1ST SOURCE CORP
Form 10-K
February 23, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2006

OR

o **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, Indiana	**46601**
(Address of principal executive offices)	*(Zip Code)*

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

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

Title of Class	Name of Exchange on Which Registered
Floating Rate Cumulative Trust Preferred Securities and related guarantee — $25 par value	**The NASDAQ Stock Market LLC**
Common Stock — without par value	**(NASDAQ Global Select Market)**

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

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 x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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

Large accelerated filer o Accelerated filer x Non-accelerated filer o

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of June 30, 2006 was $363,301,455

The number of shares outstanding of each of the registrant's classes of stock as of February 20, 2007:

Common Stock, without par value -- 22,498,087 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the annual proxy statement for the 2007 annual meeting of shareholders to be held April 26, 2007, are incorporated by reference into Part III.

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PART I

ITEM 1. BUSINESS.

1st SOURCE CORPORATION

1st Source Corporation, an Indiana corporation incorporated in 1971, is a bank holding company headquartered in South Bend, Indiana that provides, through our subsidiaries (collectively referred to as "1st Source"), a broad array of financial products and services. 1st Source Bank ("Bank"), our principal subsidiary, offers commercial and consumer banking services, trust and investment management services, and insurance to individual and business clients through most of our 67 banking center locations in 16 counties, one Trustcorp Mortgage office located in each state of Indiana and Ohio. 1st Source Bank Specialty Finance Group, with 24 locations nationwide, offers specialized financing services for new and used private and cargo aircraft, automobiles and light trucks for leasing and rental agencies, medium and heavy duty trucks, construction equipment, and environmental equipment. While concentrated in certain equipment types, we enjoy serving a very diverse client base. We are not dependent upon any single industry or client. At December 31, 2006, we had consolidated total assets of $3.81 billion, loans and leases of $2.70 billion, deposits of $3.05 billion, and total shareholders' equity of $368.90 million.

Our principal executive office is located at 100 North Michigan Street, South Bend, Indiana 46601 and our telephone number is 574 235-2000. Access to our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports is available, free of charge, at www.1stsource.com soon after the material is electronically filed with the Securities Exchange Commission (SEC). We will provide a printed copy of any of the aforementioned documents to any requesting shareholder.

1st SOURCE BANK

1st Source Bank is a wholly owned subsidiary of 1st Source Corporation that offers a broad range of consumer and commercial banking services through its lending operations, retail branches, and fee based businesses.

Commercial, Agricultural, and Real Estate Loans— 1st Source Bank provides commercial and agriculture loans to corporations and other business clients primarily located within our regional market area. Loans are made for a wide variety of general corporate purposes, including financing for industrial and commercial properties, financing for equipment, inventories and accounts receivable, and acquisition financing. Other services include commercial leasing and cash management services.

Consumer Services— 1st Source Bank provides a full range of consumer banking services, including checking accounts, on-line banking, savings programs, installment and real estate loans, home equity loans and lines of credit, drive-in and night deposit services, safe deposit facilities, automated teller machines, overdraft facilities, debit and credit card services, and brokerage services.

Trust Services— 1st Source Bank provides a wide range of trust, investment, agency, and custodial services for individual and corporate clients. These services include the administration of estates and personal trusts, as well as the management of investment accounts for individuals, employee benefit plans, and charitable foundations.

Specialty Finance Group Services— 1st Source Bank, through its Specialty Finance Group, provides a broad range of comprehensive lease and equipment finance products addressing the financing needs of diverse companies. This Group can be broken down into four areas: auto, light truck, and environmental equipment financing; medium and heavy duty truck financing; aircraft financing; and construction equipment financing.

Auto, light truck, and environmental equipment financing consists of financings to automobile rental and leasing companies, light truck rental and leasing companies, and environmental equipment companies. Auto, light truck, and environmental equipment finance receivables generally range from $50,000 to $15 million with fixed or variable interest rates and terms of two to seven years.

Medium and heavy duty truck financing consists of financings for highway tractors and trailers and delivery trucks to the commercial trucking industry. Medium and heavy duty truck finance receivables generally range from $50,000 to $15 million with fixed or variable interest rates and terms of two to seven years.

Aircraft financing consists of financings for new and used aircraft for individual and corporate aircraft users, aircraft dealers, charter operators, and air cargo carriers. Aircraft finance receivables generally range from $100,000 to $15 million with fixed or variable interest rates and terms of two to ten years.

Construction equipment financing includes financing of equipment (i.e., asphalt and concrete plants, bulldozers, excavators, cranes, and loaders, etc.) to the construction industry. Construction equipment finance receivables generally range from $100,000 to $15 million with fixed or variable interest rates and terms of three to seven years.

We also generate equipment rental income through the leasing of construction equipment, various trucks, and other equipment to clients through operating leases.

SPECIALITY FINANCE GROUP SUBSIDIARIES

The Specialty Finance Group also consists of separate wholly owned subsidiaries of 1st Source Bank which include: Michigan Transportation Finance Corporation, 1st Source Specialty Finance, Inc., SFG Equipment Leasing, Inc., 1st Source Intermediate Holding, LLC, 1st Source Commercial Aircraft Leasing, Inc., and SFG Equipment Leasing Corporation I.

TRUSTCORP MORTGAGE COMPANY

Trustcorp Mortgage Company (Trustcorp) is a mortgage banking company with one office in Indiana and one office in Ohio and is a wholly owned subsidiary of 1st Source Corporation. Trustcorp provides real estate mortgage loan services primarily in the one-to-four family residential housing market. Most of the residential mortgages originated and/or purchased are sold into the secondary market and serviced by Trustcorp.

1st SOURCE INSURANCE, INC.

1st Source Insurance, Inc. is a wholly owned subsidiary of 1st Source Bank that provides insurance services to individuals and businesses covering corporate and personal property products, casualty insurance products, and individual and group health and life insurance products.

1st SOURCE CORPORATION INVESTMENT ADVISORS, INC.

1st Source Corporation Investment Advisors, Inc. is a wholly owned subsidiary of 1st Source Bank that provides investment advisory services to trust and investment clients of 1st Source Bank and to the 1st Source Monogram Funds. 1st Source Corporation Investment Advisors, Inc. is registered as an investment advisor with the Securities and Exchange Commision under the Investment Advisors Act of 1940. 1st Source Corporation Investment Advisors, Inc. serves strictly in an advisory capacity and, as such, does not hold any client securities.

OTHER CONSOLIDATED SUBSIDIARIES

We have various other subsidiaries that are not significant to the consolidated entity.

1st SOURCE CAPITAL TRUST II, III, AND IV

Our unconsolidated subsidiaries include, 1st Source Capital Trust II, III, and IV (1st Source Capital Trust I was dissolved on May 26, 2005). These subsidiaries were created for the purposes of issuing \$17.25 million, \$10.00 million, and \$30.00 million of trust preferred securities, respectively, and lending the proceeds to 1st Source. We guarantee, on a limited basis, payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities.

COMPETITION

The activities in which we and the Bank engage are highly competitive. These activities and the geographic markets served involve competition with other banks, some of which are affiliated with large bank holding companies headquartered outside of our principal market. We generally compete on the basis of client service and responsiveness to client needs, available loan and deposit products, the rates of interest charged on loans and leases, the rates of interest paid for funds, other credit and service charges, the quality of services rendered, the convenience of banking facilities, and in the case of loans and leases to large commercial borrowers, relative lending limits.

In addition to competing with other banks within our primary service areas, the Bank also competes with other financial service companies, such as credit unions, industrial loan associations, securities firms, insurance companies, small loan companies, finance companies, mortgage companies, real estate investment trusts, certain governmental agencies, credit organizations, and other enterprises. Additional competition for depositors' funds comes from United States Government securities, private issuers of debt obligations, and suppliers of other investment alternatives for depositors. Many of our non-bank competitors are not subject to the same extensive Federal regulations that govern bank holding companies and banks. Such non-bank competitors may, as a result, have certain advantages over us in providing some services.

We compete against these financial institutions by offering a full array of products and highly personalized services. We also rely on our history in our core market dating back to 1863, as well as, relationships that long-term colleagues have with our clients, and the capacity we have for quick local decision-making.

EMPLOYEES

At December 31, 2006, we had approximately 1,200 employees on a full-time equivalent basis. We provide a wide range of employee benefits and consider employee relations to be good.

REGULATION AND SUPERVISION

General— 1st Source and the Bank are extensively regulated under Federal and State law. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statutory and regulatory provisions. Any change in applicable laws or regulations may have a material effect on our business and our prospective business. Our operations may be affected by legislative changes and by the policies of various regulatory authorities. We are unable to predict the nature or the extent of the effects on our business and earnings that fiscal or monetary policies, economic controls, or new Federal or State legislation may have in the future.

We are a registered bank holding company under the Bank Holding Company Act of 1956 (BHCA) and, as such, we are subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System (Federal Reserve). We are required to file annual reports with the Federal Reserve and to provide the Federal Reserve such additional information as it may require.

The Bank, as an Indiana state bank and member of the Federal Reserve System, is supervised by the Indiana Department of Financial Institutions (DFI) and the Federal Reserve. As such, the Bank is regularly examined by and subject to regulations promulgated by the DFI and the Federal Reserve. Because the Federal Deposit Insurance Corporation (FDIC) provides deposit insurance to the Bank, the Bank is also subject to supervision and regulation by the FDIC (even though the FDIC is not its primary Federal regulator).

Bank Holding Company Act— Under the BHCA, as amended, our activities are limited to business so closely related to banking, managing, or controlling banks as to be a proper incident thereto. We are also subject to capital requirements applied on a consolidated basis in a form substantially similar to those required of the Bank. The BHCA also requires a bank holding company to obtain approval from the Federal Reserve before (i) acquiring, or holding more than 5% voting interest in any bank or bank holding company, (ii) acquiring all or substantially all of the assets of another bank or bank holding company, or (iii) merging or consolidating with another bank holding company.

The BHCA also restricts non-bank activities to those which, by statute or by Federal Reserve regulation or order, have been identified as activities closely related to the business of banking or of managing or controlling banks. As discussed below, the Gramm-Leach-Bliley Act, which was enacted in 1999, established a new type of bank holding company known as a "financial holding company," that has powers that are not otherwise available to bank holding companies.

Financial Institutions Reform, Recovery and Enforcement Act of 1989— The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) reorganized and reformed the regulatory structure applicable to financial institutions generally.

The Federal Deposit Insurance Corporation Improvement Act of 1991— The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was adopted to supervise and regulate a wide variety of banking issues. In general, FDICIA provides for the recapitalization of the Bank Insurance Fund (BIF), deposit insurance reform, including the implementation of risk-based deposit insurance premiums, the establishment of five capital levels for financial institutions ("well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized") that would impose more scrutiny and restrictions on less capitalized institutions, along with a number of other supervisory and regulatory issues. At December 31, 2006, the Bank was categorized as "well capitalized," meaning that its total risk-based capital ratio exceeded 10.00%, its Tier 1 risk-based capital ratio exceeded 6.00%, its leverage ratio exceeded 5.00%, and it was not subject to a regulatory order, agreement, or directive to meet and maintain a specific capital level for any capital measure.

Federal Deposit Insurance Reform Act— On February 1, 2006, Congress approved the Federal Deposit Insurance Reform Act of 2005 (FDIRA). Among other things, the FDIRA provides for the merger of the Bank Insurance Fund with the Savings Association Insurance Fund and for an immediate increase in Federal deposit insurance for certain retirement accounts up to $250,000. The statute further provides for the indexing of the maximum deposit insurance coverage for all types of deposit accounts in the future to account for inflation. The FDIRA also requires the FDIC to provide certain banks and thrifts that were in existence prior to December 31, 1996 with one-time credits against future premiums based on the amount of their payments to the Bank Insurance Fund or Savings Association Insurance Fund prior to that date.

