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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549  
**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 30, 2015

OR

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

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

Commission file number 0-6233



(Exact name of registrant as specified in its charter)

**INDIANA**

(State or other jurisdiction of incorporation or organization)

**35-1068133**

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

**100 North Michigan Street**

**South Bend, IN**

(Address of principal executive offices)

**46601**

(Zip Code)

**(574) 235-2000**

(Registrant's telephone number, including area code)

**Not Applicable**

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

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

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

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

(Do not check if a smaller reporting company)

Smaller reporting company ☐

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

Number of shares of common stock outstanding as of July 17, 2015 — 26,199,344 shares

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

|                                                                                                                                           | June 30,<br>2015    | December 31,<br>2014 |
|-------------------------------------------------------------------------------------------------------------------------------------------|---------------------|----------------------|
| <b><u>ASSETS</u></b>                                                                                                                      |                     |                      |
| Cash and due from banks                                                                                                                   | \$ 66,302           | \$ 64,834            |
| Federal funds sold and interest bearing deposits with other banks                                                                         | 11,396              | 1,356                |
| Investment securities available-for-sale (amortized cost of \$773,195 and \$776,057 at June 30, 2015 and December 31, 2014, respectively) | 786,471             | 791,118              |
| Other investments                                                                                                                         | 20,743              | 20,801               |
| Trading account securities                                                                                                                | 211                 | 205                  |
| Mortgages held for sale                                                                                                                   | 14,782              | 13,604               |
| Loans and leases, net of unearned discount:                                                                                               |                     |                      |
| Commercial and agricultural                                                                                                               | 719,972             | 710,758              |
| Auto and light truck                                                                                                                      | 446,731             | 397,902              |
| Medium and heavy duty truck                                                                                                               | 250,045             | 247,153              |
| Aircraft financing                                                                                                                        | 751,665             | 727,665              |
| Construction equipment financing                                                                                                          | 445,479             | 399,940              |
| Commercial real estate                                                                                                                    | 641,205             | 616,587              |
| Residential real estate                                                                                                                   | 454,730             | 445,759              |
| Consumer                                                                                                                                  | 142,872             | 142,810              |
| <b>Total loans and leases</b>                                                                                                             | 3,852,699           | 3,688,574            |
| Reserve for loan and lease losses                                                                                                         | (86,588)            | (85,068)             |
| <b>Net loans and leases</b>                                                                                                               | 3,766,111           | 3,603,506            |
| Equipment owned under operating leases, net                                                                                               | 93,875              | 74,143               |
| Net premises and equipment                                                                                                                | 50,931              | 50,328               |
| Goodwill and intangible assets                                                                                                            | 84,967              | 85,371               |
| Accrued income and other assets                                                                                                           | 118,234             | 124,692              |
| <b>Total assets</b>                                                                                                                       | <b>\$ 5,014,023</b> | <b>\$ 4,829,958</b>  |
| <b><u>LIABILITIES</u></b>                                                                                                                 |                     |                      |
| Deposits:                                                                                                                                 |                     |                      |
| Noninterest bearing                                                                                                                       | \$ 857,079          | \$ 796,241           |
| Interest bearing                                                                                                                          | 3,105,506           | 3,006,619            |
| <b>Total deposits</b>                                                                                                                     | 3,962,585           | 3,802,860            |
| Short-term borrowings:                                                                                                                    |                     |                      |
| Federal funds purchased and securities sold under agreements to repurchase                                                                | 122,658             | 138,843              |
| Other short-term borrowings                                                                                                               | 139,529             | 106,979              |
| <b>Total short-term borrowings</b>                                                                                                        | 262,187             | 245,822              |
| Long-term debt and mandatorily redeemable securities                                                                                      | 57,488              | 56,232               |
| Subordinated notes                                                                                                                        | 58,764              | 58,764               |
| Accrued expenses and other liabilities                                                                                                    | 41,368              | 51,807               |
| <b>Total liabilities</b>                                                                                                                  | 4,382,392           | 4,215,485            |
| <b><u>SHAREHOLDERS' EQUITY</u></b>                                                                                                        |                     |                      |
| Preferred stock; no par value                                                                                                             |                     |                      |
| Authorized 10,000,000 shares; none issued or outstanding                                                                                  | —                   | —                    |
| Common stock; no par value                                                                                                                |                     |                      |
| Authorized 40,000,000 shares; issued 28,206,076 at June 30, 2015 and December 31, 2014*                                                   | 436,538             | 346,535              |
| Retained earnings*                                                                                                                        | 232,507             | 302,242              |
| Cost of common stock in treasury (2,009,732 shares at June 30, 2015 and 1,957,386 shares at December 31, 2014)*                           | (45,706)            | (43,711)             |
| Accumulated other comprehensive income                                                                                                    | 8,292               | 9,407                |

|                                                   |                     |                     |
|---------------------------------------------------|---------------------|---------------------|
| <b>Total shareholders' equity</b>                 | 631,631             | 614,473             |
| <b>Total liabilities and shareholders' equity</b> | <u>\$ 5,014,023</u> | <u>\$ 4,829,958</u> |

\*Share data and June 30, 2015 common stock and retained earnings gives retrospective recognition to a 10% stock dividend declared on July 22, 2015.

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

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

|                                                                      | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|----------------------------------------------------------------------|--------------------------------|------------------|------------------------------|------------------|
|                                                                      | 2015                           | 2014             | 2015                         | 2014             |
| Interest income:                                                     |                                |                  |                              |                  |
| Loans and leases                                                     | \$ 42,583                      | \$ 40,401        | \$ 82,187                    | \$ 79,316        |
| Investment securities, taxable                                       | 2,648                          | 3,401            | 5,652                        | 6,746            |
| Investment securities, tax-exempt                                    | 754                            | 816              | 1,523                        | 1,635            |
| Other                                                                | 229                            | 232              | 484                          | 509              |
| <b>Total interest income</b>                                         | <b>46,214</b>                  | <b>44,850</b>    | <b>89,846</b>                | <b>88,206</b>    |
| Interest expense:                                                    |                                |                  |                              |                  |
| Deposits                                                             | 2,838                          | 2,994            | 5,397                        | 5,965            |
| Short-term borrowings                                                | 131                            | 169              | 234                          | 306              |
| Subordinated notes                                                   | 1,055                          | 1,055            | 2,110                        | 2,110            |
| Long-term debt and mandatorily redeemable securities                 | 525                            | 470              | 1,004                        | 1,045            |
| <b>Total interest expense</b>                                        | <b>4,549</b>                   | <b>4,688</b>     | <b>8,745</b>                 | <b>9,426</b>     |
| <b>Net interest income</b>                                           | <b>41,665</b>                  | <b>40,162</b>    | <b>81,101</b>                | <b>78,780</b>    |
| Provision for loan and lease losses                                  | 811                            | 2,543            | 1,168                        | 3,347            |
| <b>Net interest income after provision for loan and lease losses</b> | <b>40,854</b>                  | <b>37,619</b>    | <b>79,933</b>                | <b>75,433</b>    |
| Noninterest income:                                                  |                                |                  |                              |                  |
| Trust fees                                                           | 5,247                          | 4,955            | 9,804                        | 9,431            |
| Service charges on deposit accounts                                  | 2,367                          | 2,207            | 4,564                        | 4,273            |
| Debit card income                                                    | 2,628                          | 2,463            | 5,027                        | 4,695            |
| Mortgage banking income                                              | 1,239                          | 1,181            | 2,490                        | 2,515            |
| Insurance commissions                                                | 1,382                          | 1,288            | 2,687                        | 2,851            |
| Equipment rental income                                              | 5,342                          | 4,098            | 10,421                       | 8,180            |
| Gains on investment securities available-for-sale                    | 4                              | —                | 4                            | 963              |
| Other income                                                         | 3,322                          | 3,029            | 6,285                        | 5,711            |
| <b>Total noninterest income</b>                                      | <b>21,531</b>                  | <b>19,221</b>    | <b>41,282</b>                | <b>38,619</b>    |
| Noninterest expense:                                                 |                                |                  |                              |                  |
| Salaries and employee benefits                                       | 20,794                         | 18,827           | 41,719                       | 38,309           |
| Net occupancy expense                                                | 2,345                          | 2,235            | 4,806                        | 4,672            |
| Furniture and equipment expense                                      | 4,531                          | 4,413            | 8,867                        | 8,650            |
| Depreciation - leased equipment                                      | 4,396                          | 3,290            | 8,484                        | 6,539            |
| Professional fees                                                    | 1,108                          | 1,062            | 1,978                        | 2,190            |
| Supplies and communication                                           | 1,409                          | 1,337            | 2,815                        | 2,729            |
| FDIC and other insurance                                             | 847                            | 850              | 1,696                        | 1,714            |
| Business development and marketing expense                           | 1,214                          | 899              | 2,263                        | 2,583            |
| Loan and lease collection and repossession expense                   | (294)                          | (17)             | 69                           | (512)            |
| Other expense                                                        | 1,891                          | 1,528            | 3,605                        | 3,522            |
| <b>Total noninterest expense</b>                                     | <b>38,241</b>                  | <b>34,424</b>    | <b>76,302</b>                | <b>70,396</b>    |
| Income before income taxes                                           | 24,144                         | 22,416           | 44,913                       | 43,656           |
| Income tax expense                                                   | 8,514                          | 7,922            | 15,772                       | 15,530           |
| <b>Net income</b>                                                    | <b>\$ 15,630</b>               | <b>\$ 14,494</b> | <b>\$ 29,141</b>             | <b>\$ 28,126</b> |

|                                                     |    |            |    |            |    |            |    |            |
|-----------------------------------------------------|----|------------|----|------------|----|------------|----|------------|
| Per common share*:                                  |    |            |    |            |    |            |    |            |
| Basic net income per common share                   | \$ | 0.59       | \$ | 0.54       | \$ | 1.10       | \$ | 1.04       |
| Diluted net income per common share                 | \$ | 0.59       | \$ | 0.54       | \$ | 1.10       | \$ | 1.04       |
| Dividends                                           | \$ | 0.164      | \$ | 0.164      | \$ | 0.327      | \$ | 0.318      |
| Basic weighted average common shares outstanding*   |    | 26,212,999 |    | 26,485,789 |    | 26,235,511 |    | 26,616,762 |
| Diluted weighted average common shares outstanding* |    | 26,212,999 |    | 26,485,789 |    | 26,235,511 |    | 26,616,762 |

\*The computation of per common share data and shares outstanding gives retrospective recognition to a 10% stock dividend declared on July 22, 2015.

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

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

|                                                                                   | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|-----------------------------------------------------------------------------------|--------------------------------|------------------|------------------------------|------------------|
|                                                                                   | 2015                           | 2014             | 2015                         | 2014             |
| Net income                                                                        | \$ 15,630                      | \$ 14,494        | \$ 29,141                    | \$ 28,126        |
| Other comprehensive income (loss):                                                |                                |                  |                              |                  |
| Change in unrealized (depreciation) appreciation of available-for-sale securities | (4,727)                        | 2,759            | (1,781)                      | 6,775            |
| Reclassification adjustment for realized (gains) losses included in net income    | (4)                            | —                | (4)                          | (963)            |
| Income tax effect                                                                 | 1,776                          | (1,036)          | 670                          | (2,182)          |
| Other comprehensive (loss) income, net of tax                                     | (2,955)                        | 1,723            | (1,115)                      | 3,630            |
| <b>Comprehensive income</b>                                                       | <b>\$ 12,675</b>               | <b>\$ 16,217</b> | <b>\$ 28,026</b>             | <b>\$ 31,756</b> |

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<br>Stock | Common<br>Stock   | Retained<br>Earnings | Cost of<br>Common<br>Stock<br>in Treasury | Accumulated<br>Other<br>Comprehensive<br>Income (Loss), Net | Total             |
|--------------------------------------------------------------------------------------------------------|--------------------|-------------------|----------------------|-------------------------------------------|-------------------------------------------------------------|-------------------|
| Balance at January 1, 2014                                                                             | \$ —               | \$ 346,535        | \$ 261,626           | \$ (29,364)                               | \$ 6,581                                                    | \$ 585,378        |
| Net income                                                                                             | —                  | —                 | 28,126               | —                                         | —                                                           | 28,126            |
| Other comprehensive income                                                                             | —                  | —                 | —                    | —                                         | 3,630                                                       | 3,630             |
| Issuance of 71,749 common shares under stock based compensation awards, including related tax effects  | —                  | —                 | (276)                | 1,716                                     | —                                                           | 1,440             |
| Cost of 524,858 shares of common stock acquired for treasury                                           | —                  | —                 | —                    | (15,797)                                  | —                                                           | (15,797)          |
| Common stock dividend (\$0.318 per share)*                                                             | —                  | —                 | (8,559)              | —                                         | —                                                           | (8,559)           |
| Balance at June 30, 2014                                                                               | <u>\$ —</u>        | <u>\$ 346,535</u> | <u>\$ 280,917</u>    | <u>\$ (43,445)</u>                        | <u>\$ 10,211</u>                                            | <u>\$ 594,218</u> |
| Balance at January 1, 2015                                                                             | \$ —               | \$ 346,535        | \$ 302,242           | \$ (43,711)                               | \$ 9,407                                                    | \$ 614,473        |
| Net income                                                                                             | —                  | —                 | 29,141               | —                                         | —                                                           | 29,141            |
| Other comprehensive loss                                                                               | —                  | —                 | —                    | —                                         | (1,115)                                                     | (1,115)           |
| Issuance of 102,257 common shares under stock based compensation awards, including related tax effects | —                  | —                 | (237)                | 2,683                                     | —                                                           | 2,446             |
| Cost of 149,844 shares of common stock acquired for treasury                                           | —                  | —                 | —                    | (4,678)                                   | —                                                           | (4,678)           |
| Common stock dividend (\$0.327 per share)*                                                             | —                  | —                 | (8,636)              | —                                         | —                                                           | (8,636)           |
| 10% common stock dividend                                                                              | —                  | 90,003            | (90,003)             | —                                         | —                                                           | —                 |
| Balance at June 30, 2015                                                                               | <u>\$ —</u>        | <u>\$ 436,538</u> | <u>\$ 232,507</u>    | <u>\$ (45,706)</u>                        | <u>\$ 8,292</u>                                             | <u>\$ 631,631</u> |

\*Per share data gives retrospective recognition to a 10% stock dividend declared on July 22, 2015.

