

1ST SOURCE CORP
Form 10-Q
October 20, 2016
Table of Contents

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 September 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 October 14, 2016 — 25,867,093 shares

Table of Contents

TABLE OF CONTENTS

| | Page |
|--|--------|
| <u>PART I. FINANCIAL INFORMATION</u> | |
| <u>Item 1. Financial Statements (Unaudited)</u> | |
| <u>Consolidated Statements of Financial Condition — September 30, 2016 and December 31, 2015</u> | 3 |
| <u>Consolidated Statements of Income — three and nine months ended September 30, 2016 and 2015</u> | 4 |
| <u>Consolidated Statements of Comprehensive Income — three and nine months ended September 30, 2016 and 2015</u> | 5 |
| <u>Consolidated Statements of Shareholders' Equity — nine months ended September 30, 2016 and 2015</u> | 5 |
| <u>Consolidated Statements of Cash Flows — nine months ended September 30, 2016 and 2015</u> | 6 |
| <u>Notes to the Consolidated Financial Statements</u> | 7 |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 29 |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u> | 38 |
| <u>Item 4. Controls and Procedures</u> | 38 |
| <u>PART II. OTHER INFORMATION</u> | |
| <u>Item 1. Legal Proceedings</u> | 39 |
| <u>Item 1A. Risk Factors</u> | 39 |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u> | 39 |
| <u>Item 3. Defaults Upon Senior Securities</u> | 39 |
| <u>Item 4. Mine Safety Disclosures</u> | 39 |
| <u>Item 5. Other Information</u> | 39 |
| <u>Item 6. Exhibits</u> | 39 |
| <u>SIGNATURES</u> | 40 |
| <u>EXHIBITS</u> | |
| <u>Exhibit 31.1</u> | |
| <u>Exhibit 31.2</u> | |
| <u>Exhibit 32.1</u> | |
| <u>Exhibit 32.2</u> | |

Table of Contents

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

| | September 30, 2016 | December 31, 2015 |
|--|-----------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 65,724 | \$ 65,171 |
| Federal funds sold and interest bearing deposits with other banks | 30,100 | 14,550 |
| Investment securities available-for-sale | 828,615 | 791,727 |
| Other investments | 22,458 | 21,973 |
| Mortgages held for sale | 19,986 | 9,825 |
| Loans and leases, net of unearned discount: | | |
| Commercial and agricultural | 786,167 | 744,749 |
| Auto and light truck | 400,809 | 425,236 |
| Medium and heavy duty truck | 271,478 | 278,254 |
| Aircraft | 836,977 | 778,012 |
| Construction equipment | 498,086 | 455,565 |
| Commercial real estate | 744,972 | 700,268 |
| Residential real estate and home equity | 490,186 | 464,129 |
| Consumer | 150,742 | 148,479 |
| Total loans and leases | 4,179,417 | 3,994,692 |
| Reserve for loan and lease losses | (88,897) | (88,112) |
| Net loans and leases | 4,090,520 | 3,906,580 |
| Equipment owned under operating leases, net | 117,883 | 110,371 |
| Net premises and equipment | 54,654 | 53,191 |
| Goodwill and intangible assets | 84,244 | 84,676 |
| Accrued income and other assets | 133,727 | 129,852 |
| Total assets | \$ 5,447,911 | \$ 5,187,916 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest-bearing demand | \$ 992,776 | \$ 902,364 |
| Interest-bearing deposits: | | |
| Interest-bearing demand | 1,417,692 | 1,350,417 |
| Savings | 799,891 | 745,661 |
| Time | 1,166,679 | 1,140,744 |
| Total interest-bearing deposits | 3,384,262 | 3,236,822 |
| Total deposits | 4,377,038 | 4,139,186 |
| Short-term borrowings: | | |
| Federal funds purchased and securities sold under agreements to repurchase | 167,029 | 130,662 |
| Other short-term borrowings | 48,978 | 102,567 |
| Total short-term borrowings | 216,007 | 233,229 |
| Long-term debt and mandatorily redeemable securities | 64,760 | 57,379 |
| Subordinated notes | 58,764 | 58,764 |
| Accrued expenses and other liabilities | 61,083 | 55,305 |
| Total liabilities | 4,777,652 | 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 September 30, 2016 and December 31, 2015 | 436,538 | 436,538 |
| Retained earnings | 280,335 | 251,812 |
| Cost of common stock in treasury (2,338,581 shares at September 30, 2016 and 2,178,090 shares at December 31, 2015) | (56,262 |) (50,852) |
| Accumulated other comprehensive income | 9,648 | 6,555 |
| Total shareholders' equity | 670,259 | 644,053 |
| Total liabilities and shareholders' equity | \$ 5,447,911 | \$ 5,187,916 |

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

Table of Contents

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|--|-----------|------------------------------------|-----------|
| | 2016 | 2015 | 2016 | 2015 |
| Interest income: | | | | |
| Loans and leases | \$44,965 | \$ 42,560 | \$131,592 | \$124,747 |
| Investment securities, taxable | 2,384 | 3,277 | 8,504 | 8,929 |
| Investment securities, tax-exempt | 672 | 738 | 2,061 | 2,261 |
| Other | 279 | 246 | 879 | 730 |
| Total interest income | 48,300 | 46,821 | 143,036 | 136,667 |
| Interest expense: | | | | |
| Deposits | 3,879 | 2,874 | 11,440 | 8,271 |
| Short-term borrowings | 150 | 147 | 430 | 381 |
| Subordinated notes | 1,055 | 1,055 | 3,165 | 3,165 |
| Long-term debt and mandatorily redeemable securities | 522 | 536 | 1,725 | 1,540 |
| Total interest expense | 5,606 | 4,612 | 16,760 | 13,357 |
| Net interest income | 42,694 | 42,209 | 126,276 | 123,310 |
| Provision for loan and lease losses | 2,067 | 992 | 5,091 | 2,160 |
| Net interest income after provision for loan and lease losses | 40,627 | 41,217 | 121,185 | 121,150 |
| Noninterest income: | | | | |
| Trust fees | 4,691 | 4,634 | 14,422 | 14,438 |
| Service charges on deposit accounts | 2,366 | 2,413 | 6,749 | 6,977 |
| Debit card | 2,745 | 2,583 | 8,160 | 7,610 |
| Mortgage banking | 1,334 | 969 | 3,495 | 3,459 |
| Insurance commissions | 1,350 | 1,460 | 4,146 | 4,147 |
| Equipment rental | 6,657 | 5,881 | 19,247 | 16,302 |
| Gains on investment securities available-for-sale | 989 | — | 790 | 4 |
| Other | 2,533 | 3,192 | 9,580 | 9,477 |
| Total noninterest income | 22,665 | 21,132 | 66,589 | 62,414 |
| Noninterest expense: | | | | |
| Salaries and employee benefits | 22,136 | 21,835 | 64,681 | 63,554 |
| Net occupancy | 2,435 | 2,496 | 7,243 | 7,302 |
| Furniture and equipment | 4,898 | 4,604 | 14,499 | 13,471 |
| Depreciation - leased equipment | 5,570 | 4,858 | 16,115 | 13,342 |
| Professional fees | 1,244 | 1,237 | 3,653 | 3,215 |
| Supplies and communication | 1,256 | 1,307 | 4,138 | 4,122 |
| FDIC and other insurance | 647 | 848 | 2,437 | 2,544 |
| Business development and marketing | 1,263 | 1,244 | 3,268 | 3,507 |
| Loan and lease collection and repossession | 324 | 416 | 1,136 | 485 |
| Other | 1,372 | 2,223 | 4,714 | 5,828 |
| Total noninterest expense | 41,145 | 41,068 | 121,884 | 117,370 |
| Income before income taxes | 22,147 | 21,281 | 65,890 | 66,194 |
| Income tax expense | 7,883 | 7,353 | 23,329 | 23,125 |
| Net income | \$14,264 | \$ 13,928 | \$42,561 | \$ 43,069 |
| Per common share: | | | | |
| Basic net income per common share | \$0.55 | \$ 0.53 | \$1.63 | \$ 1.63 |

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|--|------------|------------|------------|------------|
| Diluted net income per common share | \$0.55 | \$ 0.53 | \$1.63 | \$ 1.63 |
| Cash dividends | \$0.180 | \$ 0.164 | \$0.540 | \$ 0.491 |
| Basic weighted average common shares outstanding | 25,867,162 | 26,164,646 | 25,881,360 | 26,211,630 |
| Diluted weighted average common shares outstanding | 25,867,162 | 26,164,646 | 25,881,360 | 26,211,630 |

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

Table of Contents

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

| | Three Months Ended September 30, 2016 | | Nine Months Ended September 30, 2015 | |
|---|--|-----------|---|-----------|
| Net income | \$ 14,264 | \$ 13,928 | \$ 42,561 | \$ 43,069 |
| Other comprehensive (loss) income: | | | | |
| Change in unrealized (depreciation) appreciation of available-for-sale securities | (905) | 2,256 | 5,742 | 475 |
| Reclassification adjustment for realized (gains) losses included in net income | (989) | — | (790) | (4) |
| Income tax effect | 711 | (847) | (1,859) | (177) |
| Other comprehensive (loss) income, net of tax | (1,183) | 1,409 | 3,093 | 294 |
| Comprehensive income | \$ 13,081 | \$ 15,337 | \$ 45,654 | \$ 43,363 |

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 | — | — | 43,069 | — | — | 43,069 |
| Other comprehensive income | — | — | — | — | 294 | 294 |
| Issuance of 117,122 common shares under stock based compensation awards, including related tax effects | — | — | (252) | 2,799 | — | 2,547 |
| Cost of 283,263 shares of common stock acquired for treasury | — | — | — | (8,208) | — | (8,208) |
| Common stock cash dividend (\$0.491 per share) | — | — | (12,941) | — | — | (12,941) |
| 10% common stock dividend (\$13 cash paid in lieu of fractional shares) | — | 90,003 | (90,016) | — | — | (13) |
| Balance at September 30, 2015 | \$ — | —\$436,538 | \$242,102 | \$(49,120) | \$ 9,701 | \$639,221 |
| Balance at January 1, 2016 | \$ — | —\$436,538 | \$251,812 | \$(50,852) | \$ 6,555 | \$644,053 |
| Net income | — | — | 42,561 | — | — | 42,561 |
| Other comprehensive income | — | — | — | — | 3,093 | 3,093 |
| Issuance of 109,887 common shares under stock based compensation awards, including related tax effects | — | — | (4) | 2,620 | — | 2,616 |
| Cost of 270,378 shares of common stock acquired for treasury | — | — | — | (8,030) | — | (8,030) |
| Common stock cash dividend (\$0.540 per share) | — | — | (14,034) | — | — | (14,034) |
| Balance at September 30, 2016 | \$ — | —\$436,538 | \$280,335 | \$(56,262) | \$ 9,648 | \$670,259 |