Securities and Exchange Commission (SEC) and The Nasdaq Stock Market (Nasdaq)— We are under the jurisdiction of the SEC and certain state securities commissions for matters relating to the offering and sale of our securities and our investment advisory services. We are subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the SEC. We are listed on the Nasdaq Global Select Market under the trading symbol "SRCE," and we are subject to the rules of Nasdaq for listed companies.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994— Congress enacted the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Interstate Act) in September 1994. Beginning in September 1995, bank holding companies have the right to expand, by acquiring existing banks, into all states, even those which had theretofore restricted entry. The legislation also provides that, subject to future action by individual states, a holding company has the right to convert the banks which it owns in different states to branches of a single bank. The states of Indiana and Michigan have adopted the interstate branching provisions of the Interstate Act.

Economic Growth and Regulatory Paperwork Reduction Act of 1996— The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA) was signed into law on September 30, 1996. Among other things, EGRPRA streamlined the non-banking activities application process for well-capitalized and well-managed bank holding companies.

Gramm-Leach-Bliley Act of 1999— The Gramm-Leach-Bliley Act of 1999 (GLBA) is intended to modernize the banking industry by removing barriers to affiliation among banks, insurance companies, the securities industry, and other financial service providers. It provides financial organizations with the flexibility of structuring such affiliations through a holding company structure or through a financial subsidiary of a bank, subject to certain limitations. The GLBA establishes a new type of bank holding company, known as a financial holding company, which may engage in an expanded list of activities that are "financial in nature," which include securities and insurance brokerage, securities underwriting, insurance underwriting, and merchant banking. The GLBA also sets forth a system of functional regulation that makes the Federal Reserve the "umbrella supervisor" for holding companies, while providing for the supervision of the holding company’s subsidiaries by other Federal and state agencies. A bank holding company may not become a financial holding company if any of its subsidiary financial institutions are not well-capitalized or well-managed. Further, each bank subsidiary of the holding company must have received at least a satisfactory Community Reinvestment Act (CRA) rating. The GLBA also expands the types of financial activities a national bank may conduct through a financial subsidiary, addresses state regulation of insurance, generally prohibits unitary thrift holding companies organized after May 4, 1999, from participating in new activities that are not financial in nature, provides privacy protection for nonpublic customer information of financial institutions, modernizes the Federal Home Loan Bank system, and makes miscellaneous regulatory improvements. The Federal Reserve and the Secretary of the Treasury must coordinate their supervision regarding approval of new financial activities to be conducted through a financial holding company or through a financial subsidiary of a bank. While the provisions of the GLBA regarding activities that may be conducted through a financial subsidiary directly apply only to national banks, those provisions indirectly apply to state-chartered banks. In addition, the Bank is subject to other provisions of the GLBA, including those relating to CRA and privacy, regardless of whether we elect to become a financial holding company or to conduct activities through a financial subsidiary of the Bank. We do not, however, currently intend to file notice with the Board to become a financial holding company or to engage in expanded financial activities through a financial subsidiary of the Bank.

Financial Privacy— In accordance with the GLBA, Federal banking regulators adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about customers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. The privacy provisions of the GLBA affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

USA Patriot Act of 2001— The USA Patriot Act of 2001 (USA Patriot Act) was signed into law primarily as a result of the terrorist attacks of September 11, 2001. The USA Patriot Act is comprehensive anti-terrorism legislation that, among other things, substantially broadened the scope of anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations on financial institutions.

The regulations adopted by the United States Treasury Department under the USA Patriot Act impose new obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering, and terrorist financing. Additionally, the regulations require that we, upon request from the appropriate Federal regulatory agency, provide records related to anti-money laundering, perform due diligence of private banking and correspondent accounts, establish standards for verifying customer identity, and perform other related duties.

Failure of a financial institution to comply with the USA Patriot Act's requirements could have serious legal and reputational consequences for the institution.

Regulations Governing Capital Adequacy— The Federal bank regulatory agencies use capital adequacy guidelines in their examination and regulation of bank holding companies and banks. If capital falls below the minimum levels established by these guidelines, a bank holding company or bank will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions. The various regulatory capital requirements that we are subject to are disclosed in Part II, Item 8, Financial Statements and Supplementary Data — Note Q of the Notes to Consolidated Financial Statements. Our management believes that the risk-weighting of assets and the risk-based capital guidelines does not have a material adverse impact on our operations or on the operations of the Bank.

Community Reinvestment Act— The Community Reinvestment Act of 1977 requires that, in connection with examinations of financial institutions within their jurisdiction, the Federal banking regulators must evaluate the record of the financial institutions in meeting the credit needs of their local communities, including low and moderate income neighborhoods, consistent with the safe and sound operation of those banks. Federal banking regulators are required to consider a financial institution's performance in these areas as they review applications filed by the institution to engage in mergers or acquisitions or to open a branch or facility.

Regulations Governing Extensions of Credit— The Bank is subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to 1st Source or our subsidiaries, or investments in our securities and on the use of our securities as collateral for loans to any borrowers. These regulations and restrictions may limit our ability to obtain funds from the Bank for our cash needs, including funds for acquisitions and for payment of dividends, interest and operating expenses. Further, the BHCA, certain regulations of the Federal Reserve, state laws and many other Federal laws govern the extensions of credit and generally prohibit a bank from extending credit, engaging in a lease or sale of property, or furnishing services to a customer on the condition that the customer obtain additional services from the bank’s holding company or from one of its subsidiaries.

The Bank is also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal shareholders, or any related interest of such persons. Extensions of credit (i) must be made on substantially the same terms, including interest rates and collateral, and following credit underwriting procedures that are at least as stringent as those prevailing at the time for comparable transactions with persons not covered above and who are not employees, and (ii) must not involve more than the normal risk of repayment or present other unfavorable features. The Bank is also subject to certain lending limits and restrictions on overdrafts to such persons.

Reserve Requirements— The Federal Reserve requires all depository institutions to maintain reserves against their transaction account deposits. Reserves of 3.00% must be maintained against net transaction accounts greater than $7.80 million and less than $48.3 million (subject to adjustment by the Federal Reserve) and reserves of 10.00% must be maintained against that portion of net transaction accounts in excess of $48.3 million.

Dividends — The ability of the Bank to pay dividends and management fees is limited by various state and Federal laws, by certain covenant agreements, by the regulations promulgated by its primary regulators, and by the principles of prudent bank management.

Monetary Policy and Economic Control— The commercial banking business in which we engage is affected not only by general economic conditions, but also by the monetary policies of the Federal Reserve. Changes in the discount rate on member bank borrowing, availability of borrowing at the "discount window," open market operations, the imposition of changes in reserve requirements against member banks deposits and assets of foreign branches, and the imposition of, and changes in, reserve requirements against certain borrowings by banks and their affiliates are some of the instruments of monetary policy available to the Federal Reserve. These monetary policies are used in varying combinations to influence overall growth and distributions of bank loans, investments, and deposits, and such use may affect interest rates charged on loans and leases or paid on deposits. The monetary policies of the Federal Reserve have had a significant effect on the operating results of commercial banks and are expected to do so in the future. The monetary policies of the Federal Reserve are influenced by various factors, including inflation, unemployment, short-term and long-term changes in the international trade balance, and in the fiscal policies of the U.S. Government. Future monetary policies and the effect of such policies on our future business and earnings, and the effect on the future business and earnings of the Bank cannot be predicted.

Sarbanes-Oxley Act of 2002— On July 30, 2002, the Sarbanes-Oxley Act of 2002 (SOA) was signed into law. The SOA's stated goals include enhancing corporate responsibility, increasing penalties for accounting and auditing improprieties at publicly traded companies and protecting investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The SOA generally applies to all companies that file or are required to file periodic reports with the SEC under the Securities Exchange Act of 1934 (Exchange Act.)

Among other things, the SOA creates the Public Company Accounting Oversight Board as an independent body subject to SEC supervision with responsibility for setting auditing, quality control, and ethical standards for auditors of public companies. The SOA also requires public companies to make faster and more-extensive financial disclosures, requires the chief executive officer and the chief financial officer of public companies to provide signed certifications as to the accuracy and completeness of financial information filed with the SEC, and provides enhanced criminal and civil penalties for violations of the Federal securities laws.

The SOA also addresses functions and responsibilities of audit committees of public companies. The statute, by mandating certain stock exchange listing rules, makes the audit committee directly responsible for the appointment, compensation, and oversight of the work of the company's outside auditor, and requires the auditor to report directly to the audit committee. The SOA authorizes each audit committee to engage independent counsel and other advisors, and requires a public company to provide the appropriate funding, as determined by its audit committees, to pay the company's auditors and any advisors that its audit committee retains. The SOA also requires public companies to include an internal control report and assessment by management, along with an attestation to this report prepared by the company's registered public accounting firm, in their annual reports to stockholders.

Pending Legislation— Because of concerns relating to competitiveness and the safety and soundness of the banking industry, Congress often considers a number of wide-ranging proposals for altering the structure, regulation, and competitive relationships of the nation’s financial institutions. We cannot predict whether or in what form any proposals will be adopted or the extent to which our business may be affected thereby.

ITEM 1A. RISK FACTORS.

An investment in our common stock is subject to risks inherent to our business. The material risk and uncertainties that we believe affect us are described below. See "Forward Looking Statements" under Item 7 of this report for a discussion of other important factors that can affect our business.

Fluctuations in interest rates could reduce our profitability and affect the value of our assets — Like other financial institutions, we are subject to interest rate risk. Our primary source of income is net interest income, which is the difference between interest earned on loans and leases and investments, and interest paid on deposits and borrowings. We expect that we will periodically experience imbalances in the interest rate sensitivities of our assets and liabilities and the relationships of various interest rates to each other. Over any defined period of time, our interest-earning assets may be more sensitive to changes in market interest rates than our interest-bearing liabilities, or vice-versa. In addition, the individual market interest rates underlying our loan and lease and deposit products may not change to the same degree over a given time period. In any event, if market interest rates should move contrary to our position, earnings may be negatively affected. In addition, loan and lease volume and quality and deposit volume and mix can be affected by market interest rates as can the businesses of our clients. Changes in levels of market interest rates could have a material adverse affect on our net interest spread, asset quality, origination volume, and overall profitability.

Over the last two years, the Federal Reserve increased its target for Federal funds rate 400 basis points. While these short-term market interest rates (which are used as a guide for pricing deposits) have increased, longer-term market interest rates (which are used as a guide for pricing longer-term loans and leases) have not. If short-term interest rates continue to rise, and if rates on our deposits and borrowings continue to reprice upwards faster than the rates on long-term loans and leases and investments, we could experience continued compression of our interest rate spread and net interest margin, which could have a negative effect on our profitability.

We principally manage interest rate risk by managing the volume and mix of our earning assets and funding liabilities. In a changing interest rate environment, we may not be able to manage this risk effectively. If we are unable to manage interest rate risk effectively, our business, financial condition and results of operations could be materially harmed.

Changes in the level of interest rates also may negatively affect our ability to originate loans and leases, the value of our assets and our ability to realize gains from the sale of our assets, all of which ultimately could affect our earnings.

Future expansion involves risks — In the future, we may acquire all or part of other financial institutions and we may establish de novo branch offices. There could be considerable costs involved in executing our growth strategy. For instance, new branches generally require a period of time to generate sufficient revenues to offset their costs, especially in areas in which we do not have an established presence. Accordingly, any new branch expansion could be expected to negatively impact earnings for some period of time until the branch reaches certain economies of scale. Acquisitions and mergers involve a number of risks, including the risk that:

- We may incur substantial costs identifying and evaluating potential acquisitions and merger partners, or in evaluating new markets, hiring experienced local managers, and opening new offices;
- Our estimates and judgments used to evaluate credit, operations, management, and market risks relating to target institutions may not be accurate;
- There may be substantial lag-time between completing an acquisition or opening a new office and generating sufficient assets and deposits to support costs of the expansion;

- We may not be able to finance an acquisition, or the financing we obtain may have an adverse effect on our operating results or dilution of our existing shareholders;
- The attention of our management in negotiating a transaction and integrating the operations and personnel of the combining businesses may be diverted from our existing business;
- Acquisitions typically involve the payment of a premium over book and market values and; therefore, some dilution of our tangible book value and net income per common share may occur in connection with any future transaction;
- We may enter new markets where we lack local experience;
- We may incur goodwill in connection with an acquisition, or the goodwill we incur may become impaired, which results in adverse short-term effects on our operating results; or
- We may lose key employees and clients.