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

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

|                                                                                   | Six Months Ended June 30, |                  |
|-----------------------------------------------------------------------------------|---------------------------|------------------|
|                                                                                   | 2015                      | 2014             |
| Operating activities:                                                             |                           |                  |
| Net income                                                                        | \$ 29,141                 | \$ 28,126        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |                  |
| Provision for loan and lease losses                                               | 1,168                     | 3,347            |
| Depreciation of premises and equipment                                            | 2,302                     | 2,370            |
| Depreciation of equipment owned and leased to others                              | 8,484                     | 6,539            |
| Stock-based compensation                                                          | 2,079                     | 1,836            |
| Amortization of investment securities premiums and accretion of discounts, net    | 2,597                     | 2,093            |
| Amortization of mortgage servicing rights                                         | 778                       | 596              |
| Deferred income taxes                                                             | (2,159)                   | (3,335)          |
| Gains on investment securities available-for-sale                                 | (4)                       | (963)            |
| Originations of loans held for sale, net of principal collected                   | (66,312)                  | (57,503)         |
| Proceeds from the sales of loans held for sale                                    | 67,143                    | 46,154           |
| Net gain on sale of loans held for sale                                           | (2,009)                   | (1,606)          |
| Net gain on sale of other real estate and repossessions                           | (772)                     | (1,510)          |
| Change in trading account securities                                              | (6)                       | (6)              |
| Change in interest receivable                                                     | 117                       | (479)            |
| Change in interest payable                                                        | 289                       | (19)             |
| Change in other assets                                                            | 987                       | (206)            |
| Change in other liabilities                                                       | (1,032)                   | (4,505)          |
| Other                                                                             | 690                       | 1,898            |
| <b>Net change in operating activities</b>                                         | <b>43,481</b>             | <b>22,827</b>    |
| Investing activities:                                                             |                           |                  |
| Proceeds from sales of investment securities                                      | 1,299                     | 1,236            |
| Proceeds from maturities of investment securities                                 | 47,314                    | 106,541          |
| Purchases of investment securities                                                | (48,344)                  | (85,452)         |
| Net change in other investments                                                   | 58                        | (1,197)          |
| Loans sold or participated to others                                              | 1,962                     | 7,805            |
| Net change in loans and leases                                                    | (171,601)                 | (186,436)        |
| Net change in equipment owned under operating leases                              | (28,216)                  | (8,922)          |
| Purchases of premises and equipment                                               | (2,934)                   | (1,587)          |
| Proceeds from sales of other real estate and repossessions                        | 6,536                     | 9,395            |
| <b>Net change in investing activities</b>                                         | <b>(193,926)</b>          | <b>(158,617)</b> |
| Financing activities:                                                             |                           |                  |
| Net change in demand deposits and savings accounts                                | 104,266                   | 70,848           |
| Net change in time deposits                                                       | 55,459                    | 91,237           |
| Net change in short-term borrowings                                               | 16,365                    | 35,871           |
| Proceeds from issuance of long-term debt                                          | —                         | 5,791            |
| Payments on long-term debt                                                        | (743)                     | (6,261)          |
| Stock issued under stock purchase plans                                           | 149                       | 197              |
| Acquisition of treasury stock                                                     | (4,678)                   | (15,797)         |
| Cash dividends paid on common stock                                               | (8,865)                   | (8,770)          |
| <b>Net change in financing activities</b>                                         | <b>161,953</b>            | <b>173,116</b>   |
| Net change in cash and cash equivalents                                           | 11,508                    | 37,326           |
| Cash and cash equivalents, beginning of year                                      | 66,190                    | 80,052           |
| Cash and cash equivalents, end of period                                          | \$ 77,698                 | \$ 117,378       |
| <b>Supplemental Information:</b>                                                  |                           |                  |

Non-cash transactions:

|                                                                                        |    |       |    |       |
|----------------------------------------------------------------------------------------|----|-------|----|-------|
| Loans transferred to other real estate and repossessed assets                          | \$ | 5,866 | \$ | 6,344 |
| Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan |    | 500   |    | —     |

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

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

**Note 1. Basis of Presentation**

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

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation’s Annual Report on Form 10-K (2014 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, 2014 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.

**Note 2. Recent Accounting Pronouncements**

**Short Duration Contracts:** In May 2015, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (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 is assessing the impact of ASU 2015-09 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 is assessing the impact of ASU 2015-02 on its accounting and disclosures.

**Troubled Debt Restructurings by Creditors:** In August 2014, the FASB issued ASU No. 2014-14 “*Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Classification of Certain Government Guaranteed Mortgage Loans upon Foreclosure.*” ASU 2014-14 requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if certain conditions are met. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. ASU 2014-14 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2014. The amendments can be applied using either a prospective transition method or a modified retrospective transition method. Early adoption is permitted. The Company adopted ASU 2014-14 on January 1, 2015 and it did not have an impact on its accounting and disclosures.

**Share Based Payments:** In June 2014, the FASB issued ASU No. 2014-12 “*Compensation - Stock Compensation (Topic 718) - Accounting for Share Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period.*” ASU 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. ASU 2014-12 is effective for interim and annual periods beginning after December 15, 2015. The amendments can be applied prospectively to all awards granted or modified after the effective date or retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented and to all new or modified awards thereafter. Early adoption is permitted. The Company has determined that ASU 2014-12 will not have an impact on its accounting and disclosures.

Repurchase to Maturity Transactions, Repurchase Financings and Disclosures: In June 2014, the FASB issued ASU No. 2014-11 “ *Transfers and Servicing (Topic 860) - Repurchase to Maturity Transactions, Repurchase Financings, and Disclosures.*” ASU 2014-11 aligns the accounting for repurchase to maturity transactions and repurchase agreements executed as a repurchase financing with the accounting for other typical repurchase agreements. Going forward, these transactions would all be accounted for as secured borrowings. ASU 2014-11 is effective for the first interim or annual period beginning after December 15, 2014. In addition the disclosure of certain transactions accounted for as a sale is effective for the first interim or annual period beginning on or after December 15, 2014, and the disclosure for transactions accounted for as secured borrowings is required for annual periods beginning after December 15, 2014, and interim periods beginning after March 15, 2015. Early adoption is prohibited. The Company adopted ASU 2014-11 on January 1, 2015 and it did not have a material 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. 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. Early application is permitted but not before the original public entity effective date, *i.e.* , annual periods beginning after December 15, 2016. The Company is assessing the impact of ASU 2014-09 on its accounting and disclosures.

Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure: In January 2014, the FASB issued ASU No. 2014-04 “ *Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) - Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans Upon Foreclosure.*” ASU 2014-04 clarifies when an in substance repossession or foreclosure occurs and requires interim and annual disclosures of the amount of foreclosed residential real estate property and the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. ASU 2014-04 is effective either on a modified retrospective transition method or a prospective transition method for interim and annual periods beginning after December 15, 2014. Early adoption is permitted. The Company adopted ASU 2014-04 on January 1, 2015 and it did not have a material impact on its disclosures.

Accounting for Investments in Qualified Affordable Housing Projects: In January 2014, the FASB issued ASU No. 2014-01 “ *Investments - Equity method and Joint Ventures (Topic 323) - Accounting for Investments in Qualified Affordable Housing Projects.*” ASU 2014-01 allows investors to use the proportional amortization method to account for investments in limited liability entities that manage or invest in affordable housing projects that qualify for low-income housing tax credits if certain conditions are met. ASU 2014-01 is effective retrospectively for interim and annual periods in fiscal years that begin after December 15, 2014. Early adoption is permitted. The Company adopted ASU 2014-01 on January 1, 2015 and it did not have a material impact on its accounting and disclosures for affordable housing projects.

### Note 3. Investment Securities

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

| <i>(Dollars in thousands)</i>                     | Amortized Cost    | Gross<br>Unrealized Gains | Gross<br>Unrealized Losses | Fair Value        |
|---------------------------------------------------|-------------------|---------------------------|----------------------------|-------------------|
| <b>June 30, 2015</b>                              |                   |                           |                            |                   |
| U.S. Treasury and Federal agencies securities     | \$ 383,369        | \$ 3,443                  | \$ (898)                   | \$ 385,914        |
| U.S. States and political subdivisions securities | 121,353           | 2,629                     | (274)                      | 123,708           |
| Mortgage-backed securities — Federal agencies     | 232,454           | 4,369                     | (1,573)                    | 235,250           |
| Corporate debt securities                         | 33,326            | 271                       | (20)                       | 33,577            |
| Foreign government and other securities           | 800               | 7                         | —                          | 807               |
| Total debt securities                             | 771,302           | 10,719                    | (2,765)                    | 779,256           |
| Marketable equity securities                      | 1,893             | 5,408                     | (86)                       | 7,215             |
| Total investment securities available-for-sale    | <u>\$ 773,195</u> | <u>\$ 16,127</u>          | <u>\$ (2,851)</u>          | <u>\$ 786,471</u> |
| <b>December 31, 2014</b>                          |                   |                           |                            |                   |
| U.S. Treasury and Federal agencies securities     | \$ 371,878        | \$ 3,593                  | \$ (1,968)                 | \$ 373,503        |
| U.S. States and political subdivisions securities | 121,510           | 3,392                     | (214)                      | 124,688           |
| Mortgage-backed securities — Federal agencies     | 248,299           | 5,490                     | (781)                      | 253,008           |
| Corporate debt securities                         | 31,677            | 281                       | (26)                       | 31,932            |
| Foreign government and other securities           | 800               | 11                        | —                          | 811               |
| Total debt securities                             | 774,164           | 12,767                    | (2,989)                    | 783,942           |
| Marketable equity securities                      | 1,893             | 5,285                     | (2)                        | 7,176             |
| Total investment securities available-for-sale    | <u>\$ 776,057</u> | <u>\$ 18,052</u>          | <u>\$ (2,991)</u>          | <u>\$ 791,118</u> |

At June 30, 2015 and December 31, 2014, 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 securities available-for-sale at June 30, 2015. 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.

| <i>(Dollars in thousands)</i>            | Amortized Cost    | Fair Value        |
|------------------------------------------|-------------------|-------------------|
| Due in one year or less                  | \$ 83,048         | \$ 83,639         |
| Due after one year through five years    | 429,898           | 434,308           |
| Due after five years through ten years   | 25,902            | 26,059            |
| Due after ten years                      | —                 | —                 |
| Mortgage-backed securities               | 232,454           | 235,250           |
| Total debt securities available-for-sale | <u>\$ 771,302</u> | <u>\$ 779,256</u> |

The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. The gross gains for the six months ended June 30, 2014 reflect the sale of marketable equity securities.

| <i>(Dollars in thousands)</i> | Three Months Ended<br>June 30, |             | Six Months Ended<br>June 30, |               |
|-------------------------------|--------------------------------|-------------|------------------------------|---------------|
|                               | 2015                           | 2014        | 2015                         | 2014          |
| Gross realized gains          | \$ 4                           | \$ —        | \$ 4                         | \$ 963        |
| Gross realized losses         | —                              | —           | —                            | —             |
| Net realized gains (losses)   | <u>\$ 4</u>                    | <u>\$ —</u> | <u>\$ 4</u>                  | <u>\$ 963</u> |



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 |
| <b>June 30, 2015</b>                              |                     |                   |                     |                   |                   |                   |
| U.S. Treasury and Federal agencies securities     | \$ 24,563           | \$ (72)           | \$ 104,158          | \$ (826)          | \$ 128,721        | \$ (898)          |
| U.S. States and political subdivisions securities | 31,585              | (241)             | 2,068               | (33)              | 33,653            | (274)             |
| Mortgage-backed securities - Federal agencies     | 62,521              | (639)             | 18,952              | (934)             | 81,473            | (1,573)           |
| Corporate debt securities                         | 3,833               | (19)              | 999                 | (1)               | 4,832             | (20)              |
| Foreign government and other securities           | —                   | —                 | —                   | —                 | —                 | —                 |
| Total debt securities                             | 122,502             | (971)             | 126,177             | (1,794)           | 248,679           | (2,765)           |
| Marketable equity securities                      | 560                 | (85)              | 3                   | (1)               | 563               | (86)              |
| Total investment securities available-for-sale    | <u>\$ 123,062</u>   | <u>\$ (1,056)</u> | <u>\$ 126,180</u>   | <u>\$ (1,795)</u> | <u>\$ 249,242</u> | <u>\$ (2,851)</u> |
| <b>December 31, 2014</b>                          |                     |                   |                     |                   |                   |                   |
| U.S. Treasury and Federal agencies securities     | \$ 54,944           | \$ (148)          | \$ 115,195          | \$ (1,820)        | \$ 170,139        | \$ (1,968)        |
| U.S. States and political subdivisions securities | 16,805              | (112)             | 8,333               | (102)             | 25,138            | (214)             |
| Mortgage-backed securities - Federal agencies     | 21,754              | (62)              | 32,781              | (719)             | 54,535            | (781)             |
| Corporate debt securities                         | 3,072               | (26)              | —                   | —                 | 3,072             | (26)              |
| Foreign government and other securities           | —                   | —                 | —                   | —                 | —                 | —                 |
| Total debt securities                             | 96,575              | (348)             | 156,309             | (2,641)           | 252,884           | (2,989)           |
| Marketable equity securities                      | —                   | —                 | 3                   | (2)               | 3                 | (2)               |
| Total investment securities available-for-sale    | <u>\$ 96,575</u>    | <u>\$ (348)</u>   | <u>\$ 156,312</u>   | <u>\$ (2,643)</u> | <u>\$ 252,887</u> | <u>\$ (2,991)</u> |

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

There were no OTTI write-downs in 2015 or 2014 .

At June 30, 2015 , 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.

At June 30, 2015 and December 31, 2014 , investment securities with carrying values of \$227.29 million and \$231.50 million , respectively, were pledged as collateral for security repurchase agreements and for other purposes.