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

Table of Contents

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

| | Nine Months Ended September 30, | |
|---|---------------------------------------|-----------|
| | 2016 | 2015 |
| Operating activities: | | |
| Net income | \$42,561 | \$43,069 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan and lease losses | 5,091 | 2,160 |
| Depreciation of premises and equipment | 3,897 | 3,517 |
| Depreciation of equipment owned and leased to others | 16,115 | 13,342 |
| Stock-based compensation | 2,036 | 2,953 |
| Amortization of investment securities premiums and accretion of discounts, net | 4,594 | 3,433 |
| Amortization of mortgage servicing rights | 1,133 | 1,117 |
| Deferred income taxes | 82 | (3,914) |
| Gains on investment securities available-for-sale | (790) | (4) |
| Originations of loans held for sale, net of principal collected | (88,161) | (90,381) |
| Proceeds from the sales of loans held for sale | 80,474 | 97,402 |
| Net gain on sale of loans held for sale | (2,474) | (2,604) |
| Net gain on sale of other real estate and repossessions | (154) | (818) |
| Change in trading account securities | — | 205 |
| Change in interest receivable | (1,204) | (666) |
| Change in interest payable | 1,089 | 312 |
| Change in other assets | 7 | (4,802) |
| Change in other liabilities | 4,820 | 5,068 |
| Other | (367) | 1,200 |
| Net change in operating activities | 68,749 | 70,589 |
| Investing activities: | | |
| Proceeds from sales of investment securities available-for-sale | 5,139 | 1,299 |
| Proceeds from maturities and paydowns of investment securities available-for-sale | 158,178 | 78,033 |
| Purchases of investment securities available-for-sale | (199,056) | (75,757) |
| Net change in other investments | (485) | (927) |
| Loans sold or participated to others | — | 1,962 |
| Net change in loans and leases | (191,881) | (276,108) |
| Net change in equipment owned under operating leases | (23,627) | (34,984) |
| Purchases of premises and equipment | (5,532) | (4,612) |
| Proceeds from sales of other real estate and repossessions | 1,523 | 6,788 |
| Net change in investing activities | (255,741) | (304,306) |
| Financing activities: | | |
| Net change in demand deposits and savings accounts | 211,917 | 140,737 |
| Net change in time deposits | 25,935 | 75,559 |
| Net change in short-term borrowings | (17,222) | 37,688 |
| Proceeds from issuance of long-term debt | 10,837 | — |
| Payments on long-term debt | (5,928) | (924) |
| Stock issued under stock purchase plans | 116 | 149 |
| Acquisition of treasury stock | (8,030) | (8,208) |
| Cash dividends paid on common stock | (14,530) | (13,285) |

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|--|----------|----------|
| Net change in financing activities | 203,095 | 231,716 |
| Net change in cash and cash equivalents | 16,103 | (2,001) |
| Cash and cash equivalents, beginning of year | 79,721 | 66,190 |
| Cash and cash equivalents, end of period | \$95,824 | \$64,189 |
| Supplemental Information: | | |
| Non-cash transactions: | | |
| Loans transferred to other real estate and repossessed assets | \$2,850 | \$7,558 |
| 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. | | |

6

Table of Contents

1ST SOURCE CORPORATION

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Accounting Policies

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as “1st Source” or “the Company”), a broad array of financial products and services.

Basis of Presentation – The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in shareholders’ equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted.

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation’s Annual Report on Form 10-K (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.

7

Table of Contents

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

Note 2. Recent Accounting Pronouncements

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

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

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

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

ASU 2016-13 is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company 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 continues to assess the impact of ASU 2016-02 on its accounting and disclosures.

Table of Contents

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 continues to assess 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 but is not expected to have a material 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.

Table of Contents

Note 3. Investment Securities Available-For-Sale

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

| (Dollars in thousands) | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|----------------|------------------------|-------------------------|--------------|
| September 30, 2016 | | | | |
| U.S. Treasury and Federal agencies securities | \$ 405,726 | \$ 2,328 | \$ (59) |) \$ 407,995 |
| U.S. States and political subdivisions securities | 130,386 | 2,590 | (147) |) 132,829 |
| Mortgage-backed securities — Federal agencies | 239,486 | 4,884 | (200) |) 244,170 |
| Corporate debt securities | 35,342 | 288 | (15) |) 35,615 |
| Foreign government and other securities | 800 | 10 | — | 810 |
| Total debt securities | 811,740 | 10,100 | (421) |) 821,419 |
| Marketable equity securities | 1,428 | 5,779 | (11) |) 7,196 |
| Total investment securities available-for-sale | \$ 813,168 | \$ 15,879 | \$ (432) |) \$ 828,615 |

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 September 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 September 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 | \$ 212,850 | \$ 213,454 |
| Due after one year through five years | 320,672 | 324,588 |
| Due after five years through ten years | 38,732 | 39,207 |
| Due after ten years | — | — |
| Mortgage-backed securities | 239,486 | 244,170 |
| Total debt securities available-for-sale | \$ 811,740 | \$ 821,419 |

Table of Contents

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

| (Dollars in thousands) | Less than 12 Months | | 12 months or Longer | | Total | |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| September 30, 2016 | | | | | | |
| U.S. Treasury and Federal agencies securities | \$ 31,409 | \$ (59) | \$ — | \$ — | \$ 31,409 | \$ (59) |
| U.S. States and political subdivisions securities | 24,850 | (108) | 2,692 | (39) | 27,542 | (147) |
| Mortgage-backed securities - Federal agencies | 48,311 | (159) | 4,995 | (41) | 53,306 | (200) |
| Corporate debt securities | 4,992 | (15) | — | — | 4,992 | (15) |
| Foreign government and other securities | — | — | — | — | — | — |
| Total debt securities | 109,562 | (341) | 7,687 | (80) | 117,249 | (421) |
| Marketable equity securities | 340 | (10) | 3 | (1) | 343 | (11) |
| Total investment securities available-for-sale | \$ 109,902 | \$ (351) | \$ 7,690 | \$ (81) | \$ 117,592 | \$ (432) |

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 potential other-than-temporary-impairment (OTTI) for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, the impaired securities are analyzed on a qualitative and quantitative basis in determining OTTI. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In estimating OTTI losses, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

At September 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 | | Nine Months Ended | |
|------------------------|--------------------|--------------------|--------------------|--------------------|
| | September 30, 2016 | September 30, 2015 | September 30, 2016 | September 30, 2015 |
| Gross realized gains | \$ 989 | \$ — | — | \$ 4 |
| Gross realized losses | — | — | — | — |
| OTTI losses | — | — | (294) | — |

Net realized gains (losses) \$ 989 \$ —\$790 \$ 4

At September 30, 2016 and December 31, 2015, investment securities available-for-sale with carrying values of \$258.35 million and \$233.14 million, respectively, were pledged as collateral for security repurchase agreements and for other purposes.

11

Table of Contents

Note 4. Loan and Lease Financings

The Company evaluates loans and leases for credit quality at least annually but more frequently if certain circumstances occur (such as material new information which becomes available and indicates a potential change in credit risk). The Company uses two methods to assess credit risk: loan or lease credit quality grades and credit risk classifications. The purpose of the loan or lease credit quality grade is to document the degree of risk associated with individual credits as well as inform management of the degree of risk in the portfolio taken as a whole. Credit risk classifications are used to categorize loans by degree of risk and to designate individual or committee approval authorities for higher risk credits at the time of origination. Credit risk classifications include categories for: Acceptable, Marginal, Special Attention, Special Risk, Restricted by Policy, Regulated and Prohibited by Law. All loans and leases, except residential real estate and home equity loans and consumer loans, are assigned credit quality grades on a scale from 1 to 12 with grade 1 representing superior credit quality. The criteria used to assign grades to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on the Company's safety and soundness. Loans or leases graded 7 or weaker are considered "special attention" credits and, as such, relationships in excess of \$100,000 are reviewed quarterly as part of management's evaluation of the appropriateness of the reserve for loan and lease losses. Grade 7 credits are defined as "watch" and contain greater than average credit risk and are monitored to limit the exposure to increased risk; grade 8 credits are "special mention" and, following regulatory guidelines, are defined as having potential weaknesses that deserve management's close attention. Credits that exhibit well-defined weaknesses and a distinct possibility of loss are considered "classified" and are graded 9 through 12 corresponding to the regulatory definitions of "substandard" (grades 9 and 10) and the more severe "doubtful" (grade 11) and "loss" (grade 12). The following table shows the credit quality grades of the recorded investment in loans and leases, segregated by class.

| (Dollars in thousands) | Credit Quality Grades | | |
|-----------------------------|-----------------------|----------|-------------|
| | 1-6 | 7-12 | Total |
| September 30, 2016 | | | |
| Commercial and agricultural | \$758,615 | \$27,552 | \$786,167 |
| Auto and light truck | 396,001 | 4,808 | 400,809 |
| Medium and heavy duty truck | 270,255 | 1,223 | 271,478 |
| Aircraft | 809,233 | 27,744 | 836,977 |
| Construction equipment | 492,309 | 5,777 | 498,086 |
| Commercial real estate | 735,076 | 9,896 | 744,972 |
| Total | \$3,461,489 | \$77,000 | \$3,538,489 |

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 |
|---|------------|---------------|-----------|
| September 30, 2016 | | | |
| Residential real estate and home equity | \$ 488,325 | \$ 1,861 | \$490,186 |
| Consumer | 149,530 | 1,212 | 150,742 |

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| | | | |
|---|------------|----------|-----------|
| Total | \$ 637,855 | \$ 3,073 | \$640,928 |
| 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 |

12

Table of Contents

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

| (Dollars in thousands) | Current | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or More Past Due and Accruing | Total Accruing Loans | Nonaccrual | Total Financing Receivables |
|---|-------------|---------------------------|---------------------------|--|----------------------------|------------|-----------------------------------|
| September 30, 2016 | | | | | | | |
| Commercial and agricultural | \$782,090 | \$ 309 | \$ — | \$ — | \$782,399 | \$ 3,768 | \$786,167 |
| Auto and light truck | 400,532 | 250 | — | — | 400,782 | 27 | 400,809 |
| Medium and heavy duty truck | 270,883 | 595 | — | — | 271,478 | — | 271,478 |
| Aircraft | 822,620 | 5,548 | — | — | 828,168 | 8,809 | 836,977 |
| Construction equipment | 496,701 | 305 | — | — | 497,006 | 1,080 | 498,086 |
| Commercial real estate | 740,847 | 299 | 52 | — | 741,198 | 3,774 | 744,972 |
| Residential real estate and home equity | 487,304 | 460 | 561 | 551 | 488,876 | 1,310 | 490,186 |
| Consumer | 148,897 | 522 | 111 | 58 | 149,588 | 1,154 | 150,742 |
| Total | \$4,149,874 | \$ 8,288 | \$ 724 | \$ 609 | \$4,159,495 | \$ 19,922 | \$4,179,417 |
| 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 |

Table of Contents

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

| (Dollars in thousands) | Recorded Investment | Unpaid Principal Balance | Related Reserve |
|---|------------------------|--------------------------------|--------------------|
| September 30, 2016 | | | |
| With no related reserve recorded: | | | |
| Commercial and agricultural | \$ 327 | \$ 327 | \$ — |
| Auto and light truck | — | — | — |
| Medium and heavy duty truck | — | — | — |
| Aircraft | — | — | — |
| Construction equipment | 429 | 429 | — |
| Commercial real estate | 844 | 844 | — |
| Residential real estate and home equity | — | — | — |
| Consumer | — | — | — |
| Total with no related reserve recorded | 1,600 | 1,600 | — |
| With a reserve recorded: | | | |
| Commercial and agricultural | 3,188 | 3,188 | 767 |
| Auto and light truck | — | — | — |
| Medium and heavy duty truck | — | — | — |
| Aircraft | 8,809 | 8,809 | 1,990 |
| Construction equipment | 568 | 568 | 128 |
| Commercial real estate | 2,809 | 2,809 | 361 |
| Residential real estate and home equity | 361 | 363 | 144 |
| Consumer | — | — | — |
| Total with a reserve recorded | 15,735 | 15,737 | 3,390 |
| Total impaired loans | \$ 17,335 | \$ 17,337 | \$ 3,390 |
| 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 |
|----------------------|-----------|-----------|--------|

14

Table of Contents

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

| (Dollars in thousands) | Three Months Ended September 30, | | | | Nine Months Ended September 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 | \$3,282 | \$ 1 | \$3,882 | \$ 11 | \$3,480 | \$ 5 | \$5,275 | \$ 27 |
| Auto and light truck | — | — | — | — | — | — | — | — |
| Medium and heavy duty truck | — | — | — | — | — | — | — | — |
| Aircraft | 9,051 | 2 | 7,422 | 1 | 5,806 | 2 | 7,945 | 6 |
| Construction equipment | 618 | — | 738 | — | 671 | — | 736 | — |
| Commercial real estate | 2,961 | — | 9,762 | 108 | 5,821 | 123 | 10,800 | 392 |
| Residential real estate and home equity | 362 | 4 | 369 | 4 | 364 | 12 | 371 | 12 |
| Consumer | — | — | — | — | — | — | — | — |
| Total | \$16,274 | \$ 7 | \$22,173 | \$ 124 | \$16,142 | \$ 142 | \$25,127 | \$ 437 |

There was one nonperforming loan and lease modification classified as a troubled debt restructuring (TDR) during the three and nine months ended September 30, 2016 and two performing loan modifications classified as TDR during the three and nine months ended September 30, 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 was one modification during 2016 and no modifications during 2015 that resulted in an interest rate reduction below market rate. Consequently, the financial impact of the modification was immaterial.

