1ST SOURCE CORP
Form 10-K
February 16, 2018
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K
(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2017
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
(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 each class	Name of each exchange on which registered
Common Stock — without par value	The NASDAQ Stock Market LLC

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 whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o
Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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. o
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer x Accelerated filer o

Non-accelerated filer o Smaller reporting company o

Emerging growth company o

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. 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, 2017 was $937,016,186

The number of shares outstanding of each of the registrant's classes of stock as of February 9, 2018: Common Stock, without par value — 25,954,101 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2018 Proxy Statement for the 2018 annual meeting of shareholders to be held April 19, 2018, are incorporated by reference into Part III.

Table of Contents

TABLE OF CONTENTS

Part I

Item 1.	Business	3
Item 1A.	Risk Factors	9
Item 1B.	Unresolved Staff Comments	14
Item 2.	Properties	14
Item 3.	Legal Proceedings	14
Item 4.	Mine Safety Disclosures	14

Part II

Item 5.	Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	15
Item 6.	Selected Financial Data	16
Item 7.	Management’s Discussion and Analysis of Financial Condition and Results of Operations	16
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	36
Item 8.	Financial Statements and Supplementary Data	37
	Reports of Independent Registered Public Accounting Firm	37
	Consolidated Statements of Financial Condition	38
	Consolidated Statements of Income	39
	Consolidated Statements of Comprehensive Income	40
	Consolidated Statements of Shareholders’ Equity	40
	Consolidated Statements of Cash Flows	41
	Notes to Consolidated Financial Statements	42
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	79
Item 9A.	Controls and Procedures	79
Item 9B.	Other Information	79

Part III

Item 10.	Directors, Executive Officers and Corporate Governance	80
Item 11.	Executive Compensation	80
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	80
Item 13.	Certain Relationships and Related Transactions, and Director Independence	80
Item 14.	Principal Accounting Fees and Services	80

Part IV

Item 15.	Exhibits and Financial Statement Schedules	81
Signatures		83
Certifications		

Table of Contents

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 its subsidiaries (collectively referred to as “1st Source”, “we”, and “our”), a broad array of financial products and services. 1st Source Bank (“Bank”), its banking subsidiary, offers commercial and consumer banking services, trust and wealth advisory services, and insurance to individual and business clients through most of our 79 banking center locations in 17 counties in Indiana and Michigan and Sarasota County in Florida. 1st Source Bank’s Specialty Finance Group, with 23 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 and construction equipment. While our lending portfolio is concentrated in certain equipment types, we serve a diverse client base. We are not dependent upon any single industry or client. At December 31, 2017, we had consolidated total assets of $5.89 billion, total loans and leases of $4.53 billion, total deposits of $4.75 billion, and total shareholders’ equity of $718.54 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 or furnished to the Securities and Exchange Commission (SEC).
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, small business, agricultural, and real estate loans to primarily privately owned business clients mainly 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, renewable energy financing, and acquisition financing. Other services include commercial leasing, treasury management services and retirement planning services.
Consumer Services — 1st Source Bank provides a full range of consumer banking products and services through our banking centers and at 1stsource.com. In a number of our markets 1st Source also offers insurance products through 1st Source Insurance offices. The traditional banking services include checking and savings accounts, certificates of deposits and Individual Retirement Accounts. 1st Source offers a full line of on-line and mobile banking products which includes bill payment. As an added convenience, a strategically located Automated Teller Machine network serves our customers and supports the debit and credit card programs of the bank. Consumers also have the ability to obtain consumer loans, real estate loans and lines of credit in any of our banking centers or on-line. Finally, 1st Source offers a variety of financial planning, financial literacy and other consultative services to our customers.
Trust and Wealth Advisory Services — 1st Source Bank provides a wide range of trust, investment, agency, and custodial services for individual, corporate, and not-for-profit 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 equipment loan and lease products addressing the financing needs of a broad array of companies. This group can be broken down into four areas: new and used aircraft; auto and light trucks; construction equipment; and medium and heavy duty trucks.
Aircraft financing consists of financings for new and used general aviation aircraft (including helicopters) for private and corporate aircraft users, aircraft distributors and dealers, air charter operators, air cargo carriers, and other aircraft operators. For many years, on a limited and selective basis, 1st Source Bank has provided international aircraft financing, primarily in Mexico and Brazil. Aircraft finance receivables generally range from $500,000 to $20 million with fixed or variable interest rates and terms of one to ten years.
The auto and light truck division (including specialty vehicles such as motor coaches, shuttle buses, step vans, work trucks and funeral cars) consists of fleet financings to automobile and light truck rental companies, commercial

