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, 2019
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

1st Source Corporation
(Exact name of registrant as specified in its charter)

Indiana	**35-1068133**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

100 North Michigan Street South Bend, IN	**46601**
(Address of principal executive offices)	(Zip Code)

(574) 235-2000
(Registrant's telephone number, including area code)

Not Applicable
(Former name, former address and former fiscal year, if changed since last report)

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock - without par value	SRCE	The NASDAQ Stock Market LLC

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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). ☒ Yes ☐ No

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

Large accelerated filer	☒	Accelerated filer	☐
Non-accelerated filer	☐	Smaller reporting company	☐
		Emerging growth company	☐

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

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 12, 2019 — 25,535,212 shares

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

	June 30, 2019	December 31, 2018
ASSETS		
Cash and due from banks	$ 71,910	$ 94,907
Federal funds sold and interest bearing deposits with other banks	24,578	4,172
Investment securities available-for-sale	1,021,786	990,129
Other investments	28,404	28,404
Mortgages held for sale	19,178	11,290
Loans and leases, net of unearned discount:		
Commercial and agricultural	1,173,000	1,073,205
Auto and light truck	635,100	559,987
Medium and heavy duty truck	300,042	283,544
Aircraft	811,163	803,111
Construction equipment	686,633	645,239
Commercial real estate	835,919	809,886
Residential real estate and home equity	529,749	523,855
Consumer	137,731	136,637
Total loans and leases	5,109,337	4,835,464
Reserve for loan and lease losses	(104,911)	(100,469)
Net loans and leases	5,004,426	4,734,995
Equipment owned under operating leases, net	126,502	134,440
Net premises and equipment	51,570	52,139
Goodwill and intangible assets	83,985	83,998
Accrued income and other assets	217,766	159,271
Total assets	$ 6,650,105	$ 6,293,745
LIABILITIES		
Deposits:		
Noninterest-bearing demand	$ 1,238,604	$ 1,217,120
Interest-bearing deposits:		
Interest-bearing demand	1,665,456	1,614,959
Savings	810,122	822,477
Time	1,689,663	1,467,766
Total interest-bearing deposits	4,165,241	3,905,202
Total deposits	5,403,845	5,122,322
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	119,781	113,627
Other short-term borrowings	66,228	85,717
Total short-term borrowings	186,009	199,344
Long-term debt and mandatorily redeemable securities	71,542	71,123
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	125,259	78,602
Total liabilities	5,845,419	5,530,155
SHAREHOLDERS' EQUITY		
Preferred stock; no par value		
Authorized 10,000,000 shares; none issued or outstanding	—	—
Common stock; no par value		
Authorized 40,000,000 shares; issued 28,205,674 at June 30, 2019 and December 31, 2018	436,538	436,538
Retained earnings	431,091	398,980
Cost of common stock in treasury (2,670,462 shares at June 30, 2019 and 2,421,946 shares at December 31, 2018)	(75,380)	(62,760)
Accumulated other comprehensive income (loss)	2,413	(10,676)
Total shareholders' equity	794,662	762,082
Noncontrolling interests	$ 10,024	$ 1,508
Total equity	$ 804,686	$ 763,590
Total liabilities and equity	$ 6,650,105	$ 6,293,745

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 June 30,		Six Months Ended June 30,	
	2019	**2018**	**2019**	**2018**
Interest income:				
Loans and leases	$ 65,599	$ 58,520	$ 128,282	$ 112,211
Investment securities, taxable	5,186	4,473	10,701	9,081
Investment securities, tax-exempt	353	475	738	1,006
Other	499	397	937	805
Total interest income	71,637	63,865	140,658	123,103
Interest expense:				
Deposits	12,978	8,319	24,448	14,881
Short-term borrowings	540	826	1,471	1,602
Subordinated notes	928	908	1,856	1,791
Long-term debt and mandatorily redeemable securities	764	643	1,508	1,128
Total interest expense	15,210	10,696	29,283	19,402
Net interest income	56,427	53,169	111,375	103,701
Provision for loan and lease losses	4,247	4,817	9,165	8,603
Net interest income after provision for loan and lease losses	52,180	48,352	102,210	95,098
Noninterest income:				
Trust and wealth advisory	5,583	5,800	10,441	10,988
Service charges on deposit accounts	2,785	2,625	5,283	5,109
Debit card	3,669	3,427	6,889	6,530
Mortgage banking	999	1,073	1,935	1,957
Insurance commissions	1,518	1,487	3,692	3,445
Equipment rental	7,809	8,104	15,791	15,859
Losses on investment securities available-for-sale	—	—	—	(345)
Other	3,301	2,507	5,757	5,287
Total noninterest income	25,664	25,023	49,788	48,830
Noninterest expense:				
Salaries and employee benefits	23,787	23,696	47,282	46,227
Net occupancy	2,481	2,115	5,253	4,981
Furniture and equipment	6,289	5,718	12,313	11,173
Depreciation – leased equipment	6,400	6,684	12,924	13,112
Professional fees	1,706	1,728	3,304	3,745
Supplies and communication	1,608	1,499	3,101	3,052
FDIC and other insurance	608	714	1,253	1,412
Business development and marketing	1,678	1,725	2,627	3,258
Loan and lease collection and repossession	230	565	1,591	1,516
Other	2,566	1,433	2,909	2,958
Total noninterest expense	47,353	45,877	92,557	91,434
Income before income taxes	30,491	27,498	59,441	52,494
Income tax expense	7,074	5,534	13,828	11,414
Net income	$ 23,417	$ 21,964	$ 45,613	$ 41,080
Net (income) loss attributable to noncontrolling interests	(32)	—	(32)	—
Net income available to common shareholders	23,385	21,964	45,581	41,080
Per common share:				
Basic net income per common share	$ 0.91	$ 0.84	$ 1.76	$ 1.57
Diluted net income per common share	$ 0.91	$ 0.84	$ 1.76	$ 1.57
Cash dividends	$ 0.27	$ 0.24	$ 0.54	$ 0.46
Basic weighted average common shares outstanding	25,615,718	25,958,128	25,687,056	25,954,278
Diluted weighted average common shares outstanding	25,615,718	25,958,128	25,687,056	25,954,278

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 June 30,		Six Months Ended June 30,	
	2019	**2018**	**2019**	**2018**
Net income	$ 23,417	$ 21,964	$ 45,613	$ 41,080
Other comprehensive income (loss):				
Unrealized appreciation (depreciation) of available-for-sale securities	7,668	(1,949)	17,241	(11,363)
Reclassification adjustment for realized losses included in net income	—	—	—	345
Income tax effect	(1,847)	469	(4,152)	2,653
Other comprehensive income (loss), net of tax	5,821	(1,480)	13,089	(8,365)
Comprehensive income	29,238	20,484	$ 58,702	$ 32,715
Comprehensive (income) loss attributable to noncontrolling interests	(32)	—	(32)	—
Comprehensive income available to common shareholders	$ 29,206	$ 20,484	$ 58,670	$ 32,715

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)

	Three Months Ended							
	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net	Total Shareholders' Equity	Noncontrolling Interests	Total Equity
Balance at April 1, 2018	$ —	$ 436,538	$ 354,608	$ (54,602)	$ (10,935)	$ 725,609	$ —	$ 725,609
Net income	—	—	21,964	—	—	21,964	—	21,964
Other comprehensive loss	—	—	—	—	(1,480)	(1,480)	—	(1,480)
Issuance of 9,911 common shares under stock based compensation awards	—	—	188	236	—	424	—	424
Cost of 5 shares of common stock acquired for treasury	—	—	—	(1)	—	(1)	—	(1)
Common stock dividend ($0.24 per share)	—	—	(6,239)	—	—	(6,239)	—	(6,239)
Balance at June 30, 2018	$ —	$ 436,538	$ 370,521	$ (54,367)	$ (12,415)	$ 740,277	$ —	740,277
Balance at April 1, 2019	$ —	$ 436,538	$ 414,428	$ (69,136)	$ (3,408)	$ 778,422	$ 2,679	$ 781,101
Net income	—	—	23,385	—	—	23,385	32	23,417
Other comprehensive income	—	—	—	—	5,821	5,821	—	5,821
Issuance of 8,906 common shares under stock based compensation awards	—	—	217	177	—	394	—	394
Cost of 141,627 shares of common stock acquired for treasury	—	—	—	(6,421)	—	(6,421)	—	(6,421)
Common stock dividend ($0.27 per share)	—	—	(6,939)	—	—	(6,939)	—	(6,939)
Contributions from noncontrolling interests	—	—	—	—	—	—	7,313	7,313
Balance at June 30, 2019	$ —	$ 436,538	$ 431,091	$ (75,380)	$ 2,413	$ 794,662	$ 10,024	$ 804,686

	Six Months Ended							
	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net	Total Shareholders' Equity	Noncontrolling Interests	Total Equity
Balance at January 1, 2018	$ —	$ 436,538	$ 339,959	$ (54,628)	$ (3,332)	$ 718,537	$ —	$ 718,537
Cumulative-effect adjustment	—	—	718	—	(718)	—	—	—
Balance at January 1, 2018, adjusted	—	436,538	340,677	(54,628)	(4,050)	718,537	—	718,537
Net income	—	—	41,080	—	—	41,080	—	41,080
Other comprehensive loss	—	—	—	—	(8,365)	(8,365)	—	(8,365)
Issuance of 44,102 common shares under stock based compensation awards	—	—	723	1,047	—	1,770	—	1,770
Cost of 15,789 shares of common stock acquired for treasury	—	—	—	(786)	—	(786)	—	(786)
Common stock dividend ($0.46 per share)	—	—	(11,959)	—	—	(11,959)	—	(11,959)
Balance at June 30, 2018	$ —	$ 436,538	$ 370,521	$ (54,367)	$ (12,415)	$ 740,277	$ —	740,277
Balance at January 1, 2019	$ —	$ 436,538	$ 398,980	$ (62,760)	$ (10,676)	$ 762,082	$ 1,508	$ 763,590
Cumulative-effect adjustment	—	—	(301)	—	—	(301)	—	(301)
Balance at January 1, 2019, adjusted	—	436,538	398,679	(62,760)	(10,676)	761,781	1,508	763,289
Net income	—	—	45,581	—	—	45,581	32	45,613
Other comprehensive income	—	—	—	—	13,089	13,089	—	13,089
Issuance of 47,271 common shares under stock based compensation awards	—	—	750	1,059	—	1,809	—	1,809
Cost of 295,787 shares of common stock acquired for treasury	—	—	—	(13,679)	—	(13,679)	—	(13,679)
Common stock dividend ($0.54 per share)	—	—	(13,919)	—	—	(13,919)	—	(13,919)
Contributions from noncontrolling interests	—	—	—	—	—	—	8,484	8,484
Balance at June 30, 2019	$ —	$ 436,538	$ 431,091	$ (75,380)	$ 2,413	$ 794,662	$ 10,024	$ 804,686

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,	
	2019	**2018**
Operating activities:		
Net income	$ 45,613	$ 41,080
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan and lease losses	9,165	8,603
Depreciation of premises and equipment	2,957	2,648
Depreciation of equipment owned and leased to others	12,924	13,112
Stock-based compensation	1,341	1,850
Amortization of investment securities premiums and accretion of discounts, net	1,737	1,967
Amortization of mortgage servicing rights	527	471
Deferred income taxes	(1,677)	(3,495)
Losses on investment securities available-for-sale	—	345
Originations of loans held for sale, net of principal collected	(52,505)	(34,035)
Proceeds from the sales of loans held for sale	45,610	39,953
Net gain on sale of loans held for sale	(993)	(1,030)
Net gain on sale of other real estate and repossessions	(470)	(57)
Net gain on sale of premises and equipment	(1,289)	(9)
Change in interest receivable	(2,234)	(2,086)
Change in interest payable	3,953	2,462
Change in other assets	(9,413)	(3,951)
Change in other liabilities	(367)	1,581
Other	1,106	277
Net change in operating activities	55,985	69,686
Investing activities:		
Proceeds from sales of investment securities available-for-sale	—	11,739
Proceeds from maturities and paydowns of investment securities available-for-sale	59,683	84,033
Purchases of investment securities available-for-sale	(76,137)	(173,416)
Proceeds from liquidation of partnership investment	—	1,868
Net change in other investments	—	(2,206)
Loans sold or participated to others	16,740	14,310
Net change in loans and leases	(305,297)	(327,802)
Net change in equipment owned under operating leases	(5,109)	(16,555)
Purchases of premises and equipment	(4,526)	(1,332)
Proceeds from disposal of premises and equipment	3,427	74
Proceeds from sales of other real estate and repossessions	5,964	1,900
Net change in investing activities	(305,255)	(407,387)
Financing activities:		
Net change in demand deposits and savings accounts	59,626	118,829
Net change in time deposits	221,897	236,880
Net change in short-term borrowings	(13,335)	62,499
Payments on long-term debt	(2,052)	(1,108)
Stock issued under stock purchase plans	49	145
Acquisition of treasury stock	(13,679)	(786)
Contributions from noncontrolling interests	8,484	—
Cash dividends paid on common stock	(14,311)	(12,331)
Net change in financing activities	246,679	404,128
Net change in cash and cash equivalents	(2,591)	66,427
Cash and cash equivalents, beginning of year	99,079	78,033
Cash and cash equivalents, end of period	$ 96,488	$ 144,460
Supplemental Information:		
Non-cash transactions:		
Loans transferred to other real estate and repossessed assets	$ 9,961	$ 868
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan	300	583
Right of use assets obtained in exchange for lease obligations	1,383	—

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

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

Note 1 — Accounting Policies

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

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

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K (2018 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, 2018 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 period presentation.