There were no TDRs which had payment defaults within the twelve months following modification during the three and nine months ended September 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 September 30, 2016 and December 31, 2015.

| (Dollars in thousands) | September 30, 2016 | December 31, 2015 |
|------------------------|--------------------|-------------------|
| Performing TDRs | \$ 361 | \$ 7,437 |
| Nonperforming TDRs | 1,780 | 1,926 |
| Total TDRs | \$ 2,141 | \$ 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.

15

Table of Contents

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

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

| (Dollars in thousands) | Commercial and agricultural | Auto and light trucks | Medium and heavy duty truck | Aircraft | Construction equipment | Commercial real estate | Residential real estate and home equity | Consumer loans | Total |
|-----------------------------------|-----------------------------|-----------------------|-----------------------------|-----------|------------------------|------------------------|---|----------------|-----------|
| September 30, 2016 | | | | | | | | | |
| Balance, beginning of period | \$ 14,835 | \$ 11,667 | \$ 4,350 | \$ 34,661 | \$ 7,512 | \$ 13,462 | \$ 3,377 | \$ 1,594 | \$ 91,458 |
| Charge-offs | 206 | 1 | — | 4,834 | 36 | 31 | 55 | 174 | 5,337 |
| Recoveries | 160 | 65 | — | 186 | 172 | 48 | 1 | 77 | 709 |
| Net charge-offs (recoveries) | 46 | (64) | — | 4,648 | (136) | (17) | 54 | 97 | 4,628 |
| Provision (recovery of provision) | 90 | (3,998) | (72) | 5,148 | 286 | 460 | 106 | 47 | 2,067 |
| Balance, end of period | \$ 14,879 | \$ 7,733 | \$ 4,278 | \$ 35,161 | \$ 7,934 | \$ 13,939 | \$ 3,429 | \$ 1,544 | \$ 88,897 |
| September 30, 2015 | | | | | | | | | |
| Balance, beginning of period | \$ 11,865 | \$ 11,445 | \$ 4,333 | \$ 32,840 | \$ 7,807 | \$ 13,226 | \$ 3,444 | \$ 1,628 | \$ 86,588 |
| Charge-offs | 88 | — | — | 195 | — | — | 39 | 310 | 632 |
| Recoveries | 80 | 64 | 10 | 279 | 112 | 39 | 2 | 82 | 668 |
| Net charge-offs (recoveries) | 8 | (64) | (10) | (84) | (112) | (39) | 37 | 228 | (36) |
| Provision (recovery of provision) | 2,182 | (2,131) | 101 | 1,117 | (276) | (244) | (8) | 251 | 992 |
| Balance, end of period | \$ 14,039 | \$ 9,378 | \$ 4,444 | \$ 34,041 | \$ 7,643 | \$ 13,021 | \$ 3,399 | \$ 1,651 | \$ 87,616 |

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

| (Dollars in thousands) | Commercial and agricultural | Auto and light trucks | Medium and heavy duty truck | Aircraft | Construction equipment | Commercial real estate | Residential real estate and home equity | Consumer loans | Total |
|------------------------|-----------------------------|-----------------------|-----------------------------|----------|------------------------|------------------------|---|----------------|-------|
| September 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 | 422 | 4 | — | 4,834 | 128 | 32 | 136 | 676 | 6,232 |
| Recoveries | 360 | 191 | 10 | 412 | 320 | 388 | 7 | 238 | 1,926 |
| Net charge-offs (recoveries) | 62 | (187) | (10) | 4,422 | (192) | (356) | 129 | 438 | 4,306 |
| Provision (recovery of provision) | (515) | (1,723) | (431) | 7,210 | 150 | (179) | 176 | 403 | 5,091 |
| Balance, end of period | \$ 14,879 | \$ 7,733 | \$ 4,278 | \$ 35,161 | \$ 7,934 | \$ 13,939 | \$ 3,429 | \$ 1,544 | \$ 88,897 |

September 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 | 1,053 | 22 | — | 244 | — | — | 104 | 630 | 2,053 |
| Recoveries | 644 | 315 | 15 | 721 | 357 | 174 | 9 | 206 | 2,441 |
| Net charge-offs (recoveries) | 409 | (293) | (15) | (477) | (357) | (174) | 95 | 424 | (388) |
| Provision (recovery of provision) | 2,688 | (1,241) | (71) | 1,330 | 278 | (423) | (608) | 207 | 2,160 |
| Balance, end of period | \$ 14,039 | \$ 9,378 | \$ 4,444 | \$ 34,041 | \$ 7,643 | \$ 13,021 | \$ 3,399 | \$ 1,651 | \$ 87,616 |

Table of Contents

The following table shows the reserve for loan and lease losses and recorded investment in loans and leases, segregated by class, separated between individually and collectively evaluated for impairment as of September 30, 2016 and December 31, 2015.

| (Dollars in thousands) | Commercial agricultural equipment | Auto and light trucks | and Medium and heavy duty truck | Aircraft | Construction equipment | Commercial real estate | Residential real estate and home equity | Consumer loans | Total |
|---|-----------------------------------|-----------------------|---------------------------------|-----------|------------------------|------------------------|---|----------------|-------------|
| September 30, 2016 | | | | | | | | | |
| Reserve for loan and lease losses | | | | | | | | | |
| Ending balance, individually evaluated for impairment | \$767 | \$— | \$— | \$1,990 | \$128 | \$361 | \$144 | \$— | \$3,390 |
| Ending balance, collectively evaluated for impairment | 14,112 | 7,733 | 4,278 | 33,171 | 7,806 | 13,578 | 3,285 | 1,544 | 85,507 |
| Total reserve for loan and lease losses | \$14,879 | \$7,733 | \$4,278 | \$35,161 | \$7,934 | \$13,939 | \$3,429 | \$1,544 | \$88,897 |
| Recorded investment in loans | | | | | | | | | |
| Ending balance, individually evaluated for impairment | \$3,515 | \$— | \$— | \$8,809 | \$997 | \$3,653 | \$361 | \$— | \$17,335 |
| Ending balance, collectively evaluated for impairment | 782,652 | 400,809 | 271,478 | 828,168 | 497,089 | 741,319 | 489,825 | 150,742 | 4,162,082 |
| Total recorded investment in loans | \$786,167 | \$400,809 | \$271,478 | \$836,977 | \$498,086 | \$744,972 | \$490,186 | \$150,742 | \$4,179,417 |
| 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 \$765.16 million and \$798.51 million at September 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.

Table of Contents

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

| (Dollars in thousands) | Three Months | | Nine Months | |
|--|--------------------------------|--------------------------------|--------------------------------|--------------------------------|
| | Ended September 30, 2016 | Ended September 30, 2015 | Ended September 30, 2016 | Ended September 30, 2015 |
| Mortgage servicing rights: | | | | |
| Balance at beginning of period | \$4,339 | \$4,661 | \$4,608 | \$4,733 |
| Additions | 313 | 342 | 760 | 1,048 |
| Amortization | (417) | (339) | (1,133) | (1,117) |
| Sales | — | — | — | — |
| Carrying value before valuation allowance at end of period | 4,235 | 4,664 | 4,235 | 4,664 |
| 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 | \$4,235 | \$4,664 | \$4,235 | \$4,664 |
| Fair value of mortgage servicing rights at end of period | \$5,666 | \$6,945 | \$5,666 | \$6,945 |

At September 30, 2016 and 2015, the fair value of MSR's exceeded the carrying value reported in the Statements of Financial Condition by \$1.43 million and \$2.28 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 \$0.68 million and \$0.71 million for the three months ended September 30, 2016 and 2015, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$2.04 million and \$2.14 million for the nine months ended September 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) | September 30, December 31, | |
|--|----------------------------|------------|
| | 2016 | 2015 |
| Amounts of commitments: | | |
| Loan commitments to extend credit | \$ 849,706 | \$ 829,509 |
| Standby letters of credit | \$ 34,070 | \$ 37,984 |
| Commercial and similar letters of credit | \$ 3,052 | \$ 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.

Table of Contents

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 September 30, 2016 and December 31, 2015, investment balances, including all legally binding commitments to fund future investments totaled \$9.90 million and \$9.62 million, respectively. In addition, the Bank had a liability for all legally binding unfunded commitments of \$4.17 million and \$3.64 million at September 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 |
| September 30, 2016 | | | | | |
| Interest rate swap contracts | \$ 561,646 | Other assets | \$ 15,068 | Other liabilities | \$ 15,354 |
| Loan commitments | 11,172 | Mortgages held for sale | 63 | N/A | — |
| Forward contracts - mortgage loan | 27,641 | N/A | — | Mortgages held for sale | 117 |
| Total | \$ 600,459 | | \$ 15,131 | | \$ 15,471 |
| 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 September | Nine Months Ended September 30, |
| | |

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| (Dollars in thousands) | Statement of Income classification | 2016 | 2015 | 2016 | 2015 |
|-----------------------------------|------------------------------------|-------|--------|---------|--------|
| Interest rate swap contracts | Other expense | \$36 | \$(67) | \$(100) | \$(45) |
| Interest rate swap contracts | Other income | 150 | 427 | 464 | 724 |
| Loan commitments | Mortgage banking | (105) | (57) | 16 | 30 |
| Forward contracts - mortgage loan | Mortgage banking | 190 | (357) | (130) | (11) |
| Total | | \$271 | \$(54) | \$250 | \$698 |

Table of Contents

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 |
| September 30, 2016 | | | | | | |
| Interest rate swaps | \$ 15,204 | \$ 136 | \$ 15,068 | \$ — | \$ — | —\$ 15,068 |
| 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 |
| September 30, 2016 | | | | | | |
| Interest rate swaps | \$ 15,490 | \$ 136 | \$ 15,354 | \$ — | \$ 15,323 | \$ 31 |
| Repurchase agreements | 167,029 | — | 167,029 | 167,029 | — | — |
| Total | \$ 182,519 | \$ 136 | \$ 182,383 | \$ 167,029 | \$ 15,323 | \$ 31 |
| 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 September 30, 2016 and December 31, 2015, repurchase agreements had a remaining contractual maturity of \$165.32 million and \$128.88 million in overnight, \$1.40 million and \$1.78 million in up to 30 days and \$0.30 million and \$0.00 million in greater than 90 days, respectively and were collateralized by U.S. Treasury and Federal agencies securities.

