— | \$— | \$148 | \$— | \$797 |
| Ending balance, collectively evaluated for impairment | 14,807 | 9,269 | 4,699 | 32,373 | 7,592 | 13,762 | 3,234 | 1,579 | 87,315 |
| Total reserve for loan and lease losses | \$15,456 | \$9,269 | \$4,699 | \$32,373 | \$7,592 | \$13,762 | \$3,382 | \$1,579 | \$88,112 |
| Recorded investment in loans | | | | | | | | | |
| Ending balance, individually evaluated for impairment | \$3,900 | \$— | \$— | \$4,384 | \$539 | \$8,494 | \$366 | \$— | \$17,683 |
| Ending balance, collectively evaluated | 740,849 | 425,236 | 278,254 | 773,628 | 455,026 | 691,774 | 463,763 | 148,479 | 3,977,009 |

for impairment

| | | | | | | | | | |
|------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-------------|
| Total recorded investment in loans | \$744,749 | \$425,236 | \$278,254 | \$778,012 | \$455,565 | \$700,268 | \$464,129 | \$148,479 | \$3,994,692 |
|------------------------------------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-------------|

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 \$774.00 million and \$798.51 million at June 30, 2016 and December 31, 2015, 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.

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The following table shows changes in the carrying value of MSR's and the associated valuation allowance.

| (Dollars in thousands) | Three Months | | Six Months | |
|--|--------------|----------|------------|----------|
| | Ended | | Ended | |
| | June 30, | June 30, | June 30, | June 30, |
| | 2016 | 2015 | 2016 | 2015 |
| Mortgage servicing rights: | | | | |
| Balance at beginning of period | \$4,481 | \$4,590 | \$4,608 | \$4,733 |
| Additions | 242 | 456 | 447 | 706 |
| Amortization | (384) | (385) | (716) | (778) |
| Sales | — | — | — | — |
| Carrying value before valuation allowance at end of period | 4,339 | 4,661 | 4,339 | 4,661 |
| 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 | \$4,339 | \$4,661 | \$4,339 | \$4,661 |
| Fair value of mortgage servicing rights at end of period | \$5,553 | \$7,342 | \$5,553 | \$7,342 |

At June 30, 2016 and 2015, the fair value of MSR's exceeded the carrying value reported in the Statements of Financial Condition by \$1.21 million and \$2.68 million, respectively. This difference represents increases in the fair value of certain MSR's that could not be recorded above cost basis.

Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$0.66 million and \$0.71 million for the three months ended June 30, 2016 and 2015, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$1.36 million and \$1.43 million for the six months ended June 30, 2016 and 2015, 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

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 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.

The following table shows financial instruments whose contract amounts represent credit risk.

| (Dollars in thousands) | June 30, | December 31, |
|--|-----------|--------------|
| | 2016 | 2015 |
| Amounts of commitments: | | |
| Loan commitments to extend credit | \$870,773 | \$ 829,509 |
| Standby letters of credit | \$37,191 | \$ 37,984 |
| Commercial and similar letters of credit | \$606 | \$ 741 |

1st Source Bank (Bank), a subsidiary of 1st Source Corporation, grants mortgage loan commitments to borrowers, subject to normal loan underwriting standards. The interest rate risk associated with these loan commitments is managed by entering into contracts for future deliveries of loans. Loan commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Bank issues 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.

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The Bank has made investments directly in low income housing tax credit (LIHTC) operating partnerships formed by third parties. 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, 2016 and December 31, 2015, investment balances, including all legally binding commitments to fund future investments totaled \$9.14 million and \$9.62 million, respectively. In addition, the Bank had a liability for all legally binding unfunded commitments of \$3.35 million and \$3.64 million at June 30, 2016 and December 31, 2015, respectively.