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

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

Direct financing leases are carried at the aggregate of lease payments plus estimated residual value of the leased property, net of unamortized deferred lease origination fees and costs and unearned income. Interest income on direct financing leases is recognized over the term of the lease to achieve a constant periodic rate of return on the outstanding investment. Effective January 1, 2019, as part of the new leasing standard, only those costs incurred as a direct result of closing a lease transaction can be capitalized. All existing deferrals will continue to be amortized over the estimated life of the lease while all new incremental direct costs will be expensed immediately.

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

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

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

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

Equipment Owned Under Operating Leases – As a lessor, the Company finances various types of construction equipment, medium and heavy duty trucks, automobiles and other equipment under leases classified as operating leases. The equipment underlying the operating leases is reported at cost, net of accumulated depreciation, in the Consolidated Statements of Financial Condition. These operating lease arrangements require the lessee to make a fixed monthly rental payment over a specified lease term generally ranging from three years to seven years. Revenue consists of the contractual lease payments and is recognized on a straight-line basis over the lease term and reported in Noninterest Income on the Consolidated Statements of Income. Leased assets are being depreciated on a straight-line method over the lease term to the estimate of the equipment's fair market value at lease termination, also referred to as "residual" value. The depreciation of these operating lease assets is reported in Noninterest Expense on the Consolidated Statements of Income. For automobile leases, fair value is based upon published industry market guides. For other equipment leases, fair value may be based upon observable market prices, third-party valuations, or prices received on sales of similar assets at the end of the lease term. These residual values are reviewed annually to ensure the recorded amount does not exceed the fair market value at the lease termination. At the end of the lease, the operating lease asset is either purchased by the lessee or returned to the Company. The Company is responsible for the payment of personal property taxes which is reported in Other Expense on the Consolidated Statements of Income. The lessee is responsible for reimbursing the Company for personal property taxes which is reported in Other Income on the Consolidated Statements of Income. The Company excludes sales taxes and other similar taxes from being reported as lease revenue with an associated expense.

Lease Commitments – The Company leases certain banking center locations, office space, land and billboards. In determining whether a contract contains a lease, the Company examines the contract to ensure an asset was specifically identified and that the Company has control of use over the asset. To determine whether a lease is classified as operating or finance, the Company performs an economic life test on all building leases with greater than a twenty year term. Further, the Company performs a fair value test to identify any leases that have a present value of future lease payments over the lease term that is greater than 90% of the fair value of the building. The Company only capitalizes leases with an initial lease liability of $2,000 or greater.

At lease inception, the Company determines the lease term by adding together the minimum lease term and all optional renewal periods that it is reasonably certain to renew. The Company determines this on each lease by considering all relevant contract-based, asset-based, market-based, and entity-based economic factors. Generally, the exercise of lease renewal options is at the Company's sole discretion. The lease term is used to determine whether a lease is operating or finance and is used to calculate straight-line rent expense. Additionally, the depreciable life of leasehold improvements is limited by the expected lease term.

Operating lease rentals are expensed on a straight-line basis over the life of the lease beginning on the date the Company takes possession of the property. Rent expense and variable lease costs are included in Net Occupancy Expense on the Company's Consolidated Statements of Income. Included in variable lease costs are leases with rent escalations based on recent financial indices, such as the Consumer Price Index, where the Company estimates future rent increases and records the actual difference to variable costs. Certain leases require the Company to pay common area maintenance, real estate taxes, insurance and other operating expenses associated with the leases premises. These expenses are classified in Net Occupancy Expense, consistent with similar costs for owned locations. There are no residual value guarantees, restrictions or covenants imposed by leases.

The Company accounts for lease and nonlease components together as a single lease component by class of underlying asset. Operating lease obligations with an initial term longer than 12 months are recorded with a right of use asset and a lease liability in the Consolidated Statements of Financial Condition.

The discount rate used in determining the lease liability and related right of use asset is based upon what would be obtained by the Company for similar loans as an incremental rate as of the date of origination or renewal.

Revenue Recognition – The Company recognizes revenues as they are earned based on contractual terms, as transactions occur, or as services are provided and collectability is reasonably assured. The Company's principal source of revenue is interest income from loans and leases and investment securities. The Company also earns noninterest income from various banking and financial services offered primarily through 1st Source Bank (Bank) and its subsidiaries.

Interest Income – The largest source of revenue for the Company is interest income which is primarily recognized on an accrual basis according to nondiscretionary formulas in written contracts, such as loan and lease agreements or investment securities contracts.

Noninterest Income – The Company earns noninterest income through a variety of financial and transaction services provided to corporate and consumer clients such as trust and wealth advisory, deposit account, debit card, mortgage banking, insurance, and equipment rental services. Revenue is recorded for noninterest income based on the contractual terms for the service or transaction performed. In certain circumstances, noninterest income is reported net of associated expenses.

Note 2 — Recent Accounting Pronouncements

Leases: In March 2019, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2019-01 *"Leases (Topic 842): Codification Improvements."* These amendments align the guidance for fair value of the underlying asset by lessors that are not manufacturers or dealers in Topic 842 with that of existing guidance. The ASU also requires lessors within the scope of Topic 842, Financial Services-Depository Lending, to present all "principal payments received under leases" within investing activities on the Consolidated Statements of Cash Flows. Finally, the ASU exempts both lessees and lessors from having to provide certain interim disclosures in the fiscal year in which a company adopts the new leases standard. The guidance is effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Early application is permitted. An entity should apply the amendments as of the date that it first applied Topic 842, using the same transition methodology in accordance with paragraph 842-10-65-1(c). The Company adopted Topic 842 on January 1, 2019 and applied the amendments in ASU 2019-01 as of the same date and it did not have a material impact on its accounting and disclosures.

Intangibles - Internal-Use Software: In August 2018, the FASB issued ASU No. 2018-15 *"Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract."* These amendments align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contact with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). The accounting for the service element of a hosting arrangement that is a service contract is not affected by these amendments. The guidance is effective for public business entities for annual periods, including interim periods within those annual periods, beginning after December 15, 2019. Early adoption is permitted. The Company is assessing ASU 2018-15 and the impact on its accounting and disclosures.

Disclosure Requirements for Fair Value Measurement: In August 2018, the FASB issued ASU No. 2018-13 *"Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement."* These amendments modify the disclosure requirements in Topic 820 as follows:

Removals: the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy; the policy for timing of transfers between levels; and the valuation processes for Level 3 fair value measurements.

Modifications: for investments in certain entities that calculate net asset value, an entity is required to disclose the timing of liquidation of an investee's assets and the date when restrictions from redemption might lapse only if the investee has communicated the timing to the entity or announced the timing publicly; and the amendments clarify that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date.

Additions: the changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements held at the end of the reporting period; and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements.

The guidance is effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The amendments on changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements, and the narrative description of measurement uncertainty should all be applied prospectively for only the most recent interim or annual period presented in the initial year of adoption. All other amendments should be applied retrospectively to all periods presented upon their effective date. Early adoption is permitted. An entity is permitted to early adopt any removed or modified disclosures upon issuance of ASU No. 2018-13 and delay adoption of the additional disclosures until their effective date. The Company is assessing ASU 2018-13 but does not expect it to have a material impact on its accounting and disclosures.

Premium Amortization: In March 2017, the FASB issued ASU No. 2017-08 "*Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20), Premium Amortization on Purchased Callable Debt Securities."* These amendments shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. The guidance is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company adopted ASU 2017-08 on January 1, 2019 and recognized a cumulative-effect adjustment to retained earnings of $0.30 million.

Simplifying the Test for Goodwill Impairment: In January 2017, the FASB issued ASU No. 2017-04 "*Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment."* These amendments eliminate Step 2 from the goodwill impairment test. The amendments also eliminate the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. The guidance is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. ASU 2017-04 should be adopted on a prospective basis. The Company has assessed ASU 2017-04 and does not expect it to have a material impact on its accounting and disclosures.

Measurement of Credit Losses on Financial Instruments: In June 2016, the FASB issued ASU No. 2016-13, *"Financial Instruments-Credit Losses (Topic 326) - Measurement of Credit Losses on Financial Instruments."* The provisions of ASU 2016-13 were issued to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments that are not accounted for at fair value through net income, including loans held for investment, held-to-maturity debt securities, trade and other receivables, net investment in leases and other commitments to extend credit held by a reporting entity at each reporting date. ASU 2016-13 requires that financial assets measured at amortized cost be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The amendments in ASU 2016-13 eliminate the probable incurred loss recognition in current GAAP and reflect an entity's current estimate of all expected credit losses. The measurement of expected credit losses is based upon historical experience, current conditions, and reasonable and supportable forecasts that affect the collectibility of the financial assets. In May 2019, the FASB issued final amendments (ASU No. 2019-05) to provide entities that have certain instruments measured at amortized cost within the scope Topic 326 with an option to irrevocably elect the fair value option in Topic 825 on an instrument-by-instrument basis for eligible instruments, upon adoption of Topic 326. The fair value option election does not apply to held-to-maturity debt securities.

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

ASU 2016-13 and 2019-05 are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early adoption is permitted for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company's cross-functional team continues to work through its implementation plan including the assessment and documentation of processes, internal controls and data as well as model development. The Company implemented a third-party software solution to assist in the application of the new standard and is currently refining portfolio segmentation according to shared characteristics and modeling methodologies. The Company is also focused on running a parallel analysis to its current allowance for loan loss model prior to implementation. While a one-time cumulative-effect adjustment to retained earnings will be recorded as of the beginning of the first reporting period in which the guidance is effective, the impact of adopting ASU 2016-13 cannot be reasonably estimated at this point and could be significantly influenced by the composition, characteristics and quality of the loan and lease portfolio as well as the prevailing economic conditions and forecasts as of the adoption date.

Note 3 — Investment Securities Available-For-Sale

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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2019				
U.S. Treasury and Federal agencies securities	$ 540,392	$ 2,011	$ (927)	$ 541,476
U.S. States and political subdivisions securities	90,211	932	(71)	91,072
Mortgage-backed securities — Federal agencies	338,142	2,711	(2,029)	338,824
Corporate debt securities	49,162	637	(85)	49,714
Foreign government and other securities	700	—	—	700
Total debt securities available-for-sale	$ 1,018,607	$ 6,291	$ (3,112)	$ 1,021,786
December 31, 2018				
U.S. Treasury and Federal agencies securities	$ 537,913	$ 196	$ (6,886)	$ 531,223
U.S. States and political subdivisions securities	95,346	172	(936)	94,582
Mortgage-backed securities — Federal agencies	324,390	718	(6,875)	318,233
Corporate debt securities	45,843	—	(451)	45,392
Foreign government and other securities	700	—	(1)	699
Total debt securities available-for-sale	$ 1,004,192	$ 1,086	$ (15,149)	$ 990,129

At June 30, 2019 and December 31, 2018, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).

The following table shows the contractual maturities of investments in debt securities available-for-sale at June 30, 2019. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 185,240	$ 185,272
Due after one year through five years	485,935	488,222
Due after five years through ten years	9,290	9,468
Due after ten years	—	—
Mortgage-backed securities	338,142	338,824
Total debt securities available-for-sale	$ 1,018,607	$ 1,021,786

The following table summarizes gross unrealized losses and fair value by investment category and age. At June 30, 2019, the Company's available-for-sale securities portfolio consisted of 626 securities, 197 of which were in an unrealized loss position.