Note 9. Earnings Per Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include non-vested restricted stock awards. Non-vested restricted stock awards are considered participating securities to the extent the holders of these securities receive non-forfeitable dividends at the same rate as holders of common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method.

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 September 30, 2016 and 2015.

Table of Contents

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 | | Nine Months | |
|---|---------------|---------------|---------------|---------------|
| | Ended | | Ended | |
| (Dollars in thousands - except per share amounts) | September 30, | September 30, | September 30, | September 30, |
| | 2016 | 2015 | 2016 | 2015 |
| Distributed earnings allocated to common stock | \$4,656 | \$ 4,299 | \$13,995 | \$ 12,888 |
| Undistributed earnings allocated to common stock | 9,515 | 9,499 | 28,260 | 29,748 |
| Net earnings allocated to common stock | 14,171 | 13,798 | 42,255 | 42,636 |
| Net earnings allocated to participating securities | 93 | 130 | 306 | 433 |
| Net income allocated to common stock and participating securities | \$14,264 | \$ 13,928 | \$42,561 | \$ 43,069 |
| Weighted average shares outstanding for basic earnings per common share | 25,867,166 | 26,164,646 | 25,881,366 | 26,211,630 |
| Dilutive effect of stock compensation | — | — | — | — |
| Weighted average shares outstanding for diluted earnings per common share | 25,867,166 | 26,164,646 | 25,881,366 | 26,211,630 |
| Basic earnings per common share | \$0.55 | \$ 0.53 | \$1.63 | \$ 1.63 |
| Diluted earnings per common share | \$0.55 | \$ 0.53 | \$1.63 | \$ 1.63 |

Note 10. Stock Based Compensation

As of September 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 September 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 nine months ended September 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 nine months ended September 30, 2016 and 2015. As of September 30, 2016 and 2015 there were no outstanding stock options. There were no stock options exercised during the nine months ended September 30, 2016 and 2015. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of September 30, 2016, there was \$5.03 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 3.15 years.

Table of Contents

Note 11. Accumulated Other Comprehensive Income

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | | Affected Line Item in the Statements of Income |
|---------------------------------------|----------------------------------|------|---------------------------------|------|---|
| (Dollars in thousands) | 2016 | 2015 | 2016 | 2015 | |
| Realized gains included in net income | \$ 989 | \$ — | -\$790 | \$ 4 | Gains on investment securities available-for-sale |
| | 989 | — | 790 | 4 | Income before income taxes |
| Tax effect | (371) | — | (296) | (2) | Income tax expense |
| Net of tax | \$ 618 | \$ — | -\$494 | \$ 2 | Net income |

Note 12. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$0.41 million at September 30, 2016 and \$0.25 million at December 31, 2015. Interest and penalties were recognized through the income tax provision. For the nine months ended September 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 September 30, 2016 and December 31, 2015, respectively.

Tax years that remain open and subject to audit include the federal 2013-2015 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 September 30, 2016 and December 31, 2015, all mortgages held for sale were carried at fair value.

Table of Contents

The following table shows the differences between the fair value carrying amount of mortgages held for sale measured at fair value and the aggregate unpaid principal amount the Company is contractually entitled to receive at maturity.

| (Dollars in thousands) | Fair value carrying amount | Aggregate unpaid principal | Excess of fair value carrying amount over (under) unpaid principal | |
|--|----------------------------|----------------------------|--|-----|
| September 30, 2016 | | | | |
| Mortgages held for sale reported at fair value | \$ 19,986 | \$ 19,605 | \$ 381 | (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.

23

Table of Contents

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

Management believes an adjustment is required to "mid-market" valuations for derivatives tied to its performing loan portfolio to recognize the imprecision and related exposure inherent in the process of estimating expected credit losses as well as velocity of deterioration evident with systemic risks embedded in these portfolios.

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

(Dollars in thousands)

September 30, 2016

Assets:

Investment securities available-for-sale:

| | Level 1 | Level 2 | Level 3 | Total |
|---|----------|-----------|---------|-----------|
| U.S. Treasury and Federal agencies securities | \$20,014 | \$387,981 | \$— | \$407,995 |
| U.S. States and political subdivisions securities | — | 128,846 | 3,983 | 132,829 |
| Mortgage-backed securities — Federal agencies | — | 244,170 | — | 244,170 |
| Corporate debt securities | — | 35,615 | — | 35,615 |
| Foreign government and other securities | — | — | 810 | 810 |
| Total debt securities | 20,014 | 796,612 | 4,793 | 821,419 |
| Marketable equity securities | 7,196 | — | — | 7,196 |
| Total investment securities available-for-sale | 27,210 | 796,612 | 4,793 | 828,615 |
| Mortgages held for sale | — | 19,986 | — | 19,986 |
| Accrued income and other assets (interest rate swap agreements) | — | 15,068 | — | 15,068 |
| Total | \$27,210 | \$831,666 | \$4,793 | \$863,669 |

Liabilities:

| | | | | |
|--|-----|----------|-----|----------|
| Accrued expenses and other liabilities (interest rate swap agreements) | \$— | \$15,354 | \$— | \$15,354 |
| Total | \$— | \$15,354 | \$— | \$15,354 |

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 |

Table of Contents

The following table shows changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended September 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 July 1, 2016 | \$ 4,661 | \$ 810 | \$ 5,471 |
| Total gains or losses (realized/unrealized): | | | |
| Included in earnings | — | — | — |
| Included in other comprehensive income | (16 |) — | (16) |
| Purchases | — | — | — |
| Issuances | — | — | — |
| Sales | — | — | — |
| Settlements | — | — | — |
| Maturities | (662 |) — | (662) |
| Transfers into Level 3 | — | — | — |
| Transfers out of Level 3 | — | — | — |
| Ending balance September 30, 2016 | \$ 3,983 | \$ 810 | \$ 4,793 |
| Beginning balance July 1, 2015 | \$ 5,444 | \$ 807 | \$ 6,251 |
| Total gains or losses (realized/unrealized): | | | |
| Included in earnings | — | — | — |
| Included in other comprehensive income | 15 | 4 | 19 |
| Purchases | — | — | — |
| Issuances | — | — | — |
| Sales | — | — | — |
| Settlements | — | — | — |
| Maturities | (780 |) — | (780) |
| Transfers into Level 3 | — | — | — |
| Transfers out of Level 3 | — | — | — |
| Ending balance September 30, 2015 | \$ 4,679 | \$ 811 | \$ 5,490 |

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 September 30, 2016 or 2015. No transfers between levels occurred during the three months ended September 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 |
|--|------------|--------------------------|--------------------------|-----------------|
| September 30, 2016 | | | | |
| Investment securities available-for sale | | | | |
| Direct placement municipal securities | \$ 3,983 | Discounted cash flows | Credit spread assumption | 0.89% - 1.68% |
| Foreign government | \$ 810 | Discounted cash flows | Market yield assumption | 0.34% - 0.98% |
| December 31, 2015 | | | | |
| Investment securities available-for sale | | | | |
| Direct placement municipal securities | \$ 4,528 | Discounted cash flows | Credit spread assumption | 1.27% - 2.03% |

Table of Contents

Financial Instruments on Non-recurring Basis:

The Company may be required, from time to time, to measure certain other financial assets at fair value on a non-recurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower of cost or market accounting or impairment charges of individual assets.

The Credit Policy Committee (CPC), a management committee, is responsible for overseeing the valuation processes and procedures for Level 3 measurements of impaired loans, other real estate and repossessions. The CPC reviews these assets on a quarterly basis to determine the accuracy of the observable inputs, generally third party appraisals, auction values, values derived from trade publications and data submitted by the borrower, and the appropriateness of the unobservable inputs, generally discounts due to current market conditions and collection issues. The CPC establishes discounts based on asset type and valuation source; deviations from the standard are documented. The discounts are reviewed periodically, annually at a minimum, to determine they remain appropriate. Consideration is given to current trends in market values for the asset categories and gains and losses on sales of similar assets. The Loan and Funds Management Committee of the Board of Directors is responsible for overseeing the CPC.

Discounts vary depending on the nature of the assets and the source of value. Aircraft are generally valued using quarterly trade publications adjusted for engine time, condition, maintenance programs, discounted by 10%. Likewise, autos are valued using current auction values, discounted by 10%; medium and heavy duty trucks are valued using trade publications and auction values, discounted by 15%. Construction equipment is generally valued using trade publications and auction values, discounted by 20%. Real estate is valued based on appraisals or evaluations, discounted by 20% with higher discounts for property in poor condition or property with characteristics which may make it more difficult to market. Commercial loans subject to borrowing base certificates are generally discounted by 20% for receivables and 40% - 75% for inventory with higher discounts when monthly borrowing base certificates are not required or received.

Impaired loans and related write-downs are based on the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are reviewed quarterly and estimated using customized discounting criteria, appraisals and dealer and trade magazine quotes which are used in a market valuation approach. In accordance with fair value measurements, only impaired loans for which a reserve for loan loss has been established based on the fair value of collateral require classification in the fair value hierarchy. As a result, only a portion of the Company's impaired loans are classified in the fair value hierarchy.

Partnership investments and the adjustments to fair value primarily result from application of lower of cost or fair value accounting. The partnership investments are priced using financial statements provided by the partnerships. Quantitative unobservable inputs are not reasonably available for reporting purposes.

The Company has established 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 September 30, 2016: impaired loans - \$4.85 million; partnership

investments - \$0.00 million; mortgage servicing rights - \$0.00 million; repossessions - \$0.02 million; and other real estate - \$0.00 million.