leasing companies, and single unit to fleet financing for users of specialty vehicles. The auto and light truck finance receivables generally range from $50,000 to $20 million with fixed or variable interest rates and terms of one to eight 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 $50,000 to $20 million with fixed or variable interest rates and terms of one to seven years.

Table of Contents

The medium and heavy duty truck division provides fleet financing for highway tractors, medium duty trucks (including environmental vehicles) and trailers 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 three to seven years.

The group also generates equipment rental income through the leasing of construction equipment, various types of trucks, vans, automobiles, motor coaches, shuttle buses and other equipment through operating leases to clients.

In addition to loan and lease financings during 2017, the group had average total deposits of approximately $64 million.

SPECIALTY 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 Aircraft, Inc., 1st Source Intermediate Holding, LLC, SFG Commercial Aircraft Leasing, Inc., and SFG Equipment Leasing Corporation I.

1ST SOURCE INSURANCE, INC.

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

1ST SOURCE CORPORATION INVESTMENT ADVISORS, INC.

1st Source Corporation Investment Advisors, Inc. (Investment Advisors) is a wholly owned subsidiary of 1st Source Bank that provides investment advisory services for trust and investment clients of 1st Source Bank and to Wasatch Advisors, Inc., the investment advisor of the Wasatch Mutual Fund family. Investment Advisors is registered as an investment advisor with the SEC under the Investment Advisors Act of 1940. Investment Advisors serves strictly in an advisory capacity and, as such, does not hold any client securities.

OTHER CONSOLIDATED SUBSIDIARIES

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

1ST SOURCE MASTER TRUST

Our unconsolidated subsidiary includes 1st Source Master Trust. This subsidiary was created for the purpose of issuing $57.00 million of trust preferred securities 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 in are highly competitive. Our businesses and the geographic markets we serve require us to compete 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 and State 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 being convenient to do business with, and by taking the time to listen and understand our clients' needs. We deliver personalized, one-on-one banking through knowledgeable local members of the community always keeping the clients' best interest in mind while offering a full array of products and highly personalized services. We rely on our history and our reputation in northern Indiana dating back to 1863.

EMPLOYEES

At December 31, 2017, we had approximately 1,125 employees on a full-time equivalent basis. We provide a wide range of employee benefits and consider employee relations to be good.

Table of Contents

ENVIRONMENTAL SUSTAINABILITY

1st Source embraces our responsibility to be a good steward of the environment. We have an approach that protects and conserves our natural resources though methods such as:

Developing business practices that protect and conserve natural resources — We use responsible, reputable, and monitored e-recyclers for our electronic assets. All computers are properly recycled including desktops, laptops and monitors.

We are conscious of our paper usage, recognizing that we depend on printed materials for important day-to-day office work, client communications, and acquiring new clients. Increasingly, consumers demand more environmentally sustainable options and prefer online statements and correspondence rather that printed materials. The majority of the paper used in our facilities is recycled through our secure shred program and in 2017 we recycled 310,000 pounds of paper.

Additionally, we are utilizing various sustainable practices in some of our facilities such as LED lights, daylight harvesting sensors, programmable thermostats, 95% or higher furnace systems, drip irrigation, 90% recycled mats, and sustainable landscaping and irrigation systems.