	Less than 12 Months		12 months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2019						
U.S. Treasury and Federal agencies securities	$ —	$ —	$ 259,376	$ (927)	$ 259,376	$ (927)
U.S. States and political subdivisions securities	651	(2)	15,437	(69)	16,088	(71)
Mortgage-backed securities - Federal agencies	20,304	(100)	145,564	(1,929)	165,868	(2,029)
Corporate debt securities	—	—	10,565	(85)	10,565	(85)
Foreign government and other securities	700	—	—	—	700	—
Total debt securities available-for-sale	$ 21,655	$ (102)	$ 430,942	$ (3,010)	$ 452,597	$ (3,112)
December 31, 2018						
U.S. Treasury and Federal agencies securities	$ 55,491	$ (177)	$ 424,269	$ (6,709)	$ 479,760	$ (6,886)
U.S. States and political subdivisions securities	21,059	(61)	45,365	(875)	66,424	(936)
Mortgage-backed securities - Federal agencies	65,554	(511)	198,221	(6,364)	263,775	(6,875)
Corporate debt securities	21,496	(143)	23,896	(308)	45,392	(451)
Foreign government and other securities	699	(1)	—	—	699	(1)
Total debt securities available-for-sale	$ 164,299	$ (893)	$ 691,751	$ (14,256)	$ 856,050	$ (15,149)

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

At June 30, 2019, the Company does not have the intent to sell any of the debt securities available-for-sale in the table above and believes that it is more likely than not, that it will not have to sell any such securities before an anticipated recovery of cost. Primarily the unrealized losses on debt securities are due to increases in market rates over the yields available at the time the underlying securities were purchased. The fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2019	2018	2019	2018
Gross realized gains	$ —	$ —	$ —	$ 2
Gross realized losses	—	—	—	(347)
OTTI losses	—	—	—	—
Net realized gains (losses)	$ —	$ —	$ —	$ (345)

At June 30, 2019 and December 31, 2018, investment securities available-for-sale with carrying values of $273.67 million and $242.31 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 and home equity loans and consumer loans, are assigned credit quality grades on a scale from 1 to 12 with grade 1 representing superior credit quality. The criteria used to assign grades to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on the Company's safety and soundness. Loans or leases graded 7 or weaker are considered "special attention" credits and, as such, relationships in excess of $100,000 are reviewed quarterly as part of management's evaluation of the appropriateness of the reserve for loan and lease losses. Grade 7 credits are defined as "watch" and contain greater than average credit risk and are monitored to limit the exposure to increased risk; grade 8 credits are "special mention" and, following regulatory guidelines, are defined as having potential weaknesses that deserve management's close attention. Credits that exhibit well-defined weaknesses and a distinct possibility of loss are considered "classified" and are graded 9 through 12 corresponding to the regulatory definitions of "substandard" (grades 9 and 10) and the more severe "doubtful" (grade 11) and "loss" (grade 12).

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

	Credit Quality Grades		
(Dollars in thousands)	1-6	7-12	Total
June 30, 2019			
Commercial and agricultural	$ 1,142,945	$ 30,055	$ 1,173,000
Auto and light truck	611,185	23,915	635,100
Medium and heavy duty truck	298,748	1,294	300,042
Aircraft	790,736	20,427	811,163
Construction equipment	660,888	25,745	686,633
Commercial real estate	823,700	12,219	835,919
Total	$ 4,328,202	$ 113,655	$ 4,441,857
December 31, 2018			
Commercial and agricultural	$ 1,043,019	$ 30,186	$ 1,073,205
Auto and light truck	528,174	31,813	559,987
Medium and heavy duty truck	281,834	1,710	283,544
Aircraft	768,442	34,669	803,111
Construction equipment	625,579	19,660	645,239
Commercial real estate	787,376	22,510	809,886
Total	$ 4,034,424	$ 140,548	$ 4,174,972

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

(Dollars in thousands)	Performing	Nonperforming	Total
June 30, 2019			
Residential real estate and home equity	$ 527,873	$ 1,876	$ 529,749
Consumer	137,494	237	137,731
Total	$ 665,367	$ 2,113	$ 667,480
December 31, 2018			
Residential real estate and home equity	$ 521,846	$ 2,009	$ 523,855
Consumer	136,423	214	136,637
Total	$ 658,269	$ 2,223	$ 660,492

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

(Dollars in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Accruing Loans	Nonaccrual	Total Financing Receivables
June 30, 2019							
Commercial and agricultural	$ 1,170,085	$ 86	$ 26	$ —	$ 1,170,197	$ 2,803	$ 1,173,000
Auto and light truck	632,056	671	—	—	632,727	2,373	635,100
Medium and heavy duty truck	299,998	—	—	—	299,998	44	300,042
Aircraft	796,757	12,964	331	—	810,052	1,111	811,163
Construction equipment	681,608	3,015	—	—	684,623	2,010	686,633
Commercial real estate	833,985	19	—	—	834,004	1,915	835,919
Residential real estate and home equity	526,990	753	130	154	528,027	1,722	529,749
Consumer	136,965	422	107	3	137,497	234	137,731
Total	$ 5,078,444	$ 17,930	$ 594	$ 157	$ 5,097,125	$ 12,212	$ 5,109,337
December 31, 2018							
Commercial and agricultural	$ 1,070,530	$ 22	$ —	$ —	$ 1,070,552	$ 2,653	$ 1,073,205
Auto and light truck	544,022	3,154	1,437	—	548,613	11,374	559,987
Medium and heavy duty truck	283,284	154	—	—	283,438	106	283,544
Aircraft	790,233	4,149	1,168	—	795,550	7,561	803,111
Construction equipment	641,270	1,643	—	—	642,913	2,326	645,239
Commercial real estate	807,793	109	—	—	807,902	1,984	809,886
Residential real estate and home equity	520,124	1,267	455	295	522,141	1,714	523,855
Consumer	135,591	682	150	73	136,496	141	136,637
Total	$ 4,792,847	$ 11,180	$ 3,210	$ 368	$ 4,807,605	$ 27,859	$ 4,835,464

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

(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Reserve
June 30, 2019			
With no related reserve recorded:			
Commercial and agricultural	$ 2,176	$ 2,176	$ —
Auto and light truck	1,805	1,805	—
Medium and heavy duty truck	—	—	—
Aircraft	1,064	1,064	—
Construction equipment	729	729	—
Commercial real estate	1,139	1,139	—
Residential real estate and home equity	—	—	—
Consumer	—	—	—
Total with no related reserve recorded	6,913	6,913	—
With a reserve recorded:			
Commercial and agricultural	486	486	39
Auto and light truck	414	414	281
Medium and heavy duty truck	—	—	—
Aircraft	—	—	—
Construction equipment	1,266	1,266	104
Commercial real estate	695	695	9
Residential real estate and home equity	341	343	123
Consumer	—	—	—
Total with a reserve recorded	3,202	3,204	556
Total impaired loans	$ 10,115	$ 10,117	$ 556
December 31, 2018			
With no related reserve recorded:			
Commercial and agricultural	$ 2,471	$ 2,471	$ —
Auto and light truck	7,504	7,504	—
Medium and heavy duty truck	106	106	—
Aircraft	556	556	—
Construction equipment	905	905	—
Commercial real estate	1,131	1,131	—
Residential real estate and home equity	—	—	—
Consumer	—	—	—
Total with no related reserve recorded	12,673	12,673	—
With a reserve recorded:			
Commercial and agricultural	—	—	—
Auto and light truck	3,840	3,840	372
Medium and heavy duty truck	—	—	—
Aircraft	7,004	7,004	1,255
Construction equipment	1,340	1,340	279
Commercial real estate	759	759	51
Residential real estate and home equity	344	346	126
Consumer	—	—	—
Total with a reserve recorded	13,287	13,289	2,083
Total impaired loans	$ 25,960	$ 25,962	$ 2,083

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,			
	2019		2018		2019		2018	
(Dollars in thousands)	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income	Average Recorded Investment	Interest Income
Commercial and agricultural	$ 4,080	$ 13	$ 2,998	$ —	$ 3,450	$ 13	$ 2,921	$ —
Auto and light truck	2,791	—	7,066	—	3,898	—	7,446	—
Medium and heavy duty truck	562	—	319	—	308	—	334	—
Aircraft	1,589	—	9,126	20	3,517	—	6,097	20
Construction equipment	1,417	—	942	—	1,673	—	1,136	—
Commercial real estate	1,834	—	2,259	—	1,846	—	2,978	—
Residential real estate and home equity	341	5	349	4	342	10	349	8
Consumer	—	—	—	—	—	—	—	—
Total	$ 12,614	$ 18	$ 23,059	$ 24	$ 15,034	$ 23	$ 21,261	$ 28

There was one nonperforming loan and lease modification classified as a troubled debt restructuring (TDR) during the three and six months ended June 30, 2019 and no loan or lease modifications classified as TDR during the three and six months ended June 30, 2018. The classification between nonperforming and performing is determined at the time of modification. Modification programs focus on extending maturity dates or modifying payment patterns with most TDRs experiencing a combination of concessions. Modifications do not result in the contractual forgiveness of principal or interest. There were no modifications during the three and six months ended June 30, 2019 and 2018 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 months ended June 30, 2019 and one TDR which had a payment default within the twelve months following modification during the six months ended June 30, 2019. There were no TDRs which had payment defaults within the twelve months following modification during the three and six months ended June 30, 2018. 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, 2019 and December 31, 2018.

(Dollars in thousands)	June 30, 2019	December 31, 2018
Performing TDRs	$ 341	$ 344
Nonperforming TDRs	512	316
Total TDRs	$ 853	$ 660

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, 2019 and 2018.

(Dollars in thousands)	Commercial and agricultural	Auto and light truck	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer	Total
June 30, 2019									
Balance, beginning of period	$ 18,307	$ 14,259	$ 4,409	$ 33,440	$ 10,883	$ 15,834	$ 3,386	$ 1,334	$ 101,852
Charge-offs	9	57	1,132	1	1	—	—	313	1,513
Recoveries	28	20	—	117	15	51	3	91	325
Net charge-offs (recoveries)	(19)	37	1,132	(116)	(14)	(51)	(3)	222	1,188
Provision (recovery of provision)	726	2,119	1,394	(1,638)	1,387	(128)	129	258	4,247
Balance, end of period	$ 19,052	$ 16,341	$ 4,671	$ 31,918	$ 12,284	$ 15,757	$ 3,518	$ 1,370	$ 104,911
June 30, 2018									
Balance, beginning of period	$ 17,609	$ 10,810	$ 4,493	$ 34,836	$ 10,917	$ 14,770	$ 3,565	$ 1,331	$ 98,331
Charge-offs	—	84	—	—	—	—	—	221	305
Recoveries	41	13	—	5	26	4	7	68	164
Net charge-offs (recoveries)	(41)	71	—	(5)	(26)	(4)	(7)	153	141
Provision (recovery of provision)	981	1,337	(151)	1,931	193	366	(8)	168	4,817
Balance, end of period	$ 18,631	$ 12,076	$ 4,342	$ 36,772	$ 11,136	$ 15,140	$ 3,564	$ 1,346	$ 103,007

The following table shows the changes in the reserve for loan and lease losses, segregated by class, for the six months ended June 30, 2019 and 2018.

(Dollars in thousands)	Commercial and agricultural loans	Auto and light truck	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer loans	Total
June 30, 2019									
Balance, beginning of period	$ 17,063	$ 14,689	$ 4,303	$ 33,047	$ 10,922	$ 15,705	$ 3,425	$ 1,315	$ 100,469
Charge-offs	88	466	1,132	3,001	196	—	21	563	5,467
Recoveries	62	29	—	302	119	60	6	166	744
Net charge-offs (recoveries)	26	437	1,132	2,699	77	(60)	15	397	4,723
Provision (recovery of provision)	2,015	2,089	1,500	1,570	1,439	(8)	108	452	9,165
Balance, end of period	$ 19,052	$ 16,341	$ 4,671	$ 31,918	$ 12,284	$ 15,757	$ 3,518	$ 1,370	$ 104,911
June 30, 2018									
Balance, beginning of period	$ 16,228	$ 10,103	$ 4,844	$ 34,619	$ 9,343	$ 14,792	$ 3,666	$ 1,288	$ 94,883
Charge-offs	25	400	—	29	5	7	11	384	861
Recoveries	90	19	—	49	45	25	13	141	382
Net charge-offs (recoveries)	(65)	381	—	(20)	(40)	(18)	(2)	243	479
Provision (recovery of provision)	2,338	2,354	(502)	2,133	1,753	330	(104)	301	8,603
Balance, end of period	$ 18,631	$ 12,076	$ 4,342	$ 36,772	$ 11,136	$ 15,140	$ 3,564	$ 1,346	$ 103,007

The following table shows the reserve for loan and lease losses and recorded investment in loans and leases, segregated by class, separated between individually and collectively evaluated for impairment as of June 30, 2019 and December 31, 2018.