Table of Contents

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

| (Dollars in thousands) | Level 1 | Level 2 | Level 3 | Total |
|---|---------|---------|-----------|----------|
| September 30, 2016 | | | | |
| Impaired loans - collateral based | \$ — | —\$ | —\$10,644 | \$10,644 |
| Accrued income and other assets (partnership investments) | — | — | 32 | 32 |
| Accrued income and other assets (mortgage servicing rights) | — | — | 4,235 | 4,235 |
| Accrued income and other assets (repossessions) | — | — | 8,089 | 8,089 |
| Accrued income and other assets (other real estate) | — | — | 551 | 551 |
| Total | \$ — | —\$ | —\$23,551 | \$23,551 |

December 31, 2015

| | | | | |
|---|------|-----|-----------|----------|
| Impaired loans - collateral based | \$ — | —\$ | —\$220 | \$220 |
| Accrued income and other assets (partnership investments) | — | — | 1,000 | 1,000 |
| Accrued income and other assets (mortgage servicing rights) | — | — | 4,608 | 4,608 |
| Accrued income and other assets (repossessions) | — | — | 6,927 | 6,927 |
| Accrued income and other assets (other real estate) | — | — | 736 | 736 |
| Total | \$ — | —\$ | —\$13,491 | \$13,491 |

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

| (Dollars in thousands) | Carrying Value | Fair Value | Valuation Methodology | Unobservable Inputs | Range of Inputs |
|---------------------------|----------------|------------|--|---|-------------------------------|
| September 30, 2016 | | | | | |
| Impaired loans | \$ 10,644 | \$ 10,644 | Collateral based measurements including appraisals, trade publications, and auction values | Discount for lack of marketability and current conditions | 10% - 100% |
| Mortgage servicing rights | 4,235 | 5,666 | Discounted cash flows | Constant prepayment rate (CPR) Discount rate | 13.4% - 18.0% 9.0% - 11.9% |
| Repossessions | 8,089 | 8,290 | Appraisals, trade publications and auction values | Discount for lack of marketability | 1% - 9% |
| Other real estate | 551 | 602 | Appraisals | Discount for lack of marketability | 0% - 14% |
| December 31, 2015 | | | | | |
| Impaired loans | \$ 220 | \$ 220 | Collateral based measurements including appraisals, trade publications, and auction values | Discount for lack of marketability and current conditions | 20% |
| Mortgage servicing rights | 4,608 | 7,246 | Discounted cash flows | Constant prepayment rate (CPR) Discount rate | 9.4% - 15.0% 9.8% - 13.3% |

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| | | | | | |
|-------------------|-------|-------|---|------------------------------------|----------|
| Repossessions | 6,927 | 7,104 | Appraisals, trade publications and auction values | Discount for lack of marketability | 2% - 3% |
| Other real estate | 736 | 851 | Appraisals | Discount for lack of marketability | 8% - 35% |

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

27

Table of Contents

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

| (Dollars in thousands) | Carrying or Contract Value | Fair Value | Level 1 | Level 2 | Level 3 |
|---|-------------------------------|-------------|-------------|-------------|-----------|
| September 30, 2016 | | | | | |
| Assets: | | | | | |
| Cash and due from banks | \$ 65,724 | \$65,724 | \$65,724 | \$— | \$ — |
| Federal funds sold and interest bearing deposits with other banks | 30,100 | 30,100 | 30,100 | — | — |
| Investment securities, available-for-sale | 828,615 | 828,615 | 27,210 | 796,612 | 4,793 |
| Other investments | 22,458 | 22,458 | 22,458 | — | — |
| Mortgages held for sale | 19,986 | 19,986 | — | 19,986 | — |
| Loans and leases, net of reserve for loan and lease losses | 4,090,520 | 4,106,384 | — | — | 4,106,384 |
| Mortgage servicing rights | 4,235 | 5,666 | — | — | 5,666 |
| Interest rate swaps | 15,068 | 15,068 | — | 15,068 | — |
| Liabilities: | | | | | |
| Deposits | \$ 4,377,038 | \$4,383,019 | \$3,210,359 | \$1,172,660 | \$ — |
| Short-term borrowings | 216,007 | 216,007 | 168,004 | 48,003 | — |
| Long-term debt and mandatorily redeemable securities | 64,760 | 64,810 | — | 64,810 | — |
| Subordinated notes | 58,764 | 56,458 | — | 56,458 | — |
| Interest rate swaps | 15,354 | 15,354 | — | 15,354 | — |
| Off-balance-sheet instruments * | — | 381 | — | 381 | — |
| December 31, 2015 | | | | | |
| Assets: | | | | | |
| Cash and due from banks | \$ 65,171 | \$65,171 | \$65,171 | \$— | \$ — |
| Federal funds sold and interest bearing deposits with other banks | 14,550 | 14,550 | 14,550 | — | — |
| Investment securities, available-for-sale | 791,727 | 791,727 | 27,458 | 758,932 | 5,337 |
| Other investments | 21,973 | 21,973 | 21,973 | — | — |
| Mortgages held for sale | 9,825 | 9,825 | — | 9,825 | — |
| Loans and leases, net of reserve for loan and lease losses | 3,906,580 | 3,927,967 | — | — | 3,927,967 |
| Mortgage servicing rights | 4,608 | 7,246 | — | — | 7,246 |
| Interest rate swaps | 9,859 | 9,859 | — | 9,859 | — |
| Liabilities: | | | | | |
| Deposits | \$ 4,139,186 | \$4,139,649 | \$2,998,443 | \$1,141,206 | \$ — |
| Short-term borrowings | 233,229 | 233,229 | 134,156 | 99,073 | — |
| Long-term debt and mandatorily redeemable securities | 57,379 | 57,193 | — | 57,193 | — |
| Subordinated notes | 58,764 | 48,304 | — | 48,304 | — |
| Interest rate swaps | 10,044 | 10,044 | — | 10,044 | — |
| Off-balance-sheet instruments * | — | 375 | — | 375 | — |

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

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

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

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

Table of Contents

Short-Term Borrowings — The carrying values of Federal funds purchased, securities sold under repurchase agreements, and other short-term borrowings, including the liability related to mortgage loans available for repurchase under GNMA optional repurchase programs, approximate their fair values.

Long-Term Debt and Mandatorily Redeemable Securities — The fair values of long-term debt are estimated using discounted cash flow analyses, based on the current estimated incremental borrowing rates for similar types of borrowing arrangements. The carrying values of mandatorily redeemable securities are based on the current estimated cost of redeeming these securities which approximate their fair values.

Subordinated Notes — Fair values are estimated based on calculated market prices of comparable securities.

Off-Balance-Sheet Instruments — Contract and fair values for certain off-balance-sheet financial instruments (guarantees) are estimated based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Limitations — Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instruments. Because no market exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other such factors.

These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. These estimates are subjective in nature and require considerable judgment to interpret market data. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange, nor are they intended to represent the fair value of the Company as a whole. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. The fair value estimates presented herein are based on pertinent information available to management as of the respective balance sheet date. Although the Company is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued since the presentation dates, and therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.

Other significant assets, such as premises and equipment, other assets, and liabilities not defined as financial instruments, are not included in the above disclosures. Also, the fair value estimates for deposits do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market.

ITEM 2.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following management's discussion and analysis is presented to provide information concerning 1st Source Corporation and its subsidiaries' (collectively referred to as "the Company", "we", and "our") financial condition as of September 30, 2016, as compared to December 31, 2015, and the results of operations for the three and nine months ended September 30, 2016 and 2015. This discussion and analysis should be read in conjunction with our consolidated financial statements and the financial and statistical data appearing elsewhere in this report and our 2015 Annual Report.

Except for historical information contained herein, the matters discussed in this document express "forward-looking statements." Generally, the words "believe," "contemplate," "seek," "plan," "possible," "assume," "expect," "intend," "targeted," "remain," "estimate," "anticipate," "project," "will," "should," "indicate," "would," "may" and other similar expressions are used to identify forward-looking statements but are not the exclusive means of identifying such statements. Those statements, including statements, projections, estimates or assumptions concerning future events or performance, and other statements that are other than statements of historical fact, are subject to material risks and uncertainties. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. We may make other written or oral forward-looking statements from time to time. Readers are advised that various important factors could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected in such forward-looking statements. Such factors include, but are not limited to, changes in law, regulations or GAAP; our competitive position within the markets we serve; increasing consolidation within the banking industry;

unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2015, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

Table of Contents

FINANCIAL CONDITION

Our total assets at September 30, 2016 were \$5.45 billion, an increase of \$260.00 million or 5.01% from December 31, 2015. Total loans and leases were \$4.18 billion, an increase of \$184.73 million or 4.62% from December 31, 2015. Total investment securities, available-for-sale were \$828.62 million which represented an increase of \$36.89 million or 4.66% and equipment owned under operating leases was \$117.88 million, an increase of \$7.51 million or 6.81% from the comparable figures at December 31, 2015. Total deposits were \$4.38 billion, an increase of \$237.85 million or 5.75% from the end of 2015. Short-term borrowings were \$216.01 million, a decrease of \$17.22 million or 7.38% from December 31, 2015.

Nonperforming assets at September 30, 2016 were \$29.22 million, an increase of \$8.60 million or 41.66% from the \$20.62 million reported at December 31, 2015. At September 30, 2016 and December 31, 2015, nonperforming assets were 0.68% and 0.50%, respectively of net loans and leases.

The following table shows accrued income and other assets.

| (Dollars in thousands) | September 30, 2016 | December 31, 2015 |
|--|-----------------------|----------------------|
| Accrued income and other assets: | | |
| Bank owned life insurance cash surrender value | \$ 63,298 | \$ 61,992 |
| Accrued interest receivable | 14,893 | 13,689 |
| Mortgage servicing rights | 4,235 | 4,608 |
| Other real estate | 551 | 736 |
| Repossessions | 8,089 | 6,927 |
| All other assets | 42,661 | 41,900 |
| Total accrued income and other assets | \$ 133,727 | \$ 129,852 |

CAPITAL

As of September 30, 2016, total shareholders' equity was \$670.26 million, up \$26.21 million or 4.07% from the \$644.05 million at December 31, 2015. In addition to net income of \$42.56 million, other significant changes in shareholders' equity during the first nine months of 2016 included \$8.03 million of common stock acquired for treasury and \$14.03 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$9.65 million at September 30, 2016, compared to \$6.56 million at December 31, 2015. The increase in accumulated other comprehensive income/(loss) during 2016 was the result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 12.30% as of September 30, 2016, compared to 12.41% at December 31, 2015. Book value per common share rose to \$25.91 at September 30, 2016, from \$24.75 at December 31, 2015.

We declared and paid cash dividends per common share of \$0.18 during the third quarter of 2016. The trailing four quarters dividend payout ratio, representing cash dividends per common share divided by diluted earnings per common share, was 32.93%. The dividend payout is continually reviewed by management and the Board of Directors subject to the Company's capital and dividend policy.

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

The final capital rules that became effective on January 1, 2015 introduced a requirement for a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain this required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. The capital buffer requirement is being phased in over three years beginning in 2016. We have included the 0.625% increase for 2016 in our minimum capital adequacy ratios in the table below. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis on January 1, 2019. Management believes that, as of September 30, 2016, 1st

Source and the Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if all such requirements were currently in effect.

30

Table of Contents

The actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of September 30, 2016, are presented in the table below.

| | Actual | | Minimum Capital Adequacy | | Minimum Capital Adequacy with Capital Buffer | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|-----------|--------|--------------------------|-------|--|--------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| (Dollars in thousands) | | | | | | | | |
| Total Capital (to Risk-Weighted Assets): | | | | | | | | |
| 1st Source Corporation | \$702,108 | 14.87% | \$377,625 | 8.00% | \$407,127 | 8.625% | \$472,031 | 10.00% |
| 1st Source Bank | 655,938 | 13.92 | 377,104 | 8.00 | 406,566 | 8.625 | 471,380 | 10.00 |
| Tier 1 Capital (to Risk-Weighted Assets): | | | | | | | | |
| 1st Source Corporation | 640,108 | 13.56 | 283,219 | 6.00 | 312,721 | 6.625 | 377,625 | 8.00 |
| 1st Source Bank | 596,451 | 12.65 | 282,828 | 6.00 | 312,290 | 6.625 | 377,104 | 8.00 |
| Common Equity Tier 1 Capital (to Risk-Weighted Assets): | | | | | | | | |
| 1st Source Corporation | 583,108 | 12.35 | 212,414 | 4.50 | 241,916 | 5.125 | 306,820 | 6.50 |
| 1st Source Bank | 596,451 | 12.65 | 212,121 | 4.50 | 241,582 | 5.125 | 306,397 | 6.50 |
| Tier 1 Capital (to Average Assets): | | | | | | | | |
| 1st Source Corporation | 640,108 | 12.00 | 213,418 | 4.00 | N/A | N/A | 266,773 | 5.00 |
| 1st Source Bank | 596,451 | 11.19 | 213,230 | 4.00 | N/A | N/A | 266,538 | 5.00 |

LIQUIDITY AND INTEREST RATE SENSITIVITY

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

We have borrowing sources available to supplement deposits and meet our funding needs. 1st Source Bank has established relationships with several banks to provide short term borrowings in the form of federal funds purchased. At September 30, 2016, we had no outstandings and could borrow approximately \$265.00 million for a short time from these banks on a collective basis. As of September 30, 2016, we had \$83.48 million outstanding in FHLB advances and could borrow an additional \$149.84 million. We also had \$492.24 million available to borrow from the FRB with no amounts outstanding as of September 30, 2016.