Competition from other financial services providers could adversely impact our results of operations— The banking and financial services business is highly competitive. We face competition in making loans and leases, attracting deposits and providing insurance, investment, trust, and other financial services. Increased competition in the banking and financial services businesses may reduce our market share, impair our growth or cause the prices we charge for our services to decline. Our results of operations may be adversely impacted in future periods depending upon the level and nature of competition we encounter in our various market areas.

We are dependent upon the services of our management team — Our future success and profitability is substantially dependent upon our management and the banking abilities of our senior executives. We believe that our future results will also depend in part upon our ability to attract and retain highly skilled and qualified management. We are especially dependent on a limited number of key management personnel, many of whom do not have employment agreements with us. The loss of the chief executive officer and other senior management and key personnel could have a material adverse impact on our operations because other officers may not have the experience and expertise to readily replace these individuals. Many of these senior officers have primary contact with our clients and are extremely important in maintaining personalized relationships with our client base. The unexpected loss of services of one or more of these key employees could have a material adverse effect on our operations and possibly result in reduced revenues if we were unable to find suitable replacements promptly. Competition for senior personnel is intense, and we may not be successful in attracting and retaining such personnel. Changes in key personnel and their responsibilities may be disruptive to our businesses and could have a material adverse effect on our businesses, financial condition, and results of operations.

Technology security breaches could expose us to possible liability and damage our reputation— Any compromise of our security also could deter our clients from using our internet banking services that involve the transmission of confidential information. We rely on standard internet security systems to provide the security and authentication necessary to effect secure transmission of data. These precautions may not protect our systems from compromises or breaches of our security measures that could result in damage to our reputation and business.

Failure to successfully implement a project we have undertaken to replace the majority of our core and ancillary data processing systems, would negatively impact our business —During 2006, we continued to work toward the implementation of our new core system. Complete conversion is slated for 2007. The replacement of our core systems has wide-reaching impacts on our internal operations and business. We can provide no assurance that the amount of this investment will not exceed our expectations and result in materially increased levels of expense or asset impairment charges. There is no assurance that this initiative will achieve the expected cost savings or result in a positive return on our investment. Additionally, if our new core system does not operate as intended, or is not implemented as planned, there could be disruptions in our business which could adversely affect our financial condition and results of operations.

We are subject to credit risks relating to our loan and lease portfolios — We have certain lending policies and procedures in place that are designed to optimize loan and lease income within an acceptable level of risk. Our management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing our management with frequent reports related to loan and lease production, loan quality, concentrations of credit, loan and lease delinquencies, and nonperforming and potential problem loans and leases. Diversification in the loan and lease portfolios is a means of managing risk associated with fluctuations and economic conditions.

We maintain an independent loan review department that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to our management. The loan and lease review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as our policies and procedures.

In the financial services industry, there is always a risk that certain borrowers may not repay borrowings. Our reserve for loan and lease losses may not be sufficient to cover the loan and lease losses that we may actually incur. If we experience defaults by borrowers in any of our businesses, our earnings could be negatively affected. Changes in local economic conditions could adversely affect credit quality, particularly in our local business loan and lease portfolio. Changes in national economic conditions could also adversely affect the quality of our loan and lease portfolio and negate, to some extent, the benefits of national diversification through our Specialty Finance Group’s portfolio.

Commercial and commercial real estate loans generally involve higher credit risks than residential real estate and consumer loans. Because payments on loans secured by commercial real estate or equipment are often dependent upon the successful operation and management of the underlying assets, repayment of such loans may be influenced to a great extent by conditions in the market or the economy. We seek to minimize these risks through our underwriting standards. We obtain financial information and perform credit risk analysis on our customers. Credit criteria may include, but are not limited to, assessments of income, cash flows, and net worth; asset ownership; bank and trade credit reference; credit bureau report; and operational history.

Commercial real estate or equipment loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and generate positive cash flows. Our management examines current and projected cash flows of the borrower to determine the ability of the borrower to repay their obligations as agreed. Underwriting standards are designed to promote relationship banking rather than transactional banking. Most commercial and industrial loans are secured by the assets being financed or other business assets; however, some loans may be made on an unsecured basis. Our credit policy sets different maximum exposure limits both by business sector and our current and historical relationship and previous experience with each customer.

We offer both fixed-rate and adjustable-rate consumer mortgage loans secured by properties, substantially all of which are located in our primary market area. Adjustable-rate mortgage loans help reduce our exposure to changes in interest rates; however, during periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase as a result of repricing and the increased payments required from the borrower. Additionally, most residential mortgages are sold into the secondary market and serviced by our mortgage subsidiary, Trustcorp.

Consumer loans are primarily all other non-real estate loans to individuals in our regional market area. Consumer loans can entail risk, particularly in the case of loans that are unsecured or secured by rapidly depreciating assets. In these cases, any repossessed collateral may not provide an adequate source of repayment of the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower’s continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness, or personal bankruptcy.

The 1st Source Specialty Finance Group loan and lease portfolio consists of commercial loans and leases secured by construction and transportation equipment, including aircraft, autos, trucks, and vans. Finance receivables for this Group generally provide for monthly payments and may include prepayment penalty provisions.

Our construction and transportation related businesses could be adversely affected by slow downs in the economy. Clients who rely on the use of assets financed through the Specialty Finance Group to produce income could be negatively affected, and we could experience substantial loan and lease losses. By the nature of the businesses these clients operate in, we could be adversely affected by continued rapid increases of fuel costs. Since some of the relationships in these industries are large (up to $15 million), a slow down could have a significant adverse impact on our performance.

Our construction and transportation related businesses could be adversely impacted by the negative effects caused by high fuel costs, terrorist attacks, potential attacks, and other destabilizing events. These factors could contribute to the deterioration of the quality of our loan and lease portfolio, as they could have a negative impact on the travel sensitive businesses for which our specialty finance businesses provide financing.

In addition, our leasing and equipment financing activity is subject to the risk of cyclical downturns, industry concentration and clumping, and other adverse economic developments affecting these industries and markets. This area of lending, with transportation in particular, is dependent upon general economic conditions and the strength of the travel, construction, and transportation industries.

ITEM 1B. UNRESOLVED STAFF COMMENTS.

None

ITEM 2. PROPERTIES.

Our headquarters building is located in downtown South Bend. In 1982, the land was leased from the City of South Bend on a 49-year lease, with a 50-year renewal option. The building is part of a larger complex, including a 300-room hotel and a 500-car parking garage. Also, in 1982, we sold the building and entered into a leaseback agreement with the purchaser for a term of 30 years. The building is a structure of approximately 160,000 square feet, with 1st Source and our subsidiaries occupying approximately 70% of the available office space and approximately 30% subleased to unrelated tenants.

At December 31, 2006, we also owned property and/or buildings on which 46 of the Bank subsidiary's 67 banking centers were located, including the facilities in Allen, Elkhart, Fulton, Huntington, Kosciusko, LaPorte, Marshall, Porter, St. Joseph, Starke, and Wells Counties in the State of Indiana and Berrien and Cass Counties in the State of Michigan, as well as an operations center, training facility, warehouse, and our former headquarters building, which is utilized for additional business operations. The Bank leases additional property and/or buildings to and from third parties under lease agreements negotiated at arms-length.

ITEM 3. LEGAL PROCEEDINGS.

1st Source and our subsidiaries are involved in various legal proceedings incidental to the conduct of our businesses. Our 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 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

None

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

Our common stock is traded on the Nasdaq Global Select Market under the symbol "SRCE." The following table sets forth for each quarter the high and low sales prices for our common stock, as reported by Nasdaq, and the cash dividends paid per share for each quarter.

Common Stock Prices*	**2006 Sales Price**		**Cash Dividends**	2005 Sales Price		Cash Dividends
(quarter ended)	**High**	**Low**	**Paid**	High	Low	Paid
March 31	**$ 27.26**	**$ 22.64**	**$ .127**	$ 23.49	$ 18.54	$ .109
June 30	**30.81**	**24.68**	**.127**	21.64	17.65	.109
September 30	**31.33**	**28.46**	**.140**	23.54	20.06	.109
December 31	**33.46**	**29.08**	**.140**	23.72	19.02	.118

As of December 31, 2006, there were 1,037 holders of record of 1st Source common stock

* The computation of per common share data gives retroactive recognition to a 10% stock dividend declared July 27, 2006.

COMPARISON OF FIVE YEAR CUMULATIVE TOTAL RETURN*

Among 1st Source, NASDAQ Market Index and Peer Group Index*****

* Assumes $100 invested on December 31, 2001, in 1st Source Corporation common stock, Nasdaq market index, and peer group index.

** The NASDAQ Market Index is calculated using all companies which trade on the Nasdaq National Market System or on the NASD Supplemental Listing. It includes both domestic and foreign companies.

*** The peer group is a market-capitalization-weighted stock index of 62 banking companies in Indiana, Michigan, Ohio, and Wisconsin.

NOTE: Total return assumes reinvestment of dividends.

The following table summarizes our share repurchase activity during the three months ended December 31, 2006.

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
October 01 - 31, 2006	-	$	-	-	954,796
November 01 - 30, 2006	5,571		30.80	5,571	949,225
December 01 - 31, 2006	536		31.47	536	948,689

*1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on April 27, 2006. Under the terms of the plan, 1st Source may repurchase up to 1,025,248 shares of its common stock when favorable conditions exist on the open market or through private transactions at various prices from time to time. Since the inception of the plan, 1st Source has repurchased a total of 76,559 shares.

Federal laws and regulations contain restrictions on the ability of 1st Source and the Bank to pay dividends. For information regarding restrictions on dividends, see Part I, Item 1, Business - Regulation and Supervision - Dividends and Part II, Item 8, Financial Statements and Supplementary Data - Note Q of the Notes to Consolidated Financial Statements.

ITEM 6. SELECTED FINANCIAL DATA.

The following selected financial data should be read in conjunction with our Consolidated Financial Statements and the accompanying notes presented elsewhere herein.

(Dollars in thousands, except per share amounts)		**2006**		2005		2004		2003		2002
Interest income	$	**208,994**	$	168,532	$	151,437	$	162,322	$	199,503
Interest expense		**102,561**		70,104		52,749		59,070		80,817
Net interest income		**106,433**		98,428		98,688		103,252		118,686
(Recovery of) provision for loan and lease losses		**(2,736)**		(5,855)		229		17,361		39,657
Net interest income after (recovery of) provision for loan and lease losses		**109,169**		104,283		98,459		85,891		79,029
Noninterest income		**76,585**		68,533		62,733		80,196		73,117
Noninterest expense		**126,211**		123,439		127,091		138,904		140,741
Income before income taxes		**59,543**		49,377		34,101		27,183		11,405

Income taxes	**20,246**	15,626	9,136	8,029	1,366
Net income	**$ 39,297**	$ 33,751	$ 24,965	$ 19,154	$ 10,039
Assets at year-end	**$ 3,807,315**	$ 3,511,277	$ 3,563,715	$ 3,330,153	$ 3,407,468
Long-term debt and mandatorily redeemable securities at year-end	**43,761**	23,237	17,964	22,802	16,878
Shareholders' equity at year-end	**368,904**	345,576	326,600	314,691	309,429
Basic net income per common share *	**1.74**	1.48	1.10	0.83	0.44
Diluted net income per common share *	**1.72**	1.46	1.08	0.82	0.43
Cash dividends per common share*	**.534**	.445	.382	.336	.327
Dividend payout ratio	**31.05%**	30.48%	35.37%	40.98%	76.05%
Return on average assets	**1.11%**	1.00%	0.75%	0.59%	0.29%
Return on average common equity	**10.98%**	10.12%	7.81%	6.12%	3.23%
Average common equity to average assets	**10.07%**	9.89%	9.55%	9.60%	8.95%

* The computaion of per common share data gives retroactive recognition to a 10% stock dividend declared July 27, 2006.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION.