#### **Note 4. Loan and Lease Financings**

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

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

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

| <i>(Dollars in thousands)</i>    | Credit Quality Grades |                   |                     |
|----------------------------------|-----------------------|-------------------|---------------------|
|                                  | 1-6                   | 7-12              | Total               |
| <b>June 30, 2015</b>             |                       |                   |                     |
| Commercial and agricultural      | \$ 703,841            | \$ 16,131         | \$ 719,972          |
| Auto and light truck             | 426,119               | 20,612            | 446,731             |
| Medium and heavy duty truck      | 247,339               | 2,706             | 250,045             |
| Aircraft financing               | 728,489               | 23,176            | 751,665             |
| Construction equipment financing | 438,594               | 6,885             | 445,479             |
| Commercial real estate           | 621,689               | 19,516            | 641,205             |
| Total                            | <u>\$ 3,166,071</u>   | <u>\$ 89,026</u>  | <u>\$ 3,255,097</u> |
| <b>December 31, 2014</b>         |                       |                   |                     |
| Commercial and agricultural      | \$ 683,169            | \$ 27,589         | \$ 710,758          |
| Auto and light truck             | 380,425               | 17,477            | 397,902             |
| Medium and heavy duty truck      | 243,798               | 3,355             | 247,153             |
| Aircraft financing               | 691,018               | 36,647            | 727,665             |
| Construction equipment financing | 393,965               | 5,975             | 399,940             |
| Commercial real estate           | 592,787               | 23,800            | 616,587             |
| Total                            | <u>\$ 2,985,162</u>   | <u>\$ 114,843</u> | <u>\$ 3,100,005</u> |

For residential real estate 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 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.

| <i>(Dollars in thousands)</i> | Performing        | Nonperforming   | Total             |
|-------------------------------|-------------------|-----------------|-------------------|
| <b>June 30, 2015</b>          |                   |                 |                   |
| Residential real estate       | \$ 452,182        | \$ 2,548        | \$ 454,730        |
| Consumer                      | 142,607           | 265             | 142,872           |
| Total                         | <u>\$ 594,789</u> | <u>\$ 2,813</u> | <u>\$ 597,602</u> |
| <b>December 31, 2014</b>      |                   |                 |                   |
| Residential real estate       | \$ 442,918        | \$ 2,841        | \$ 445,759        |
| Consumer                      | 142,476           | 334             | 142,810           |
| Total                         | <u>\$ 585,394</u> | <u>\$ 3,175</u> | <u>\$ 588,569</u> |

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

| <i>(Dollars in thousands)</i>    | <b>Current</b>      | <b>30-59 Days<br/>Past Due</b> | <b>60-89 Days<br/>Past Due</b> | <b>90 Days or More<br/>Past Due<br/>and Accruing</b> | <b>Total<br/>Accruing<br/>Loans</b> | <b>Nonaccrual</b> | <b>Total<br/>Financing<br/>Receivables</b> |
|----------------------------------|---------------------|--------------------------------|--------------------------------|------------------------------------------------------|-------------------------------------|-------------------|--------------------------------------------|
| <b>June 30, 2015</b>             |                     |                                |                                |                                                      |                                     |                   |                                            |
| Commercial and agricultural      | \$ 717,653          | \$ 114                         | \$ 77                          | \$ —                                                 | \$ 717,844                          | \$ 2,128          | \$ 719,972                                 |
| Auto and light truck             | 446,507             | 131                            | 80                             | —                                                    | 446,718                             | 13                | 446,731                                    |
| Medium and heavy duty truck      | 250,045             | —                              | —                              | —                                                    | 250,045                             | —                 | 250,045                                    |
| Aircraft financing               | 736,085             | 531                            | 7,748                          | —                                                    | 744,364                             | 7,301             | 751,665                                    |
| Construction equipment financing | 444,001             | 562                            | 184                            | —                                                    | 444,747                             | 732               | 445,479                                    |
| Commercial real estate           | 638,832             | —                              | —                              | —                                                    | 638,832                             | 2,373             | 641,205                                    |
| Residential real estate          | 451,216             | 640                            | 326                            | 221                                                  | 452,403                             | 2,327             | 454,730                                    |
| Consumer                         | 141,713             | 679                            | 215                            | 57                                                   | 142,664                             | 208               | 142,872                                    |
| <b>Total</b>                     | <b>\$ 3,826,052</b> | <b>\$ 2,657</b>                | <b>\$ 8,630</b>                | <b>\$ 278</b>                                        | <b>\$ 3,837,617</b>                 | <b>\$ 15,082</b>  | <b>\$ 3,852,699</b>                        |
| <b>December 31, 2014</b>         |                     |                                |                                |                                                      |                                     |                   |                                            |
| Commercial and agricultural      | \$ 696,351          | \$ —                           | \$ 123                         | \$ —                                                 | \$ 696,474                          | \$ 14,284         | \$ 710,758                                 |
| Auto and light truck             | 397,815             | 48                             | 1                              | —                                                    | 397,864                             | 38                | 397,902                                    |
| Medium and heavy duty truck      | 247,097             | —                              | —                              | —                                                    | 247,097                             | 56                | 247,153                                    |
| Aircraft financing               | 699,054             | 541                            | 15,597                         | —                                                    | 715,192                             | 12,473            | 727,665                                    |
| Construction equipment financing | 396,821             | 999                            | 1,369                          | —                                                    | 399,189                             | 751               | 399,940                                    |
| Commercial real estate           | 611,780             | —                              | —                              | —                                                    | 611,780                             | 4,807             | 616,587                                    |
| Residential real estate          | 441,508             | 1,099                          | 311                            | 873                                                  | 443,791                             | 1,968             | 445,759                                    |
| Consumer                         | 141,577             | 676                            | 223                            | 109                                                  | 142,585                             | 225               | 142,810                                    |
| <b>Total</b>                     | <b>\$ 3,632,003</b> | <b>\$ 3,363</b>                | <b>\$ 17,624</b>               | <b>\$ 982</b>                                        | <b>\$ 3,653,972</b>                 | <b>\$ 34,602</b>  | <b>\$ 3,688,574</b>                        |

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

| <i>(Dollars in thousands)</i>          | Recorded Investment | Unpaid Principal Balance | Related Reserve |
|----------------------------------------|---------------------|--------------------------|-----------------|
| <b>June 30, 2015</b>                   |                     |                          |                 |
| With no related reserve recorded:      |                     |                          |                 |
| Commercial and agricultural            | \$ 656              | \$ 655                   | \$ —            |
| Auto and light truck                   | —                   | —                        | —               |
| Medium and heavy duty truck            | —                   | —                        | —               |
| Aircraft financing                     | 4,714               | 4,714                    | —               |
| Construction equipment financing       | 728                 | 728                      | —               |
| Commercial real estate                 | 9,166               | 9,166                    | —               |
| Residential real estate                | —                   | —                        | —               |
| Consumer                               | —                   | —                        | —               |
| Total with no related reserve recorded | 15,264              | 15,263                   | —               |
| With a reserve recorded:               |                     |                          |                 |
| Commercial and agricultural            | 1,382               | 1,382                    | 112             |
| Auto and light truck                   | —                   | —                        | —               |
| Medium and heavy duty truck            | —                   | —                        | —               |
| Aircraft financing                     | 2,460               | 2,460                    | 501             |
| Construction equipment financing       | —                   | —                        | —               |
| Commercial real estate                 | 767                 | 767                      | 38              |
| Residential real estate                | 369                 | 372                      | 152             |
| Consumer                               | —                   | —                        | —               |
| Total with a reserve recorded          | 4,978               | 4,981                    | 803             |
| Total impaired loans                   | \$ 20,242           | \$ 20,244                | \$ 803          |
| <b>December 31, 2014</b>               |                     |                          |                 |
| With no related reserve recorded:      |                     |                          |                 |
| Commercial and agricultural            | \$ 14,468           | \$ 14,467                | \$ —            |
| Auto and light truck                   | —                   | —                        | —               |
| Medium and heavy duty truck            | —                   | —                        | —               |
| Aircraft financing                     | 12,740              | 12,741                   | —               |
| Construction equipment financing       | 746                 | 746                      | —               |
| Commercial real estate                 | 11,707              | 11,707                   | —               |
| Residential real estate                | —                   | —                        | —               |
| Consumer                               | —                   | —                        | —               |
| Total with no related reserve recorded | 39,661              | 39,661                   | —               |
| With a reserve recorded:               |                     |                          |                 |
| Commercial and agricultural            | 74                  | 74                       | 5               |
| Auto and light truck                   | —                   | —                        | —               |
| Medium and heavy duty truck            | —                   | —                        | —               |
| Aircraft financing                     | —                   | —                        | —               |
| Construction equipment financing       | —                   | —                        | —               |
| Commercial real estate                 | 798                 | 798                      | 80              |
| Residential real estate                | 373                 | 376                      | 156             |
| Consumer                               | —                   | —                        | —               |
| Total with a reserve recorded          | 1,245               | 1,248                    | 241             |
| Total impaired loans                   | \$ 40,906           | \$ 40,909                | \$ 241          |

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

|                                  | Three Months Ended June 30, |                 |                             |                 | Six Months Ended June 30,   |                 |                             |                 |
|----------------------------------|-----------------------------|-----------------|-----------------------------|-----------------|-----------------------------|-----------------|-----------------------------|-----------------|
|                                  | 2015                        |                 | 2014                        |                 | 2015                        |                 | 2014                        |                 |
|                                  | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income | Average Recorded Investment | Interest Income |
| <i>(Dollars in thousands)</i>    |                             |                 |                             |                 |                             |                 |                             |                 |
| Commercial and agricultural      | \$ 2,134                    | \$ 6            | \$ 15,261                   | \$ 9            | \$ 5,971                    | \$ 16           | \$ 13,258                   | \$ 24           |
| Auto and light truck             | —                           | —               | —                           | —               | —                           | —               | 814                         | —               |
| Medium and heavy duty truck      | —                           | —               | —                           | —               | —                           | —               | —                           | —               |
| Aircraft financing               | 7,269                       | —               | 1,573                       | 4               | 8,207                       | 6               | 4,274                       | 14              |
| Construction equipment financing | 731                         | —               | 1,113                       | —               | 735                         | —               | 1,031                       | —               |
| Commercial real estate           | 10,735                      | 142             | 12,709                      | 147             | 11,319                      | 284             | 13,188                      | 294             |
| Residential real estate          | 371                         | 4               | 377                         | 4               | 372                         | 8               | 377                         | 8               |
| Consumer                         | —                           | —               | —                           | —               | —                           | —               | —                           | —               |
| <b>Total</b>                     | <b>\$ 21,240</b>            | <b>\$ 152</b>   | <b>\$ 31,033</b>            | <b>\$ 164</b>   | <b>\$ 26,604</b>            | <b>\$ 314</b>   | <b>\$ 32,942</b>            | <b>\$ 340</b>   |

There were no loan and lease modifications classified as troubled debt restructurings (TDR) during the three months ended June 30, 2015 and 2014 . There were no loan and lease modifications classified as TDR during the six months ended June 30, 2015 and one performing loan modification classified as TDR during the six months ended June 30, 2014 . 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. The modification did not result in the contractual forgiveness of principal or interest. There were no modifications during the six months ended June 30, 2015 and 2014 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 six months ended June 30, 2015 and 2014 . Default occurs when a loan or lease is 90 days or more past due under the modified terms or transferred to nonaccrual.

The following table shows the recorded investment of loans and leases classified as troubled debt restructurings as of June 30, 2015 and December 31, 2014 .

| <i>(Dollars in thousands)</i> | June 30,<br>2015 | December 31,<br>2014 |
|-------------------------------|------------------|----------------------|
| Performing TDRs               | \$ 8,344         | \$ 9,118             |
| Nonperforming TDRs            | 2,227            | 14,507               |
| <b>Total TDRs</b>             | <b>\$ 10,571</b> | <b>\$ 23,625</b>     |

#### **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.

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

The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the three months ended June 30, 2015 and 2014.

| <i>(Dollars in thousands)</i>                         | Commercial and<br>agricultural | Auto and<br>light truck | Medium and<br>heavy duty truck | Aircraft<br>financing | Construction<br>equipment<br>financing | Commercial<br>real estate | Residential<br>real estate | Consumer          | Total               |
|-------------------------------------------------------|--------------------------------|-------------------------|--------------------------------|-----------------------|----------------------------------------|---------------------------|----------------------------|-------------------|---------------------|
| <b>June 30, 2015</b>                                  |                                |                         |                                |                       |                                        |                           |                            |                   |                     |
| <i>Reserve for loan and lease losses</i>              |                                |                         |                                |                       |                                        |                           |                            |                   |                     |
| Balance, beginning of period                          | \$ 11,620                      | \$ 10,793               | \$ 4,364                       | \$ 31,301             | \$ 7,740                               | \$ 13,186                 | \$ 4,115                   | \$ 1,979          | \$ 85,098           |
| Charge-offs                                           | 22                             | —                       | —                              | —                     | —                                      | —                         | 25                         | 173               | 220                 |
| Recoveries                                            | 86                             | 191                     | 2                              | 398                   | 123                                    | 38                        | 5                          | 56                | 899                 |
| Net charge-offs (recoveries)                          | (64)                           | (191)                   | (2)                            | (398)                 | (123)                                  | (38)                      | 20                         | 117               | (679)               |
| Provision (recovery of provision)                     | 181                            | 461                     | (33)                           | 1,141                 | (56)                                   | 2                         | (651)                      | (234)             | 811                 |
| Balance, end of period                                | <u>\$ 11,865</u>               | <u>\$ 11,445</u>        | <u>\$ 4,333</u>                | <u>\$ 32,840</u>      | <u>\$ 7,807</u>                        | <u>\$ 13,226</u>          | <u>\$ 3,444</u>            | <u>\$ 1,628</u>   | <u>\$ 86,588</u>    |
| Ending balance, individually evaluated for impairment | \$ 112                         | \$ —                    | \$ —                           | \$ 501                | \$ —                                   | \$ 38                     | \$ 152                     | \$ —              | \$ 803              |
| Ending balance, collectively evaluated for impairment | 11,753                         | 11,445                  | 4,333                          | 32,339                | 7,807                                  | 13,188                    | 3,292                      | 1,628             | 85,785              |
| Total reserve for loan and lease losses               | <u>\$ 11,865</u>               | <u>\$ 11,445</u>        | <u>\$ 4,333</u>                | <u>\$ 32,840</u>      | <u>\$ 7,807</u>                        | <u>\$ 13,226</u>          | <u>\$ 3,444</u>            | <u>\$ 1,628</u>   | <u>\$ 86,588</u>    |
| <i>Recorded investment in loans</i>                   |                                |                         |                                |                       |                                        |                           |                            |                   |                     |
| Ending balance, individually evaluated for impairment | \$ 2,038                       | \$ —                    | \$ —                           | \$ 7,174              | \$ 728                                 | \$ 9,933                  | \$ 369                     | \$ —              | \$ 20,242           |
| Ending balance, collectively evaluated for impairment | 717,934                        | 446,731                 | 250,045                        | 744,491               | 444,751                                | 631,272                   | 454,361                    | 142,872           | 3,832,457           |
| Total recorded investment in loans                    | <u>\$ 719,972</u>              | <u>\$ 446,731</u>       | <u>\$ 250,045</u>              | <u>\$ 751,665</u>     | <u>\$ 445,479</u>                      | <u>\$ 641,205</u>         | <u>\$ 454,730</u>          | <u>\$ 142,872</u> | <u>\$ 3,852,699</u> |
| <b>June 30, 2014</b>                                  |                                |                         |                                |                       |                                        |                           |                            |                   |                     |
| <i>Reserve for loan and lease losses</i>              |                                |                         |                                |                       |                                        |                           |                            |                   |                     |
| Balance, beginning of period                          | \$ 11,819                      | \$ 9,656                | \$ 4,411                       | \$ 34,509             | \$ 6,314                               | \$ 12,609                 | \$ 4,062                   | \$ 1,630          | \$ 85,010           |
| Charge-offs                                           | 213                            | 8                       | —                              | —                     | —                                      | —                         | 27                         | 131               | 379                 |
| Recoveries                                            | 307                            | 823                     | 99                             | 54                    | 59                                     | 116                       | 65                         | 79                | 1,602               |
| Net charge-offs (recoveries)                          | (94)                           | (815)                   | (99)                           | (54)                  | (59)                                   | (116)                     | (38)                       | 52                | (1,223)             |
| Provision (recovery of provision)                     | 4,853                          | (44)                    | (229)                          | (1,476)               | (55)                                   | (372)                     | (166)                      | 32                | 2,543               |
| Balance, end of period                                | <u>\$ 16,766</u>               | <u>\$ 10,427</u>        | <u>\$ 4,281</u>                | <u>\$ 33,087</u>      | <u>\$ 6,318</u>                        | <u>\$ 12,353</u>          | <u>\$ 3,934</u>            | <u>\$ 1,610</u>   | <u>\$ 88,776</u>    |
| Ending balance, individually evaluated for impairment | \$ 4,769                       | \$ —                    | \$ —                           | \$ —                  | \$ —                                   | \$ —                      | \$ 159                     | \$ —              | \$ 4,928            |
| Ending balance, collectively evaluated for impairment | 11,997                         | 10,427                  | 4,281                          | 33,087                | 6,318                                  | 12,353                    | 3,775                      | 1,610             | 83,848              |
| Total reserve for loan and lease losses               | <u>\$ 16,766</u>               | <u>\$ 10,427</u>        | <u>\$ 4,281</u>                | <u>\$ 33,087</u>      | <u>\$ 6,318</u>                        | <u>\$ 12,353</u>          | <u>\$ 3,934</u>            | <u>\$ 1,610</u>   | <u>\$ 88,776</u>    |
| <i>Recorded investment in loans</i>                   |                                |                         |                                |                       |                                        |                           |                            |                   |                     |
| Ending balance, individually evaluated for impairment | \$ 22,533                      | \$ —                    | \$ —                           | \$ 1,120              | \$ 1,105                               | \$ 12,699                 | \$ 376                     | \$ —              | \$ 37,833           |
| Ending balance, collectively evaluated for impairment | 697,693                        | 471,080                 | 243,358                        | 732,074               | 368,650                                | 589,622                   | 454,469                    | 128,756           | 3,685,702           |
| Total recorded investment in loans                    | <u>\$ 720,226</u>              | <u>\$ 471,080</u>       | <u>\$ 243,358</u>              | <u>\$ 733,194</u>     | <u>\$ 369,755</u>                      | <u>\$ 602,321</u>         | <u>\$ 454,845</u>          | <u>\$ 128,756</u> | <u>\$ 3,723,535</u> |