(Dollars in thousands)	Commercial and agricultural loans	Auto and light truck	Medium and heavy duty truck	Aircraft	Construction equipment	Commercial real estate	Residential real estate and home equity	Consumer loans	Total
June 30, 2019									
Reserve for loan and lease losses									
Ending balance, individually evaluated for impairment	$ 39	$ 281	$ —	$ —	$ 104	$ 9	$ 123	$ —	$ 556
Ending balance, collectively evaluated for impairment	19,013	16,060	4,671	31,918	12,180	15,748	3,395	1,370	104,355
Total reserve for loan and lease losses	$ 19,052	$ 16,341	$ 4,671	$ 31,918	$ 12,284	$ 15,757	$ 3,518	$ 1,370	$ 104,911
Recorded investment in loans									
Ending balance, individually evaluated for impairment	$ 2,662	$ 2,219	$ —	$ 1,064	$ 1,995	$ 1,834	$ 341	$ —	$ 10,115
Ending balance, collectively evaluated for impairment	1,170,338	632,881	300,042	810,099	684,638	834,085	529,408	137,731	5,099,222
Total recorded investment in loans	$ 1,173,000	$ 635,100	$ 300,042	$ 811,163	$ 686,633	$ 835,919	$ 529,749	$ 137,731	$ 5,109,337
December 31, 2018									
Reserve for loan and lease losses									
Ending balance, individually evaluated for impairment	$ —	$ 372	$ —	$ 1,255	$ 279	$ 51	$ 126	$ —	$ 2,083
Ending balance, collectively evaluated for impairment	17,063	14,317	4,303	31,792	10,643	15,654	3,299	1,315	98,386
Total reserve for loan and lease losses	$ 17,063	$ 14,689	$ 4,303	$ 33,047	$ 10,922	$ 15,705	$ 3,425	$ 1,315	$ 100,469
Recorded investment in loans									
Ending balance, individually evaluated for impairment	$ 2,471	$ 11,344	$ 106	$ 7,560	$ 2,245	$ 1,890	$ 344	$ —	$ 25,960
Ending balance, collectively evaluated for impairment	1,070,734	548,643	283,438	795,551	642,994	807,996	523,511	136,637	4,809,504
Total recorded investment in loans	$ 1,073,205	$ 559,987	$ 283,544	$ 803,111	$ 645,239	$ 809,886	$ 523,855	$ 136,637	$ 4,835,464

Note 6 — Lease Investments

As a lessor, the Company's loan and lease portfolio includes direct finance leases, which are included in commercial and agricultural, auto and light truck, medium and heavy duty truck, aircraft, and construction equipment on the Consolidated Statements of Financial Condition. The Company also finances various types of construction equipment, medium and heavy duty trucks, automobiles and other equipment under leases classified as operating leases, which are included in Equipment Owned Under Operating Leases, net, on the Consolidated Statements of Financial Condition.

The following table shows the components of the investment in direct finance and operating leases.

(Dollars in thousands)	June 30, 2019	December 31, 2018
Direct finance leases:		
Minimum lease payments	$ 236,701	$ 257,398
Estimated unguaranteed residual values	41	41
Less: Unearned income	(41,979)	(46,709)
Net investment in direct finance leases	$ 194,763	$ 210,730
Operating leases:		
Gross investment in operating leases	$ 196,147	$ 199,954
Accumulated depreciation	(69,645)	(65,514)
Net investment in operating leases	$ 126,502	$ 134,440

The following table shows future minimum lease payments due from clients on direct finance and operating leases at June 30, 2019.

(Dollars in thousands)	Direct Finance Leases	Operating Leases
Remainder of 2019	$ 27,361	$ 15,830
2020	46,285	34,120
2021	38,822	20,091
2022	36,562	12,027
2023	31,618	6,470
Thereafter	56,053	3,020
Total	$ 236,701	$ 91,558

To mitigate the risk of loss, the Company seeks to diversify both the type of equipment leased and the industries in which the lessees participate. In addition, a portion of our leases are terminal rental adjustment clause or "TRAC" leases where the lessee effectively guarantees the full residual value through a rental adjustment at the end of term or those where partial value is guaranteed ("split-TRAC"), which has a limited residual risk. Under a split-TRAC structure, the limited residual risk would be satisfied first by the net sale proceeds of the leased asset. The lessee's at-risk portion, or top risk, is satisfied last and is subject to repayment as additional rent, if the TRAC amount is not satisfied by the net sale proceeds. The carrying amount of residual assets covered by residual value guarantees was $79.65 million and $87.61 million at June 30, 2019 and December 31, 2018, respectively.

The following table shows interest income recognized from direct finance lease payments and operating lease equipment rental income and related depreciation expense.

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2019	2018	2019	2018
Direct finance leases:				
Interest income on lease receivable	$ 3,241	$ 3,684	$ 6,419	$ 6,669
Operating leases:				
Income related to lease payments	$ 7,809	$ 8,104	$ 15,791	$ 15,859
Depreciation expense	6,400	6,684	12,924	13,112

Income related to reimbursements from lessees for personal property tax on operating leased equipment for the three and six months ended June 30, 2019 was $0.11 million and $0.35 million, respectively. Expense related to personal property tax payments on operating leased equipment for the three and six months ended June 30, 2019 was $0.11 million and $0.35 million, respectively.

Note 7 — 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 $731.02 million and $734.30 million at June 30, 2019 and December 31, 2018, 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 MSRs and the associated valuation allowance.

	Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	2019	2018	2019	2018
Mortgage servicing rights:				
Balance at beginning of period	$ 4,247	$ 4,356	$ 4,283	$ 4,349
Additions	188	202	385	445
Amortization	(294)	(235)	(527)	(471)
Sales	—	—	—	—
Carrying value before valuation allowance at end of period	4,141	4,323	4,141	4,323
Valuation allowance:				
Balance at beginning of period	—	—	—	—
Impairment recoveries	—	—	—	—
Balance at end of period	$ —	$ —	$ —	$ —
Net carrying value of mortgage servicing rights at end of period	$ 4,141	$ 4,323	$ 4,141	$ 4,323
Fair value of mortgage servicing rights at end of period	$ 5,987	$ 7,536	$ 5,987	$ 7,536

At June 30, 2019 and 2018, the fair value of MSRs exceeded the carrying value reported in the Consolidated Statements of Financial Condition by $1.85 million and $3.21 million, respectively. This difference represents increases in the fair value of certain MSRs that could not be recorded above cost basis.

Mortgage loan contractual servicing fees, including late fees and ancillary income, were $0.63 million and $0.64 million for the three months ended June 30, 2019 and 2018, respectively. Mortgage loan contractual servicing fees, including late fees and ancillary income, were $1.25 million and $1.30 million for the six months ended June 30, 2019 and 2018, respectively. Mortgage loan contractual servicing fees are included in Mortgage Banking on the Consolidated Statements of Income.

Note 8 — Commitments and Financial Instruments with Off-Balance-Sheet Risk

Lease Commitments — The Company and its subsidiaries are obligated under operating leases for certain office premises and equipment.

The following table shows operating lease right of use assets and operating lease liabilities as of June 30, 2019.

(Dollars in thousands)	Statement of Financial Condition classification	June 30, 2019
Operating lease right of use assets	Accrued income and other assets	$ 9,930
Operating lease liabilities	Accrued expenses and other liabilities	$ 10,253

The following table shows the components of operating leases expense for the three and six months ended June 30, 2019.

(Dollars in thousands)	Statement of Income classification	Three Months Ended June 30, 2019	Six Months Ended June 30, 2019
Operating lease cost	Net occupancy expense	$ 883	$ 1,761
Short-term lease cost	Net occupancy expense	7	10
Variable lease cost	Net occupancy expense	—	—
Total operating lease cost		$ 890	$ 1,771

Gross rental expense for the three and six months ended June 30, 2018 was $0.77 million and $1.71 million, respectively.

The following table shows future minimum rental commitments for all noncancellable operating leases with an initial term longer than 12 months for the next five years and thereafter.

(Dollars in thousands)		
Remainder of 2019	$	1,564
2020		3,648
2021		2,459
2022		1,203
2023		497
Thereafter		1,736
Total lease payments		11,107
Less: imputed interest		(854)
Present value of operating lease liabilities	$	10,253

The following table shows the weighted average remaining operating lease term, the weighted average discount rate and supplemental Consolidated Statement of Cash Flows information for operating leases at June 30, 2019.

(Dollars in thousands)		**June 30, 2019**
Weighted average remaining lease term		4.81 years
Weighted average discount rate		3.00%
Cash paid for amounts included in the measurement of lease liabilities:		
Operating cash flows from operating leases	$	947

During the six months ended June 30, 2019, the Company recognized a net gain on the sale of an office building in the amount of $1.32 million. The Company commenced an operating lease with the buyer of the building to lease a portion of it for office space resulting in a new right of use asset and operating lease liability.

There are no new significant leases that have not yet commenced as of June 30, 2019.

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

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

(Dollars in thousands)		**June 30, 2019**		**December 31, 2018**
Amounts of commitments:				
Loan commitments to extend credit	$	1,107,331	$	1,095,053
Standby letters of credit	$	27,881	$	31,133
Commercial and similar letters of credit	$	2,849	$	2,500

The exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan commitments and standby letters of credit is represented by the dollar amount of those instruments. The Company uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on-balance-sheet instruments.

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

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

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

Note 9 — 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 8 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 Consolidated Statements of Financial Condition and do not take into account the effects of master netting agreements. Master netting agreements allow the Company to settle all derivative contracts held with a single counterparty on a net basis, and to offset net derivative positions with related collateral, where applicable. These derivative positions relate to transactions in which the Company enters into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. In connection with each transaction, the Company agrees to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate. At the same time, the Company agrees to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to effectively convert a variable rate loan to a fixed rate. Because the terms of the swaps with the customers and the other financial institutions offset each other, with the only difference being counterparty credit risk, changes in the fair value of the underlying derivative contracts are not materially different and do not significantly impact the Company's results of operations.

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

		Asset derivatives		Liability derivatives	
(Dollars in thousands)	Notional or contractual amount	Statement of Financial Condition classification	Fair value	Statement of Financial Condition classification	Fair value
June 30, 2019					
Interest rate swap contracts	$ 992,453	Other assets	$ 21,397	Other liabilities	$ 21,772
Loan commitments	15,756	Mortgages held for sale	204	N/A	—
Forward contracts - mortgage loan	27,722	N/A	—	Mortgages held for sale	174
Total	$ 1,035,931		$ 21,601		$ 21,946
December 31, 2018					
Interest rate swap contracts	$ 855,848	Other assets	$ 7,124	Other liabilities	$ 7,250
Loan commitments	5,871	Mortgages held for sale	112	N/A	—
Forward contracts - mortgage loan	14,087	N/A	—	Mortgages held for sale	135
Total	$ 875,806		$ 7,236		$ 7,385

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

		Gain (loss)			
		Three Months Ended June 30,		Six Months Ended June 30,	
(Dollars in thousands)	Statement of Income classification	2019	2018	2019	2018
Interest rate swap contracts	Other expense	$ (192)	$ (35)	$ (249)	$ (36)
Interest rate swap contracts	Other income	505	246	784	579
Loan commitments	Mortgage banking	15	61	92	57
Forward contracts - mortgage loan	Mortgage banking	(49)	(40)	(39)	(37)
Total		$ 279	$ 232	$ 588	$ 563

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		Net Amount
				Financial Instruments	Cash Collateral Received	
June 30, 2019						
Interest rate swaps	$ 21,397	$ —	$ 21,397	$ —	$ —	$ 21,397
December 31, 2018						
Interest rate swaps	$ 7,128	$ 4	$ 7,124	$ 177	$ 610	$ 6,337

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

(Dollars in thousands)	Gross Amounts of Recognized Liabilities	Gross Amounts Offset in the Statement of Financial Condition	Net Amounts of Liabilities Presented in the Statement of Financial Condition	Gross Amounts Not Offset in the Statement of Financial Condition		Net Amount
				Financial Instruments	Cash Collateral Pledged	
June 30, 2019						
Interest rate swaps	$ 21,772	$ —	$ 21,772	$ 21,390	$ —	$ 382
Repurchase agreements	119,781	—	119,781	119,781	—	—
Total	$ 141,553	$ —	$ 141,553	$ 141,171	$ —	$ 382
December 31, 2018						
Interest rate swaps	$ 7,254	$ 4	$ 7,250	$ 1,700	$ —	$ 5,550
Repurchase agreements	103,627	—	103,627	103,627	—	—
Total	$ 110,881	$ 4	$ 110,877	$ 105,327	$ —	$ 5,550

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, 2019 and December 31, 2018, repurchase agreements had a remaining contractual maturity of $117.53 million and $102.34 million in overnight and $2.25 million and $1.29 million in up to 30 days, respectively and were collateralized by U.S. Treasury and Federal agencies securities.