Our loan to asset ratio was 76.72% at September 30, 2016 compared to 77.00% at December 31, 2015 and 77.47% at September 30, 2015. Cash and cash equivalents totaled \$95.82 million at September 30, 2016 compared to \$79.72 million at December 31, 2015 and \$64.19 million at September 30, 2015. At September 30, 2016, the Statement of Financial Condition was rate sensitive by \$640.35 million more assets than liabilities scheduled to reprice within one year, or approximately 1.30%. Management believes that the present funding sources provide adequate liquidity to meet our cash flow needs.

Under Indiana law governing the collateralization of public fund deposits, the Indiana Board of Depositories determines which financial institutions are required to pledge collateral based on the strength of their financial ratings. We have been informed that no collateral is required for our public fund deposits. However, the Board of Depositories could alter this requirement in the future and adversely impact our liquidity. Our potential liquidity exposure if we must pledge collateral is approximately \$578 million.

RESULTS OF OPERATIONS

Net income for the three and nine month periods ended September 30, 2016 was \$14.26 million and \$42.56 million, compared to \$13.93 million and \$43.07 million for the same periods in 2015. Diluted net income per common share was \$0.55 and \$1.63 for the three and nine month periods ended September 30, 2016, compared to \$0.53 and \$1.63 for the same periods in 2015. Return on average common shareholders' equity was 8.62% for the nine months ended September 30, 2016, compared to 9.12% in 2015. The return on total average assets was 1.07% for the nine months

ended September 30, 2016, compared to 1.16% in 2015.

Net income decreased slightly for the nine months ended September 30, 2016 compared to the first nine months of 2015. Net interest income and noninterest income increased offset by an increase in provision for loan and lease losses, noninterest expense and income tax expense. Details of the changes in the various components of net income are discussed further below.

31

Table of Contents

NET INTEREST INCOME

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

DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY

INTEREST RATES AND INTEREST DIFFERENTIAL

| (Dollars in thousands) | September 30, 2016 | | | Three Months Ended June 30, 2016 | | | September 30, 2015 | | |
|---|--------------------|-------------------------|------------|-------------------------------------|-------------------------|------------|--------------------|-------------------------|------------|
| | Average Balance | Interest Income/Expense | Yield/Rate | Average Balance | Interest Income/Expense | Yield/Rate | Average Balance | Interest Income/Expense | Yield/Rate |
| ASSETS | | | | | | | | | |
| Investment securities available-for-sale: | | | | | | | | | |
| Taxable | \$690,867 | \$2,384 | 1.37% | \$678,849 | \$3,040 | 1.80% | \$660,921 | \$3,277 | 1.97% |
| Tax exempt ⁽¹⁾ | 130,201 | 973 | 2.97% | 126,007 | 1,012 | 3.23% | 121,050 | 1,087 | 3.56% |
| Mortgages held for sale | 14,681 | 134 | 3.63% | 11,100 | 110 | 3.99% | 9,610 | 100 | 4.13% |
| Loans and leases, net of unearned discount ⁽¹⁾ | 4,189,340 | 44,980 | 4.27% | 4,105,111 | 43,926 | 4.30% | 3,910,981 | 42,527 | 4.31% |
| Other investments | 41,286 | 279 | 2.69% | 65,568 | 309 | 1.90% | 30,774 | 246 | 3.17% |
| Total earning assets ⁽¹⁾ | 5,066,375 | 48,750 | 3.83% | 4,986,635 | 48,397 | 3.90% | 4,733,336 | 47,237 | 3.96% |
| Cash and due from banks | 60,665 | | | 60,786 | | | 59,172 | | |
| Reserve for loan and lease losses | (92,237) | | | (90,107) | | | (87,109) | | |
| Other assets | 390,727 | | | 386,316 | | | 355,951 | | |
| Total assets | \$5,425,530 | | | \$5,343,630 | | | \$5,061,350 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | | | |
| Interest-bearing deposits | \$3,393,457 | \$3,879 | 0.45% | \$3,380,208 | \$3,790 | 0.45% | \$3,107,108 | \$2,874 | 0.37% |
| Short-term borrowings | 217,460 | 150 | 0.27% | 204,828 | 119 | 0.23% | 266,201 | 147 | 0.22% |
| Subordinated notes | 58,764 | 1,055 | 7.14% | 58,764 | 1,055 | 7.22% | 58,764 | 1,055 | 7.12% |
| Long-term debt and mandatorily redeemable securities | 64,641 | 522 | 3.21% | 65,906 | 680 | 4.15% | 57,432 | 536 | 3.70% |
| Total interest-bearing liabilities | 3,734,322 | 5,606 | 0.60% | 3,709,706 | 5,644 | 0.61% | 3,489,505 | 4,612 | 0.52% |
| Noninterest-bearing deposits | 959,796 | | | 920,194 | | | 888,687 | | |
| Other liabilities | 61,406 | | | 54,638 | | | 44,193 | | |

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| | | | | | | |
|--|-------------|--------|-------------|--------|-------------|--------|
| Shareholders' equity | 670,006 | | 659,092 | | 638,965 | |
| Total liabilities and shareholders' equity | \$5,425,530 | | \$5,343,630 | | \$5,061,350 | |
| Less: Fully tax-equivalent adjustments | (450) | | (460) | | (416) | |
| Net interest income/margin (GAAP-derived) ⁽¹⁾ | \$42,694 | 3.35 % | \$42,293 | 3.41 % | \$42,209 | 3.54 % |
| Fully tax-equivalent adjustments | 450 | | 460 | | 416 | |
| Net interest income/margin - FTE ⁽¹⁾ | \$43,144 | 3.39 % | \$42,753 | 3.45 % | \$42,625 | 3.57 % |

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

Quarter Ended September 30, 2016 compared to the Quarter Ended September 30, 2015

The taxable equivalent net interest income for the three months ended September 30, 2016 was \$43.14 million, an increase of 1.22% over the same period in 2015. The net interest margin on a fully taxable equivalent basis was 3.39% for the three months ended September 30, 2016, compared to 3.57% for the three months ended September 30, 2015. During the three month period ended September 30, 2016, average earning assets increased \$333.04 million or 7.04% over the comparable period in 2015. Average interest-bearing liabilities increased \$244.82 million or 7.02%. The yield on average earning assets decreased 13 basis points to 3.83% from 3.96% primarily due to lower rates on loans and leases and investment securities available-for-sale. Total cost of average interest-bearing liabilities increased 8 basis points to 0.60% from 0.52%. The result to the net interest margin, or the ratio of net interest income to average earning assets, was a decrease of 18 basis points.

The largest contributors to the decrease in the yield on average earning assets for the three months ended September 30, 2016, compared to the three months ended September 30, 2015, was a reduction in yields on net loans and leases of 4 basis points and a reduction in yields on investment securities available-for-sale of 59 basis points due to market conditions. Average net loans and leases increased \$278.36 million or 7.12%. Total average investment securities increased \$39.10 million or 5.00%. Average mortgages held for sale increased \$5.07 million or 52.77%. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, increased \$10.51 million or 34.16%.

Table of Contents

Average interest-bearing deposits increased \$286.35 million or 9.22% for the third quarter of 2016 over the same period in 2015. The effective rate paid on average interest-bearing deposits increased 8 basis points to 0.45% from 0.37%. The increase in the average cost of interest-bearing deposits was primarily the result of higher rates on certificates of deposit.

Average short-term borrowings decreased \$48.74 million or 18.31% for the third quarter of 2016 compared to the same period in 2015. Interest paid on short-term borrowings increased 5 basis points. Average long-term debt and mandatorily redeemable securities increased \$7.21 million or 12.55%. Interest paid on long-term debt and mandatorily redeemable securities decreased 49 basis points. The decrease was due to lower rates on mandatorily redeemable securities.

DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY

INTEREST RATES AND INTEREST DIFFERENTIAL

| (Dollars in thousands) | Nine Months Ended September 30, 2016 | | | September 30, 2015 | | |
|---|---|----------------------------|----------------|--------------------|----------------------------|----------------|
| | Average Balance | Interest Income/Expense | Yield/ Rate | Average Balance | Interest Income/Expense | Yield/ Rate |
| ASSETS | | | | | | |
| Investment securities available-for-sale: | | | | | | |
| Taxable | \$680,606 | \$ 8,504 | 1.67 % | \$664,787 | \$ 8,929 | 1.80 % |
| Tax exempt ⁽¹⁾ | 126,370 | 2,998 | 3.17 % | 122,556 | 3,332 | 3.63 % |
| Mortgages held for sale | 11,650 | 339 | 3.89 % | 12,010 | 351 | 3.91 % |
| Loans and leases, net of unearned discount ⁽¹⁾ | 4,101,284 | 131,687 | 4.29 % | 3,795,929 | 124,566 | 4.39 % |
| Other investments | 52,694 | 879 | 2.23 % | 31,829 | 730 | 3.07 % |
| Total earning assets ⁽¹⁾ | 4,972,604 | 144,407 | 3.88 % | 4,627,111 | 137,908 | 3.98 % |
| Cash and due from banks | 60,103 | | | 61,047 | | |
| Reserve for loan and lease losses | (90,403) | | | (86,321) | | |
| Other assets | 384,366 | | | 345,062 | | |
| Total assets | \$5,326,670 | | | \$4,946,899 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | |
| Interest-bearing deposits | \$3,342,828 | \$ 11,440 | 0.46 % | \$3,077,922 | \$ 8,271 | 0.36 % |
| Short-term borrowings | 217,920 | 430 | 0.26 % | 241,570 | 381 | 0.21 % |
| Subordinated notes | 58,764 | 3,165 | 7.19 % | 58,764 | 3,165 | 7.20 % |
| Long-term debt and mandatorily redeemable securities | 64,351 | 1,725 | 3.58 % | 57,188 | 1,540 | 3.60 % |
| Total interest-bearing liabilities | 3,683,863 | 16,760 | 0.61 % | 3,435,444 | 13,357 | 0.52 % |
| Noninterest-bearing deposits | 926,456 | | | 836,009 | | |
| Other liabilities | 56,748 | | | 43,835 | | |
| Shareholders' equity | 659,603 | | | 631,611 | | |
| Total liabilities and shareholders' equity | \$5,326,670 | | | \$4,946,899 | | |
| Less: Fully tax-equivalent adjustments | | (1,371) | | | (1,241) | |
| Net interest income/margin (GAAP-derived) ⁽¹⁾ | | \$ 126,276 | 3.39 % | | \$ 123,310 | 3.56 % |
| Fully tax-equivalent adjustments | | 1,371 | | | 1,241 | |
| Net interest income/margin - FTE ⁽¹⁾ | | \$ 127,647 | 3.43 % | | \$ 124,551 | 3.60 % |

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

Nine Months Ended September 30, 2016 compared to the Nine Months Ended September 30, 2015

The taxable equivalent net interest income for the nine months ended September 30, 2016 was \$127.65 million, an increase of 2.49% over the comparable period in 2015. The net interest margin on a fully taxable equivalent basis was 3.43% for the nine months ended September 30, 2016 compared to a net interest margin of 3.60% for the same period in 2015.