The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the six months ended June 30, 2015 and 2014 .

| <i>(Dollars in thousands)</i>                         | Commercial and agricultural loans | Auto and light truck | Medium and heavy duty truck | Aircraft financing | Construction equipment financing | Commercial real estate | Residential real estate | Consumer loans    | Total               |
|-------------------------------------------------------|-----------------------------------|----------------------|-----------------------------|--------------------|----------------------------------|------------------------|-------------------------|-------------------|---------------------|
| <b>June 30, 2015</b>                                  |                                   |                      |                             |                    |                                  |                        |                         |                   |                     |
| <i>Reserve for loan and lease losses</i>              |                                   |                      |                             |                    |                                  |                        |                         |                   |                     |
| Balance, beginning of period                          | \$ 11,760                         | \$ 10,326            | \$ 4,500                    | \$ 32,234          | \$ 7,008                         | \$ 13,270              | \$ 4,102                | \$ 1,868          | \$ 85,068           |
| Charge-offs                                           | 965                               | 22                   | —                           | 49                 | —                                | —                      | 65                      | 320               | 1,421               |
| Recoveries                                            | 564                               | 251                  | 5                           | 442                | 245                              | 135                    | 7                       | 124               | 1,773               |
| Net charge-offs (recoveries)                          | 401                               | (229)                | (5)                         | (393)              | (245)                            | (135)                  | 58                      | 196               | (352)               |
| Provision (recovery of provision)                     | 506                               | 890                  | (172)                       | 213                | 554                              | (179)                  | (600)                   | (44)              | 1,168               |
| Balance, end of period                                | <u>\$ 11,865</u>                  | <u>\$ 11,445</u>     | <u>\$ 4,333</u>             | <u>\$ 32,840</u>   | <u>\$ 7,807</u>                  | <u>\$ 13,226</u>       | <u>\$ 3,444</u>         | <u>\$ 1,628</u>   | <u>\$ 86,588</u>    |
| Ending balance, individually evaluated for impairment | \$ 112                            | \$ —                 | \$ —                        | \$ 501             | \$ —                             | \$ 38                  | \$ 152                  | \$ —              | \$ 803              |
| Ending balance, collectively evaluated for impairment | 11,753                            | 11,445               | 4,333                       | 32,339             | 7,807                            | 13,188                 | 3,292                   | 1,628             | 85,785              |
| Total reserve for loan and lease losses               | <u>\$ 11,865</u>                  | <u>\$ 11,445</u>     | <u>\$ 4,333</u>             | <u>\$ 32,840</u>   | <u>\$ 7,807</u>                  | <u>\$ 13,226</u>       | <u>\$ 3,444</u>         | <u>\$ 1,628</u>   | <u>\$ 86,588</u>    |
| <i>Recorded investment in loans</i>                   |                                   |                      |                             |                    |                                  |                        |                         |                   |                     |
| Ending balance, individually evaluated for impairment | \$ 2,038                          | \$ —                 | \$ —                        | \$ 7,174           | \$ 728                           | \$ 9,933               | \$ 369                  | \$ —              | \$ 20,242           |
| Ending balance, collectively evaluated for impairment | 717,934                           | 446,731              | 250,045                     | 744,491            | 444,751                          | 631,272                | 454,361                 | 142,872           | 3,832,457           |
| Total recorded investment in loans                    | <u>\$ 719,972</u>                 | <u>\$ 446,731</u>    | <u>\$ 250,045</u>           | <u>\$ 751,665</u>  | <u>\$ 445,479</u>                | <u>\$ 641,205</u>      | <u>\$ 454,730</u>       | <u>\$ 142,872</u> | <u>\$ 3,852,699</u> |
| <b>June 30, 2014</b>                                  |                                   |                      |                             |                    |                                  |                        |                         |                   |                     |
| <i>Reserve for loan and lease losses</i>              |                                   |                      |                             |                    |                                  |                        |                         |                   |                     |
| Balance, beginning of period                          | \$ 11,515                         | \$ 9,657             | \$ 4,212                    | \$ 34,037          | \$ 5,972                         | \$ 12,406              | \$ 4,093                | \$ 1,613          | \$ 83,505           |
| Charge-offs                                           | 228                               | 19                   | —                           | —                  | 2                                | 1                      | 43                      | 389               | 682                 |
| Recoveries                                            | 686                               | 1,055                | 136                         | 112                | 225                              | 155                    | 70                      | 167               | 2,606               |
| Net charge-offs (recoveries)                          | (458)                             | (1,036)              | (136)                       | (112)              | (223)                            | (154)                  | (27)                    | 222               | (1,924)             |
| Provision (recovery of provision)                     | 4,793                             | (266)                | (67)                        | (1,062)            | 123                              | (207)                  | (186)                   | 219               | 3,347               |
| Balance, end of period                                | <u>\$ 16,766</u>                  | <u>\$ 10,427</u>     | <u>\$ 4,281</u>             | <u>\$ 33,087</u>   | <u>\$ 6,318</u>                  | <u>\$ 12,353</u>       | <u>\$ 3,934</u>         | <u>\$ 1,610</u>   | <u>\$ 88,776</u>    |
| Ending balance, individually evaluated for impairment | \$ 4,769                          | \$ —                 | \$ —                        | \$ —               | \$ —                             | \$ —                   | \$ 159                  | \$ —              | \$ 4,928            |
| Ending balance, collectively evaluated for impairment | 11,997                            | 10,427               | 4,281                       | 33,087             | 6,318                            | 12,353                 | 3,775                   | 1,610             | 83,848              |
| Total reserve for loan and lease losses               | <u>\$ 16,766</u>                  | <u>\$ 10,427</u>     | <u>\$ 4,281</u>             | <u>\$ 33,087</u>   | <u>\$ 6,318</u>                  | <u>\$ 12,353</u>       | <u>\$ 3,934</u>         | <u>\$ 1,610</u>   | <u>\$ 88,776</u>    |
| <i>Recorded investment in loans</i>                   |                                   |                      |                             |                    |                                  |                        |                         |                   |                     |
| Ending balance, individually evaluated for impairment | \$ 22,533                         | \$ —                 | \$ —                        | \$ 1,120           | \$ 1,105                         | \$ 12,699              | \$ 376                  | \$ —              | \$ 37,833           |
| Ending balance, collectively evaluated for impairment | 697,693                           | 471,080              | 243,358                     | 732,074            | 368,650                          | 589,622                | 454,469                 | 128,756           | 3,685,702           |
| Total recorded investment in loans                    | <u>\$ 720,226</u>                 | <u>\$ 471,080</u>    | <u>\$ 243,358</u>           | <u>\$ 733,194</u>  | <u>\$ 369,755</u>                | <u>\$ 602,321</u>      | <u>\$ 454,845</u>       | <u>\$ 128,756</u> | <u>\$ 3,723,535</u> |

## 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 \$814.57 million and \$825.17 million at June 30, 2015 and December 31, 2014 , 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.

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

| (Dollars in thousands)                                           | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|------------------------------------------------------------------|--------------------------------|----------|------------------------------|----------|
|                                                                  | 2015                           | 2014     | 2015                         | 2014     |
| Mortgage servicing rights:                                       |                                |          |                              |          |
| Balance at beginning of period                                   | \$ 4,590                       | \$ 4,759 | \$ 4,733                     | \$ 4,844 |
| Additions                                                        | 456                            | 246      | 706                          | 447      |
| Amortization                                                     | (385)                          | (310)    | (778)                        | (596)    |
| Sales                                                            | —                              | —        | —                            | —        |
| Carrying value before valuation allowance at end of period       | 4,661                          | 4,695    | 4,661                        | 4,695    |
| Valuation allowance:                                             |                                |          |                              |          |
| Balance at beginning of period                                   | —                              | —        | —                            | —        |
| Impairment (charges) recoveries                                  | —                              | —        | —                            | —        |
| Balance at end of period                                         | \$ —                           | \$ —     | \$ —                         | \$ —     |
| Net carrying value of mortgage servicing rights at end of period | \$ 4,661                       | \$ 4,695 | \$ 4,661                     | \$ 4,695 |
| Fair value of mortgage servicing rights at end of period         | \$ 7,342                       | \$ 7,584 | \$ 7,342                     | \$ 7,584 |

At June 30, 2015 and 2014 , the fair value of MSR's exceeded the carrying value reported in the Statements of Financial Condition by \$2.68 million and \$2.89 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 \$0.71 million and \$0.75 million for the three months ended June 30, 2015 and 2014 , respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were \$1.43 million and \$1.54 million for the six months ended June 30, 2015 and 2014 , respectively. Mortgage loan contractual servicing fees are included in Mortgage Banking Income 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.

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 totaled \$28.47 million and \$26.94 million at June 30, 2015 and December 31, 2014 , respectively. Standby letters of credit generally have terms ranging from six months to one year.

#### Note 8. Derivative Financial Instruments

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

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

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

| (Dollars in thousands)            | Notional or contractual amount | Asset derivatives                               |                 | Liability derivatives                           |                 |
|-----------------------------------|--------------------------------|-------------------------------------------------|-----------------|-------------------------------------------------|-----------------|
|                                   |                                | Statement of Financial Condition classification | Fair value      | Statement of Financial Condition classification | Fair value      |
| June 30, 2015                     |                                |                                                 |                 |                                                 |                 |
| Interest rate swap contracts      | \$ 482,862                     | Other assets                                    | \$ 8,186        | Other liabilities                               | \$ 8,342        |
| Loan commitments                  | 13,776                         | Mortgages held for sale                         | 89              | N/A                                             | —               |
| Forward contracts - mortgage loan | 22,050                         | Mortgages held for sale                         | 204             | N/A                                             | —               |
| Total                             | <u>\$ 518,688</u>              |                                                 | <u>\$ 8,479</u> |                                                 | <u>\$ 8,342</u> |
|                                   |                                |                                                 |                 |                                                 |                 |
| December 31, 2014                 |                                |                                                 |                 |                                                 |                 |
| Interest rate swap contracts      | \$ 459,508                     | Other assets                                    | \$ 9,125        | Other liabilities                               | \$ 9,302        |
| Loan commitments                  | 11,109                         | Mortgages held for sale                         | 2               | N/A                                             | —               |
| Forward contracts - mortgage loan | 19,800                         | N/A                                             | —               | Mortgages held for sale                         | 142             |
| Total                             | <u>\$ 490,417</u>              |                                                 | <u>\$ 9,127</u> |                                                 | <u>\$ 9,444</u> |

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

| (Dollars in thousands)               | Statement of Income classification | Gain (loss)                 |                 |                           |                 |
|--------------------------------------|------------------------------------|-----------------------------|-----------------|---------------------------|-----------------|
|                                      |                                    | Three Months Ended June 30, |                 | Six Months Ended June 30, |                 |
|                                      |                                    | 2015                        | 2014            | 2015                      | 2014            |
| Interest rate swap contracts         | Other expense                      | \$ 41                       | \$ (7)          | \$ 22                     | \$ (1)          |
| Interest rate swap contracts         | Other income                       | 221                         | 103             | 297                       | 195             |
| Loan commitments                     | Mortgage banking income            | (52)                        | (83)            | 87                        | 27              |
| Forward contracts - mortgage loan    | Mortgage banking income            | 372                         | (266)           | 346                       | (386)           |
| Forward contracts - foreign exchange | Other income                       | —                           | (3)             | —                         | (4)             |
| Total                                |                                    | <u>\$ 582</u>               | <u>\$ (256)</u> | <u>\$ 752</u>             | <u>\$ (169)</u> |

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

| (Dollars in thousands) | Gross Amounts of Recognized Assets | Gross Amounts Offset in the Statement of Financial Condition | Net Amounts of Assets Presented in the Statement of Financial Condition | Gross Amounts Not Offset in the Statement of Financial Condition |                          |            |
|------------------------|------------------------------------|--------------------------------------------------------------|-------------------------------------------------------------------------|------------------------------------------------------------------|--------------------------|------------|
|                        |                                    |                                                              |                                                                         | Financial Instruments                                            | Cash Collateral Received | Net Amount |
| June 30, 2015          |                                    |                                                              |                                                                         |                                                                  |                          |            |
| Interest rate swaps    | \$ 8,458                           | \$ 272                                                       | \$ 8,186                                                                | \$ —                                                             | \$ —                     | \$ 8,186   |
| December 31, 2014      |                                    |                                                              |                                                                         |                                                                  |                          |            |
| Interest rate swaps    | \$ 9,492                           | \$ 367                                                       | \$ 9,125                                                                | \$ —                                                             | \$ —                     | \$ 9,125   |



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

|                        |                                         |                                                              |                                                                              | Gross Amounts Not Offset in the Statement of Financial Condition |                         |            |
|------------------------|-----------------------------------------|--------------------------------------------------------------|------------------------------------------------------------------------------|------------------------------------------------------------------|-------------------------|------------|
| (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 | Financial Instruments                                            | Cash Collateral Pledged | Net Amount |
| June 30, 2015          |                                         |                                                              |                                                                              |                                                                  |                         |            |
| Interest rate swaps    | \$ 8,614                                | \$ 272                                                       | \$ 8,342                                                                     | \$ —                                                             | \$ 7,994                | \$ 348     |
| Repurchase agreements  | 122,658                                 | —                                                            | 122,658                                                                      | 122,658                                                          | —                       | —          |
| Total                  | \$ 131,272                              | \$ 272                                                       | \$ 131,000                                                                   | \$ 122,658                                                       | \$ 7,994                | \$ 348     |
| December 31, 2014      |                                         |                                                              |                                                                              |                                                                  |                         |            |
| Interest rate swaps    | \$ 9,669                                | \$ 367                                                       | \$ 9,302                                                                     | \$ —                                                             | \$ 9,018                | \$ 284     |
| Repurchase agreements  | 128,343                                 | —                                                            | 128,343                                                                      | 128,343                                                          | —                       | —          |
| Total                  | \$ 138,012                              | \$ 367                                                       | \$ 137,645                                                                   | \$ 128,343                                                       | \$ 9,018                | \$ 284     |

If a default in performance of any obligation of a repurchase agreement occurs, each party will set-off property held in respect of transactions against obligations owing in respect of any other transactions. At June 30, 2015 and December 31, 2014, repurchase agreements had a remaining contractual maturity of \$120.32 million and \$107.63 million in overnight and \$2.34 million and \$20.71 million in up to 30 days, respectively and were collateralized by U.S. Treasury and Federal agencies securities.