The purpose of this analysis is to provide the reader with information relevant to understanding and assessing our results of operations for each of the past three years and financial condition for each of the past two years. In order to fully appreciate this analysis the reader is encouraged to review the consolidated financial statements and statistical data presented in this document.

FORWARD-LOOKING STATEMENTS

This report, including Management's Discussion and Analysis of Financial Condition and Results of Operations, contains forward-looking statements. Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions, and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. Words such as “believe”, “contemplate”, “seek”, “estimate”, “plan”, “project”, “anticipate”, “assume”, “expect”, “intend”, “targeted”, “remain”, “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. Forward-looking statements provide current expectations or forecasts of future events and are not guarantees of future performance, nor should they be relied upon as representing management’s views as of any subsequent date. The forward-looking statements are based on our expectations and are subject to a number of risks and uncertainties.

All written or oral forward-looking statements that are made by or attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise, or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made. We have expressed our expectations, beliefs, and projections in good faith and we believe they have a reasonable basis. However, we make no assurances that our expectations, beliefs, or projections will be achieved or accomplished. These forward-looking statements may not be realized due to a variety of factors, including, without limitation, the following:

- Local, regional, national, and international economic conditions and the impact they may have on us and our clients and our assessment of that impact.
- Changes in the level of nonperforming assets and charge-offs.
- Changes in estimates of future cash reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements.
- The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board.
- Inflation, interest rate, securities market, and monetary fluctuations.
- Political instability.
- Acts of war or terrorism.
- Substantial increases in the cost of fuel.
- The timely development and acceptance of new products and services and perceived overall value of these products and services by others.
- Changes in consumer spending, borrowings, and savings habits.
- Changes in the financial performance and/or condition of our borrowers.
- Technological changes.
- Acquisitions and integration of acquired businesses.
- The ability to increase market share and control expenses.
- Changes in the competitive environment among bank holding companies.
- The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities, and insurance) with which we and our subsidiaries must comply.
- The effect of changes in accounting policies and practices and auditing requirements, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board, and other accounting standard setters.
- Changes in our organization, compensation, and benefit plans.
- The costs and effects of legal and regulatory developments including the resolution of legal proceedings or regulatory or other governmental inquires and the results of regulatory examinations or reviews.
- Greater than expected costs or difficulties related to the integration of new products and lines of business.
- Our success at managing the risks described in Item 1A. Risk Factors.

EXECUTIVE SUMMARY

Our mission is to help individuals, institutions, businesses, and communities achieve security, build wealth, and realize their dreams. We accomplish our mission by maintaining a high degree of integrity, offering outstanding client service, attaining superior quality in everything we do, working as a team, and providing leadership in the communities we serve.

We have established goals in our 2010 strategic plan which are being driven by six initiatives - develop our people; vitalize sales; roll out full services in all markets; open new markets; upgrade our core systems; and achieve superior financial performance.

In order to meet our 2010 objectives we have focused our staff development on recruiting, hiring, and retaining employees who share our core values of being accessible and attentive to the needs of our clients. To vitalize sales, we opened newly designed banking centers to give better service and more convenience to our customers. We focused on small business clients and became the #1 SBA lender in Northern Indiana and Southwestern Michigan in 2006; and we piloted a program of retail bankers who became "micro-lenders" serving the needs of small business clients. In Fort Wayne, we added private banking, agricultural and small business banking, investment and asset management, and business banking to our service offerings. In our retail banking system, we added asset advisors to assist our clients in investments and we opened a new banking center in our traditional market.

In 2006, we also focused on opening in totally new markets. To gain new clients, we opened a facility in Kalamazoo which will initially focus on private banking and small business clients; and have hired leadership for our efforts in Lafayette, Indiana which will open in 2007. Additionally, we conducted significant analysis on areas within our own markets and across the country to showcase opportunities where 1st Source might expand through de novo branching or acquisitions. Our goal is to find acquisition partners that are culturally similar and possess significant market presence or have potential for improved profitability through financial management, economies of scale, and expanded services. Consistent with our goal of growth market expansion, on February 19, 2007, we announced the agreement and plan of merger with FINA Bancorp, Inc., the parent company of First National Bank, Valparaiso. Pending customary closing conditions, including regulatory approval, we expect the merger to be completed in the second quarter of 2007. We believe this acquisition provides us with an opportunity to join two strong local banks with similar values, history, and legacies. First National Bank, Valparaiso is located in the fastest growing area of our retail market and will serve as a platform for future expansion.

None of this can be accomplished without the proper infrastructure. We are in the process of replacing our core accounting and management systems that will allow us to grow and expand by becoming more effective and efficient. A major portion of this will be installed during 2007.

CRITICAL ACCOUNTING POLICIES

Our consolidated financial statements are prepared in accordance with U. S. generally accepted accounting principles and follow general practices within the industries in which we operate. Application of these principles requires our management to make estimates or judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates or judgments reflect our management's view of the most appropriate manner in which to record and report our overall financial performance. Because these estimates or judgments are based on current circumstances, they may change over time or prove to be inaccurate based on actual experience. As such, changes in these estimates, judgments, and/or assumptions may have a significant impact on our financial statements. All accounting policies are important, and all policies described in Part II, Item 8, Financial Statements and Supplementary Data, Note A (Note A), should be reviewed for a greater understanding of how our financial performance is recorded and reported.

We have identified three policies as being critical because they require our management to make particularly difficult, subjective, and/or complex estimates or judgments about matters that are inherently uncertain and because of the likelihood that materially different amounts would be reported under different conditions or using different assumptions. These policies relate to the determination of the reserve for loan and lease losses, the valuation of mortgage servicing rights, and the valuation of securities. Our management has used the best information available to make the estimations or judgments necessary to value the related assets and liabilities. Actual performance that differs from estimates or judgments and future changes in the key variables could change future valuations and impact net income. Our management has reviewed the application of these policies with the Audit Committee of the Board of Directors. A brief discussion of our critical accounting policies appears below.

Reserve for Loan and Lease Losses— The reserve for loan and lease losses represents our management's estimate of probable losses inherent in the loan and lease portfolio and the establishment of a reserve that is sufficient to absorb those losses. In determining an adequate reserve, our management makes numerous judgments, assumptions, and estimates based on continuous review of the loan and lease portfolio, estimates of future client performance, collateral values, and disposition, as well as historical loss rates and expected cash flows. In assessing these factors, our management benefits from a lengthy organizational history and experience with credit decisions and related outcomes. Nonetheless, if our management's underlying assumptions prove to be inaccurate, the reserve for loan and lease losses would have to be adjusted. Our accounting policy related to the reserve is disclosed in Note A under the heading "Reserve for Loan and Lease Losses."

Mortgage Servicing Rights Valuation— We recognize as assets the rights to service mortgage loans for others, known as mortgage servicing rights whether the servicing rights are acquired through purchases or through originated loans. Mortgage servicing rights do not trade in an active open market with readily observable market prices. Although sales of mortgage servicing rights do occur, the precise terms and conditions may not be readily available. As such, the value of mortgage servicing assets are established and valued using discounted cash flow modeling techniques which require management to make estimates regarding estimated future net servicing cash flows, taking into consideration actual and expected mortgage loan prepayment rates, discount rates, servicing costs, and other economic factors. The expected and actual rates of mortgage loan prepayments are the most significant factors driving the value of mortgage servicing assets. Increases in mortgage loan prepayments reduce estimated future net servicing cash flows because the life of the underlying loan is reduced. In determining the fair value of the mortgage servicing assets, mortgage interest rates (which are used to determine prepayment rates), and discount rates are held constant over the estimated life of the portfolio. Expected mortgage loan prepayment rates are derived from a third-party model and adjusted to reflect our actual prepayment experience. Mortgage servicing assets are carried at the lower of the initial capitalized amount, net of accumulated amortization or fair value. The values of these assets are sensitive to changes in the assumptions used and readily available market pricing does not exist. The valuation of mortgage servicing assets is discussed further in Note A under the heading "Mortgage Banking Activities."

Valuation of Securities—Our available-for-sale security portfolio is reported at fair value. The fair value of a security is determined based on quoted market prices. If quoted market prices are not available, fair value is determined based on quoted prices of similar instruments. Available-for-sale and held-to-maturity securities are reviewed quarterly for possible other-than-temporary impairment. The review includes an analysis of the facts and circumstances of each individual investment such as length of time the fair value has been below cost, the expectation for that security's performance, the credit worthiness of the issuer, and our intent and ability to hold the security for a time necessary to recover the amortized cost. A decline in value that is considered to be other-than-temporary is recorded as investment securities and other investment losses in the Consolidated Statements of Income. The valuation of securities is discussed further in Note A under the heading "Securities."

EARNINGS SUMMARY

Net income in 2006 was $39.30 million, up from $33.75 million in 2005 and up from $24.97 million in 2004. We declared a 10% stock dividend on July 27, 2006; therefore, all share and per share information has been adjusted accordingly. Diluted net income per common share was $1.72 in 2006, $1.46 in 2005, and $1.08 in 2004. Return on average total assets was 1.11% in 2006 compared to 1.00% in 2005, and 0.75% in 2004. Return on average common shareholders' equity was 10.98% in 2006 versus 10.12% in 2005, and 7.81% in 2004.

Net income in 2006 was favorably affected by a strong increase in noninterest income that was primarily related to solid progress in growing our leased equipment portfolio during the year and positive market valuation adjustments related to our investments in venture partnerships. Net interest income improved 8.13% for 2006 over 2005. The improvement in net interest income was driven primarily by an increase in average earning assets; however, the higher cost of deposits greatly offset the increase in average earning assets. Noninterest expense increased moderately in 2006 as compared to 2005. Net income in 2005 was favorably affected by a recovery in the provision for loan and lease losses, a reduction in loan and lease collection and repossession expense, and decreased professional fee expense. In addition, income from deposit fees increased and losses on investment securities decreased notably from 2005 and 2004. Equipment rental income decreased and depreciation on leased equipment decreased accordingly in 2005 from 2004. We did not record any other-than-temporary impairment on investment securities in 2006. Net income included $0.61 million and $4.78 million of other-than-temporary impairment on investment securities, for 2005 and 2004, respectively.

Dividends paid on common stock in 2006 amounted to $0.534 per share, compared to $0.445 per share in 2005, and $0.382 per share in 2004. The level of earnings reinvested and dividend payouts are based on management's assessment of future growth opportunities and the level of capital necessary to support them.

Upgrade of Core Systems— On December 1, 2005, 1st Source Bank, entered into a license and service agreement with Fiserv Solutions, Inc. (Fiserv), a subsidiary of Fiserv, Inc. The agreement was an integral part of the decision we made to upgrade a majority of our core and ancillary data processing systems. We expect the completion of core systems upgrade will increase the effectiveness and efficiency of our operations and facilitate future growth. We also expect that, over time, this investment should be offset by elimination of current costs for ongoing support of the current technology platform.