During the nine month period ended September 30, 2016, average earning assets increased \$345.49 million or 7.47% over the comparable period in 2015. Average interest-bearing liabilities increased \$248.42 million or 7.23%. The yield on average earning assets decreased 10 basis points to 3.88% from 3.98%. The rate earned on assets decreased during 2016 over 2015 partially due to lower net interest recoveries of \$1.46 million or 4 basis points largely related to one commercial loan relationship. Total cost of average interest-bearing liabilities increased 9 basis points to 0.61% from 0.52%. The result to the net interest margin, or the ratio of net interest income to average earning assets, was a decrease of 17 basis points.

Table of Contents

The largest contributor to the decrease in the yield on average earning assets for the nine months ended September 30, 2016, compared to the nine months ended September 30, 2015, was a reduction in yields on net loans and leases of 10 basis points due to the aforementioned net interest recoveries in 2015 which impacted the yield on net loans and leases by 6 basis points. Average net loans and leases increased \$305.36 million or 8.04%. Total average investment securities increased \$19.63 million or 2.49%. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank stock and commercial paper, increased \$20.87 million or 65.55%.

Average interest-bearing deposits increased \$264.91 million or 8.61% for the first nine months of 2016 over the same period in 2015. The effective rate paid on average interest-bearing deposits increased 10 basis points to 0.46% compared to 0.36%. The increase in the average cost of interest-bearing deposits was primarily the result of higher rates on certificates of deposit and accelerated discount amortization on called brokered certificates of deposit during the first quarter of 2016.

Average short-term borrowings decreased \$23.65 million or 9.79% for the first nine months of 2016 compared to the same period in 2015. Interest paid on short-term borrowings increased 5 basis points. The decrease in short-term borrowings was primarily the result of decreased borrowings with the Federal Home Loan Bank (FHLB). Average long-term debt and mandatorily redeemable securities increased \$7.16 million or 12.53%. Interest paid on long-term debt and mandatorily redeemable securities decreased 2 basis points. The decrease was due to lower rates on long-term debt.

Reconciliation of Non-GAAP Financial Measures

The accounting and reporting policies of 1st Source conform to generally accepted accounting principles (“GAAP”) in the United States and prevailing practices in the banking industry. However, certain non-GAAP performance measures are used by management to evaluate and measure the Company’s performance. These include taxable-equivalent net interest income (including its individual components) and net interest margin (including its individual components). Management believes that these measures provide users of the Company’s financial information a more meaningful view of the performance of the interest-earning assets and interest-bearing liabilities. Management reviews yields on certain asset categories and the net interest margin of the Company and its banking subsidiaries on a fully taxable-equivalent (“FTE”) basis. In this non-GAAP presentation, net interest income is adjusted to reflect tax-exempt interest income on an equivalent before-tax basis. This measure ensures comparability of net interest income arising from both taxable and tax-exempt sources.

| | Three Months Ended | | September 30, 2015 | Nine Months Ended | | |
|---|--------------------------|------------------|--------------------------|--------------------------|--------------------------|---|
| | September 30, 2016 | June 30, 2016 | | September 30, 2016 | September 30, 2015 | |
| (Dollars in thousands) | | | | | | |
| Calculation of Net Interest Margin | | | | | | |
| (A) Interest income (GAAP) | \$48,300 | \$47,937 | \$46,821 | \$143,036 | \$136,667 | |
| Fully tax-equivalent adjustments: | | | | | | |
| (B) - Loans and leases | 150 | 145 | 67 | 434 | 170 | |
| (C) - Tax-exempt investment securities | 300 | 315 | 349 | 937 | 1,071 | |
| (D) Interest income - FTE (A+B+C) | 48,750 | 48,397 | 47,237 | 144,407 | 137,908 | |
| (E) Interest expense (GAAP) | 5,606 | 5,644 | 4,612 | 16,760 | 13,357 | |
| (F) Net interest income (GAAP) (A-E) | 42,694 | 42,293 | 42,209 | 126,276 | 123,310 | |
| (G) Net interest income - FTE (D-E) | 43,144 | 42,753 | 42,625 | 127,647 | 124,551 | |
| (H) Annualization factor | 3.978 | 4.022 | 3.967 | 1.336 | 1.337 | |
| (I) Total earning assets | \$5,066,375 | \$4,986,635 | \$4,733,336 | \$4,972,604 | \$4,627,111 | |
| Net interest margin (GAAP-derived) (F*H)/I | 3.35 | % 3.41 | % 3.54 | % 3.39 | % 3.56 | % |
| Net interest margin - FTE (G*H)/I | 3.39 | % 3.45 | % 3.57 | % 3.43 | % 3.60 | % |

PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES

The provision for loan and lease losses for the three and nine month periods ended September 30, 2016 was \$2.07 million and \$5.09 million compared to a provision for loan and lease losses in the three and nine month periods ended September 30, 2015 of \$0.99 million and \$2.16 million respectively. Net charge offs of \$4.63 million were recorded for the third quarter 2016, compared to net recoveries of \$0.04 million for the same quarter a year ago. Year-to-date net charge offs of \$4.31 million have been recorded in 2016, compared to net recoveries of \$0.39 million through September 30, 2015.

Table of Contents

We believe geopolitical events have the potential to negatively impact the U.S. economy. Current concerns include the ongoing corruption scandals and political uncertainty in Latin American countries and the heightened concerns globally of terrorist attacks. We include a factor in our loss ratios for the global risk, as we are increasingly aware of the threat that global concerns may affect our customers. While we are unable to determine with any precision the impact of global economic and political issues on our loan portfolios, we feel the risks are real and significant. We believe there is a risk of negative consequences for our borrowers that would affect their ability to repay their financial obligations. Therefore, we continue to include a factor for global risk in our analysis for the third quarter of 2016. Another area of concern continues to be our aircraft portfolio where we have a collateral concentration and \$243 million in foreign exposure. The aircraft industry was among the sectors affected most by the sluggish economy. Once again, we are noting softening collateral values, particularly for private jets. We remain concerned about the prolonged low prices for several models. We also have some foreign exposure in this portfolio, particularly in Mexico and Brazil. Brazil is suffering from its worst recession in twenty-five years. We continue to monitor individual customer performance and assess risks in the portfolio as a whole. We do not see a clear trend of improvement or deterioration. We have assessed our reserve ratios, which were established based on the higher and more volatile loss histories and believe our reserve ratios remain appropriate.

On September 30, 2016, 30 day and over loan and lease delinquencies as a percentage of loan and lease outstandings were 0.23% compared to 0.46% on September 30, 2015. The decrease in delinquencies is largely attributable to the aircraft and consumer portfolios. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.13% as compared to 2.22% one year ago. A summary of loan and lease loss experience during the three and nine months ended September 30, 2016 and 2015 is located in Note 5 of the Consolidated Financial Statements.

A loan or lease is considered impaired, based on current information and events, if it is probable that we 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. We evaluate loans and leases exceeding \$100,000 for impairment and establish 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. A summary of impaired loans as of September 30, 2016 and December 31, 2015 is reflected in Note 4 of the Consolidated Financial Statements.

NONPERFORMING ASSETS

The following table shows nonperforming assets.

| (Dollars in thousands) | September 30, 2016 | December 31, 2015 | September 30, 2015 |
|---|-----------------------|----------------------|-----------------------|
| Loans and leases past due 90 days or more | \$ 611 | \$ 122 | \$ 411 |
| Nonaccrual loans and leases | 19,922 | 12,718 | 18,985 |
| Other real estate | 551 | 736 | 232 |
| Former bank premises held for sale | — | — | 515 |
| Repossessions | 8,089 | 6,927 | 6,602 |
| Equipment owned under operating leases | 43 | 121 | 146 |
| Total nonperforming assets | \$ 29,216 | \$ 20,624 | \$ 26,891 |

Nonperforming assets as a percentage of total loans and leases were 0.68% at September 30, 2016, 0.50% at December 31, 2015, and 0.66% at September 30, 2015. Nonperforming assets totaled \$29.22 million at September 30, 2016, an increase of 41.66% from the \$20.62 million reported at December 31, 2015, and a 8.65% increase from the \$26.89 million reported at September 30, 2015. The increase in nonperforming assets during the first nine months of 2016 was related to an increase in nonaccrual loans and leases, repossessions and loans and leases past due 90 days or more offset by a decrease in equipment owned under operating leases and sales of other real estate. The increase in nonperforming assets at September 30, 2016 from September 30, 2015 occurred primarily in nonaccrual loans and leases and repossessions.

The increase in loans past due 90 days or more at September 30, 2016 from December 31, 2015 occurred in the residential real estate and home equity portfolio. The increase in nonaccrual loans and leases at September 30, 2016 from December 31, 2015 occurred primarily in the aircraft, commercial real estate, consumer, and construction equipment portfolios offset by decreases in the commercial and agricultural and residential real estate and home equity portfolios. The increase in nonaccrual loans and leases at September 30, 2016 from September 30, 2015 occurred primarily in the commercial real estate, aircraft, consumer, and construction equipment portfolios offset by decreases in the commercial and agricultural and residential real estate and home equity portfolios. A summary of nonaccrual loans and leases and past due aging for the period ended September 30, 2016 and December 31, 2015 is located in Note 4 of the Consolidated Financial Statements.

Other real estate is the result of foreclosing on real estate in the local market for which we have a current appraisal and are well secured. Other real estate increased slightly over the past year due to current foreclosures outpacing sales of existing properties.

Table of Contents

Repossessions consisted mainly of aircraft financing. At the time of repossession, the recorded amount of the loan or lease is written down to the fair value of the equipment or vehicle by a charge to the reserve for loan and lease losses or other income, if a positive adjustment, unless the equipment is in the process of immediate sale. Any subsequent fair value write-downs or write-ups, to the extent of previous write-downs, are included in noninterest expense.

The following table shows a summary of other real estate and repossessions.

| (Dollars in thousands) | September 30, December 31, September 30, | | |
|---|--|----------|----------|
| | 2016 | 2015 | 2015 |
| Commercial and agricultural | \$ 62 | \$ 564 | \$ 24 |
| Auto and light truck | 28 | 10 | 29 |
| Medium and heavy duty truck | — | — | — |
| Aircraft | 7,828 | 6,916 | 6,506 |
| Construction equipment | 200 | — | — |
| Commercial real estate | 69 | — | 137 |
| Residential real estate and home equity | 453 | 159 | 94 |
| Consumer | — | 14 | 44 |
| Total | \$ 8,640 | \$ 7,663 | \$ 6,834 |

For financial statement purposes, nonaccrual loans and leases are included in loan and lease outstandings, whereas repossessions and other real estate are included in other assets.

Foreign Outstandings — Our foreign loan and lease outstandings, all denominated in U.S. dollars were \$242.88 million and \$205.83 million as of September 30, 2016 and December 31, 2015, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were \$95.58 million and \$135.64 million as of September 30, 2016, respectively, compared to \$76.79 million and \$116.73 million as of December 31, 2015, respectively. As of September 30, 2016 and December 31, 2015 there was not a significant concentration in any other country.