#### Note 9. Earnings Per Share

Earnings per common share is computed using the two-class method. Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of common shares outstanding during the applicable period, excluding outstanding participating securities. Participating securities include non-vested restricted stock awards. Non-vested restricted stock awards are considered participating securities to the extent the holders of these securities receive non-forfeitable dividends at the same rate as holders of common stock. Diluted earnings per common share is computed using the weighted-average number of shares determined for the basic earnings per common share computation plus the dilutive effect of stock compensation using the treasury stock method. Stock options, where the exercise price was greater than the average market price of the common shares, were excluded from the computation of diluted earnings per common share because the result would have been antidilutive. There were no stock options outstanding as of June 30, 2015 and 2014.

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

| (Dollars in thousands - except per share amounts)                          | Three Months Ended<br>June 30, |                   | Six Months Ended<br>June 30, |                   |
|----------------------------------------------------------------------------|--------------------------------|-------------------|------------------------------|-------------------|
|                                                                            | 2015                           | 2014              | 2015                         | 2014              |
| Distributed earnings allocated to common stock                             | \$ 4,293                       | \$ 4,362          | \$ 8,589                     | \$ 8,497          |
| Undistributed earnings allocated to common stock                           | 11,186                         | 9,956             | 20,249                       | 19,267            |
| Net earnings allocated to common stock                                     | 15,479                         | 14,318            | 28,838                       | 27,764            |
| Net earnings allocated to participating securities                         | 151                            | 176               | 303                          | 362               |
| Net income allocated to common stock and participating securities          | <u>\$ 15,630</u>               | <u>\$ 14,494</u>  | <u>\$ 29,141</u>             | <u>\$ 28,126</u>  |
| Weighted average shares outstanding for basic earnings per common share*   | 26,212,999                     | 26,485,789        | 26,235,511                   | 26,616,762        |
| Dilutive effect of stock compensation                                      | —                              | —                 | —                            | —                 |
| Weighted average shares outstanding for diluted earnings per common share* | <u>26,212,999</u>              | <u>26,485,789</u> | <u>26,235,511</u>            | <u>26,616,762</u> |
| Basic earnings per common share*                                           | \$ 0.59                        | \$ 0.54           | \$ 1.10                      | \$ 1.04           |
| Diluted earnings per common share*                                         | \$ 0.59                        | \$ 0.54           | \$ 1.10                      | \$ 1.04           |

\*Outstanding shares and per common share figures have been adjusted for 10% stock dividend declared July 22, 2015.

## Note 10. Stock Based Compensation

As of June 30, 2015, 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, 2014. These plans include three executive stock award plans, the Executive Incentive Plan, the Restricted Stock Award Plan, the 1998 Performance Compensation Plan; and the Employee Stock Purchase Plan. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but the Company had not made any grants through June 30, 2015.

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

The stock-based compensation expense recognized in the Statements of Income for the three and six months ended June 30, 2015 and 2014 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. GAAP requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

Total fair value of options vested and expensed was zero for the six months ended June 30, 2015 and 2014. As of June 30, 2015 and 2014 there were no outstanding stock options. There were no stock options exercised during the six months ended June 30, 2015 and 2014. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of June 30, 2015, there was \$6.38 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 3.30 years.

## 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.

| (Dollars in thousands)                | Three Months Ended<br>June 30, |      | Six Months Ended<br>June 30, |        | Affected Line Item in the Statements of Income    |
|---------------------------------------|--------------------------------|------|------------------------------|--------|---------------------------------------------------|
|                                       | 2015                           | 2014 | 2015                         | 2014   |                                                   |
| Realized gains included in net income | \$ 4                           | \$ — | \$ 4                         | \$ 963 | Gains on investment securities available-for-sale |
|                                       | 4                              | —    | 4                            | 963    | Income before income taxes                        |
| Tax effect                            | (2)                            | —    | (2)                          | (361)  | Income tax expense                                |
| Net of tax                            | \$ 2                           | \$ — | \$ 2                         | \$ 602 | Net income                                        |

## Note 12. Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was \$0.15 million at June 30, 2015 and there were no unrecognized tax benefits that would affect the effective tax rate at December 31, 2014. Interest and penalties were recognized through the income tax provision. For the six months ended June 30, 2015, the Company recognized no interest or penalties. For the six months ended June 30, 2014, the Company recognized approximately \$0.09 million in interest, net of tax effect, and penalties. There were no accrued interest and penalties at June 30, 2015 and December 31, 2014, respectively.

Tax years that remain open and subject to audit include the federal 2011-2014 years and the Indiana 2013-2014 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

## Note 13. Fair Value Measurements

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

management’s estimates of the assumptions a market participant would use in pricing the asset or liability.

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

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

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

The Company elected fair value accounting for mortgages held for sale. The Company believes the election for mortgages held for sale (which are economically hedged with free standing derivatives) will reduce certain timing differences and better match changes in the value of these assets with changes in the value of derivatives used as economic hedges for these assets. At June 30, 2015 and December 31, 2014, all mortgages held for sale were carried at fair value.

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.

| <i>(Dollars in thousands)</i>                  | Fair value carrying amount | Aggregate unpaid principal | Excess of fair value carrying amount over (under) unpaid principal |
|------------------------------------------------|----------------------------|----------------------------|--------------------------------------------------------------------|
| <b>June 30, 2015</b>                           |                            |                            |                                                                    |
| Mortgages held for sale reported at fair value | \$ 14,782                  | \$ 14,455                  | \$ 327 (1)                                                         |
| <b>December 31, 2014</b>                       |                            |                            |                                                                    |
| Mortgages held for sale reported at fair value | \$ 13,604                  | \$ 13,526                  | \$ 78 (1)                                                          |

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

#### **Financial Instruments on Recurring Basis:**

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

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

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

Both the market and income valuation approaches are implemented using the following types of inputs:

- U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.



- Government-sponsored agency debt securities and corporate bonds are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.
- Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded REMICs and CMOs, are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.
- 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.

Trading account securities are 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.

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.

| <i>(Dollars in thousands)</i>                                          | Level 1          | Level 2           | Level 3         | Total             |
|------------------------------------------------------------------------|------------------|-------------------|-----------------|-------------------|
| <b>June 30, 2015</b>                                                   |                  |                   |                 |                   |
| <u>Assets:</u>                                                         |                  |                   |                 |                   |
| Investment securities available-for-sale:                              |                  |                   |                 |                   |
| U.S. Treasury and Federal agencies securities                          | \$ 19,945        | \$ 365,969        | \$ —            | \$ 385,914        |
| U.S. States and political subdivisions securities                      | —                | 118,264           | 5,444           | 123,708           |
| Mortgage-backed securities — Federal agencies                          | —                | 235,250           | —               | 235,250           |
| Corporate debt securities                                              | —                | 33,577            | —               | 33,577            |
| Foreign government and other securities                                | —                | —                 | 807             | 807               |
| Total debt securities                                                  | 19,945           | 753,060           | 6,251           | 779,256           |
| Marketable equity securities                                           | 7,215            | —                 | —               | 7,215             |
| Total investment securities available-for-sale                         | 27,160           | 753,060           | 6,251           | 786,471           |
| Trading account securities                                             | 211              | —                 | —               | 211               |
| Mortgages held for sale                                                | —                | 14,782            | —               | 14,782            |
| Accrued income and other assets (interest rate swap agreements)        | —                | 8,186             | —               | 8,186             |
| Total                                                                  | <u>\$ 27,371</u> | <u>\$ 776,028</u> | <u>\$ 6,251</u> | <u>\$ 809,650</u> |
| <u>Liabilities:</u>                                                    |                  |                   |                 |                   |
| Accrued expenses and other liabilities (interest rate swap agreements) | \$ —             | \$ 8,342          | \$ —            | \$ 8,342          |
| Total                                                                  | <u>\$ —</u>      | <u>\$ 8,342</u>   | <u>\$ —</u>     | <u>\$ 8,342</u>   |
| <b>December 31, 2014</b>                                               |                  |                   |                 |                   |
| <u>Assets:</u>                                                         |                  |                   |                 |                   |
| Investment securities available-for-sale:                              |                  |                   |                 |                   |
| U.S. Treasury and Federal agencies securities                          | \$ 19,808        | \$ 353,695        | \$ —            | \$ 373,503        |
| U.S. States and political subdivisions securities                      | —                | 118,222           | 6,466           | 124,688           |
| Mortgage-backed securities — Federal agencies                          | —                | 253,008           | —               | 253,008           |
| Corporate debt securities                                              | —                | 31,932            | —               | 31,932            |
| Foreign government and other securities                                | —                | —                 | 811             | 811               |
| Total debt securities                                                  | 19,808           | 756,857           | 7,277           | 783,942           |
| Marketable equity securities                                           | 7,176            | —                 | —               | 7,176             |
| Total investment securities available-for-sale                         | 26,984           | 756,857           | 7,277           | 791,118           |
| Trading account securities                                             | 205              | —                 | —               | 205               |
| Mortgages held for sale                                                | —                | 13,604            | —               | 13,604            |
| Accrued income and other assets (interest rate swap agreements)        | —                | 9,125             | —               | 9,125             |
| Total                                                                  | <u>\$ 27,189</u> | <u>\$ 779,586</u> | <u>\$ 7,277</u> | <u>\$ 814,052</u> |
| <u>Liabilities:</u>                                                    |                  |                   |                 |                   |
| Accrued expenses and other liabilities (interest rate swap agreements) | \$ —             | \$ 9,302          | \$ —            | \$ 9,302          |
| Total                                                                  | <u>\$ —</u>      | <u>\$ 9,302</u>   | <u>\$ —</u>     | <u>\$ 9,302</u>   |

The following table shows changes in Level 3 assets and liabilities measured at fair value on a recurring basis for the quarter ended June 30, 2015 and 2014 .

| <i>(Dollars in thousands)</i>                | U.S. States and<br>political<br>subdivisions<br>securities | Foreign<br>government and<br>other securities | Investment securities<br>available-for-sale |
|----------------------------------------------|------------------------------------------------------------|-----------------------------------------------|---------------------------------------------|
| <b>Beginning balance April 1, 2015</b>       | \$ 5,632                                                   | \$ 808                                        | \$ 6,440                                    |
| Total gains or losses (realized/unrealized): |                                                            |                                               |                                             |
| Included in earnings                         | —                                                          | —                                             | —                                           |
| Included in other comprehensive income       | (38)                                                       | (1)                                           | (39)                                        |
| Purchases                                    | —                                                          | —                                             | —                                           |
| Issuances                                    | —                                                          | —                                             | —                                           |
| Sales                                        | —                                                          | —                                             | —                                           |
| Settlements                                  | —                                                          | —                                             | —                                           |
| Maturities                                   | (150)                                                      | —                                             | (150)                                       |
| Transfers into Level 3                       | —                                                          | —                                             | —                                           |
| Transfers out of Level 3                     | —                                                          | —                                             | —                                           |
| <b>Ending balance June 30, 2015</b>          | <u>\$ 5,444</u>                                            | <u>\$ 807</u>                                 | <u>\$ 6,251</u>                             |
| <b>Beginning balance April 1, 2014</b>       | \$ 4,709                                                   | \$ —                                          | \$ 4,709                                    |
| Total gains or losses (realized/unrealized): |                                                            |                                               |                                             |
| Included in earnings                         | —                                                          | —                                             | —                                           |
| Included in other comprehensive income       | (10)                                                       | —                                             | (10)                                        |
| Purchases                                    | —                                                          | —                                             | —                                           |
| Issuances                                    | —                                                          | —                                             | —                                           |
| Sales                                        | —                                                          | —                                             | —                                           |
| Settlements                                  | —                                                          | —                                             | —                                           |
| Maturities                                   | —                                                          | —                                             | —                                           |
| Transfers into Level 3                       | —                                                          | 905                                           | 905                                         |
| Transfers out of Level 3                     | —                                                          | —                                             | —                                           |
| <b>Ending balance June 30, 2014</b>          | <u>\$ 4,699</u>                                            | <u>\$ 905</u>                                 | <u>\$ 5,604</u>                             |

There were no gains or losses for the period included in earnings attributable to the change in unrealized gains or losses relating to assets and liabilities still held at June 30, 2015 or 2014 . No transfers between levels occurred during the three months ended June 30, 2015 . One transfer between levels occurred during the three months ended June 30, 2014. A foreign government debt security was transferred from Level 2 to Level 3 as of June 30, 2014 due to the Company's periodic review of valuation methodologies and inputs. The Company determined that the observable inputs used in determining fair value warranted a transfer to Level 3 as the unobservable inputs were deemed significant to the overall fair value measurement.