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.

| (Dollars in thousands) | Notional or contractual amount | Asset derivatives | | Liability derivatives | |
|-----------------------------------|--------------------------------|---|------------|---|------------|
| | | Statement of Financial Condition classification | Fair value | Statement of Financial Condition classification | Fair value |
| June 30, 2016 | | | | | |
| Interest rate swap contracts | \$ 562,698 | Other assets | \$ 17,012 | Other liabilities | \$ 17,334 |
| Loan commitments | 13,349 | Mortgages held for sale | 168 | N/A | — |
| Forward contracts - mortgage loan | 25,078 | N/A | — | Mortgages held for sale | 307 |
| Total | \$ 601,125 | | \$ 17,180 | | \$ 17,641 |
| December 31, 2015 | | | | | |
| Interest rate swap contracts | \$ 554,083 | Other assets | \$ 9,859 | Other liabilities | \$ 10,044 |
| Loan commitments | 12,440 | Mortgages held for sale | 47 | N/A | — |
| Forward contracts - mortgage loan | 16,416 | Mortgages held for sale | 13 | N/A | — |
| Total | \$ 582,939 | | \$ 9,919 | | \$ 10,044 |

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, |
| | |

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| (Dollars in thousands) | Statement of Income classification | 2016 | 2015 | 2016 | 2015 |
|-----------------------------------|------------------------------------|--------|-------|---------|-------|
| Interest rate swap contracts | Other expense | \$(43) | \$41 | \$(136) | \$22 |
| Interest rate swap contracts | Other income | 110 | 221 | 314 | 297 |
| Loan commitments | Mortgage banking | 73 | (52) | 121 | 87 |
| Forward contracts - mortgage loan | Mortgage banking | (175) | 372 | (320) | 346 |
| Total | | \$(35) | \$582 | \$(21) | \$752 |

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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 | Cash Collateral Received | Net Amount |
| June 30, 2016 | | | | | | |
| Interest rate swaps | \$ 17,245 | \$ 233 | \$ 17,012 | \$ — | \$ — | —\$ 17,012 |
| December 31, 2015 | | | | | | |
| Interest rate swaps | \$ 10,016 | \$ 157 | \$ 9,859 | \$ — | \$ — | —\$ 9,859 |

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 | Cash Collateral Pledged | Net Amount |
| June 30, 2016 | | | | | | |
| Interest rate swaps | \$ 17,567 | \$ 233 | \$ 17,334 | \$ — | \$ 17,334 | \$ — |
| Repurchase agreements | 161,826 | — | 161,826 | 161,826 | — | — |
| Total | \$ 179,393 | \$ 233 | \$ 179,160 | \$ 161,826 | \$ 17,334 | \$ — |
| December 31, 2015 | | | | | | |
| Interest rate swaps | \$ 10,201 | \$ 157 | \$ 10,044 | \$ — | \$ 9,833 | \$ 211 |
| Repurchase agreements | 130,662 | — | 130,662 | 130,662 | — | — |
| Total | \$ 140,863 | \$ 157 | \$ 140,706 | \$ 130,662 | \$ 9,833 | \$ 211 |

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, 2016 and December 31, 2015, repurchase agreements had a remaining contractual maturity of \$160.05 million and \$128.88 million in overnight and \$1.78 million and \$1.78 million in up to 30 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.

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, 2016 and 2015.

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The following table presents a reconciliation of the number of shares used in the calculation of basic and diluted earnings per common share.

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|------------|------------------|------------|
| | June 30, | | June 30, | |
| (Dollars in thousands - except per share amounts) | 2016 | 2015 | 2016 | 2015 |
| Distributed earnings allocated to common stock | \$4,653 | \$ 4,293 | \$9,339 | \$ 8,589 |
| Undistributed earnings allocated to common stock | 9,728 | 11,186 | 18,745 | 20,249 |
| Net earnings allocated to common stock | 14,381 | 15,479 | 28,084 | 28,838 |
| Net earnings allocated to participating securities | 98 | 151 | 213 | 303 |
| Net income allocated to common stock and participating securities | \$14,479 | \$ 15,630 | \$28,297 | \$ 29,141 |
| Weighted average shares outstanding for basic earnings per common share* | 25,853,537 | 26,212,999 | 25,888,537 | 26,235,511 |
| Dilutive effect of stock compensation | — | — | — | — |
| Weighted average shares outstanding for diluted earnings per common share* | 25,853,537 | 26,212,999 | 25,888,537 | 26,235,511 |
| Basic earnings per common share* | \$0.56 | \$ 0.59 | \$1.08 | \$ 1.10 |
| Diluted earnings per common share* | \$0.56 | \$ 0.59 | \$1.08 | \$ 1.10 |

*Three and six months ended June 30, 2015 outstanding shares and per common share figures have been adjusted for a 10% stock dividend declared July 22, 2015 and issued on August 14, 2015.