Under the agreement, 1st Source and our affiliates are licensing integrated core technology and ancillary systems from Fiserv. The core technology licensing includes a loan system, deposit system, general ledger system, and customer information file system. Fiserv is obligated to provide professional services for installation of the technology and training, and maintenance support services. The agreement provides an initial five year maintenance period to begin no later than March 2007. The agreement provides for automatic renewal of the maintenance period, after the initial five year term, unless either party notifies the other of its intent not to renew. We are subject to termination fees for early termination of the maintenance period. We expect the initial cost will be approximately $6.0 million for the technology licenses, professional fees for installation and training, and hardware delivered under the Fiserv agreement.

During 2006, we worked to organize the various components of this large conversion effort. Numerous internal teams have been formed to manage the installation and conversion of data and various systems. Additionally, ATM networks, a voice response unit (VRU) system, and document imaging systems have been or are being installed. We are relying on several third party vendors to integrate several systems, including internet banking and cash management. Our intent is to convert independent systems, such as the legacy centralized information repository and document image systems, as they are ready. Our goal is to convert the core systems in 2007. Our timeframe for conversion could be impacted by the delivery of systems from outside vendors, as well as our own internal testing. We will implement these new systems only when we are confident and certain of their successful conversion. We look forward to the implementation of new core systems and their impact on the effectiveness and efficiency of our operations and the increased functionality that will facilitate future growth.

Net Interest Income— Our primary source of earnings is net interest income, the difference between income on earning assets and the cost of funds supporting those assets. Significant categories of earning assets are loans and securities while deposits and borrowings represent the major portion of interest-bearing liabilities. For purposes of the following discussion, comparison of net interest income is done on a tax equivalent basis, which provides a common basis for comparing yields on earning assets exempt from federal income taxes to those which are fully taxable.

Net interest margin (the ratio of net interest income to average earning assets) is affected by movements in interest rates and changes in the mix of earning assets and the liabilities that fund those assets. Net interest margin on a fully taxable equivalent basis was 3.29% in 2006 compared to 3.21% in 2005, and 3.25% in 2004. Our focus on loan and lease portfolio credit quality coupled with increased competition for deposits across all markets offset efforts to improve the net interest margin resulting in nominal changes in our net interest margin for the past three years.

Net interest income was $106.43 million for 2006, compared to $98.43 million for 2005. Tax-equivalent net interest income totaled $108.98 million for 2006, an increase of $7.88 million from the $101.10 million reported for 2005. The increase reflects a $5.97 million increase due to increased volume and a $1.91 million increase due to rate changes on the underlying assets and liabilities.

During 2006, average earning assets increased $162.87 million while average interest-bearing liabilities increased $189.66 million over the comparable period. The yield on average earning assets increased 95 basis points to 6.38% for 2006 from 5.43% for 2005. The rate earned on assets was positively impacted by the continued increases in short-term market interest rates throughout 2005 and the first two quarters of 2006. Total cost of average interest-bearing liabilities increased 98 basis points during 2006 as liabilities were also affected by increases in short-term market interest rates. The result was a decrease of three basis points to net interest spread, or the difference between interest income on earning assets and expense on interest-bearing liabilities. Our tax-equivalent net interest margin of 3.29% for 2006 was a moderate increase from 3.21% in 2005.

The largest contributor to the increase in the yield on average earning assets in 2006, on a volume-weighted basis, was the $217.53 million increase in net loans and leases. The loan and lease portfolio contributed approximately $34.83 million to the change in interest income, while the portfolio's average yield increased 84 basis points from the prior year to 6.94%.

During 2006, the tax-equivalent yield on securities available for sale increased 103 basis points to 4.23% while the average balance decreased $58.51 million. Although the portfolio decreased through the year, the average tax-equivalent yield increased due to the addition of higher-rate securities and the maturities of lower-rate securities. Funds received from the maturities, calls, and sales of investment securities helped fund loan growth.

Average interest-bearing deposits increased $200.42 million during 2006 while the effective rate paid on those deposits increased 98 basis points. The increase in the average cost of interest-bearing deposits was primarily the result of increases in interest rates offered on deposit products due to increases in short-term market interest rates and increased competition for deposits across all markets.

Average demand deposits decreased $40.27 million during 2006. Much of the decline was attributed to fact that clients preferred the interest provided on fixed-term Certificates on Deposit over the liquidity provided by noninterest bearing deposit accounts and low interest bearing savings accounts.

Average short-term borrowings decreased $29.45 million during 2006; however, the effective rate paid increased 122 basis points. Average subordinated notes which represent our trust preferred borrowings remained unchanged from 2005 to 2006 while the effective rate increased 53 basis points. Interest paid on short-term and trust preferred borrowings increased due to the interest rate increase in adjustable rate borrowings. Average long-term debt increased $18.68 million during 2006 as the effective rate declined 32 basis points. The majority of the increase in long-term debt was made up of Federal Home Loan Bank (FHLB) borrowings.

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

(Dollars in thousands)	**2006** Average Balance	**2006** Interest Income/ Expense	**2006** Yield/ Rate	2005 Average Balance	2005 Interest Income/ Expense	2005 Yield/ Rate	2004 Average Balance	2004 Interest Income/ Expense	2004 Yield/ Rate
ASSETS									
Investment securities:									
Taxable	**$ 470,447**	**$ 19,816**	**4.21%**	$ 515,992	$ 14,777	2.86%	$ 590,786	$ 16,361	2.77%
Tax-exempt	**173,652**	**7,416**	**4.27**	186,614	7,682	4.12	171,600	7,502	4.37
Mortgages held for sale	**53,034**	**3,549**	**6.69**	82,174	4,779	5.82	69,964	3,868	5.53
Net loans and leases	**2,566,217**	**178,125**	**6.94**	2,348,690	143,295	6.10	2,240,055	125,469	5.60
Other investments	**51,754**	**2,632**	**5.09**	18,765	666	3.55	49,585	952	1.92
Total earning assets	**3,315,104**	**211,538**	**6.38**	3,152,235	171,199	5.43	3,121,990	154,152	4.94
Cash and due from banks	**78,365**			84,517			81,334		
Reserve for loan and lease losses	**(59,082)**			(61,072)			(69,567)		
Other assets	**217,914**			197,457			215,607		
Total assets	**$ 3,552,301**			$ 3,373,137			$ 3,349,364		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest bearing deposits	**$ 2,418,344**	**$ 85,067**	**3.52%**	$ 2,217,923	$ 56,341	2.54%	$ 2,105,013	$ 41,698	1.98%
Short-term borrowings	**265,824**	**11,011**	**4.14**	295,271	8,628	2.92	405,192	6,079	1.50
Subordinated notes	**59,022**	**4,320**	**7.32**	59,022	4,008	6.79	57,198	3,863	6.75
Long-term debt and mandatorily redeemable securities	**36,952**	**2,163**	**5.85**	18,270	1,127	6.17	22,921	1,109	4.84
Total interest bearing liabilities	**2,780,142**	**102,561**	**3.69**	2,590,486	70,104	2.71	2,590,324	52,749	2.04
Noninterest bearing deposits	**352,204**			392,475			384,157		
Other liabilities	**62,196**			56,553			55,146		
Shareholders' equity	**357,759**			333,623			319,737		
Total liabilities and shareholders' equity	**$ 3,552,301**			$ 3,373,137			$ 3,349,364		
Net interest income		**$ 108,977**			$ 101,095			$ 101,403	
Net interest margin on a tax equivalent basis			**3.29%**			3.21%			3.25%

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The change in interest due to both rate and volume has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each. The following table shows changes in tax equivalent interest earned and interest paid, resulting from changes in volume and changes in rates:

	Increase (Decrease) due to		
(Dollars in thousands)	Volume	Rate	Net
2006 compared to 2005			
Interest earned on:			
Investment securities:			
Taxable	**$ (1,169)**	**$ 6,208**	**$ 5,039**
Tax-exempt	**(568)**	**302**	**(266)**
Mortgages held for sale	**(2,143)**	**913**	**(1,230)**
Net loans and leases	**14,009**	**20,821**	**34,830**
Other investments	**1,576**	**390**	**1,966**
Total earning assets	**$ 11,705**	**$ 28,634**	**$ 40,339**
Interest paid on:			
Interest bearing deposits	**$ 5,395**	**$ 23,331**	**$ 28,726**
Short-term borrowings	**(747)**	**3,130**	**2,383**
Subordinated notes	**-**	**312**	**312**
Long-term debt and mandatorily redeemable securities	**1,091**	**(55)**	**1,036**
Total interest bearing liabilities	**$ 5,739**	**$ 26,718**	**$ 32,457**
Net interest income	**$ 5,966**	**$ 1,916**	**$ 7,882**
2005 compared to 2004			
Interest earned on:			
Investment securities:			
Taxable	$ (2,139)	$ 555	$ (1,584)
Tax-exempt	534	(354)	180
Mortgages held for sale	700	211	911
Net loans and leases	6,273	11,553	17,826
Other investments	781	(1,067)	(286)
Total earning assets	$ 6,149	$ 10,898	$ 17,047
Interest paid on:			
Interest bearing deposits	$ 2,323	$ 12,320	$ 14,643
Short-term borrowings	(1,020)	3,569	2,549
Subordinated notes	122	23	145
Long-term debt and mandatorily redeemable securities	(51)	69	18
Total interest bearing liabilities	$ 1,374	$ 15,981	$ 17,355
Net interest income	$ 4,775	$ (5,083)	$ (308)

Noninterest Income— Noninterest income for the most recent three years ended December 31 was as follows:

(Dollars in thousands)	**2006**	2005	2004
Noninterest income:			
Trust fees	**$ 13,806**	$ 12,877	$ 12,361
Service charges on deposit accounts	**19,040**	17,775	16,228

Mortgage banking income		**11,637**		10,868		9,553
Insurance commissions		**4,574**		4,133		3,695
Equipment rental income		**18,972**		16,067		18,856
Other income		**6,554**		6,463		6,759
Investment securities and other investment gains (losses)		**2,002**		350		(4,719)
Total noninterest income	**$**	**76,585**	$	68,533	$	62,733

Noninterest income increased 11.75% in 2006 over 2005 mainly due to increases in the operating lease portfolio that resulted in increased equipment rental income; market valuation adjustments that resulted in gains on venture partnership investments; growth in assets under management and an increase in IRA custodian revenue that resulted in increased trust fee income; and increased overdraft and NSF activity that resulted in increased service charges on deposit accounts. Noninterest income increased 9.25% in 2005 from 2004 mainly due to recoveries of mortgage servicing rights impairment, decreased charges for other-than-temporary impairment of securities, and market valuation adjustments resulting in gains on partnership investments.

Equipment rental income generated from operating leases grew by 18.08% during 2006 from 2005 compared to a decrease of 14.79% in 2005 from 2004. Revenues from operating leases for construction equipment, various trucks, and other equipment increased as clients responded positively to our strong marketing efforts and entered into new lease agreements over the course of 2006. Revenues for 2005 were negatively affected due to maturities of leases and revenues for 2004 were negatively affected as clients opted to take advantage of the tax benefits available for purchases of equipment versus equipment rental.

Investment securities and other investment gains totaled $2.00 million for the year ended 2006 compared to $0.35 million for the year ended 2005. Favorable market valuation adjustments on our venture partnership investments during 2006 were the main factor contributing to the gains. Gains on venture capital investments during 2005 were partially offset by other-than-temporary impairment of $0.61 million for 2005. In 2004, investment securities and other investment losses totaled $4.72 million, of this amount $4.58 million was comprised of other-than-temporary impairment charges on investments in Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) preferred stock.

Service charges on deposit accounts increased 7.12% in 2006 from 2005 compared to an increase of 9.53% in 2005 from 2004. Growth in the number of deposit accounts led to increased consumer NSF and overdraft fees.