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

| <i>(Dollars in thousands)</i>            | <b>Fair Value</b> | <b>Valuation Methodology</b> | <b>Unobservable Inputs</b> | <b>Range of Inputs</b> |
|------------------------------------------|-------------------|------------------------------|----------------------------|------------------------|
| <b>June 30, 2015</b>                     |                   |                              |                            |                        |
| Investment securities available-for sale |                   |                              |                            |                        |
| Direct placement municipal securities    | \$ 5,444          | Discounted cash flows        | Credit spread assumption   | 1.46% - 2.34%          |
| Foreign government                       | \$ 807            | Discounted cash flows        | Market yield assumption    | 0.06% - 1.43%          |
| <b>December 31, 2014</b>                 |                   |                              |                            |                        |
| Investment securities available-for sale |                   |                              |                            |                        |
| Direct placement municipal securities    | \$ 6,466          | Discounted cash flows        | Credit spread assumption   | 0.99% - 2.08%          |
| Foreign government                       | \$ 811            | Discounted cash flows        | Market yield assumption    | 0.25% - 1.31%          |

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

#### ***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% at a minimum with higher discounts for property in poor condition or property with characteristics which may make it more difficult to market. Commercial loans subject to borrowing base certificates are generally discounted by 20% for receivables and 40% - 75% for inventory with higher discounts when monthly borrowing base certificates are not required or received.

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

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

The Company has established MSR valuation policies and procedures based on industry standards and to ensure valuation methodologies are consistent and verifiable. MSRs and related adjustments to fair value result from application of lower of cost or fair value accounting. For purposes of impairment, MSRs are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. The fair value of each tranche of the servicing portfolio is estimated by calculating the present value of estimated future net servicing cash flows, taking into consideration actual and expected mortgage loan prepayment rates, discount rates, servicing costs, and other economic factors. Prepayment rates and discount rates are derived through a third party pricing agent. Changes in the most significant inputs, including prepayment rates and discount rates, are compared to the changes in the fair value measurements and appropriate resolution is made. A fair value analysis is also obtained from an independent third party agent and compared to the internal valuation for reasonableness. MSRs do not trade in an active, open market with readily observable prices and though sales of MSRs do occur, precise terms and conditions typically are not readily available and the characteristics of the Company's servicing portfolio may differ from those of any servicing portfolios that do trade.

Other real estate is based on the lower of cost or fair value of the underlying collateral less expected selling costs. Collateral values are estimated primarily using appraisals and reflect a market value approach. Fair values are reviewed quarterly and new appraisals are obtained annually. Repossessions are similarly valued.

For assets measured at fair value on a nonrecurring basis the following represents impairment charges (recoveries) recognized on these assets during the quarter ended June 30, 2015 : impaired loans \$0.00 million ; partnership investments - \$0.00 million ; mortgage servicing rights \$0.00 million ; repossessions \$0.00 million , and other real estate - \$0.01 million .

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

| <i>(Dollars in thousands)</i>                               | Level 1     | Level 2     | Level 3          | Total            |
|-------------------------------------------------------------|-------------|-------------|------------------|------------------|
| <b>June 30, 2015</b>                                        |             |             |                  |                  |
| Impaired loans - collateral based                           | \$ —        | \$ —        | \$ 4,178         | \$ 4,178         |
| Accrued income and other assets (partnership investments)   | —           | —           | 1,010            | 1,010            |
| Accrued income and other assets (mortgage servicing rights) | —           | —           | 4,661            | 4,661            |
| Accrued income and other assets (repossessions)             | —           | —           | 5,433            | 5,433            |
| Accrued income and other assets (other real estate)         | —           | —           | 927              | 927              |
| Total                                                       | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 16,209</u> | <u>\$ 16,209</u> |
| <b>December 31, 2014</b>                                    |             |             |                  |                  |
| Impaired loans - collateral based                           | \$ —        | \$ —        | \$ 1,007         | \$ 1,007         |
| Accrued income and other assets (partnership investments)   | —           | —           | 1,343            | 1,343            |
| Accrued income and other assets (mortgage servicing rights) | —           | —           | 4,733            | 4,733            |
| Accrued income and other assets (repossessions)             | —           | —           | 5,156            | 5,156            |
| Accrued income and other assets (other real estate)         | —           | —           | 1,735            | 1,735            |
| Total                                                       | <u>\$ —</u> | <u>\$ —</u> | <u>\$ 13,974</u> | <u>\$ 13,974</u> |

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.

| <i>(Dollars in thousands)</i> | <b>Carrying Value</b> | <b>Fair Value</b> | <b>Valuation Methodology</b>                                                               | <b>Unobservable Inputs</b>                                | <b>Range of Inputs</b>        |
|-------------------------------|-----------------------|-------------------|--------------------------------------------------------------------------------------------|-----------------------------------------------------------|-------------------------------|
| <b>June 30, 2015</b>          |                       |                   |                                                                                            |                                                           |                               |
| Impaired loans                | \$ 4,178              | \$ 4,178          | Collateral based measurements including appraisals, trade publications, and auction values | Discount for lack of marketability and current conditions | 10% - 100%                    |
| Mortgage servicing rights     | 4,661                 | 7,342             | Discounted cash flows                                                                      | Constant prepayment rate (CPR)<br>Discount rate           | 10.5% - 17.1%<br>9.8% - 13.3% |
| Repossessions                 | 5,433                 | 5,583             | Appraisals, trade publications and auction values                                          | Discount for lack of marketability                        | 0% - 3%                       |
| Other real estate             | 927                   | 1,031             | Appraisals                                                                                 | Discount for lack of marketability                        | 7% - 20%                      |
| <b>December 31, 2014</b>      |                       |                   |                                                                                            |                                                           |                               |
| Impaired loans                | \$ 1,007              | \$ 1,007          | Collateral based measurements including appraisals, trade publications, and auction values | Discount for lack of marketability and current conditions | 20% - 25%                     |
| Mortgage servicing rights     | 4,733                 | 6,979             | Discounted cash flows                                                                      | Constant prepayment rate (CPR)<br>Discount rate           | 10.2% - 16.3%<br>9.5% - 13.0% |
| Repossessions                 | 5,156                 | 5,307             | Appraisals, trade publications and auction values                                          | Discount for lack of marketability                        | 0% - 3%                       |
| Other real estate             | 1,735                 | 1,953             | Appraisals                                                                                 | Discount for lack of marketability                        | 5% - 38%                      |

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.

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

| <i>(Dollars in thousands)</i>                                     | <b>Carrying or<br/>Contract Value</b> | <b>Fair Value</b> | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> |
|-------------------------------------------------------------------|---------------------------------------|-------------------|----------------|----------------|----------------|
| <b>June 30, 2015</b>                                              |                                       |                   |                |                |                |
| <u>Assets:</u>                                                    |                                       |                   |                |                |                |
| Cash and due from banks                                           | \$ 66,302                             | \$ 66,302         | \$ 66,302      | \$ —           | \$ —           |
| Federal funds sold and interest bearing deposits with other banks | 11,396                                | 11,396            | 11,396         | —              | —              |
| Investment securities, available-for-sale                         | 786,471                               | 786,471           | 27,160         | 753,060        | 6,251          |
| Other investments and trading account securities                  | 20,954                                | 20,954            | 20,954         | —              | —              |
| Mortgages held for sale                                           | 14,782                                | 14,782            | —              | 14,782         | —              |
| Loans and leases, net of reserve for loan and lease losses        | 3,766,111                             | 3,774,907         | —              | —              | 3,774,907      |
| Mortgage servicing rights                                         | 4,661                                 | 7,342             | —              | —              | 7,342          |
| Interest rate swaps                                               | 8,186                                 | 8,186             | —              | 8,186          | —              |
| <u>Liabilities:</u>                                               |                                       |                   |                |                |                |
| Deposits                                                          | \$ 3,962,585                          | \$ 3,963,633      | \$ 2,929,200   | \$ 1,034,433   | \$ —           |
| Short-term borrowings                                             | 262,187                               | 262,187           | 125,674        | 136,513        | —              |
| Long-term debt and mandatorily redeemable securities              | 57,488                                | 57,344            | —              | 57,344         | —              |
| Subordinated notes                                                | 58,764                                | 49,204            | —              | 49,204         | —              |
| Interest rate swaps                                               | 8,342                                 | 8,342             | —              | 8,342          | —              |
| Off-balance-sheet instruments *                                   | —                                     | 291               | —              | 291            | —              |
| <b>December 31, 2014</b>                                          |                                       |                   |                |                |                |
| <u>Assets:</u>                                                    |                                       |                   |                |                |                |
| Cash and due from banks                                           | \$ 64,834                             | \$ 64,834         | \$ 64,834      | \$ —           | \$ —           |
| Federal funds sold and interest bearing deposits with other banks | 1,356                                 | 1,356             | 1,356          | —              | —              |
| Investment securities, available-for-sale                         | 791,118                               | 791,118           | 26,984         | 756,857        | 7,277          |
| Other investments and trading account securities                  | 21,006                                | 21,006            | 21,006         | —              | —              |
| Mortgages held for sale                                           | 13,604                                | 13,604            | —              | 13,604         | —              |
| Loans and leases, net of reserve for loan and lease losses        | 3,603,506                             | 3,626,682         | —              | —              | 3,626,682      |
| Mortgage servicing rights                                         | 4,733                                 | 6,979             | —              | —              | 6,979          |
| Interest rate swaps                                               | 9,125                                 | 9,125             | —              | 9,125          | —              |
| <u>Liabilities:</u>                                               |                                       |                   |                |                |                |
| Deposits                                                          | \$ 3,802,860                          | \$ 3,803,958      | \$ 2,824,935   | \$ 979,023     | \$ —           |
| Short-term borrowings                                             | 245,822                               | 245,822           | 123,337        | 122,485        | —              |
| Long-term debt and mandatorily redeemable securities              | 56,232                                | 56,044            | —              | 56,044         | —              |
| Subordinated notes                                                | 58,764                                | 59,427            | —              | 59,427         | —              |
| Interest rate swaps                                               | 9,302                                 | 9,302             | —              | 9,302          | —              |
| Off-balance-sheet instruments *                                   | —                                     | 305               | —              | 305            | —              |

\* 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, other investments, and cash surrender value of life insurance policies. 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.



**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.

#### **Note 14. Subsequent Events**

On July 22, 2015, the Company declared a 10% stock dividend of 1st Source common stock. All per share computations and number of common shares outstanding have been retroactively adjusted for all periods presented as a result of the stock dividend. Additionally, in accordance with Staff Accounting Bulletin Topic 4.C, the effect of the stock dividend was retroactively applied to the Statements of Financial Condition and the Statements of Shareholders' Equity to increase common stock and decrease retained earnings each by \$90.00 million as of June 30, 2015.

## ITEM 2.

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

The following management's discussion and analysis is presented to provide information concerning 1st Source Corporation and its subsidiaries' (collectively referred to as "the Company", "we", and "our") financial condition as of June 30, 2015, as compared to December 31, 2014, and the results of operations for the three and six months ended June 30, 2015 and 2014. 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 2014 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," "continue," "remain," "estimate," "anticipate," "project," "will," "should," "indicate," "would," "may" and other similar expressions are intended 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 2014, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

#### FINANCIAL CONDITION

Our total assets at June 30, 2015 were \$5.01 billion, an increase of \$184.07 million or 3.81% from December 31, 2014. Total loans and leases were \$3.85 billion, an increase of \$164.13 million or 4.45% from December 31, 2014. Total investment securities, available for sale were \$786.47 million which represented a decrease of \$4.65 million and total deposits were \$3.96 billion, an increase of \$159.73 million or 4.20% over the comparable figures at the end of 2014. Short-term borrowings were \$262.19 million, an increase of \$16.37 million or 6.66% from December 31, 2014.

Nonperforming assets at June 30, 2015 were \$21.72 million, a decrease of \$20.76 million or 48.87% from the \$42.48 million reported at December 31, 2014. At June 30, 2015 and December 31, 2014, nonperforming assets were 0.55% and 1.13%, respectively of net loans and leases.

The following table shows accrued income and other assets.

| <i>(Dollars in thousands)</i>                  | June 30,<br>2015  | December 31,<br>2014 |
|------------------------------------------------|-------------------|----------------------|
| Accrued income and other assets:               |                   |                      |
| Bank owned life insurance cash surrender value | \$ 61,288         | \$ 60,371            |
| Accrued interest receivable                    | 13,023            | 13,140               |
| Mortgage servicing rights                      | 4,661             | 4,733                |
| Other real estate                              | 301               | 1,109                |
| Former bank premises held for sale             | 626               | 626                  |
| Repossessions                                  | 5,433             | 5,156                |
| All other assets                               | 32,902            | 39,557               |
| Total accrued income and other assets          | <u>\$ 118,234</u> | <u>\$ 124,692</u>    |

## CAPITAL

As of June 30, 2015 , total shareholders' equity was \$631.63 million, up \$17.16 million or 2.79% from the \$614.47 million at December 31, 2014 . In addition to net income of \$29.14 million, other significant changes in shareholders' equity during the first six months of 2015 included \$4.68 million of common stock acquired for treasury and \$8.64 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$8.29 million at June 30, 2015 , compared to \$9.41 million at December 31, 2014 . The increase in accumulated other comprehensive income/(loss) during 2015 was the result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 12.60% as of June 30, 2015 , compared to 12.72% at December 31, 2014 . Book value per common share rose to \$24.11 at June 30, 2015 , from \$23.41 at December 31, 2014 .

We declared and paid dividends per common share of \$0.164 during the second quarter of 2015 . The trailing four quarters dividend payout ratio, representing dividends per common share divided by diluted earnings per common share, was 29.42%. 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 actual capital amounts and ratios of 1st Source Corporation and 1st Source Bank as of June 30, 2015 , are presented in the table below.

| <i>(Dollars in thousands)</i>                           | <b>Actual</b> |              | <b>Minimum Capital Adequacy</b> |              | <b>To Be Well Capitalized Under Prompt Corrective Action Provisions</b> |              |
|---------------------------------------------------------|---------------|--------------|---------------------------------|--------------|-------------------------------------------------------------------------|--------------|
|                                                         | <b>Amount</b> | <b>Ratio</b> | <b>Amount</b>                   | <b>Ratio</b> | <b>Amount</b>                                                           | <b>Ratio</b> |
| Total Capital (to Risk-Weighted Assets):                |               |              |                                 |              |                                                                         |              |
| 1st Source Corporation                                  | \$ 658,383    | 15.36%       | \$ 342,850                      | 8.00%        | \$ 428,562                                                              | 10.00%       |
| 1st Source Bank                                         | 621,693       | 14.57        | 341,364                         | 8.00         | 426,705                                                                 | 10.00        |
| Tier 1 Capital (to Risk-Weighted Assets):               |               |              |                                 |              |                                                                         |              |
| 1st Source Corporation                                  | 601,982       | 14.05        | 257,137                         | 6.00         | 342,850                                                                 | 8.00         |
| 1st Source Bank                                         | 567,840       | 13.31        | 256,023                         | 6.00         | 341,364                                                                 | 8.00         |
| Common Equity Tier 1 Capital (to Risk-Weighted Assets): |               |              |                                 |              |                                                                         |              |
| 1st Source Corporation                                  | 544,982       | 12.72        | 192,853                         | 4.50         | 278,566                                                                 | 6.50         |
| 1st Source Bank                                         | 567,840       | 13.31        | 192,017                         | 4.50         | 277,358                                                                 | 6.50         |
| Tier 1 Capital (to Average Assets):                     |               |              |                                 |              |                                                                         |              |
| 1st Source Corporation                                  | 601,982       | 12.37        | 194,601                         | 4.00         | 243,252                                                                 | 5.00         |
| 1st Source Bank                                         | 567,840       | 11.69        | 194,235                         | 4.00         | 242,794                                                                 | 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, Federal Home Loan Bank (FHLB) borrowings, Federal Reserve Bank (FRB) borrowings, and the capability to package loans for sale.