Note 10. Stock Based Compensation

As of June 30, 2016, 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, 2015. 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, 2016.

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

The stock-based compensation expense recognized in the Statements of Income for the three and six months ended June 30, 2016 and 2015 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

Total fair value of options vested and expensed was zero for the six months ended June 30, 2016 and 2015. As of June 30, 2016 and 2015 there were no outstanding stock options. There were no stock options exercised during the six months ended June 30, 2016 and 2015. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of June 30, 2016, there was \$5.39 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

3.31 years.

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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 |
|--|-----------------------------|------|---------------------------|------|--|
| | 2016 | 2015 | 2016 | 2015 | |
| (Dollars in thousands) | | | | | |
| Realized (losses) gains included in net income | \$ (209) | \$ 4 | \$ (199) | \$ 4 | (Losses) gains on investment securities available-for-sale |
| Tax effect | (209) | 4 | (199) | 4 | Income before income taxes |
| Net of tax | 78 | (2) | 75 | (2) | Income tax expense |
| | \$ (131) | \$ 2 | \$ (124) | \$ 2 | Net income |

Note 12. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$0.37 million at June 30, 2016 and \$0.25 million at December 31, 2015. Interest and penalties were recognized through the income tax provision. For the six months ended June 30, 2016 and 2015, the Company recognized \$0.04 million and \$0.00 million in interest or penalties, respectively. There were \$0.04 million and \$0.00 million in accrued interest and penalties at June 30, 2016 and December 31, 2015, respectively.

Tax years that remain open and subject to audit include the federal 2012-2015 years and the Indiana 2013-2015 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, 2016 and December 31, 2015, all mortgages held for sale were carried at fair value.

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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, 2016 | | | | |
| Mortgages held for sale reported at fair value | \$ 15,924 | \$ 15,671 | \$ 253 | (1) |
| December 31, 2015 | | | | |
| Mortgages held for sale reported at fair value | \$ 9,825 | \$ 9,691 | \$ 134 | (1) |

The excess of fair value carrying amount over (under) unpaid principal is included in mortgage banking income (1) 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.

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

• State and political subdivisions are largely grouped by characteristics, i.e., geographical data and source of revenue in trade dissemination systems. Since some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities. Local 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.

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Interest rate swap positions, both assets and liabilities, are valued by a third party pricing agent using an income approach and utilizing models that use as their basis readily observable market parameters. This valuation process considers various factors including interest rate yield curves, time value and volatility factors. Validation of third party agent valuations is accomplished by comparing those values to the Company's swap counterparty valuations.