Embracing opportunities for new products, services and partnerships — In 2017, we increased our focus on renewable energy sources through lending and investment partnerships with renewable energy providers. We recognize the opportunities and complexities associated with energy financing and understand the value of innovative technology that leverages the wind and sun, which are sustainable from an environmental and financial perspective. We will continue to finance and invest in sustainable opportunities, and we will explore new opportunities to develop products and solutions that support our clients and advance sustainability.

Adopting new technologies — We encourage our clients to take advantage of our online and mobile banking tools. Our ATM devices allow clients to make deposits without the need for an envelope. This reduces the use of paper, which again reduces emissions throughout our supply chain.

To help reduce emissions associated with travel, we have tools that help clients choose the banking center and ATM's closest to them. In addition, mobile deposit features are available to our clients, enabling them to deposit checks into their accounts using their mobile devices.

Many of these approaches can create long-term value for our clients and shareholders through increased revenues, reduced costs and improved convenience.

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, as amended (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, 1st Source 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, we are also subject to supervision and regulation by the FDIC (even though the FDIC is not our primary Federal regulator).

Bank Holding Company Act — Under the BHCA 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 (GLBA), which was enacted in 1999, established a distinct type of bank holding company known as a "financial holding company" that has powers that are not otherwise available to bank holding companies.

Table of Contents

Capital Standards — 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 must submit an acceptable plan for achieving compliance with the capital guidelines and, until its capital sufficiently improves, will be subject to denial of applications and appropriate supervisory enforcement actions.

In July 2013, the Federal Reserve and other federal banking agencies approved final rules implementing the Basel Committee on Banking Supervision's capital guidelines for all U.S. banks and for bank holding companies with greater than $500 million in assets. Under these final rules, minimum requirements will increase for both the quantity and quality of capital held by 1st Source and the Bank. The rules include a new common equity Tier 1 capital ratio of 4.5%, a minimum Tier 1 capital ratio of 6.0%, a total capital ratio of 8.0%, and a minimum leverage ratio of 4.0%. The final rules also require a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets which is in addition to the other minimum risk-based capital standards in the rule. Institutions that do not maintain the required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases and on the payment of discretionary bonuses to senior executive management. A three-year phase in period for the capital buffer requirement began in 2016. The capital buffer requirement effectively raises the minimum required common equity Tier 1 capital ratio to 7.0%, the Tier 1 capital ratio to 8.5%, and the total capital ratio to 10.5% on a fully phased-in basis.

The final rules also increase the required capital for certain categories of assets, including higher-risk construction real estate loans and certain exposures related to securitizations. The final rules do not, however, adopt the changes in the proposed rule to the risk weights assigned to certain mortgage loan assets. The final rules instead adopt the risk weights for residential mortgages under the existing general risk-based capital rules, which assign a risk weight of either 50% (for most first-lien exposures) or 100% for other residential mortgage exposures. Similarly, the final rules do not adopt the proposed rule's elimination of Tier 1 treatment of trust preferred securities for banking organizations with less than $15 billion in assets as of December 31, 2010. Instead, the final rules permit these banking organizations to retain non-qualifying Tier 1 capital trust preferred securities issued prior to May 19, 2010, subject generally to a limit of 25% of Tier 1 capital.

These new minimum capital ratios became effective for us on January 1, 2015 and will be fully phased-in on January 1, 2019. As of December 31, 2017, we were in compliance with all applicable regulatory capital requirements. Management also believes that, as of that date, we would have met all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis had those requirements been currently in effect.

Prompt Corrective Action Regulations — The FDIC's prompt corrective action regulations establish five capital levels for financial institutions ("well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized"), and impose mandatory regulatory scrutiny and limitations on institutions that are less than adequately capitalized. At December 31, 2017, the Bank was categorized as "well capitalized," meaning that our total risk-based capital ratio exceeded 10.00%, our Tier 1 risk-based capital ratio exceeded 8.00%, our common equity Tier-1 risk-based capital ratio exceeded 6.50%, our leverage ratio exceeded 5.00%, and we are not subject to a regulatory order, agreement, or directive to meet and maintain a specific capital level for any capital measure.