Trust fees (which includes investment management fees, estate administration fees, mutual fund fees, annuity fees, and fiduciary fees) increased by 7.21% in 2006 from 2005 compared to an increase of 4.17% in 2005 over 2004. Trust fees are largely based on the size of client relationships and the market value and mix of assets under management. The market value of trust assets under management at December 31, 2006 and 2005, were $2.98 billion and $2.66 billion, respectively. At December 31, 2006, these trust assets were comprised of $1.49 billion of personal and agency trusts, $1.03 billion of employee benefit plan assets, $358.84 million of estate administration assets, and $98.56 million of custody assets. Growth in trust fees was mainly attributed to an increase in assets under management coupled with a stronger stock and bond market in 2006. A weaker stock and bond market slowed the growth of trust fees in 2005 from 2004.

Mortgage banking income increased 7.08% in 2006 over 2005, compared to an increase of 13.77% in 2005 from 2004. The increase in 2006 was primarily due to $4.75 million, pre-tax gains on bulk sales of mortgage servicing rights related to both governmental and conventional loans that occurred during the second and third quarters. The increase in 2005 was primarily the result of a recovery of impairment on mortgage servicing assets of $2.27 million versus impairment recoveries of $0.28 million during 2004. During 2006 and 2005, we determined that no permanent write-down was necessary for previously recorded impairment on mortgage servicing assets. Mortgage production declined 17.96% during 2006 compared to 2005 as the Bank and Trustcorp, jointly, produced $678.14 million in new mortgages --$103.00 million through the Bank; $126.89 million through Trustcorp; and $448.25 million from wholesale production sources. During 2005, the Bank and Trustcorp together produced $826.63 million in new mortgages -- $139.06 million through the Bank; $214.05 million through Trustcorp; and $473.52 million purchased from wholesale production sources.

Insurance commissions were up 10.67% in 2006 from 2005 compared to an increase of 11.85% in 2005 from 2004. The increases for 2006 and 2005 were mainly attributed to higher contingent commissions and new business sales growth, respectively.

Other income remained relatively unchanged in 2006 as compared to 2005 compared to a decrease of 4.38% in 2005 from 2004. The decline in other income during 2005 was primarily the result of lower standby letter of credit fee income which decreased by $0.17 million and miscellaneous fee income which decreased by $0.31 million.

Noninterest Expense— Noninterest expense for the recent three years ended December 31 was as follows:

(Dollars in thousands)	**2006**	2005	2004
Noninterest expense:			
Salaries and employee benefits	**$ 66,605**	$ 69,767	$ 63,083
Net occupancy expense	**7,492**	7,749	7,196
Furniture and equipment expense	**12,316**	11,418	10,290

Depreciation — leased equipment	**14,958**	12,895	15,315
Professional fees	**3,998**	3,362	6,563
Supplies and communications	**5,496**	5,462	5,708
Business development and marketing expense	**4,008**	3,630	3,613
Intangible asset amortization	**1,910**	2,663	2,631
Loan and lease collection and repossession expense	**704**	(1,094)	4,946
Other expense	**8,724**	7,587	7,746
Total noninterest expense	**$ 126,211**	$ 123,439	$ 127,091

In 2006 we experienced an increase in noninterest expense of 2.25% from 2005 compared to a decrease of 2.87% in 2005 from 2004. The leading factors contributing to the increase in noninterest expense in 2006 were increased depreciation expense on leased equipment, lower gains and valuation adjustments on repossessed assets, and higher professional fees. The increase in 2006 was partially offset by decreases in salaries and employee benefits, net occupancy expense, and intangible asset amortization. The decline in noninterest expense in 2005 was mostly due to reduced professional fees, decreased depreciation on leased equipment, and a decline in loan and lease collection and repossession expenses.

Total salaries and employee benefits decreased 4.53% in 2006 from 2005, following a 10.60% increase in 2005 from 2004.

Employee salaries decreased 5.56% in 2006 compared to an increase of 7.65% in 2005. The decrease in salaries in 2006 was primarily due to the first quarter 2006 reversal of previously recognized stock-based compensation expense under historical accounting methods related to the estimated forfeiture of stock awards. This one-time expense reversal, combined with the adoption of Statement of Financial Accounting Standards No. 123(R), *Share-based Payment*, (SFAS No. 123(R)) estimated forfeiture accounting requirements, resulted in a reduction in stock-based compensation of $2.07 million, pre-tax, for the year. The increase in salaries in 2005 was primarily the result of merit-based and market-driven salary increases and increased commissions due to higher insurance revenues.

Employee benefits remained relatively stable in 2006, following a 23.70% increase in 2005. We were able to contain employee benefit costs during 2006 as our group insurance costs for 2006 were maintained close to 2005 levels.

Occupancy expense decreased 3.32% in 2006 from 2005, compared to a 7.68% increase in 2005 from 2004. The decrease in 2006 was primarily driven by lower depreciation expense than that experienced in 2005. The increase in 2005 was primarily due to higher leasehold improvements and repair of premises expenses.

Furniture and equipment expense, including depreciation, increased in 2006 over 2005 by 7.86%, compared to a 10.96% increase in 2005 from 2004. Higher software costs which were mostly related to implementation of upgrades to our core accounting and management systems, and higher debit card transaction expense were the significant factors contributing to the increased costs in 2006. The leading causes for the increase in 2005 were increased third-party processing charges and desktop computer upgrades.

Depreciation on equipment owned under operating leases increased 16.00% in 2006 from 2005, following a 15.80% decrease in 2005 from 2004. In 2006, depreciation on equipment owned under operating leases increased in conjunction with the increase in equipment rental income as some of our clients opted to enter into new lease arrangements rather than purchase equipment. Conversely, during 2005, depreciation on operating leases declined in conjunction with the decline in noninterest income from equipment owned under operating leases due to maturities in the operating lease portfolio and clients who opted to take advantage of the tax benefits available for purchases of equipment versus equipment rental during 2004.

Professional fees increased 18.92% in 2006 from 2005, compared to a 48.77% decrease in 2005 from 2004. The majority of the increase in 2006 was due to higher legal fees and audit and examination fees which were mainly incurred in the normal course of business. The decrease in 2005 was mainly due to the settlement, during the fourth quarter of 2004, of the lawsuit described in the 2003 Form 10-K Item 3, Legal Proceedings and a reduction in the associated legal fees.

Supplies and communications expense remained relatively unchanged in 2006 as compared to 2005. Supplies and communications expense decreased 4.31% in 2005 from 2004. The decrease in 2005 was primarily due to lower charges for postage and freight and telephone service.

Business development and marketing expense increased 10.41% in 2006 from 2005. The increase in 2006 was mainly due to robust marketing related to the opening of new branches and expansion of our business into the Kalamazoo area. Business development and marketing expense remained relatively steady for the year 2005 as compared to 2004.

Intangible asset amortization decreased 28.28% in 2006 from 2005 compared to a 1.22% increase in 2005 from 2004. The decrease in intangible asset amortization for 2006 was primarily due to the effects of the complete amortization of assets associated with acquisitions which occurred during 2001. The increase in 2005 was due to amortization related to an insurance agency acquisition made during the year.

Loan and lease collection and repossession expenses increased 164.35% (or $1.80 million) in 2006 as compared to 2005. Loan and lease collection and repossession expenses decreased 122.12% (or $6.04 million) in 2005 from 2004. The increase in 2006 was mainly due to lower gains on the disposition of repossessed assets as we continued to vigorously dispose of our inventory of repossessed assets. In 2005 and 2004, valuation adjustments on repossessed assets continued to decrease along with a decrease in legal and collection expenses. From 2003 through 2005, we took back 72 aircraft in repossession and all of those repossessed aircraft had been disposed of as of December 31, 2006.

Other expenses increased 14.99% in 2006 as compared to 2005. The increase was largely due to losses related to an employee defalcation and expenses related to employee training and education and relocation. A decrease of 2.05% occurred in other expenses during 2005, compared to 2004. Lower insurance cost was the primary factor for the decline for 2005.

Income Taxes— 1st Source recognized income tax expense in 2006 of $20.25 million, compared to $15.63 million in 2005, and $9.14 million in 2004. The effective tax rate in 2006 was 34.00% compared to 31.65% in 2005, and 26.79% in 2004. The effective tax rate increased in 2006 due to a decrease in tax-exempt interest in relation to taxable income. For detailed analysis of 1st Source’s income taxes see Part II, Item 8, Financial Statements and Supplementary Data —

Note N of the Notes to Consolidated Financial Statements.

FINANCIAL CONDITION

Loan and Lease Portfolio— The following table shows 1st Source's loan and lease distribution at the end of each of the last five years as of December 31:

(Dollars in thousands)	**2006**	2005	2004	2003	2002
Commercial and agricultural loans	**$ 478,310**	$ 453,197	$ 425,018	$ 402,905	$ 428,367
Auto, light truck and environmental equipment	**317,604**	310,786	263,637	269,490	247,883
Medium and heavy duty truck	**341,744**	302,137	267,834	221,562	197,312
Aircraft financing	**498,914**	459,645	444,481	489,155	323,802
Construction equipment financing	**305,976**	224,230	196,516	219,562	303,126
Loans secured by real estate	**632,283**	601,077	583,437	533,749	567,950
Consumer loans	**127,706**	112,359	99,245	94,577	111,012
Total loans and leases	**$ 2,702,537**	$ 2,463,431	$ 2,280,168	$ 2,231,000	$ 2,179,452

At December 31, 2006, 16.9% and 12.6% of total loans and leases were concentrated with borrowers in trucking and truck leasing and construction end users, respectively.

Average loans and leases, net of unearned discount, increased 9.26% and 4.85% in 2006 and 2005, respectively. Loans and leases, net of unearned discount, at December 31, 2006, were $2.70 billion and were 70.98% of total assets, compared to $2.46 billion and 70.16% of total assets at December 31, 2005.

Commercial and agricultural lending, excluding those loans secured by real estate, increased 5.54% in 2006 over 2005. Commercial and agricultural lending outstandings were $478.31 million and $453.20 million at December 31, 2006 and December 31, 2005, respectively. This increase was mainly due to increased sales activity within the commercial loan and small business loan areas coupled with improved market conditions and market expansion.

Loans secured by real estate increased 5.19% during 2006 over 2005. Loans secured by real estate outstanding at December 31, 2006, were $632.28 million and $601.08 million at December 31, 2005. The primary focus of this lending area is commercial real estate ($412.52 million at December 31, 2006, the majority of which is owner occupied) and residential mortgage lending ($219.76 million at December 31, 2006) in the regional market area. This increase was mostly due to business clients' continued investment in real estate for expansion or relocation of their commercial facilities and our ability to meet those funding needs.

Auto, light truck, and environmental equipment financing increased 2.19% in 2006 over 2005. At December 31, 2006, auto, light truck, and environmental equipment financing had outstandings of $317.60 million and $310.79 million at December 31, 2005. Environmental equipment financing increased 21.07% in 2006 over 2005, most of this increase was in the municipal equipment lease portfolio as a result of focused sales activity. Auto and light truck financing decreased 4.93% at December 31, 2006 compared to December 31, 2005, mainly due to car rental companies reducing their inventories during the off-season in order to avoid higher interest costs.

Medium and heavy duty truck loans and leases experienced growth of $39.61 million, or an increase of 13.11%, in 2006. Medium and heavy duty truck financing at December 31, 2006 and 2005, had outstandings of $341.74 million and $302.14 million, respectively. Most of the increase at December 31, 2006 from December 31, 2005 can be attributed to clients' making proactive decisions to contain their future costs by completing purchases of 2007 new tractor needs in 2006. Most of our clients were affected by a new regulatory standard which mandated that, effective January 1, 2007, all Class 8 diesel trucks produced have emission compliant engines. This requirement will increase the cost of each vehicle approximately $6,000 to $9,000.

Aircraft financing at year-end 2006 increased 8.54% from year-end 2005. Aircraft financing at December 31, 2006 and 2005, had outstandings of $498.91 million and $459.65 million, respectively. The increase in 2006 was primarily due to rigorous marketing efforts and a strong focus on sales.