NONINTEREST INCOME

The following table shows the details of noninterest income.

| (Dollars in thousands) | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|--|-------------------------------------|----------|--------------|-------------|------------------------------------|----------|--------------|-------------|
| | 2016 | 2015 | \$ Change | % Change | 2016 | 2015 | \$ Change | % Change |
| Noninterest income: | | | | | | | | |
| Trust fees | \$4,691 | \$4,634 | 57 | 1.23 % | \$14,422 | \$14,438 | (16) | (0.11) % |
| Service charges on deposit accounts | 2,366 | 2,413 | (47) | (1.95) % | 6,749 | 6,977 | (228) | (3.27) % |
| Debit card | 2,745 | 2,583 | 162 | 6.27 % | 8,160 | 7,610 | 550 | 7.23 % |
| Mortgage banking | 1,334 | 969 | 365 | 37.67 % | 3,495 | 3,459 | 36 | 1.04 % |
| Insurance commissions | 1,350 | 1,460 | (110) | (7.53) % | 4,146 | 4,147 | (1) | (0.02) % |
| Equipment rental | 6,657 | 5,881 | 776 | 13.20 % | 19,247 | 16,302 | 2,945 | 18.07 % |
| Gains on investment securities available-for-sale | 989 | — | 989 | NM | 790 | 4 | 786 | NM |
| Other | 2,533 | 3,192 | (659) | (20.65) % | 9,580 | 9,477 | 103 | 1.09 % |
| Total noninterest income | \$22,665 | \$21,132 | 1,533 | 7.25 % | \$66,589 | \$62,414 | 4,175 | 6.69 % |

NM = Not Meaningful

Trust fees were relatively flat during the three months ended September 30, 2016 and during the first nine months of 2016 compared with the same periods a year ago. Trust fees are largely based on the number and size of client relationships and the market value of assets under management. The market value of trust assets under management at September 30, 2016 and December 31, 2015 was \$4.08 billion and \$3.78 billion, respectively.

Service charges on deposit accounts declined for the three and nine months ended September 30, 2016 over the comparable periods in 2015. The decrease in service charges on deposit accounts primarily reflects a lower volume of

nonsufficient fund transactions and a decrease in paper statement fees as clients continue to move to online access for account statements.

Debit card income increased in the three and nine months ended September 30, 2016 over the same periods a year ago. The improvement in debit card income was mainly the result of an increased volume of debit card transactions in 2016.

Table of Contents

Mortgage banking income increased in the three and nine months ended September 30, 2016 as compared to the same periods a year ago. The increase in the third quarter of 2016 compared to the third quarter of 2015 was caused by increased gains on loan sales and higher secondary market loan production offset by a decrease in servicing fees. The slight increase for the first nine months of 2016 compared with the same period a year ago was primarily caused by increased gains on loan sales offset by lower secondary market production and a reduction in loan servicing fees. Insurance commissions declined during the three months ended September 30, 2016 over the same period a year ago. The decrease in insurance commissions was primarily due to a smaller book of business in the third quarter of 2016. Insurance commissions were flat for the nine months ended September 30, 2016 compared to the same period in 2015. Equipment rental income grew for the three and nine months ended September 30, 2016 over the comparable periods in 2015. The increase was the result of the average equipment rental portfolio increasing 29.32% over the same period a year ago due to improving market conditions for equipment finance mainly in auto and light trucks and construction equipment. The increase in equipment rental income was offset by a similar increase in depreciation on equipment owned under operating leases.

Gains on investment securities available-for-sale during the three months ended September 30, 2016 compared to the same period in 2015 resulted from the sale of marketable equity securities. Gains on investment securities available-for-sale during the first nine months of 2016 compared with the same period a year ago resulted from the sale of marketable equity securities and U.S. States and political subdivisions securities offset by an other than temporary impairment charge of \$0.29 million on a marketable equity security.

Other income decreased for the three months ended September 30, 2016 over the same period a year ago as a result of lower monogram fund income and decreased customer swap fees. Other income increased during the first nine months of 2016 compared to the same period a year ago. The increased income was mainly due to gains on the liquidation of a partnership investment required by the Volcker Rule and higher mutual fund income offset by lower monogram fund income, decreased customer swap fees and a reduction in claim proceeds from bank owned life insurance.

NONINTEREST EXPENSE

The following table shows the details of noninterest expense.

| (Dollars in thousands) | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | | |
|--|-------------------------------------|----------|--------------|-------------|------------------------------------|-----------|--------------|-------------|--|
| | 2016 | 2015 | \$ Change | % Change | 2016 | 2015 | \$ Change | % Change | |
| Noninterest expense: | | | | | | | | | |
| Salaries and employee benefits | \$22,136 | \$21,835 | 301 | 1.38 % | \$64,681 | \$63,554 | 1,127 | 1.77 % | |
| Net occupancy | 2,435 | 2,496 | (61) | (2.44)% | 7,243 | 7,302 | (59) | (0.81)% | |
| Furniture and equipment | 4,898 | 4,604 | 294 | 6.39 % | 14,499 | 13,471 | 1,028 | 7.63 % | |
| Depreciation - leased equipment | 5,570 | 4,858 | 712 | 14.66 % | 16,115 | 13,342 | 2,773 | 20.78 % | |
| Professional fees | 1,244 | 1,237 | 7 | 0.57 % | 3,653 | 3,215 | 438 | 13.62 % | |
| Supplies and communication | 1,256 | 1,307 | (51) | (3.90)% | 4,138 | 4,122 | 16 | 0.39 % | |
| FDIC and other insurance | 647 | 848 | (201) | (23.70)% | 2,437 | 2,544 | (107) | (4.21)% | |
| Business development and marketing | 1,263 | 1,244 | 19 | 1.53 % | 3,268 | 3,507 | (239) | (6.81)% | |
| Loan and lease collection and repossession | 324 | 416 | (92) | (22.12)% | 1,136 | 485 | 651 | NM | |
| Other | 1,372 | 2,223 | (851) | (38.28)% | 4,714 | 5,828 | (1,114) | (19.11)% | |
| Total noninterest expense | \$41,145 | \$41,068 | 77 | 0.19 % | \$121,884 | \$117,370 | 4,514 | 3.85 % | |

Salaries and employee benefits increased for the three and nine months ended September 30, 2016 compared to the same periods in 2015. The increase in 2016 was mainly due to higher base salary expense offset by decreased group insurance costs. Higher base salary expense was primarily due to normal performance raises. Group insurance costs decreased as a result of overall lower health insurance claims experience.

Net occupancy expense decreased slightly during the three and nine months ended September 30, 2016 compared to the same periods a year ago.

Furniture and equipment expense, including depreciation, increased during the three and nine months ended September 30, 2016 compared to the same periods in 2015. Furniture and equipment expense was higher in 2016 mainly due to increased software maintenance costs and depreciation on new equipment with banking center remodels.

During the third quarter and first nine months of 2016, depreciation on leased equipment increased in conjunction with the increase in equipment rental income as compared to the same periods one year ago.

Table of Contents

Professional fees were flat during the third quarter of 2016 compared to the same period a year ago. Professional fees grew during the first nine months of 2016 compared to the same period in 2015 mainly due to higher legal fees offset by lower audit fees.

Supplies and communication expense decreased slightly during the third quarter of 2016 compared to the same period a year ago and increased slightly for the first nine months of 2016 compared with the same period in 2015.

FDIC and other insurance decreased during the three and nine months ended September 30, 2016 compared to the same periods a year ago. The decrease in 2016 was mainly due to lower assessments as a result of the Deposit Insurance Fund's reserve ratio exceeding the FDIC's established benchmark at the end of the second quarter.

Business development and marketing expense increased slightly during the third quarter of 2016 and decreased for the nine months ended September 30, 2016 compared to the same periods a year ago. The lower expense for 2016 was primarily the result of decreased marketing promotions.

Loan and lease collection and repossession expense decreased during the third quarter of 2016 and increased for the nine months ended September 30, 2016 compared to the same periods in 2015. The decrease during the third quarter of 2016 over the same period a year ago was primarily due to decreased valuation adjustments offset by lower recoveries on repurchased mortgage loans and higher collection and repossession expenses. Loan and lease collection and repossession expense increased for the first nine months of 2016 compared to the same period in 2015 mainly due to fewer gains on the sale of other real estate owned and repossessions and lower recoveries on repurchased mortgage loans offset by decreased valuation adjustments.

Other expenses were lower during the three and nine months ended September 30, 2016 compared to the same periods in 2015. The decrease during the third quarter of 2016 over a year ago primarily related to reduced residential mortgage foreclosure expenses, a decrease in provision on unfunded loan commitments and fewer write-downs on fixed assets, offset by higher ATM losses. The decrease during the first nine months of 2016 compared to the same period in 2015 was mainly the result of reduced residential mortgage foreclosure expenses, writedowns of fixed assets and expenses related to a previously reported proceeding that involved the Bank as trustee in 2015 not present in 2016, a decrease in employment and relocation expenses, and reduced intangible asset amortization as items fully amortize offset by higher ATM losses, increased provision on unfunded loan commitments and reduced gains on the sale of operating lease equipment.

INCOME TAXES

The provision for income taxes for the three and nine month periods ended September 30, 2016 was \$7.88 million and \$23.33 million respectively, compared to \$7.35 million and \$23.13 million for the same periods in 2015. The effective tax rates were 35.59% and 34.55% for the third quarters ended September 30, 2016 and 2015, respectively and 35.41% and 34.94% for the nine months ended September 30, 2016 and 2015 respectively.

ITEM 3.

QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

There have been no material changes in market risks faced by 1st Source since December 31, 2015. For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2015.

ITEM 4.

CONTROLS AND PROCEDURES

As of the end of the period covered by this report an evaluation was carried out, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, at September 30, 2016, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by 1st Source in reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms and are designed to ensure that information required to be disclosed in those reports is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.

In addition, there were no changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the third fiscal quarter of 2016 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

ITEM 1. Legal Proceedings.

1st Source and its subsidiaries are involved in various legal proceedings incidental to the conduct of our businesses. Management does not expect that the outcome of any such proceedings will have a material adverse effect on our consolidated financial position or results of operations.

ITEM 1A. Risk Factors.

There have been no material changes in risks faced by 1st Source since December 31, 2015. For information regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2015.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs* | Maximum Number (or Approximate Dollar Value) of Shares that may yet be Purchased Under the Plans or Programs |
|-------------------------|----------------------------------|------------------------------|---|--|
| July 01 - 31, 2016 | — | \$ — | — | 1,387,785 |
| August 01 - 31, 2016 | 711 | 34.39 | 711 | 1,387,074 |
| September 01 - 30, 2016 | — | — | — | 1,387,074 |

* 1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on July 24, 2014. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock from time to time to mitigate the potential dilutive effects of stock-based incentive plans and other potential uses of common stock for corporate purposes. Since the inception of the plan, 1st Source has repurchased a total of 612,926 shares.

ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Mine Safety Disclosures.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits

The following exhibits are filed with this report:

31.1 Certification of Chief Executive Officer required by Rule 13a-14(a).

31.2 Certification of Chief Financial Officer required by Rule 13a-14(a).

32.1 Certification pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer.

32.2 Certification pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer.

101.INS XBRL Instance Document

101.SCH XBRL Taxonomy Extension Schema Document

101.CAL XBRL Taxonomy Extension Calculation Linkbase Document

101.LAB XBRL Taxonomy Extension Labels Linkbase Document

101.PRE XBRL Taxonomy Extension Presentation Linkbase Document

101.DEF XBRL Taxonomy Extension Definition Linkbase Document

39

Table of Contents

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

1st Source Corporation

DATE October 20, 2016 /s/ CHRISTOPHER J. MURPHY III
Christopher J. Murphy III
Chairman of the Board and CEO

DATE October 20, 2016 /s/ ANDREA G. SHORT
Andrea G. Short
Treasurer and Chief Financial Officer
Principal Accounting Officer