Note 10 — Variable Interest Entities

A variable interest entity (VIE) is a partnership, limited liability company, trust or other legal entity that meets any one of the following criteria:

- The entity does not have sufficient equity to conduct its activities without additional subordinated financial support from another party.
- The entity's investors lack the power to direct the activities that most significantly affect the entity's economic performance.
- The entity's at-risk holders do not have the obligation to absorb the losses or the right to receive residual returns.
- The voting rights of some investors are not proportional to their economic interests in the entity, and substantially all of the entity's activities involve, or are conducted on behalf of, investors with disproportionately few voting rights.

The Company is involved in various entities that are considered to be VIEs. The Company's investments in VIEs are primarily related to investments promoting affordable housing, community development and renewable energy sources. Some of these tax-advantaged investments support the Company's regulatory compliance with the Community Reinvestment Act. The Company's investments in these entities generate a return primarily through the realization of federal and state income tax credits, and other tax benefits, such as tax deductions from operating losses of the investments, over specified time periods. These tax credits are recognized as a reduction of tax expense or, for investments qualifying as investment tax credits, as a reduction to the related investment asset. The Company recognized federal income tax credits related to its affordable housing and community development tax-advantaged investments in tax expense of $0.35 million and $0.32 million for the three months ended June 30, 2019 and 2018, respectively and $0.70 million and $0.64 million for the six months ended June 30, 2019 and 2018, respectively. The Company also recognized $3.95 million and $(0.21) million of investment tax credits for the three months ended June 30, 2019 and 2018, respectively and $5.55 million and $7.94 million for the six months ended June 30, 2019 and 2018, respectively.

The Company is not required to consolidate VIEs in which it has concluded it does not have a controlling financial interest, and thus is not the primary beneficiary. In such cases, the Company does not have both the power to direct the entities' most significant activities and the obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIEs. As a limited partner in these operating partnerships, we are allocated credits and deductions associated with the underlying properties. The Company has determined that it is not the primary beneficiary of these investments because the general partners have the power to direct activities that most significantly influence the economic performance of their respective partnerships.

The Company's investments in these unconsolidated VIEs are carried in Other Assets on the Consolidated Statements of Financial Condition. The Company's unfunded capital and other commitments related to these unconsolidated VIEs are generally carried in Other Liabilities on the Consolidated Statements of Financial Condition. The Company's maximum exposure to loss from these unconsolidated VIEs include the investment recorded on the Company's Consolidated Statements of Financial Condition, net of unfunded capital commitments, and previously recorded tax credits which remain subject to recapture by taxing authorities based on compliance features required to be met at the project level. While the Company believes potential losses from these investments are remote, the maximum exposure was determined by assuming a scenario where the community-based business, housing projects and renewable energy projects completely fail and do not meet certain taxing authority compliance requirements resulting in recapture of the related tax credits.

The following table provides a summary of investments in affordable housing, community development and renewable energy VIEs that the Company has not consolidated.

(Dollars in thousands)	June 30, 2019	December 31, 2018
Investment carrying amount	**$ 17,397**	$ 15,083
Unfunded capital and other commitments	**12,306**	6,449
Maximum exposure to loss	**35,949**	40,705

The Company is required to consolidate VIEs in which it has concluded it has significant involvement in and the ability to direct the activities that impact the entity's economic performance. The Company is the managing general partner of entities to which it shares interest in tax-advantaged investments with third parties. At June 30, 2019 and December 31, 2018, approximately $41.09 million and $8.38 million of the Company's assets and $29.99 million and $6.70 million of its liabilities included on the Consolidated Statements of Financial Condition were related to tax-advantaged investment VIEs which the Company has consolidated, respectively. The assets of the consolidated VIEs are reported in Other Assets, the liabilities are reported in Other Liabilities and the non-controlling interest is reported in Equity on the Consolidated Statements of Financial Condition. The assets of a particular VIE are the primary source of funds to settle its obligations. The creditors of the VIE do not have recourse to the general credit of the Company. The Company's exposure to the consolidated VIE is generally limited to the carrying value of its variable interest plus any related tax credits previously recognized.

Additionally, the Company sponsors one trust, 1st Source Master Trust (Capital Trust) of which 100% of the common equity is owned by the Company. The Capital Trust was formed in 2007 for the purpose of issuing corporation-obligated mandatorily redeemable capital securities (the capital securities) to third-party investors and investing the proceeds from the sale of the capital securities solely in junior subordinated debenture securities of the Company (the subordinated notes). The subordinated notes held by the Capital Trust are the sole assets of the Capital Trust. The Capital Trust qualifies as a variable interest entity for which the Company is not the primary beneficiary and therefore reported in the financial statements as an unconsolidated subsidiary. The junior subordinated debentures are reflected as subordinated notes in the Statements of Financial Condition with the corresponding interest distributions reflected as Interest Expense in the Statements of Income. The common shares issued by the Capital Trust are included in Other Assets in the Statements of Financial Condition.

Distributions on the capital securities issued by the Capital Trust are payable quarterly at a rate per annum equal to the interest rate being earned by the Capital Trust on the subordinated notes held by the Capital Trust. The capital securities are subject to mandatory redemption, in whole or in part, upon repayment of the subordinated notes. The Company has entered into agreements which, taken collectively, fully and unconditionally guarantee the capital securities subject to the terms of each of the guarantees. The capital securities held by the Capital Trust qualify as Tier 1 capital under Federal Reserve Board guidelines.

The following table shows subordinated notes at June 30, 2019.

(Dollars in thousands)		Amount of Subordinated Notes	Interest Rate	Maturity Date
June 2007 issuance (1)	$	41,238	7.22%	6/15/2037
August 2007 issuance (2)		17,526	3.89%	9/15/2037
Total	**$**	**58,764**		

(1) Fixed rate through life of debt.
(2) 3-Month LIBOR +1.48% through remaining life of debt.

Note 11 — 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, 2019 and 2018.

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

	Three Months Ended June 30,				Six Months Ended June 30,			
(Dollars in thousands - except per share amounts)		2019		2018		2019		2018
Distributed earnings allocated to common stock	$	6,930	$	6,225	$	13,896	$	11,929
Undistributed earnings allocated to common stock		16,323		15,591		31,425		28,869
Net earnings allocated to common stock		23,253		21,816		45,321		40,798
Net earnings allocated to participating securities		132		148		260		282
Net income allocated to common stock and participating securities	$	23,385	$	21,964	$	45,581	$	41,080
Weighted average shares outstanding for basic earnings per common share		25,615,718		25,958,128		25,687,056		25,954,278
Dilutive effect of stock compensation		—		—		—		—
Weighted average shares outstanding for diluted earnings per common share		25,615,718		25,958,128		25,687,056		25,954,278
Basic earnings per common share	$	0.91	$	0.84	$	1.76	$	1.57
Diluted earnings per common share	$	0.91	$	0.84	$	1.76	$	1.57

Note 12 — Stock Based Compensation

As of June 30, 2019, 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, 2018. These plans include three executive stock award plans, the Executive Incentive Plan, the Restricted Stock Award Plan, the Strategic Deployment Incentive Plan; and the Employee Stock Purchase Plan. The 2011 Stock Option Plan was approved by the shareholders on April 21, 2011 but the Company had not made any grants through June 30, 2019.

Stock-based compensation expense for all stock-based compensation awards granted is based on the grant-date fair value. For all awards except stock option awards, the grant date fair value is either the fair market value per share or book value per share (corresponding to the type of stock awarded) as of the grant date. For stock option awards, the grant date fair value is estimated using the Black-Scholes option pricing model. For all awards the Company recognizes these compensation costs on a straight-line basis over the requisite service period of the award, for which the Company uses the related vesting term.

Total fair value of options vested and expensed was zero for the six months ended June 30, 2019 and 2018. As of June 30, 2019 and 2018 there were no outstanding stock options. There were no stock options exercised during the six months ended June 30, 2019 and 2018. All shares issued in connection with stock option exercises are issued from available treasury stock.

As of June 30, 2019, there was $6.03 million of total unrecognized compensation cost related to non-vested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 3.21 years.

Note 13 — Accumulated Other Comprehensive Income (Loss)

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

	Three Months Ended June 30,		Six Months Ended June 30,		
(Dollars in thousands)	2019	2018	2019	2018	Affected Line Item in the Statements of Income
Realized losses included in net income	$ —	$ —	$ —	$ (345)	Losses on investment securities available-for-sale
	—	—	—	(345)	Income before income taxes
Tax effect	—	—	—	83	Income tax expense
Net of tax	$ —	$ —	$ —	$ (262)	Net income

Note 14 — Income Taxes

The total amount of unrecognized tax benefits that would affect the effective tax rate if recognized was zero at June 30, 2019 and December 31, 2018. Interest and penalties are recognized through the income tax provision. For the three months ended June 30, 2019 and 2018, the Company recognized $0.00 million and $(0.10) million in interest and penalties, respectively. For the six months ended June 30, 2019 and 2018, the Company recognized $0.00 million and $(0.09) million in interest or penalties, respectively. There was no accrued interest and penalties at June 30, 2019 and December 31, 2018.

Tax years that remain open and subject to audit include the federal 2015-2018 years and the Indiana 2015-2018 years. The Company does not anticipate a significant change in the amount of uncertain tax positions within the next 12 months.

Note 15 — 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, 2019 and December 31, 2018, 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.

(Dollars in thousands)	Fair value carrying amount	Aggregate unpaid principal	Excess of fair value carrying amount over (under) unpaid principal	
June 30, 2019				
Mortgages held for sale reported at fair value	$ 19,178	$ 18,808	$ 370	(1)
December 31, 2018				
Mortgages held for sale reported at fair value	$ 11,290	$ 11,076	$ 214	(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.
- 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.

Mortgages held for sale and the related loan commitments and forward contracts (hedges) are valued using a market value approach and utilizing an appropriate current market yield and a loan commitment closing rate based on historical analysis.

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Interest rate swap positions, both assets and liabilities, are valued by a third-party pricing agent using an income approach and utilizing models that use as their basis readily observable market parameters. This valuation process considers various factors including interest rate yield curves, time value and volatility factors. Validation of third party agent valuations is accomplished by comparing those values to the Company's swap counterparty valuations. Management believes an adjustment is required to "mid-market" valuations for derivatives tied to its performing loan portfolio to recognize the imprecision and related exposure inherent in the process of estimating expected credit losses as well as velocity of deterioration evident with systemic risks embedded in these portfolios. Any change in the mid-market derivative valuation adjustment will be recognized immediately through the Consolidated Statements of Income.

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

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
June 30, 2019				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	$ 34,081	$ 507,395	$ —	$ 541,476
U.S. States and political subdivisions securities	—	86,011	5,061	91,072
Mortgage-backed securities — Federal agencies	—	338,824	—	338,824
Corporate debt securities	—	49,714	—	49,714
Foreign government and other securities	—	700	—	700
Total debt securities available-for-sale	34,081	982,644	5,061	1,021,786
Mortgages held for sale	—	19,178	—	19,178
Accrued income and other assets (interest rate swap agreements)	—	21,397	—	21,397
Total	$ 34,081	$ 1,023,219	$ 5,061	$ 1,062,361
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	$ —	$ 21,772	$ —	$ 21,772
Total	$ —	$ 21,772	$ —	$ 21,772
December 31, 2018				
Assets:				
Investment securities available-for-sale:				
U.S. Treasury and Federal agencies securities	$ 33,746	$ 497,477	$ —	$ 531,223
U.S. States and political subdivisions securities	—	93,557	1,025	94,582
Mortgage-backed securities — Federal agencies	—	318,233	—	318,233
Corporate debt securities	—	45,392	—	45,392
Foreign government and other securities	—	699	—	699
Total debt securities available-for-sale	33,746	955,358	1,025	990,129
Mortgages held for sale	—	11,290	—	11,290
Accrued income and other assets (interest rate swap agreements)	—	7,124	—	7,124
Total	$ 33,746	$ 973,772	$ 1,025	$ 1,008,543
Liabilities:				
Accrued expenses and other liabilities (interest rate swap agreements)	$ —	$ 7,250	$ —	$ 7,250
Total	$ —	$ 7,250	$ —	$ 7,250

The following table shows changes in Level 3 assets measured at fair value on a recurring basis for the quarter ended June 30, 2019 and 2018.

(Dollars in thousands)	U.S. States and political subdivisions securities	Foreign government and other securities	Investment securities available-for-sale
Beginning balance April 1, 2019	$ 5,064	$ —	$ 5,064
Total gains or losses (realized/unrealized):			
Included in earnings	—	—	—
Included in other comprehensive income	16	—	16
Purchases	—	—	—
Issuances	—	—	—
Sales	—	—	—
Settlements	—	—	—
Maturities	(19)	—	(19)
Transfers into Level 3	—	—	—
Transfers out of Level 3	—	—	—
Ending balance June 30, 2019	$ 5,061	$ —	$ 5,061
Beginning balance April 1, 2018	$ 2,155	$ 708	$ 2,863
Total gains or losses (realized/unrealized):			
Included in earnings	—	—	—
Included in other comprehensive income	4	(1)	3
Purchases	—	—	—
Issuances	—	—	—
Sales	—	—	—
Settlements	—	—	—
Maturities	(518)	—	(518)
Transfers into Level 3	—	—	—
Transfers out of Level 3	—	—	—
Ending balance June 30, 2018	$ 1,641	$ 707	$ 2,348

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, 2019 or 2018. No transfers between levels occurred during the three months ended June 30, 2019 or 2018.