Construction equipment financing increased 36.46% in 2006 over 2005. Construction equipment financing at December 31, 2006, had outstandings of $305.98 million, compared to outstandings of $224.23 million at December 31, 2005. The increase at December 31, 2006 from December 31, 2005 was mainly the result of continued strong commercial, industrial, and non-residential building industries, as well as, substantial Federal, state and local funding for roads, bridges, and general transportation projects upon which our client base relies for business. During 2006, we added two new sales territories which further enhanced growth in this portfolio.

Consumer loans increased 13.66% in 2006 over 2005. Consumer loans outstanding at December 31, 2006, were $127.71 million and $112.36 million at December 31, 2005. Successful marketing to new and established clients was the main factor in the increase.

The following table shows the maturities of loans and leases in the categories of commercial and agriculture, auto, light truck and environmental equipment, medium and heavy duty truck, aircraft and construction equipment outstanding as of December 31, 2006. The amounts due after one year are also classified according to the sensitivity to changes in interest rates.

(Dollars in thousands)	0-1 Year	1-5 Years	Over 5 Years	Total
Commercial and agricultural loans	$ 274,867	$ 183,103	$ 20,340	$ 478,310
Auto, light truck and environmental equipment	145,567	166,002	6,035	317,604
Medium and heavy duty truck	100,896	231,197	9,651	341,744
Aircraft financing	111,769	348,080	39,065	498,914
Construction equipment financing	89,991	212,473	3,512	305,976
Total	**$ 723,090**	**$ 1,140,855**	**$ 78,603**	**$ 1,942,548**

Rate Sensitivity *(Dollars in thousands)*	Fixed Rate	Variable Rate	Total
1 - 5 Years	$ 840,995	$ 299,860	$ 1,140,855
Over 5 Years	35,752	42,851	78,603

Total	**$**	**876,747**	**$**	**342,711**	**$**	**1,219,458**

Most of the Bank's residential mortgages are sold into the secondary market and serviced by our mortgage subsidiary, Trustcorp Mortgage Company (Trustcorp). Mortgage loans held for sale were $50.16 million at December 31, 2006 and were $67.22 million at December 31, 2005.

CREDIT EXPERIENCE

Reserve for Loan and Lease Losses— Our reserve for loan and lease losses is provided for by direct charges to operations. Losses on loans and leases are charged against the reserve and likewise, recoveries during the period for prior losses are credited to the reserve. Our management evaluates the adequacy of the reserve quarterly, reviewing all loans and leases over a fixed-dollar amount ($100,000) where the internal credit rating is at or below a predetermined classification, actual and anticipated loss experience, current economic events in specific industries, and other pertinent factors including general economic conditions. Determination of the reserve is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows or fair value of collateral on collateral-dependent impaired loans and leases, estimated losses on pools of homogeneous loans and leases based on historical loss experience, and consideration of economic trends, all of which may be susceptible to significant and unforeseen changes. We review the status of the loan and lease portfolio to identify borrowers that might develop financial problems in order to aid borrowers in the handling of their accounts and to mitigate losses. See Part II, Item 8, Financial Statements and Supplementary Data — Note A of the Notes to Consolidated Financial Statements for additional information on management’s evaluation of the adequacy of the reserve for loan and lease losses.

The reserve for loan and lease losses at December 31, 2006 totaled $58.80 million and was 2.18% of loans and leases, compared to $58.70 million or 2.38% of loans and leases at December 31, 2005 and $63.67 million or 2.79% of loans and leases at December 31, 2004. It is our opinion that the reserve for loan and lease losses was adequate to absorb losses inherent in the loan and lease portfolio as of December 31, 2006.

The recovery of provision for loan and lease losses was $2.74 million and $5.86 million for 2006 and 2005, respectively, compared to the provision for loan and lease losses of $0.23 million in 2004. The recovery of the provision for 2006 and 2005 was consistent with our improved credit quality of the loan and lease portfolio.

The following table summarizes our loan and lease loss experience for each of the last five years ended December 31:

(Dollars in thousands)	**2006**	2005	2004	2003	2002
Amounts of loans and leases outstanding at end of period	**$ 2,702,537**	$ 2,463,431	$ 2,280,168	$ 2,231,000	$ 2,179,452
Average amount of net loans and leases outstanding during period	**$ 2,566,217**	$ 2,348,690	$ 2,240,055	$ 2,091,004	$ 2,332,992
Balance of reserve for loan and lease losses at beginning of period	**$ 58,697**	$ 63,672	$ 70,045	$ 59,218	$ 57,624
Charge-offs:					
Commercial and agricultural loans	**1,038**	1,478	6,104	1,187	2,376
Auto, light truck and environmental equipment	**340**	630	2,408	2,789	6,380
Medium and heavy duty truck	**-**	15	352	69	771
Aircraft financing	**1,126**	2,424	3,585	6,877	27,401
Construction equipment financing	**118**	-	686	4,712	2,326
Loans secured by real estate	**129**	167	456	344	340
Consumer loans	**1,203**	858	1,090	1,560	2,127
Total charge-offs	**3,954**	5,572	14,681	17,538	41,721
Recoveries:					
Commercial and agricultural loans	**1,594**	1,308	1,312	519	1,311
Auto, light truck and environmental equipment	**430**	1,140	1,277	1,182	616
Medium and heavy duty truck	**59**	174	14	-	-
Aircraft financing	**3,612**	2,255	4,460	1,698	759
Construction equipment financing	**753**	1,065	547	248	465
Loans secured by real estate	**31**	89	107	11	26
Consumer loans	**316**	421	362	523	481
Total recoveries	**6,795**	6,452	8,079	4,181	3,658
Net (recoveries) charge-offs	**(2,841)**	(880)	6,602	13,357	38,063
(Recoveries) provisions charged to operating expense	**(2,736)**	(5,855)	229	17,361	39,657
Reserves acquired in acquisitions	**-**	-	-	6,823	-
Balance at end of period	**$ 58,802**	$ 58,697	$ 63,672	$ 70,045	$ 59,218
Ratio of net (recoveries) charge-offs to average net					

loans and leases outstanding	**(0.11)%**	(0.04)%	0.29%	0.64%	1.63%

Net (recoveries) charge-offs as a percentage of average loans and leases by portfolio type follow:

	2006	2005	2004	2003	2002
Commercial and agricultural loans	**(0.12) %**	0.04 %	1.14 %	0.16 %	0.23 %
Auto, light truck and environmental equipment	**(0.03)**	(0.17)	0.43	0.62	2.27
Medium and heavy duty truck	**(0.02)**	(0.06)	0.14	0.03	0.47
Aircraft financing	**(0.54)**	0.04	(0.19)	1.73	6.40
Construction equipment financing	**(0.24)**	(0.51)	0.07	1.67	0.55
Loans secured by real estate	**0.02**	0.01	0.06	0.06	0.05
Consumer loans	**0.74**	0.41	0.77	1.04	1.39
Total net (recoveries) charge-offs to average portfolio loans and leases	**(0.11) %**	(0.04) %	0.29 %	0.64 %	1.63 %

The reserve for loan and lease losses has been allocated according to the amount deemed necessary to provide for the estimated probable losses that have been incurred within the categories of loans and leases set forth in the table below. The amount of such components of the reserve at December 31 and the ratio of such loan and lease categories to total outstanding loan and lease balances, are as follows (for purposes of this analysis, auto, light truck and environmental equipment and medium and heavy duty truck loans and leases have been consolidated into the category truck and automobile financing):

	2006		2005		2004		2003		2002	
(Dollars in thousands)	**Reserve Amount**	**Percent of Loans and Leases in Each Category to Total Loans and Leases**	Reserve Amount	Percent of Loans and Leases in Each Category to Total Loans and Leases	Reserve Amount	Percent of Loans and Leases in Each Category to Total Loan and Leases	Reserve Amount	Percent of Loans and Leases in Each Category to Total Loans and Leases	Reserve Amount	Percent of Loans and Leases in Each Category to Total Loans and Leases
Commercial and agricultural loans	**$ 14,547**	**17.70%**	$ 15,472	18.40%	$ 13,612	18.64%	$ 9,589	18.06%	$ 11,163	19.65%
Truck and automobile financing	**13,359**	**24.40**	13,008	24.88	12,633	23.31	13,966	22.01	11,006	20.43
Aircraft financing	**18,621**	**18.46**	19,583	18.66	26,475	19.49	31,733	21.93	21,603	14.86
Construction equipment financing	**5,030**	**11.32**	4,235	9.10	4,502	8.62	9,061	9.84	9,394	13.91
Loans secured by real estate	**4,672**	**23.40**	4,058	24.40	4,187	25.59	3,798	23.92	3,656	26.06
Consumer loans	**2,573**	**4.72**	2,341	4.56	2,263	4.35	1,898	4.24	2,396	5.09
Total	**$ 58,802**	**100.00%**	$ 58,697	100.00%	$ 63,672	100.00%	$ 70,045	100.00%	$ 59,218	100.00%

Nonperforming Assets— Our policy is to discontinue the accrual of interest on loans and leases where principal or interest is past due and remains unpaid for 90 days or more, except for mortgage loans, which are placed on nonaccrual at the time the loan is placed in foreclosure and consumer loans that are both well secured and in the process of collection. Nonperforming assets amounted to $17.67 million at December 31, 2006, compared to $22.04 million at December 31, 2005, and $33.21 million at December 31, 2004. Impaired loans and leases totaled $12.32 million, $16.87 million, and $45.39 million at December 31, 2006, 2005, and 2004, respectively. During 2006, interest income that would have been recorded on nonaccrual loans and leases under their original terms was $1.90 million, compared to $2.19 million in 2005. Interest income that was recorded on nonaccrual loans and leases was $0.62

million and $0.81 million in 2006 and 2005, respectively.

Nonperforming assets at December 31, 2006, decreased 19.84% from December 31, 2005. During 2006, decreases in repossessed assets, commercial and agricultural loans, construction equipment financing, auto, light truck and environmental equipment, other real estate, and consumer loans were partially offset by increases in medium and heavy duty truck, loans secured by real estate, and aircraft financing.

Nonperforming assets at December 31 *(Dollars in thousands)*	**2006**	2005	2004	2003	2002
Loans past due over 90 days	**$ 116**	$ 245	$ 481	$ 212	$ 154
Nonaccrual loans and leases and restructured loans:					
Commercial and agricultural loans	**1,768**	3,701	6,928	2,795	4,819
Auto, light truck and environmental equipment	**481**	812	2,336	2,419	4,730
Medium and heavy duty truck	**1,755**	17	179	1,823	1,384
Aircraft financing	**8,219**	7,641	10,132	12,900	12,281
Construction equipment financing	**853**	2,513	4,097	4,663	9,844
Loans secured by real estate	**2,214**	1,475	1,141	1,786	2,191
Consumer loans	**285**	393	440	699	415
Total nonaccrual loans and leases and restructured loans	**15,575**	16,552	25,253	27,085	35,664
Total nonperforming loans and leases	**15,691**	16,797	25,734	27,297	35,818
Other real estate	**800**	960	1,307	3,010	4,362
Repossessions:					
Commercial and agricultural loans	**2**	-	-	34	-
Auto, light truck and environmental equipment	**178**	128	1,112	847	1,364
Medium and heavy duty truck	**-**	-	-	-	-
Aircraft financing	**300**	4,073	3,037	4,551	19,242
Construction equipment financing	**400**	-	183	753	681
Consumer loans	**95**	83	50	78	56
Total repossessions	**975**	4,284	4,382	6,263	21,343
Operating leases	**201**	-	1,785	257	2,594
Total nonperforming assets	**$ 17,667**	$ 22,041	$ 33,208	$ 36,827	$ 64,117
Nonperforming loans and leases to loans and leases, net of unearned discount	**0.58%**	0.68%	1.13%	1.22%	1.64%
Nonperforming assets to loans and leases and operating leases, net of unearned discount	**0.64%**	0.87%	1.42%	1.59%	2.79%

Potential Problem Loans and Leases— At December 31, 2006, the Bank had a $2.95 million standby letter of credit outstanding which supported bond indebtedness of a customer. If this standby letter of credit is funded, due to the current financial condition of the customer, the Bank likely will foreclose on the real estate securing the customer's reimbursement obligation. This likely will result in an increase in other real estate for approximately the same amount as the funding.