We have borrowing sources available to supplement deposits and meet our funding needs. 1st Source Bank has established relationships with several banks to provide short term borrowings in the form of federal funds purchased. At June 30, 2015 , we had no outstandings and could borrow approximately \$225.00 million for a short time from these banks on a collective basis. As of June 30, 2015 , we had \$163.31 million outstanding in FHLB advances and could borrow an additional \$70.00 million. We also had \$415.95 million available to borrow from the FRB with no amounts outstanding as of June 30, 2015 .

Our loan to asset ratio was 76.84% at June 30, 2015 compared to 76.37% at December 31, 2014 and 75.59% at June 30, 2014 . Cash and cash equivalents totaled \$77.70 million at June 30, 2015 compared to \$66.19 million at December 31, 2014 and \$117.38 million at June 30, 2014 . At June 30, 2015 , the Statement of Financial Condition was rate sensitive by \$525.81 million more assets than liabilities scheduled to reprice within one year, or approximately 1.27%. 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 \$586 million.



## **RESULTS OF OPERATIONS**

Net income for the three and six month periods ended June 30, 2015 was \$15.63 million and \$29.14 million, compared to \$14.49 million and \$28.13 million for the same periods in 2014 . Diluted net income per common share was \$0.59 and \$1.10 for the three and six month periods ended June 30, 2015 , compared to \$0.54 and \$1.04 for the same periods in 2014 . Return on average common shareholders' equity was 9.36% for the six months ended June 30, 2015 , compared to 9.50% in 2014 . The return on total average assets was 1.20% for the six months ended June 30, 2015 , compared to 1.19% in 2014 .

The increase in net income for the six months ended June 30, 2015 , compared to the first six months of 2014 , was the result of an increase in net interest income and noninterest income along with a decrease in provision for loan and lease losses offset by an increase in noninterest expense and income tax expense. Details of the changes in the various components of net income are discussed further below.

### **NET INTEREST INCOME**

The taxable equivalent net interest income for the three months ended June 30, 2015 was \$42.07 million, an increase of 3.57% over the same period in 2014 . The net interest margin on a fully taxable equivalent basis was 3.64% for the three months ended June 30, 2015 , compared to 3.59% for the three months ended June 30, 2014 . The taxable equivalent net interest income for the six months ended June 30, 2015 was \$81.93 million, an increase of 2.78% over 2014 , resulting in a net interest margin of 3.61% compared to a net interest margin of 3.59% for the same period in 2014 .

During the three and six month periods ended June 30, 2015 , average earning assets increased \$95.00 million or 2.09% and \$96.03 million or 2.14% respectively, over the comparable periods in 2014 . Average interest-bearing liabilities decreased \$0.92 million and increased \$11.31 million or 0.33% respectively, for the three and six month periods ended June 30, 2015 over the comparable periods one year ago. The yield on average earning assets increased 4 basis points to 4.04% for the second quarter of 2015 from 4.00% for the second quarter of 2014 . The yield on average earning assets for the six month period ended June 30, 2015 decreased 1 basis point to 4.00% from 4.01% for the six month period ended June 30, 2014 . The rate earned on assets increased during the second quarter of 2015 over the same period in 2014 due to higher net interest recoveries of \$1.24 million largely related to one commercial loan relationship. Total cost of average interest-bearing liabilities decreased 1 basis point to 0.53% for the second quarter of 2015 from 0.54% for the second quarter 2014 . Total cost of average interest-bearing liabilities decreased 4 basis points to 0.52% for the six months ended June 30, 2015 , from 0.56% for the six months ended June 30, 2014 . The result to the net interest margin, or the ratio of net interest income to average earning assets, was an increase of 5 basis points and 2 basis points for the three and six month periods ended June 30, 2015 from June 30, 2014 .

The largest contributor to the decrease in the yield on average earning assets for the six months ended June 30, 2015 , compared to the six months ended June 30, 2014 , was a reduction in yields on net loans and leases of 1 basis point. Average net loans and leases increased \$137.96 million or 3.77% for the second quarter of 2015 from the second quarter of 2014 and \$134.43 million or 3.73% for the six months ended June 30, 2015 compared to the same period in 2014 . Total average investment securities decreased \$44.19 million or 5.29% for the second quarter and decreased \$43.62 million or 5.23% for the six month period over one year ago. Average mortgages held for sale decreased \$0.28 million or 2.07% and increased \$3.55 million or 36.70% respectively, for the three and six month periods ended June 30, 2015 , over the comparable periods a year ago. 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 \$1.50 million or 5.48% and \$1.66 million or 5.41% for the three and six month periods ended June 30, 2015 , over the comparable periods a year ago.

Average interest-bearing deposits increased \$68.46 million or 2.26% and \$70.93 million or 2.37% respectively, for the second quarter of 2015 and the first six months of 2015 over the same periods in 2014 . The effective rate paid on average interest-bearing deposits decreased 3 basis points to 0.37% for the second quarter 2015 compared to 0.40% for the second quarter 2014 . The effective rate paid on average interest-bearing deposits decreased 4 basis points to 0.36% for the first six months of 2015 compared to 0.40% for the first six months of 2014 . The decline in the average cost of interest-bearing deposits during the second quarter of 2015 and the first six months of 2015 as compared to the second quarter and first six months of 2014 was primarily the result of the continued change in deposit mix.

Average short-term borrowings decreased \$67.12 million or 21.99% and decreased \$57.60 or 20.09% respectively, for the second quarter of 2015 and the first six months of 2015 compared to the same periods in 2014 . Interest paid on short-term borrowings did not change for the second quarter and decreased 1 basis point for the first six months of 2015 . The decrease in short-term borrowings during the second quarter of 2015 and the first six months of 2015 as compared to the same periods in 2014 was primarily the result of decreased borrowings with the Federal Home Loan Bank (FHLB). Average long-term debt and mandatorily redeemable securities decreased \$2.27 million or 3.80% during the second quarter of 2015 as compared to the second quarter of 2014 and decreased \$2.03 million or 3.43% during the first six months of 2015 as compared to the first six months of 2014 . Interest paid on long-term debt and mandatorily redeemable securities increased 51 basis points for the second quarter and decreased 2 basis points for the first six months of 2015 compared to the second quarter and first six months of 2014 . The increase during the second quarter of 2015 as compared to the second quarter of 2014 was due to higher rates on mandatorily redeemable securities.

The following table provides 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)                               | Three Months Ended June 30, |                         |              |                    |                         |              | Six Months Ended June 30, |                         |              |                    |                         |              |
|------------------------------------------------------|-----------------------------|-------------------------|--------------|--------------------|-------------------------|--------------|---------------------------|-------------------------|--------------|--------------------|-------------------------|--------------|
|                                                      | 2015                        |                         |              | 2014               |                         |              | 2015                      |                         |              | 2014               |                         |              |
|                                                      | Average Balance             | Interest Income/Expense | Yield/Rate   | Average Balance    | Interest Income/Expense | Yield/Rate   | Average Balance           | Interest Income/Expense | Yield/Rate   | Average Balance    | Interest Income/Expense | Yield/Rate   |
| <b><u>ASSETS</u></b>                                 |                             |                         |              |                    |                         |              |                           |                         |              |                    |                         |              |
| Investment securities:                               |                             |                         |              |                    |                         |              |                           |                         |              |                    |                         |              |
| Taxable                                              | \$ 667,914                  | \$ 2,648                | 1.59%        | \$ 705,960         | \$ 3,401                | 1.93%        | \$ 666,752                | \$ 5,652                | 1.71%        | \$ 706,037         | \$ 6,746                | 1.93%        |
| Tax exempt                                           | 123,655                     | 1,111                   | 3.60%        | 129,795            | 1,206                   | 3.73%        | 123,321                   | 2,245                   | 3.67%        | 127,651            | 2,419                   | 3.82%        |
| Mortgages held for sale                              | 13,452                      | 125                     | 3.73%        | 13,736             | 135                     | 3.94%        | 13,231                    | 251                     | 3.83%        | 9,679              | 206                     | 4.29%        |
| Net loans and leases                                 | 3,800,120                   | 42,508                  | 4.49%        | 3,662,156          | 40,336                  | 4.42%        | 3,737,449                 | 82,039                  | 4.43%        | 3,603,016          | 79,255                  | 4.44%        |
| Other investments                                    | 28,950                      | 229                     | 3.17%        | 27,446             | 232                     | 3.39%        | 32,364                    | 484                     | 3.02%        | 30,703             | 509                     | 3.34%        |
| Total earning assets                                 | 4,634,091                   | 46,621                  | 4.04%        | 4,539,093          | 45,310                  | 4.00%        | 4,573,117                 | 90,671                  | 4.00%        | 4,477,086          | 89,135                  | 4.01%        |
| Cash and due from banks                              | 62,452                      |                         |              | 63,678             |                         |              | 62,000                    |                         |              | 60,889             |                         |              |
| Reserve for loan and lease losses                    | (86,047)                    |                         |              | (86,067)           |                         |              | (85,920)                  |                         |              | (85,173)           |                         |              |
| Other assets                                         | 345,750                     |                         |              | 314,609            |                         |              | 339,527                   |                         |              | 312,305            |                         |              |
| Total assets                                         | <u>\$4,956,246</u>          |                         |              | <u>\$4,831,313</u> |                         |              | <u>\$4,888,724</u>        |                         |              | <u>\$4,765,107</u> |                         |              |
| <b><u>LIABILITIES AND SHAREHOLDERS' EQUITY</u></b>   |                             |                         |              |                    |                         |              |                           |                         |              |                    |                         |              |
| Interest-bearing deposits                            | \$3,096,622                 | \$ 2,838                | 0.37%        | \$3,028,158        | \$ 2,994                | 0.40%        | \$3,063,087               | \$ 5,397                | 0.36%        | \$2,992,156        | \$ 5,965                | 0.40%        |
| Short-term borrowings                                | 238,051                     | 131                     | 0.22%        | 305,169            | 169                     | 0.22%        | 229,050                   | 234                     | 0.21%        | 286,647            | 306                     | 0.22%        |
| Subordinated notes                                   | 58,764                      | 1,055                   | 7.20%        | 58,764             | 1,055                   | 7.20%        | 58,764                    | 2,110                   | 7.24%        | 58,764             | 2,110                   | 7.24%        |
| Long-term debt and mandatorily redeemable securities | 57,393                      | 525                     | 3.67%        | 59,661             | 470                     | 3.16%        | 57,064                    | 1,004                   | 3.55%        | 59,093             | 1,045                   | 3.57%        |
| Total interest bearing liabilities                   | 3,450,830                   | 4,549                   | 0.53%        | 3,451,752          | 4,688                   | 0.54%        | 3,407,965                 | 8,745                   | 0.52%        | 3,396,660          | 9,426                   | 0.56%        |
| Noninterest-bearing deposits                         | 830,455                     |                         |              | 735,885            |                         |              | 809,233                   |                         |              | 725,103            |                         |              |
| Other liabilities                                    | 42,661                      |                         |              | 44,384             |                         |              | 43,653                    |                         |              | 46,342             |                         |              |
| Shareholders' equity                                 | 632,300                     |                         |              | 599,292            |                         |              | 627,873                   |                         |              | 597,002            |                         |              |
| Total liabilities and shareholders' equity           | <u>\$4,956,246</u>          |                         |              | <u>\$4,831,313</u> |                         |              | <u>\$4,888,724</u>        |                         |              | <u>\$4,765,107</u> |                         |              |
| Net interest income                                  | <u>\$ 42,072</u>            |                         |              | <u>\$ 40,622</u>   |                         |              | <u>\$ 81,926</u>          |                         |              | <u>\$ 79,709</u>   |                         |              |
| Net interest margin on a tax equivalent basis        |                             |                         | <u>3.64%</u> |                    |                         | <u>3.59%</u> |                           |                         | <u>3.61%</u> |                    |                         | <u>3.59%</u> |

**PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES**

The provision for loan and lease losses for the three and six month periods ended June 30, 2015 was \$0.81 million and \$1.17 million compared to a provision for loan and lease losses in the three and six month periods ended June 30, 2014 of \$2.54 million and \$3.35 million respectively. Net recoveries of \$0.68 million were recorded for the second quarter 2015 , compared to net recoveries of \$1.22 million for the same quarter a year ago. Year-to-date net recoveries of \$0.35 million have been recorded in 2015 , compared to net recoveries of \$1.92 million through June 30, 2014 .

Weaknesses overseas could negatively impact the U.S. recovery, as could geopolitical events. Current concerns include the weak EU economies and deflationary pressures, the recession in Brazil and the resultant decline in the value of the Brazilian Real, the continued slowdown in China, and the geopolitical threats to the Russian economy as a result of the crisis in the Ukraine as well as the economic decline due to Russia's significant dependence on oil. 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 that there is a risk from these global economic factors 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 second quarter of 2015. We reviewed the factor we applied against each portfolio and reduced the factor for some portfolios this quarter.

Another area of concern continues to be our aircraft portfolio where we have collateral concentration and a sizable foreign exposure. The aircraft industry was among the sectors affected most by the sluggish economy. We have seen some evidence that depressed private jet markets have stabilized. As the U.S. economy slowly improves, the industry is likely to benefit and we should see a decrease in the fleet of unsold pre-owned aircraft which will result in further strengthening of values. Nevertheless, we remain concerned about the prolonged low prices for several models. We also have foreign exposure in this portfolio, particularly in Brazil and Mexico. The recession in Brazil and the currency fluctuations are having a negative impact on our client's cost of paying dollar denominated debts and, as a result throughout 2014 and into 2015, we have experienced higher delinquency in the portfolio. We assessed our ratios, which were established based on the higher and more volatile loss histories and pronounced exposure to global risks, and believe our reserve ratios remain appropriate.

On June 30, 2015, 30 day and over loan and lease delinquencies were 0.30% compared to 0.38% on June 30, 2014. The decrease in delinquencies occurred in most portfolios but was most significant in the commercial and agricultural portfolio. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.25% as compared to 2.38% one year ago. A summary of loan and lease loss experience during the three and six months ended June 30, 2015 and 2014 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 June 30, 2015 and December 31, 2014 is reflected in Note 4 of the Consolidated Financial Statements.