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

(Dollars in thousands)	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
June 30, 2019				
Debt securities available-for sale				
Direct placement municipal securities	$ 5,061	Discounted cash flows	Credit spread assumption	0.13% - 2.19%
December 31, 2018				
Debt securities available-for sale				
Direct placement municipal securities	$ 1,025	Discounted cash flows	Credit spread assumption	0.17% - 3.02%

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.

Financial Instruments on Non-recurring Basis:

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

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

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

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

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

Other real estate is based on the 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, 2019: impaired loans - $0.00 million; mortgage servicing rights - $0.00 million; repossessions - $0.01 million; and other real estate - $0.00 million.

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

(Dollars in thousands)	Level 1	Level 2	Level 3	Total
June 30, 2019				
Impaired loans - collateral based	$ —	$ —	$ 1,962	$ 1,962
Accrued income and other assets (mortgage servicing rights)	—	—	4,141	4,141
Accrued income and other assets (repossessions)	—	—	8,799	8,799
Accrued income and other assets (other real estate)	—	—	543	543
Total	$ —	$ —	$ 15,445	$ 15,445
December 31, 2018				
Impaired loans - collateral based	$ —	$ —	$ 7,306	$ 7,306
Accrued income and other assets (mortgage servicing rights)	—	—	4,283	4,283
Accrued income and other assets (repossessions)	—	—	6,666	6,666
Accrued income and other assets (other real estate)	—	—	299	299
Total	$ —	$ —	$ 18,554	$ 18,554

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

(Dollars in thousands)	Carrying Value	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
June 30, 2019					
Impaired loans	$ 1,962	$ 1,962	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	20% - 100%
Mortgage servicing rights	4,141	5,987	Discounted cash flows	Constant prepayment rate (CPR)	11.3% - 24.5%
				Discount rate	9.3% - 12.1%
Repossessions	8,799	9,184	Appraisals, trade publications and auction values	Discount for lack of marketability	2% - 10%
Other real estate	543	550	Appraisals	Discount for lack of marketability	0% - 9%
December 31, 2018					
Impaired loans	$ 7,306	$ 7,306	Collateral based measurements including appraisals, trade publications, and auction values	Discount for lack of marketability and current conditions	20% - 35%
Mortgage servicing rights	4,283	7,238	Discounted cash flows	Constant prepayment rate (CPR)	7.2% - 24.8%
				Discount rate	10.3 % - 13.1%
Repossessions	6,666	6,991	Appraisals, trade publications and auction values	Discount for lack of marketability	4% - 6%
Other real estate	299	305	Appraisals	Discount for lack of marketability	0% - 10%

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.

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

(Dollars in thousands)	Carrying or Contract Value	Fair Value	Level 1	Level 2	Level 3
June 30, 2019					
Assets:					
Cash and due from banks	$ 71,910	$ 71,910	$ 71,910	$ —	$ —
Federal funds sold and interest bearing deposits with other banks	24,578	24,578	24,578	—	—
Investment securities, available-for-sale	1,021,786	1,021,786	34,081	982,644	5,061
Other investments	28,404	28,404	28,404	—	—
Mortgages held for sale	19,178	19,178	—	19,178	—
Loans and leases, net of reserve for loan and lease losses	5,004,426	4,994,307	—	—	4,994,307
Mortgage servicing rights	4,141	5,987	—	—	5,987
Accrued interest receivable	21,114	21,114	—	21,114	—
Interest rate swaps	21,397	21,397	—	21,397	—
Liabilities:					
Deposits	$ 5,403,845	$ 5,409,315	$ 3,714,182	$ 1,695,133	$ —
Short-term borrowings	186,009	186,009	119,188	66,821	—
Long-term debt and mandatorily redeemable securities	71,542	70,547	—	70,547	—
Subordinated notes	58,764	59,978	—	59,978	—
Accrued interest payable	12,903	12,903	—	12,903	—
Interest rate swaps	21,772	21,772	—	21,772	—
Off-balance-sheet instruments *	—	251	—	251	—
December 31, 2018					
Assets:					
Cash and due from banks	$ 94,907	$ 94,907	$ 94,907	$ —	$ —
Federal funds sold and interest bearing deposits with other banks	4,172	4,172	4,172	—	—
Investment securities, available-for-sale	990,129	990,129	33,746	955,358	1,025
Other investments	28,404	28,404	28,404	—	—
Mortgages held for sale	11,290	11,290	—	11,290	—
Loans and leases, net of reserve for loan and lease losses	4,734,995	4,689,267	—	—	4,689,267
Mortgage servicing rights	4,283	7,238	—	—	7,238
Accrued interest receivable	18,880	18,880	—	18,880	—
Interest rate swaps	7,124	7,124	—	7,124	—
Liabilities:					
Deposits	$ 5,122,322	$ 5,111,711	$ 3,654,556	$ 1,457,155	$ —
Short-term borrowings	199,344	199,344	113,734	85,610	—
Long-term debt and mandatorily redeemable securities	71,123	68,751	—	68,751	—
Subordinated notes	58,764	45,874	—	45,874	—
Accrued interest payable	8,950	8,950	—	8,950	—
Interest rate swaps	7,250	7,250	—	7,250	—
Off-balance-sheet instruments *	—	259	—	259	—

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

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

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

ITEM 2.

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

The following management's discussion and analysis is presented to provide information concerning 1st Source Corporation and its subsidiaries' (collectively referred to as "the Company", "we", and "our") financial condition as of June 30, 2019, as compared to December 31, 2018, and the results of operations for the three and six months ended June 30, 2019 and 2018. 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 2018 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 2018, 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, 2019 were $6.65 billion, an increase of $356.36 million or 5.66% from December 31, 2018. Total investment securities, available-for-sale were $1.02 billion, an increase of $31.66 million or 3.20% from December 31, 2018. Federal funds sold and interest bearing deposits with other banks were $24.58 million, an increase of $20.41 million or 489.12% from December 31, 2018.

Total loans and leases were $5.11 billion, an increase of $273.87 million or 5.66% from December 31, 2018. Our foreign loan and lease outstandings, all denominated in U.S. dollars were $211.82 million and $224.44 million as of June 30, 2019 and December 31, 2018, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were $77.60 million and $128.06 million as of June 30, 2019, respectively, compared to $83.90 million and $127.16 million as of December 31, 2018, respectively. As of June 30, 2019 and December 31, 2018 there was not a significant concentration in any other country. Solar loan and lease outstandings were $114.89 million as of June 30, 2019, an increase of $18.90 million or 19.68% from the $96.00 million at December 31, 2018. Solar loan and lease outstandings are included in commercial and agricultural loans. Equipment owned under operating leases was $126.50 million, a decrease of $7.94 million, or 5.90% compared to December 31, 2018.

Total deposits were $5.40 billion, an increase of $281.52 million or 5.50% from the end of 2018. Short-term borrowings were $186.01 million, a decrease of $13.34 million or 6.69% from December 31, 2018. Long-term debt and mandatorily redeemable securities were $71.54 million, an increase of $0.42 million or 0.59% from December 31, 2018.

The following table shows accrued income and other assets.

(Dollars in thousands)	June 30, 2019	December 31, 2018
Accrued income and other assets:		
Bank owned life insurance cash surrender value	$ 68,014	$ 67,434
Operating lease right of use assets	9,930	—
Accrued interest receivable	21,114	18,880
Mortgage servicing rights	4,141	4,283
Other real estate	543	299
Repossessions	8,799	6,666
All other assets	105,225	61,709
Total accrued income and other assets	$ 217,766	$ 159,271

CAPITAL

As of June 30, 2019, total shareholders' equity was $794.66 million, up $32.58 million, or 4.28% from the $762.08 million at December 31, 2018. In addition to net income of $45.58 million, other significant changes in shareholders' equity during the first six months of 2019 included $13.68 million of common stock acquired for treasury and $13.92 million of dividends paid. The accumulated other comprehensive income (loss) component of shareholders' equity totaled $2.41 million at June 30, 2019, compared to $(10.68) million at December 31, 2018. Our shareholders' equity-to-assets ratio was 11.95% as of June 30, 2019, compared to 12.11% at December 31, 2018. Book value per common share rose to $31.12 at June 30, 2019, from $29.56 at December 31, 2018.

We declared and paid cash dividends per common share of $0.27 during the second quarter of 2019. The trailing four quarters dividend payout ratio, representing cash dividends per common share divided by diluted earnings per common share, was 31.04%. 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, 2019, are presented in the table below.

	Actual		Minimum Capital Adequacy		Minimum Capital Adequacy with Capital Buffer		To Be Well Capitalized Under Prompt Corrective Action Provisions	
(Dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk-Weighted Assets):								
1st Source Corporation	$ 855,335	14.20%	$ 482,053	8.00%	$ 632,695	10.50%	$ 602,567	10.00%
1st Source Bank	782,674	12.98	482,276	8.00	632,987	10.50	602,844	10.00
Tier 1 Capital (to Risk-Weighted Assets):								
1st Source Corporation	779,609	12.94	361,540	6.00	512,182	8.50	482,053	8.00
1st Source Bank	706,913	11.73	361,707	6.00	512,418	8.50	482,276	8.00
Common Equity Tier 1 Capital (to Risk-Weighted Assets):								
1st Source Corporation	712,585	11.83	271,155	4.50	421,797	7.00	391,668	6.50
1st Source Bank	696,889	11.56	271,280	4.50	421,991	7.00	391,849	6.50
Tier 1 Capital (to Average Assets):								
1st Source Corporation	779,609	12.15	256,701	4.00	N/A	N/A	320,876	5.00
1st Source Bank	706,913	11.02	256,574	4.00	N/A	N/A	320,718	5.00

LIQUIDITY AND INTEREST RATE SENSITIVITY

Effective liquidity management ensures that the cash flow requirements of depositors and borrowers, as well as our operating cash needs are met. Funds are available from a number of sources, including the securities portfolio, the core deposit base, access to the national brokered certificates of deposit market, national listing service certificates of deposit, 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, 2019, we had no borrowings in the federal funds market. We could borrow $265.00 million in additional funds for a short time from these banks on a collective basis. As of June 30, 2019, we had $106.11 million outstanding in FHLB advances and could borrow an additional $447.46 million contingent on the FHLB activity-based stock ownership requirement. We also had no outstandings with the FRB and could borrow $735.81 million as of June 30, 2019.

Our loan to asset ratio was 76.83% at June 30, 2019 compared to 76.83% at December 31, 2018 and 76.58% at June 30, 2018. Cash and cash equivalents totaled $96.49 million at June 30, 2019 compared to $99.08 million at December 31, 2018 and $144.46 million at June 30, 2018. At June 30, 2019, the Statement of Financial Condition was rate sensitive by $510.34 million more assets than liabilities scheduled to reprice within one year, or approximately 1.19%. 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 $802 million.

RESULTS OF OPERATIONS

Net income available to common shareholders for the three and six month periods ended June 30, 2019 was $23.39 million and $45.58 million, compared to $21.96 million and $41.08 million for the same periods in 2018. Diluted net income per common share was $0.91 and $1.76 for the three and six month periods ended June 30, 2019, compared to $0.84 and $1.57 for the same periods in 2018. Return on average common shareholders' equity was 11.75% for the six months ended June 30, 2019, compared to 11.33% in 2018. The return on total average assets was 1.44% for the six months ended June 30, 2019, compared to 1.37% in 2018.

Net income increased for the six months ended June 30, 2019 compared to the first six months of 2018. Net interest income and noninterest income increased which was offset by an increase in the provision for loan and lease losses and noninterest expense. Details of the changes in the various components of net income are discussed further below.

NET INTEREST INCOME

The following tables provide an analysis of net interest income and illustrates the interest income earned and interest expense charged for each major component of interest earning assets and interest bearing liabilities. Yields/rates are computed on a tax-equivalent basis, using a 21% rate. Nonaccrual loans and leases are included in the average loan and lease balance outstanding.