At December 31, 2006, our management was not aware of any potential problem loans or leases that would have a material effect on loan and lease delinquency or loan and lease charge-offs. Loans and leases are subject to continual review and are given management's attention whenever a problem situation appears to be developing.

INVESTMENT PORTFOLIO

The amortized cost of securities at year-end 2006 increased 11.16% from 2005, following a 19.30% decrease from year-end 2004 to year-end 2005. The amortized cost of securities at December 31, 2006 was $709.09 million or 18.62% of total assets, compared to $637.88 million or 18.17% of total assets at December 31, 2005.

The amortized cost of securities available-for-sale as of December 31 is summarized as follows:

(Dollars in thousands)		**2006**		2005		2004
U.S. Treasury and government agencies, including agency mortgage-backed securities	**$**	**466,326**	$	415,793	$	552,949
States and political subdivisions		**182,356**		179,797		171,338
Other securities		**60,409**		42,288		66,117
Total investment securities available-for-sale	**$**	**709,091**	$	637,878	$	790,404

Yields on tax-exempt obligations are calculated on a fully tax equivalent basis assuming a 35% tax rate. The following table shows the maturities of securities available-for-sale at December 31, 2006, at the amortized costs and weighted average yields of such securities:

(Dollars in thousands)		Amount	Yield
U.S. Treasury and government agencies, including agency mortgage-backed securities			
Under 1 year	$	344,393	5.36%
1 - 5 years		53,450	3.38
5 - 10 years		6,589	5.13
Over 10 years		61,894	5.34
Total U.S. Treasury and government agencies, including agency mortgage-backed securities		**466,326**	**5.13**
States and political subdivisions			
Under 1 year		47,658	5.27
1 - 5 years		96,616	5.74
5 - 10 years		38,082	7.20
Over 10 years		-	-
Total states and political subdivisions		**182,356**	**5.92**
Other securities			

Under 1 year		20,170	5.34
1 - 5 years		3,925	2.92
5 - 10 years		75	6.55
Over 10 years		-	-
Marketable equity securities		36,239	5.81
Total other securities		**60,409**	**5.47**
Total investment securities available-for-sale	**$**	**709,091**	**5.36%**

DEPOSITS

The average daily amounts of deposits and rates paid on such deposits are summarized as follows:

		2006			2005			2004	
(Dollars in thousands)		**Amount**	**Rate**		Amount	Rate		Amount	Rate
Noninterest bearing demand deposits	**$**	**352,204**	**-%**	$	392,475	-%	$	384,157	-%
Interest bearing demand deposits		**715,242**	**2.51**		784,366	1.78		707,168	0.88
Savings deposits		**190,347**	**0.44**		210,151	0.30		228,836	0.29
Other time deposits		**1,512,755**	**4.38**		1,223,406	3.41		1,169,009	2.98
Total	**$**	**2,770,548**	**-**	$	2,610,398	-	$	2,489,170	-

The amount of certificates of deposit of $100,000 or more and other time deposits of $100,000 or more outstanding at December 31, 2006, by time remaining until maturity is as follows:

(Dollars in thousands)		
Under 3 months	$	206,555
4 - 6 months		69,420
7 - 12 months		148,966
Over 12 months		195,836
Total	**$**	**620,777**

Scheduled maturities of time deposits, including both private and public funds, at December 31, 2006 were as follows:

(Dollars in thousands)		
2007	$	1,161,555
2008		324,772
2009		104,491
2010		16,318
2011		8,686
Thereafter		18,176
Total	**$**	**1,633,998**

SHORT-TERM BORROWINGS

The following table shows the distribution of our short-term borrowings and the weighted average interest rates thereon at the end of each of the last three years. Also provided are the maximum amount of borrowings and the average amount of borrowings, as well as weighted average interest rates for the last three years.

(Dollars in thousands)	Federal Funds Purchased and Security Repurchase Agreements	Commercial Paper	Other Short-Term Borrowings	Total Borrowings
2006				
Balance at December 31, 2006	**$ 195,262**	**$ 10,907**	**$ 16,549**	**$ 222,718**
Maximum amount outstanding at any month-end	**265,362**	**12,922**	**90,689**	**368,973**
Average amount outstanding	**211,973**	**7,997**	**45,854**	**265,824**
Weighted average interest rate during the year	**3.95%**	**4.99%**	**4.87%**	**4.14%**
Weighted average interest rate for outstanding amounts at December 31,2006	**3.41%**	**5.08%**	**4.89%**	**3.60%**
2005				
Balance at December 31, 2005	$ 230,756	$ 4,600	$ 42,113	$ 277,469
Maximum amount outstanding at any month-end	273,428	5,552	122,038	401,018
Average amount outstanding	214,199	2,054	79,018	295,271

Weighted average interest rate during the year	2.55%	3.36%	3.91%	2.92%
Weighted average interest rate for outstanding amounts at December 31,2005	3.86%	3.88%	2.76%	3.70%
2004				
Balance at December 31, 2004	$ 216,751	$ 836	$ 82,075	$ 299,662
Maximum amount outstanding at any month-end	411,812	1,152	113,958	526,922
Average amount outstanding	295,172	815	109,205	405,192
Weighted average interest rate during the year	1.15%	1.23%	2.46%	1.50%
Weighted average interest rate for outstanding amounts at December 31, 2004	2.09%	1.72%	2.09%	2.09%

LIQUIDITY

Core Deposits— Our major source of investable funds is provided by stable core deposits consisting of all interest bearing and noninterest bearing deposits, excluding brokered certificates of deposit and certain certificates of deposit of $100,000 and over. In 2006, average core deposits equaled 63.27% of average total assets, compared to 67.60% in 2005 and 66.97% in 2004. The effective cost rate of core deposits in 2006 was 2.65%, compared to 1.96% in 2005 and 1.59% in 2004.

Average demand deposits (noninterest bearing core deposits) decreased 10.26% in 2006 compared to an increase of 2.17% in 2005. These represented 15.67% of total core deposits in 2006, compared to 17.21% in 2005, and 17.13% in 2004.

Purchased Funds— We use purchased funds to supplement core deposits and include certain certificates of deposit of $100,000 and over, brokered certificates of deposit, Federal funds, securities sold under agreements to repurchase, commercial paper, and other short-term borrowings. Purchased funds are raised from customers seeking short-term investments and are used to manage the Bank's interest rate sensitivity. During 2006, our reliance on purchased funds increased to 22.21% of average total assets from 18.55% in 2005.

Shareholders' Equity— Average shareholders' equity equated to 10.07% of average total assets in 2006 compared to 9.89% in 2005. Shareholders' equity was 9.69% of total assets at year-end 2006, compared to 9.84% at year-end 2005. In accordance with SFAS No. 115, *"Accounting for Certain Investments in Debt and Equity Securities,"* we include unrealized gain (loss) on available-for-sale securities, net of income taxes, as accumulated other comprehensive income (loss) which is a component of shareholders' equity. While regulatory capital adequacy ratios exclude unrealized gain (loss), it does impact our equity as reported in the audited financial statements. The unrealized loss on available-for-sale securities, net of income taxes, was $0.26 million and $3.24 million at December 31, 2006 and 2005, respectively.

Liquidity Risk Management— The Bank's liquidity is monitored and closely managed by the Asset/Liability Management Committee (ALCO), whose members are comprised of the Bank's senior management. Asset and liability management includes the management of interest rate sensitivity and the maintenance of an adequate liquidity position. The purpose of interest rate sensitivity management is to stabilize net interest income during periods of changing interest rates.

Liquidity management is the process by which the Bank ensures that adequate liquid funds are available to meet financial commitments on a timely basis. Financial institutions must maintain liquidity to meet day-to-day requirements of depositors and borrowers, take advantage of market opportunities and provide a cushion against unforeseen needs.

Liquidity of the Bank is derived primarily from core deposits, principal payments received on loans, the sale and maturity of investment securities, net cash provided by operating activities, and access to other funding sources. The most stable source of liability funded liquidity is deposit growth and retention of the core deposit base. The principal source of asset-funded liquidity is available-for-sale investment securities, cash and due from banks, Federal funds sold, securities purchased under agreements to resell, and loans and interest bearing deposits with other banks maturing within one year. Additionally, liquidity is provided by repurchase agreements, and the ability to borrow from the Federal Reserve Bank and Federal Home Loan Bank.

Interest Rate Risk Management— ALCO monitors and manages the relationship of earning assets to interest bearing liabilities and the responsiveness of asset yields, interest expense, and interest margins to changes in market interest rates. In the normal course of business, we face ongoing interest rate risks and uncertainties. We occasionally utilize interest rate swaps to partially manage the primary market exposures associated with the interest rate risk related to underlying assets, liabilities, and anticipated transactions.

A hypothetical change in earnings was modeled by calculating an immediate 100 basis point (1.00%) change in interest rates across all maturities. This analysis presents the hypothetical change in earnings of those rate sensitive financial instruments and interest rate swaps which we held at December 31, 2006. The aggregate hypothetical decrease in pre-tax earnings was estimated to be $0.92 million on an annualized basis on all rate-sensitive financial instruments, based on a hypothetical increase of a 100 basis point change in interest rates. The aggregate hypothetical increase in pre-tax earnings was estimated to be $0.59 million on an annualized basis on all rate-sensitive financial instruments based on a hypothetical decrease of a 100 basis point change in interest rates. The earnings simulation model excludes the earnings dynamics related to how fee income and noninterest expense may be affected by changes in interest rates. Actual results may differ materially from those projected. The use of this methodology to quantify the market risk of the balance sheet should not be construed as an endorsement of its accuracy or the accuracy of the related assumptions. At December 31, 2006, the impact of these hypothetical fluctuations in interest rates on our derivative holdings was not significant, and, as such, separate disclosure is not presented.

Due to the nature of the mortgage banking business, we manage the earning assets and interest-bearing liabilities of Trustcorp on a separate basis. The predominant assets on Trustcorp's balance sheet are mortgage loans held for sale, which are funded by short-term borrowings (normally less than 30 days). These borrowings are managed on a daily basis. We fund a portion of Trustcorp's other borrowings for working capital.

Trustcorp manages the interest rate risk related to loan commitments by entering into contracts for future delivery of loans with outside parties. See Part II, Item 8, Financial Statements and Supplementary Data — Note O of the Notes to Consolidated Financial Statements.

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

In the ordinary course of operations, we enter into certain contractual obligations. Such obligations include the funding of operations through debt issuances as well as leases for premises and equipment. The following table summarizes our significant fixed, determinable, and estimated contractual obligations, by payment date, at December 31, 2006, except for obligations associated with short-term borrowing arrangements. Payments for borrowings do not include interest. Further discussion of the nature of each obligation is included in the referenced note to the consolidated financial statements.

Contractual obligations payments by period.

(Dollars in thousands)	Note	0 - 1 Year	1 - 3 Years	3 - 5 Years	Over 5 Years	Indeterminate maturity	Total
Deposits without stated maturity	-	$ 1,414,287	$ 0	$ 0	$ 0	$ 0	$ 1,414,287
Certificates of deposit	-	1,161,555	429,263	25,004	18,176	0	1,633,998
Long-term debt and mandatorily redeemable securities	J	10,407	25,789	481	903	6,181	43,761
Subordinated notes	L	0	0	0	59,022	0	59,022
Operating leases	O	2,680	4,359	3,322	1,484	0	11,845
Purchase obligations	-	30,424	5,616				