### **NONPERFORMING ASSETS**

The following table shows nonperforming assets.

| <i>(Dollars in thousands)</i>             | <b>June 30,<br/>2015</b> | <b>December 31,<br/>2014</b> | <b>June 30,<br/>2014</b> |
|-------------------------------------------|--------------------------|------------------------------|--------------------------|
| Loans and leases past due 90 days or more | \$ 278                   | \$ 981                       | \$ 475                   |
| Nonaccrual loans and leases               | 15,082                   | 34,602                       | 32,486                   |
| Other real estate                         | 301                      | 1,109                        | 1,853                    |
| Former bank premises held for sale        | 626                      | 626                          | 801                      |
| Repossessions                             | 5,433                    | 5,156                        | 5,455                    |
| Equipment owned under operating leases    | —                        | 6                            | 23                       |
| <b>Total nonperforming assets</b>         | <b>\$ 21,720</b>         | <b>\$ 42,480</b>             | <b>\$ 41,093</b>         |

Nonperforming assets as a percentage of total loans and leases were 0.55% at June 30, 2015, 1.13% at December 31, 2014, and 1.08% at June 30, 2014. Nonperforming assets totaled \$21.72 million at June 30, 2015, a decrease of 48.87% from the \$42.48 million reported at December 31, 2014, and a 47.14% decrease from the \$41.09 million reported at June 30, 2014. The decrease in nonperforming assets during the first six months of 2015 was primarily related to a decrease in nonaccrual loans and leases, the sale of other real estate and fewer loans and leases past due 90 days or more as the economy slowly improves. The decrease in nonperforming assets at June 30, 2015 from June 30, 2014 occurred primarily in nonaccrual loans and leases and the sale of other real estate.

The decrease in nonaccrual loans and leases at June 30, 2015 from December 31, 2014 occurred primarily in the commercial and agricultural, aircraft and commercial real estate portfolios. The decrease in nonaccrual loans and leases at June 30, 2015 from June 30, 2014 occurred primarily in the commercial and agricultural portfolio and commercial real estate portfolios offset by increases in aircraft and residential real estate. A summary of nonaccrual loans and leases and past due aging for the period ended June 30, 2015 and December 31, 2014 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 decreased over the past year due to current sales of existing properties outpacing current foreclosures.

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.

| <i>(Dollars in thousands)</i>    | June 30,<br>2015 | December 31,<br>2014 | June 30,<br>2014 |
|----------------------------------|------------------|----------------------|------------------|
| Commercial and agricultural      | \$ —             | \$ —                 | \$ —             |
| Auto and light truck             | —                | 25                   | 125              |
| Medium and heavy duty truck      | —                | —                    | 66               |
| Aircraft financing               | 5,404            | 5,123                | 5,260            |
| Construction equipment financing | —                | 32                   | 88               |
| Commercial real estate           | 284              | 292                  | 521              |
| Residential real estate          | —                | 530                  | 776              |
| Consumer                         | 46               | 263                  | 472              |
| Total                            | <u>\$ 5,734</u>  | <u>\$ 6,265</u>      | <u>\$ 7,308</u>  |

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 \$202.73 million and \$224.51 million as of June 30, 2015 and December 31, 2014, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were \$78.90 million and \$110.79 million as of June 30, 2015, respectively, compared to \$105.39 million and \$100.76 million as of December 31, 2014, respectively. As of June 30, 2015 and December 31, 2014 there was not a significant concentration in any other country.

### NONINTEREST INCOME

Noninterest income for the three month period ended June 30, 2015 and 2014 was \$21.53 million and \$19.22 million, respectively. Noninterest income for the six month period ended June 30, 2015 and 2014 was \$41.28 million and \$38.62 million, respectively. The following table shows the details of noninterest income.

| <i>(Dollars in thousands)</i>                     | Three Months Ended<br>June 30, |                  | Six Months Ended<br>June 30, |                  |
|---------------------------------------------------|--------------------------------|------------------|------------------------------|------------------|
|                                                   | 2015                           | 2014             | 2015                         | 2014             |
| Noninterest income:                               |                                |                  |                              |                  |
| Trust fees                                        | \$ 5,247                       | \$ 4,955         | \$ 9,804                     | \$ 9,431         |
| Service charges on deposit accounts               | 2,367                          | 2,207            | 4,564                        | 4,273            |
| Debit card income                                 | 2,628                          | 2,463            | 5,027                        | 4,695            |
| Mortgage banking income                           | 1,239                          | 1,181            | 2,490                        | 2,515            |
| Insurance commissions                             | 1,382                          | 1,288            | 2,687                        | 2,851            |
| Equipment rental income                           | 5,342                          | 4,098            | 10,421                       | 8,180            |
| Gains on investment securities available-for-sale | 4                              | —                | 4                            | 963              |
| Other income                                      | 3,322                          | 3,029            | 6,285                        | 5,711            |
| Total noninterest income                          | <u>\$ 21,531</u>               | <u>\$ 19,221</u> | <u>\$ 41,282</u>             | <u>\$ 38,619</u> |

Noninterest income increased \$2.31 million or 12.02% for the three months ended June 30, 2015 as compared to the same period in 2014. Noninterest income increased \$2.66 million or 6.90% for the six months ended June 30, 2015 as compared to the same period one year ago. Mortgage banking income and insurance commissions increased slightly during the second quarter of 2015 compared to the same period in 2014 and decreased slightly during the first six months of 2015 over the comparable period a year ago.

Trust fees increased \$0.29 million or 5.89% and \$0.37 million or 3.96% for the three and six months ended June 30, 2015, respectively over the same periods a year ago. Trust fees are largely based on the size of client relationships and the market value of assets under management. The market value of trust assets under management at June 30, 2015 and December 31, 2014 was \$3.99 billion and \$3.95 billion, respectively.

Service charges on deposit accounts increased \$0.16 million or 7.25% and \$0.29 million or 6.81% for the three and six months ended June 30, 2015 over the comparable periods one year ago. The increase in service charges on deposit accounts reflects an increase in statement fees over the same periods a year ago due to a change in the fee structure that went into effect January 1, 2015.



Debit card income increased \$0.17 million or 6.70% and \$0.33 million or 7.07% in the three and six months ended June 30, 2015 , respectively over the same periods a year ago. The increase in debit card income was the result of an increased volume of debit card transactions in 2015 .

Equipment rental income increased \$1.24 million or 30.36% and \$2.24 million and 27.40% for the three and six months ended June 30, 2015 , respectively over the comparable periods one year ago. The increase was the result of the average equipment rental portfolio increasing 30.29% over the same period a year ago due to improving market conditions for equipment finance.

Gains on investment securities available-for-sale were flat during the second quarter of 2015 compared to the second quarter of 2014 . Gains on investment securities available-for-sale decreased \$0.96 million during the first six months of 2015 versus the first six months on 2014 due to the partial sale of a marketable equity security in the first quarter of 2014 .

Other income increased \$0.29 million or 9.67% and \$0.57 million or 10.05% for the three and six months ended June 30, 2015 over the same periods a year ago. The increase during the second quarter of 2015 compared to the second quarter of 2014 was the result of claim proceeds from bank owned life insurance and decreased losses on partnership investments offset by lower mutual fund income. The increase during the first six months of 2015 compared to the same period a year ago was due to decreased losses on partnership investments and claim proceeds from bank owned life insurance offset by a one-time valuation adjustment in 2014 which was not present in 2015 and lower mutual fund income.

### **NONINTEREST EXPENSE**

Noninterest expense for the three month period ended June 30, 2015 and 2014 was \$38.24 million and \$34.42 million, respectively. Noninterest expense for the six month period ended June 30, 2015 and 2014 was \$76.30 million and \$70.40 million, respectively The following table shows the details of noninterest expense.

| <i>(Dollars in thousands)</i>                      | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|----------------------------------------------------|--------------------------------|-----------|------------------------------|-----------|
|                                                    | 2015                           | 2014      | 2015                         | 2014      |
| Noninterest expense:                               |                                |           |                              |           |
| Salaries and employee benefits                     | \$ 20,794                      | \$ 18,827 | \$ 41,719                    | \$ 38,309 |
| Net occupancy expense                              | 2,345                          | 2,235     | 4,806                        | 4,672     |
| Furniture and equipment expense                    | 4,531                          | 4,413     | 8,867                        | 8,650     |
| Depreciation - leased equipment                    | 4,396                          | 3,290     | 8,484                        | 6,539     |
| Professional fees                                  | 1,108                          | 1,062     | 1,978                        | 2,190     |
| Supplies and communication                         | 1,409                          | 1,337     | 2,815                        | 2,729     |
| FDIC and other insurance                           | 847                            | 850       | 1,696                        | 1,714     |
| Business development and marketing expense         | 1,214                          | 899       | 2,263                        | 2,583     |
| Loan and lease collection and repossession expense | (294)                          | (17)      | 69                           | (512)     |
| Other expense                                      | 1,891                          | 1,528     | 3,605                        | 3,522     |
| Total noninterest expense                          | \$ 38,241                      | \$ 34,424 | \$ 76,302                    | \$ 70,396 |

Noninterest expense increased \$3.82 million or 11.09% for the second quarter and \$5.91 million or 8.39% for year-to-date 2015 as compared to the same periods in 2014 . Net occupancy expense, supplies and communication expense and furniture and equipment expense increased slightly during the second quarter and first six months of 2015 compared to the same periods a year ago. FDIC and other insurance expense was flat for the three and six months ended June 30, 2015 compared to the same periods in 2014 .

Salaries and employee benefits increased \$1.97 million or 10.45% and \$3.41 million or 8.90% for the three and six months ended June 30, 2015 compared to the same periods in 2014 . The increase for the second quarter and year-to date 2015 periods was due to higher base salary, executive incentives and group insurance costs. Higher base salary expense was primarily due to more full-time equivalent employees as a result of opening three new banking centers in 2014 and one in the second quarter of 2015 , temporary summer staffing and normal annual performance raises. Group insurance costs have increased as a result of higher claims experience.

During the second quarter and first six months of 2015 , depreciation on leased equipment increased \$1.11 million or 33.62% and \$1.95 million or 29.74%, respectively in conjunction with the increase in equipment rental income as compared to the same periods one year ago.

Professional fees increased slightly during the second quarter of 2015 and decreased \$0.21 million or 9.68% for year-to-date 2015 compared to the same periods in 2014 . The lower professional fees in 2015 was primarily due to reduced audit fees as a result of a change in independent audit firms and decreased legal fees.

Business development and marketing expense increased \$0.32 million or 35.04% for the three months ended June 30, 2015 versus the three months ended June 30, 2014 and decreased \$0.32 million or 12.39% for the six months ended June 30, 2015 versus the six months ended June 30, 2014 . The higher expense during the second quarter of 2015 was mainly due to increased marketing promotions. The decrease during the first six months of 2015 was mainly due to lower charitable contributions offset by increased marketing promotions.

Loan and lease collection and repossession expense decreased \$0.28 million or 1629.41% for the three months ended June 30, 2015 compared to the same period in 2014 primarily due to a decrease in repurchased mortgage loan losses and increased gains on the sale of other real estate owned offset by fewer gains on the sale of repossessions. Loan and lease collection and repossession expense increased \$0.58 million or 113.48% in the six month period ended June 30, 2015 compared to the same period a year ago mainly due to lower gains on the sale of other real estate owned and repossessions and increased valuation adjustments offset by a decrease in repurchased mortgage loan losses.

Other expenses increased \$0.36 million or 23.76% during the second quarter of 2015 and increased slightly during the six months ended June 30, 2015 respectively, as compared to the same periods in 2014 . The increase during the second quarter of 2015 related to write-downs on fixed assets and increased debit card losses over the same period a year ago.

### **INCOME TAXES**

The provision for income taxes for the three and six month periods ended June 30, 2015 was \$8.51 million and \$15.77 million respectively, compared to \$7.92 million and \$15.53 million for the same periods in 2014 . The effective tax rates were 35.26% and 35.34% for the second quarter ended June 30, 2015 and 2014 , respectively and 35.12% and 35.57% for the six months ended June 30, 2015 and 2014 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, 2014 . For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2014 .

### **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 June 30, 2015 , 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 second fiscal quarter of 2015 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

## **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, 2014 . For information regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2014 .

## 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 |
|---------------------|----------------------------------|------------------------------|-----------------------------------------------------------------------------------|--------------------------------------------------------------------------------------------------------------|
| April 01 - 30, 2015 | 401                              | \$ 32.16                     | 401                                                                               | 1,885,905                                                                                                    |
| May 01 - 31, 2015   | 53,063                           | 31.33                        | 53,063                                                                            | 1,832,842                                                                                                    |
| June 01 - 30, 2015  | 1,234                            | 31.72                        | 1,234                                                                             | 1,831,608                                                                                                    |

\* 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 168,392\*\* shares.

\*\*Unadjusted for 10% stock dividend declared July 22, 2015.

## 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                         |

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 | <u>July 23, 2015</u> | <u>/s/ CHRISTOPHER J. MURPHY III</u><br>Christopher J. Murphy III<br>Chairman of the Board and CEO |
|------|----------------------|----------------------------------------------------------------------------------------------------|

|      |                      |                                                                                                                        |
|------|----------------------|------------------------------------------------------------------------------------------------------------------------|
| DATE | <u>July 23, 2015</u> | <u>/s/ ANDREA G. SHORT</u><br>Andrea G. Short<br>Treasurer and Chief Financial Officer<br>Principal Accounting Officer |
|------|----------------------|------------------------------------------------------------------------------------------------------------------------|

## CERTIFICATION

I, Christopher J. Murphy III, Chief Executive Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of 1st Source Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 23, 2015

/s/ CHRISTOPHER J. MURPHY III

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Christopher J. Murphy III

Chief Executive Officer

## CERTIFICATION

I, Andrea G. Short, Chief Financial Officer, certify that:

1. I have reviewed this quarterly report on Form 10-Q of 1st Source Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: July 23, 2015

/s/ ANDREA G. SHORT

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Andrea G. Short

Chief Financial Officer

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of 1st Source Corporation (1st Source) on Form 10-Q for the quarterly period ended June 30, 2015 , as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Christopher J. Murphy III, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of sections 13(a) or 15(d) of the Securities and Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of 1st Source.

Date: July 23, 2015

/s/ CHRISTOPHER J. MURPHY III

Christopher J. Murphy III  
Chief Executive Officer

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with the Quarterly Report of 1st Source Corporation (1st Source) on Form 10-Q for the quarterly period ended June 30, 2015 , as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Andrea G. Short, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to my knowledge:

- (1) The Report fully complies with the requirements of sections 13(a) or 15(d) of the Securities and Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of 1st Source.

Date: July 23, 2015

/s/ ANDREA G. SHORT

Andrea G. Short

Chief Financial Officer