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

	Three Months Ended								
	June 30, 2019			March 31, 2019			June 30, 2018		
(Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
ASSETS									
Investment securities available-for-sale:									
Taxable	$ 929,264	$ 5,186	2.24%	$ 909,422	$ 5,515	2.46%	$ 857,600	$ 4,473	2.09%
Tax exempt[1]	71,878	437	2.44%	78,171	472	2.45%	90,735	589	2.60%
Mortgages held for sale	12,014	127	4.24%	8,826	101	4.64%	6,985	92	5.28%
Loans and leases, net of unearned discount[1]	5,001,392	65,565	5.26%	4,858,183	62,677	5.23%	4,770,361	58,517	4.92%
Other investments	53,323	499	3.75%	42,095	438	4.22%	51,141	397	3.11%
Total earning assets[1]	6,067,871	71,814	4.75%	5,896,697	69,203	4.76%	5,776,822	64,068	4.45%
Cash and due from banks	67,448			63,886			65,895		
Reserve for loan and lease losses	(102,787)			(101,697)			(99,277)		
Other assets	455,212			431,500			423,577		
Total assets	$ 6,487,744			$ 6,290,386			$ 6,167,017		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest-bearing deposits	$ 4,137,118	$ 12,978	1.26%	$ 3,934,921	$ 11,470	1.18%	$ 3,950,546	$ 8,319	0.84%
Short-term borrowings	201,401	540	1.08%	251,379	931	1.50%	290,220	826	1.14%
Subordinated notes	58,764	928	6.33%	58,764	928	6.40%	58,764	908	6.20%
Long-term debt and mandatorily redeemable securities	71,308	764	4.30%	70,481	744	4.28%	71,162	643	3.62%
Total interest-bearing liabilities	4,468,591	15,210	1.37%	4,315,545	14,073	1.32%	4,370,692	10,696	0.98%
Noninterest-bearing deposits	1,127,794			1,124,441			1,010,927		
Other liabilities	98,475			73,183			49,088		
Shareholders' equity	789,009			775,657			736,310		
Noncontrolling interests	3,875			1,560			—		
Total liabilities and equity	$ 6,487,744			$ 6,290,386			$ 6,167,017		
Less: Fully tax-equivalent adjustments		(177)			(182)			(203)	
Net interest income/margin (GAAP-derived)[1]		$ 56,427	3.73%		$ 54,948	3.78%		$ 53,169	3.69%
Fully tax-equivalent adjustments		177			182			203	
Net interest income/margin - FTE[1]		$ 56,604	3.74%		$ 55,130	3.79%		$ 53,372	3.71%

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

Quarter Ended June 30, 2019 compared to the Quarter Ended June 30, 2018

The taxable-equivalent net interest income for the three months ended June 30, 2019 was $56.60 million, an increase of 6.06% over the same period in 2018. The net interest margin on a fully taxable-equivalent basis was 3.74% for the three months ended June 30, 2019, compared to 3.71% for the three months ended June 30, 2018.

During the three month period ended June 30, 2019, average earning assets increased $291.05 million, up 5.04% over the comparable period in 2018. Average interest-bearing liabilities increased $97.90 million or 2.24%. The yield on average earning assets increased 30 basis points to 4.75% from 4.45% primarily due to higher rates on loans and leases and taxable investment securities available-for-sale. Total cost of average interest-bearing liabilities increased 39 basis points to 1.37% from 0.98% as a result of the rising interest rate environment during 2018 and competitive pressure on deposit rates. The result to the net interest margin, or the ratio of net interest income to average earning assets, was an increase of three basis points.

The largest contributor to the improved yield on average earning assets for the three months ended June 30, 2019, compared to the three months ended June 30, 2018, was an increase in yields on net loans and leases of 34 basis points primarily due to market conditions as a result of 2018 Federal interest rate increases. The improved yield on net loans and leases was also negatively impacted by three basis points due to net interest reversals of $0.01 million in the second quarter of 2019 vs. net interest recoveries of $0.36 million in the second quarter of 2018. Average net loans and leases increased $231.03 million or 4.84% with the largest increases occurring within the commercial and agricultural and commercial real estate portfolios as a result of market demand. Total average investment securities increased $52.81 million or 5.57%. Average mortgages held for sale increased $5.03 million or 72.00%. 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 (FHLB) stock and commercial paper increased $2.18 million or 4.27% from the second quarter of 2018.

Average interest-bearing deposits increased $186.57 million or 4.72% for the second quarter of 2019 over the same period in 2018 primarily due to organic customer growth and higher rates on certain deposit products to attract deposits in order to support increased loan and lease demand. The effective rate paid on average interest-bearing deposits grew 42 basis points to 1.26% from 0.84%. The increase in the average cost of interest-bearing deposits was primarily the result of higher rates, competitive pressure on rates, and a shift in the deposit mix from the second quarter of 2018.

Average short-term borrowings decreased $88.82 million or 30.60% for the second quarter of 2019 compared to the same period in 2018. Interest paid on short-term borrowings decreased six basis points. Interest paid on subordinated notes increased 13 basis points during the second quarter of 2019 from the same period a year ago due to a variable rate on one traunche. Average long-term debt and mandatorily redeemable securities balances were relatively flat. Interest paid on long-term debt and mandatorily redeemable securities increased 68 basis points during the second quarter of 2019 from the same period in 2018 primarily due to higher rates on mandatorily redeemable securities.

	Six Months Ended					
	June 30, 2019			June 30, 2018		
(Dollars in thousands)	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
ASSETS						
Investment securities available-for-sale:						
Taxable	$ 919,398	$ 10,701	2.35%	$ 835,495	$ 9,081	2.19%
Tax exempt[(1)]	75,007	909	2.44%	97,249	1,244	2.58%
Mortgages held for sale	10,429	228	4.41%	7,350	172	4.72%
Loans and leases, net of unearned discount[(1)]	4,930,183	128,242	5.25%	4,680,073	112,216	4.84%
Other investments	47,740	937	3.96%	45,252	805	3.59%
Total earning assets[(1)]	5,982,757	141,017	4.75%	5,665,419	123,518	4.40%
Cash and due from banks	65,677			63,657		
Reserve for loan and lease losses	(102,245)			(97,502)		
Other assets	443,421			422,350		
Total assets	$ 6,389,610			$ 6,053,924		
LIABILITIES AND SHAREHOLDERS' EQUITY						
Interest-bearing deposits	$ 4,036,578	$ 24,448	1.22%	$ 3,827,398	$ 14,881	0.78%
Short-term borrowings	226,252	1,471	1.31%	306,150	1,602	1.06%
Subordinated notes	58,764	1,856	6.37%	58,764	1,791	6.15%
Long-term debt and mandatorily redeemable securities	70,897	1,508	4.29%	70,739	1,128	3.22%
Total interest-bearing liabilities	4,392,491	29,283	1.34%	4,263,051	19,402	0.92%
Noninterest-bearing deposits	1,126,126			1,008,257		
Other liabilities	85,899			51,312		
Shareholders' equity	782,370			731,304		
Noncontrolling interests	2,724			—		
Total liabilities and equity	$ 6,389,610			$ 6,053,924		
Less: Fully tax-equivalent adjustments		(359)			(415)	
Net interest income/margin (GAAP-derived)[(1)]		$ 111,375	3.75%		$ 103,701	3.69%
Fully tax-equivalent adjustments		359			415	
Net interest income/margin - FTE[(1)]		$ 111,734	3.77%		$ 104,116	3.71%

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

Six Months Ended June 30, 2019 compared to the Six Months Ended June 30, 2018

The taxable-equivalent net interest income for the six months ended June 30, 2019 was $111.73 million, an increase of 7.32% over the comparable period in 2018. The net interest margin on a fully taxable-equivalent basis was 3.77% compared to a net interest margin of 3.71% for the same period in 2018.

During the six month period ended June 30, 2019, average earning assets increased $317.34 million or 5.60% over the comparable period in 2018. Average interest-bearing liabilities increased $129.44 million or 3.04%. The yield on average earning assets increased 35 basis points to 4.75% from 4.40% primarily due to higher rates on loans and leases and taxable investment securities available- for-sale. The total cost of average interest-bearing liabilities increased 42 basis points to 1.34% from 0.92%. The result to the net interest margin, or the ratio of net interest income to average earning assets, was an increase of six basis points.

The largest contributor to the improved yield on average earning assets for the six months ended June 30, 2019, compared to the six months ended June 30, 2018, was an increase in yields on net loans and leases of 41 basis points primarily due to market conditions as a result of Federal interest rate increases in 2018. The improved yield on net loans and leases was also negatively impacted by two basis points due to net interest recoveries of $0.08 million in 2019 vs. $0.48 million in 2018. Average net loans and leases increased $250.11 million or 5.34% primarily in the commercial and agricultural and commercial real estate portfolios as a result of market demand. Total average investment securities increased $61.66 million or 6.61%. Average mortgages held for sale increased $3.08 million or 41.89%. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and FHLB stock and commercial paper, increased $2.49 million or 5.50%.

Average interest-bearing deposits increased $209.18 million or 5.47% for the first six months of 2019 over the same period in 2018 largely due to organic customer growth and higher rates on certain deposit products to attract deposits in order to support increased loan and lease demand. The effective rate paid on average interest-bearing deposits grew 44 basis points to 1.22% compared to 0.78%. The increase in the average cost of interest-bearing deposits was primarily the result of higher rates, competitive pressure on rates, and a shift in the deposit mix.

Average short-term borrowings decreased $79.90 million or 26.10% for the first six months of 2019 compared to the same period in 2018. Interest paid on short-term borrowings increased 25 basis points. The decrease in short-term borrowings was primarily the result of lower borrowings with the FHLB. Interest paid on subordinated notes increased 22 basis points due to a variable rate associated with one traunche. Average long-term debt and mandatorily redeemable securities were relatively stable. Interest paid on long-term debt and mandatorily redeemable securities increased 107 basis points due to higher rates on mandatorily redeemable securities.

Reconciliation of Non-GAAP Financial Measures

The accounting and reporting policies of 1st Source conform to generally accepted accounting principles ("GAAP") in the United States and prevailing practices in the banking industry. However, certain non-GAAP performance measures are used by management to evaluate and measure the Company's performance. These include taxable-equivalent net interest income (including its individual components) and net interest margin (including its individual components). Management believes that these measures provide users of the Company's financial information a more meaningful view of the performance of the interest-earning assets and interest-bearing liabilities.

Management reviews yields on certain asset categories and the net interest margin of the Company and its banking subsidiaries on a fully taxable-equivalent ("FTE") basis. In this non-GAAP presentation, net interest income is adjusted to reflect tax-exempt interest income on an equivalent before-tax basis. This measure ensures comparability of net interest income arising from both taxable and tax-exempt sources.

		Three Months Ended			Six Months Ended	
(Dollars in thousands)		June 30, 2019	March 31, 2019	June 30, 2018	June 30, 2019	June 30, 2018
Calculation of Net Interest Margin						
(A)	Interest income (GAAP)	$ 71,637	$ 69,021	$ 63,865	$ 140,658	$ 123,103
	Fully tax-equivalent adjustments:					
(B)	- Loans and leases	93	95	89	188	177
(C)	- Tax-exempt investment securities	84	87	114	171	238
(D)	Interest income - FTE (A+B+C)	71,814	69,203	64,068	141,017	123,518
(E)	Interest expense (GAAP)	15,210	14,073	10,696	29,283	19,402
(F)	Net interest income (GAAP) (A–E)	56,427	54,948	53,169	111,375	103,701
(G)	Net interest income - FTE (D–E)	56,604	55,130	53,372	111,734	104,116
(H)	Annualization factor	4.011	4.056	4.011	2.017	2.017
(I)	Total earning assets	$ 6,067,871	$ 5,896,697	$ 5,776,822	$ 5,982,757	$ 5,665,419
	Net interest margin (GAAP-derived) (F*H)/I	3.73%	3.78%	3.69%	3.75%	3.69%
	Net interest margin - FTE (G*H)/I	3.74%	3.79%	3.71%	3.77%	3.71%

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, 2019 was $4.25 million and $9.17 million compared to a provision for loan and lease losses in the three and six month periods ended June 30, 2018 of $4.82 million and $8.60 million. Net charge-offs of $1.19 million or 0.10% of average loans and leases were recorded for the second quarter 2019, compared to net charge-offs of $0.14 million or 0.01% of average loans and leases for the same quarter a year ago. Year-to-date net charge-offs of $4.72 million or 0.19% of average loans and leases have been recorded in 2019, compared to net charge-offs of $0.48 million or 0.02% of average loans and leases through June 30, 2018.

The increase in the amount of the provision for the six month period ended June 30, 2019 was principally driven by a large charge-off in the aircraft portfolio during the first quarter as well as to support strong loan growth year-to-date. Loan growth during the three and six month periods ended June 30, 2019 was $183.15 million and $273.87 million, respectively.

We continue to evaluate risks which may impact our loan portfolios. We believe geopolitical events have the potential to negatively impact the U.S. economy. Current concerns include slower growth projections for world economies and the sharp decline in global trade growth exacerbated by tariff disputes, particularly between China and the U.S. Political uncertainty continues in Latin America, with ongoing corruption scandals, fueling U.S. border concerns. Mexico's economy is slowing and Brazil continues to require further structural reforms. Concerns continue to be heightened globally due to actual and potential terrorist attacks.