Management believes an adjustment is required to "mid-market" valuations for derivatives tied to its performing loan portfolio to recognize the imprecision and related exposure inherent in the process of estimating expected credit losses as well as velocity of deterioration evident with systemic risks 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, 2016 | | | | |
| Assets: | | | | |
| Investment securities available-for-sale: | | | | |
| U.S. Treasury and Federal agencies securities | \$20,044 | \$380,087 | \$— | \$400,131 |
| U.S. States and political subdivisions securities | — | 124,557 | 4,661 | 129,218 |
| Mortgage-backed securities — Federal agencies | — | 244,539 | — | 244,539 |
| Corporate debt securities | — | 32,430 | — | 32,430 |
| Foreign government and other securities | — | — | 810 | 810 |
| Total debt securities | 20,044 | 781,613 | 5,471 | 807,128 |
| Marketable equity securities | 7,130 | — | — | 7,130 |
| Total investment securities available-for-sale | 27,174 | 781,613 | 5,471 | 814,258 |
| Mortgages held for sale | — | 15,924 | — | 15,924 |
| Accrued income and other assets (interest rate swap agreements) | — | 17,012 | — | 17,012 |
| Total | \$27,174 | \$814,549 | \$5,471 | \$847,194 |
| Liabilities: | | | | |
| Accrued expenses and other liabilities (interest rate swap agreements) | \$— | \$17,334 | \$— | \$17,334 |
| Total | \$— | \$17,334 | \$— | \$17,334 |
| December 31, 2015 | | | | |
| Assets: | | | | |
| Investment securities available-for-sale: | | | | |
| U.S. Treasury and Federal agencies securities | \$19,879 | \$369,790 | \$— | \$389,669 |
| U.S. States and political subdivisions securities | — | 118,462 | 4,528 | 122,990 |
| Mortgage-backed securities — Federal agencies | — | 236,297 | — | 236,297 |
| Corporate debt securities | — | 34,383 | — | 34,383 |
| Foreign government and other securities | — | — | 809 | 809 |
| Total debt securities | 19,879 | 758,932 | 5,337 | 784,148 |
| Marketable equity securities | 7,579 | — | — | 7,579 |
| Total investment securities available-for-sale | 27,458 | 758,932 | 5,337 | 791,727 |
| Mortgages held for sale | — | 9,825 | — | 9,825 |
| Accrued income and other assets (interest rate swap agreements) | — | 9,859 | — | 9,859 |
| Total | \$27,458 | \$778,616 | \$5,337 | \$811,411 |
| Liabilities: | | | | |
| Accrued expenses and other liabilities (interest rate swap agreements) | \$— | \$10,044 | \$— | \$10,044 |
| Total | \$— | \$10,044 | \$— | \$10,044 |

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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, 2016 and 2015.

| (Dollars in thousands) | U.S. States and political subdivisions securities | Foreign government and other securities | Investment securities available-for-sale |
|--|--|--|--|
| 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 |
| Beginning balance April 1, 2015 | \$ 5,632 | \$ 808 | \$ 6,440 |
| Total gains or losses (realized/unrealized): | | | |
| Included in earnings | — | — | — |
| Included in other comprehensive income | (38 |) (1) | (39) |
| Purchases | — | — | — |
| Issuances | — | — | — |
| Sales | — | — | — |
| Settlements | — | — | — |
| Maturities | (150 |) — | (150) |
| Transfers into Level 3 | — | — | — |
| Transfers out of Level 3 | — | — | — |
| Ending balance June 30, 2015 | \$ 5,444 | \$ 807 | \$ 6,251 |

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, 2016 or 2015. No transfers between levels occurred during the three months ended June 30, 2016 or 2015.

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, 2016 | | | | |
| Investment securities available-for sale | | | | |
| Direct placement municipal securities | \$ 4,661 | Discounted cash flows | Credit spread assumption | 0.03% - 1.40% |
| Foreign government | \$ 801 | Discounted cash flows | Market yield assumption | 0.49% - 1.56% |
| December 31, 2015 | | | | |
| Investment securities available-for sale | | | | |
| Direct placement municipal securities | \$ 4,528 | Discounted cash flows | Credit spread assumption | 1.27% - 2.03% |

Foreign government \$ 809 Discounted cash flows Market yield assumption 0.88% - 2.00%

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.

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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 MSR 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, 2016: impaired loans - \$0.00 million; partnership

investments - \$0.00 million; mortgage servicing rights - \$0.00 million; repossessions - \$0.19 million; and other real estate - \$0.00 million.

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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, 2016 | | | | |
| Impaired loans - collateral based | \$ | —\$ | —\$ 915 | \$915 |
| Accrued income and other assets (partnership investments) | — | — | 24 | 24 |
| Accrued income and other assets (mortgage servicing rights) | — | — | 4,339 | 4,339 |
| Accrued income and other assets (repossessions) | — | — | 7,619 | 7,619 |
| Accrued income and other assets (other real estate) | — | — | 452 | |