Another area of concern continues to be our aircraft portfolio where we have a collateral concentration and $212 million in foreign exposure. Currently, the U.S. economy remains strong, but the global economy is showing signs of weakness. The majority of our foreign exposure is in Mexico and Brazil. The Brazilian economy continues its path of gradual improvement, but remains weak and extreme poverty is the source of much of the violence and turmoil within the country. Mexico's economy is currently stronger but is exhibiting weakness as demonstrated by the downward revision of their 2019 gross domestic product growth estimate to 1.3% from 1.6%. Tensions continue regarding threats of tariffs and border immigration issues. We continue to monitor individual customer performance and assess risks in the portfolio as a whole.

On June 30, 2019, 30 day and over loan and lease delinquencies as a percentage of loan and lease outstandings were 0.37%, improving slightly from 0.54% on June 30, 2018. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.05% compared to 2.13% one year ago. The decrease in the reserve as a percent of loans and leases outstanding was primarily due to charging off a significant exposure and lower special attention loan outstanding balances. A summary of loan and lease loss experience during the three and six months ended June 30, 2019 and 2018 is located in Note 5 of the Consolidated Financial Statements.

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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, 2019 and December 31, 2018 is reflected in Note 4 of the Consolidated Financial Statements.

NONPERFORMING ASSETS

The following table shows nonperforming assets.

(Dollars in thousands)	June 30, 2019	December 31, 2018	June 30, 2018
Loans and leases past due 90 days or more	$ 156	$ 366	$ 263
Nonaccrual loans and leases	12,212	27,859	34,582
Other real estate	543	299	133
Repossessions	8,799	6,666	9,389
Equipment owned under operating leases	—	126	—
Total nonperforming assets	$ 21,710	$ 35,316	$ 44,367

Nonperforming assets as a percentage of loans and leases were 0.41% at June 30, 2019, 0.71% at December 31, 2018, and 0.89% at June 30, 2018. Nonperforming assets totaled $21.71 million at June 30, 2019, a decrease of 38.53% from the $35.32 million reported at December 31, 2018, and a 51.07% decrease from the $44.37 million reported at June 30, 2018. The decrease in nonperforming assets during the first six months of 2019 was related to lower nonaccrual loans and leases offset by an increase in repossessions. The decrease in nonperforming assets at June 30, 2019 from June 30, 2018 occurred primarily in nonaccrual loans and leases and repossessions offset by an increase in other real estate.

The decrease in nonaccrual loans and leases at June 30, 2019 from December 31, 2018 occurred primarily in the aircraft and auto and light truck portfolios. The decrease in nonaccrual loans and leases at June 30, 2019 from June 30, 2018 also occurred primarily in the aircraft and auto and light truck portfolios. A summary of nonaccrual loans and leases and past due aging for the period ended June 30, 2019 and December 31, 2018 is located in Note 4 of the Consolidated Financial Statements.

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

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

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

(Dollars in thousands)	June 30, 2019	December 31, 2018	June 30, 2018
Commercial and agricultural	$ 16	$ —	$ —
Auto and light truck	3,810	440	568
Medium and heavy duty truck	554	15	—
Aircraft	4,400	6,209	8,635
Construction equipment	—	—	172
Commercial real estate	—	—	26
Residential real estate and home equity	543	299	67
Consumer	19	2	54
Total	$ 9,342	$ 6,965	$ 9,522

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.

NONINTEREST INCOME

The following table shows the details of noninterest income.

	Three Months Ended June 30,				Six Months Ended June 30,			
(Dollars in thousands)	2019	2018	$ Change	% Change	2019	2018	$ Change	% Change
Noninterest income:								
Trust and wealth advisory	$ 5,583	$ 5,800	(217)	(3.74)%	$ 10,441	$ 10,988	(547)	(4.98)%
Service charges on deposit accounts	2,785	2,625	160	6.10 %	5,283	5,109	174	3.41 %
Debit card	3,669	3,427	242	7.06 %	6,889	6,530	359	5.50 %
Mortgage banking	999	1,073	(74)	(6.90)%	1,935	1,957	(22)	(1.12)%
Insurance commissions	1,518	1,487	31	2.08 %	3,692	3,445	247	7.17 %
Equipment rental	7,809	8,104	(295)	(3.64)%	15,791	15,859	(68)	(0.43)%
Losses on investment securities available-for-sale	—	—	—	— %	—	(345)	345	NM
Other	3,301	2,507	794	31.67 %	5,757	5,287	470	8.89 %
Total noninterest income	$ 25,664	$ 25,023	641	2.56 %	$ 49,788	$ 48,830	958	1.96 %

NM = Not Meaningful

Trust and wealth advisory fees (which include investment management fees, estate administration fees, mutual fund fees, annuity fees, and fiduciary fees) decreased during the three and six months ended June 30, 2019 compared with the same periods a year ago. Trust and wealth advisory fees are largely based on the number and size of client relationships and the market value of assets under management. The market value of trust assets under management at June 30, 2019, December 31, 2018, and June 30, 2018 was $4.25 billion, $3.94 billion, and $4.65 billion, respectively. The decrease in trust and wealth advisory fees compared to one year ago is primarily due to a reduction in the market value of trust assets under management due to stock market movements and the loss of a large employee benefit plan account.

Service charges on deposit accounts increased for the three and six months ended June 30, 2019 over the comparable periods in 2018. The increase in service charges on deposit accounts primarily reflects a higher volume of nonsufficient fund transactions.

Debit card income improved in the three and six months ended June 30, 2019 over the same periods a year ago. The majority of the improvement in debit card income was the result of an increased volume of debit card transactions in 2019.

Mortgage banking income decreased in the three and six months ended June 30, 2019 as compared to the same periods in 2018. The decrease was primarily caused by reduced loan servicing fees offset by a higher volume of loans originated for the secondary market during the first half of 2019.

Insurance commissions were higher during the three and six months ended June 30, 2019 over the same periods a year ago. The increase in insurance commissions was primarily due to an increased book of business and higher contingent commissions received.

Equipment rental income decreased for the three and six months ended June 30, 2019 over the comparable periods in 2018. The decrease was the result of reduced leasing volume in our construction and medium and heavy duty truck portfolios offset by the average equipment rental portfolio increasing by 1.10% over the same period a year ago due to equipment finance mainly in solar financing.

Losses on investment securities available-for-sale decreased during the six months ended June 30, 2019 compared the same period in 2018 primarily from repositioning the portfolio during the first quarter of 2018 in response to tax reform.

Other income increased for the three and six months ended June 30, 2019 over the comparable periods in 2018. The increase was primarily a result of higher customer swap fees and increased claim proceeds from bank owned life insurance offset by reduced gains on partnership investments and less brokerage fees and commissions. The increase was also helped by personal property tax reimbursements on leased equipment from lessees that are reported gross as required by the new leasing standard effective January 1, 2019. These personal property tax reimbursements were offset by a similar increase in other expense resulting from the payment of personal property taxes to the taxing jurisdictions.

NONINTEREST EXPENSE

The following table shows the details of noninterest expense.

	Three Months Ended June 30,				Six Months Ended June 30,			
(Dollars in thousands)	2019	2018	$ Change	% Change	2019	2018	$ Change	% Change
Noninterest expense:								
Salaries and employee benefits	$ 23,787	$ 23,696	91	0.38 %	$ 47,282	$ 46,227	1,055	2.28 %
Net occupancy	2,481	2,115	366	17.30 %	5,253	4,981	272	5.46 %
Furniture and equipment	6,289	5,718	571	9.99 %	12,313	11,173	1,140	10.20 %
Depreciation – leased equipment	6,400	6,684	(284)	(4.25)%	12,924	13,112	(188)	(1.43)%
Professional fees	1,706	1,728	(22)	(1.27)%	3,304	3,745	(441)	(11.78)%
Supplies and communication	1,608	1,499	109	7.27 %	3,101	3,052	49	1.61 %
FDIC and other insurance	608	714	(106)	(14.85)%	1,253	1,412	(159)	(11.26)%
Business development and marketing	1,678	1,725	(47)	(2.72)%	2,627	3,258	(631)	(19.37)%
Loan and lease collection and repossession	230	565	(335)	(59.29)%	1,591	1,516	75	4.95 %
Other	2,566	1,433	1,133	79.06 %	2,909	2,958	(49)	(1.66)%
Total noninterest expense	$ 47,353	$ 45,877	1,476	3.22 %	$ 92,557	$ 91,434	1,123	1.23 %

Salaries and employee benefits increased during the three and six months ended June 30, 2019 compared to the same periods in 2018. The increase was mainly the result of higher base salaries as a result of normal merit increases, increased company contributions to employee retirement accounts and a rise in group insurance claims offset by a decrease in incentive compensation due to fewer vestings of share-based compensation arrangements as compared to the same periods in 2018.

Net occupancy expense increased during the three and six months ended June 30, 2019 compared to the same periods a year ago. The increase for 2019 was primarily attributable to higher rent expense as a result of the Company leasing office space in its former headquarters building which was sold during the first quarter of 2019 offset by reduced snow removal costs compared to 2018.

Furniture and equipment expense, including depreciation, increased during the three and six months ended June 30, 2019 compared to the same periods a year ago. Furniture and equipment expense was higher in 2019 mainly due to software maintenance costs and increased equipment depreciation.

Depreciation on leased equipment decreased slightly for the three and six months ended June 30, 2019 compared to the same periods in 2018. Depreciation on leased equipment correlates with the decrease in equipment rental income.

Professional fees decreased during the second quarter and first six months of 2019 compared to the same period a year ago. The decrease was mainly due to reduced utilization of consulting services related to a customer relationship management project in 2018 and information technology projects during the first quarter of 2018 and decreased legal fees offset by an increase in board of director compensation.

Supplies and communication increased during the second quarter and first six months of 2019 compared to the same periods a year ago. The increase resulted primarily from higher printing costs offset by decreased telephone service and equipment costs.

FDIC and other insurance was lower during the three and six months ended June 30, 2019 compared to the same periods in 2018. The decrease in 2019 was mainly due to lower assessments for FDIC insurance offset by increased general insurance costs.

Business development and marketing expense decreased during the second quarter and first six months of 2019 compared to the same periods a year ago. The reduction was primarily the result of fewer marketing promotions.

Loan and lease collection and repossession expense decreased during the second quarter of 2019 compared to the same period in 2018 and increased during the six months ended June 30, 2019 compared to the same period in 2018. The lower expense during the second quarter of 2019 was mainly due to fewer valuation adjustments on repossessed assets and higher gains on the sale of repossessed assets. The increase during the first half of 2019 was the result of higher general collections and repossession expense compared to the first half of 2018 offset by improved gains on the sale of repossessed assets.

Other expenses increased during the second quarter of 2019 compared to the same period in 2018 and was flat for the first half of 2019 compared to same period in 2018. The increase during the second quarter was primarily related to growth in the provision for unfunded loan commitments and the provision for customer swaps. Additionally, other expense during 2019 included personal property taxes on leased equipment of $0.35 million that are reported gross as required by the new leasing standard effective January 1, 2019. These personal property taxes on leased equipment were offset by a similar increase in other income from the reimbursement of personal property taxes by lessees.

INCOME TAXES

The provision for income taxes for the three and six month periods ended June 30, 2019 was $7.07 million and $13.83 million, compared to $5.53 million and $11.41 million for the same periods in 2018. The effective tax rate was 23.20% and 20.13% for the second quarter ended June 30, 2019 and 2018, respectively and 23.26% and 21.74% for the first six months ended June 30, 2019 and 2018, respectively. A $0.80 million benefit from a state tax settlement during the second quarter of 2018 resulted in an effective tax rate decrease of 2.91% and 1.52% for the three and six months ended June 30, 2018, 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, 2018. For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2018.

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, 2019, 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 2019 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, 2018. For information regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2018.

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, 2019	—	$ —	—	1,031,001
May 01 - 31, 2019	101,212	45.55	101,212	929,789
June 01 - 30, 2019	40,415	44.81	40,415	889,374

* 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 1,110,626 shares.

ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Mine Safety Disclosures.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits

The following exhibits are filed with this report:

31.1	Certification of Chief Executive Officer required by Rule 13a-14(a).
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a).
32.1	Certification pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer.
32.2	Certification pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer.
101.INS	XBRL Instance Document — The instance document does not appear in the interactive data file because its XBRL tags are embedded within the inline XBRL 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	July 18, 2019	/s/ CHRISTOPHER J. MURPHY III
		Christopher J. Murphy III Chairman of the Board and CEO
DATE	July 18, 2019	/s/ ANDREA G. SHORT
		Andrea G. Short Treasurer and Chief Financial Officer Principal Accounting Officer