FDIC Deposit Insurance Assessments —The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was signed into law on July 21, 2010, changed how the FDIC calculates deposit insurance premiums payable by insured depository institutions. The Dodd-Frank Act directs the FDIC to calculate the deposit insurance assessments payable by each insured depository institution based generally upon the institution's average total consolidated assets minus its average tangible equity during the assessment period. Previously, an institution's assessments were based on the amount of its insured deposits. The minimum deposit insurance fund rate will increase from 1.15% to 1.35% by September 30, 2020, and the cost of the increase will be borne by depository institutions with assets of $10 billion or more. The Dodd-Frank Act also provides the FDIC with discretion to determine whether to pay rebates to insured depository institutions when its deposit insurance reserves exceed certain thresholds.

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.

Interstate Branching — The Dodd-Frank Act expanded the authority of a state or national bank to open offices in other states. A state or national bank may now open a de novo branch in a state where the bank does not already operate a branch if the law of the state where the branch is to be located would permit a state bank chartered by that state to open the branch. This provision removed restrictions under prior law that restricted a state or national bank from expanding into another state unless the laws of the bank’s home state and the laws of the other state both permitted out-of-state banks to open de novo branches.

Table of Contents

Gramm-Leach-Bliley Act of 1999 — The GLBA removed barriers to affiliations among banks, insurance companies, the securities industry, and other financial service providers, and provides greater flexibility to these organizations in structuring such affiliations. The GLBA also expanded the types of financial activities a bank may conduct through a financial subsidiary and established a distinct 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." These activities include securities and insurance brokerage, securities underwriting, insurance underwriting, and merchant banking. A bank holding company may become a financial holding company only if all of its subsidiary financial institutions are well-capitalized and well-managed and have at least a satisfactory Community Reinvestment Act (CRA) rating. While we meet these standards, we do not currently intend to file notice with the Federal Reserve to become a financial holding company or to engage in expanded financial activities through a financial subsidiary of the Bank. The GLBA also includes privacy protections for nonpublic personal information held by financial institutions regarding their customers, and establishes a system of functional regulation that makes the Federal Reserve the "umbrella supervisor" for holding companies, and other federal and state agencies the supervisor of the holding company's subsidiaries.

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. We are also subject to various state laws that generally require us to notify any customer whose personal financial information may have been released to an unauthorized person as the result of a breach of our data security policies and procedures.

USA Patriot Act of 2001 — The USA Patriot Act of 2001 (USA Patriot Act) 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 Treasury under the USA Patriot Act require financial institutions to maintain appropriate controls to combat money laundering activities, perform due diligence of private banking and correspondent accounts, establish standards for verifying customer identity, and provide records related to suspected anti-money laundering activities upon request from federal authorities. A financial institution's failure to comply with these regulations could result in fines or sanctions, including restrictions on conducting acquisitions or establishing new branches, and could also have other serious legal and reputational consequences for the institution. We have established policies, procedures and systems designed to comply with these regulations.

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 20 of the Notes to Consolidated Financial Statements.

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 subject to credit underwriting procedures that are at least as stringent as those prevailing at the time for comparable transactions with non affiliates, 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.

Table of Contents

Reserve Requirements — The Federal Reserve requires all depository institutions to maintain reserves against their transaction account deposits. For 2018, the Bank must maintain reserves of 3.00% against net transaction accounts greater than $16.00 million and up to $122.30 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 $122.30 million. These amounts are indexed to inflation and adjusted annually by the Federal Reserve.

Dividends — The ability of the Bank to pay dividends is limited by state and Federal laws and regulations that require the Bank to obtain the prior approval of the DFI and the Federal Reserve Bank of Chicago before paying a dividend that, together with other dividends it has paid during a calendar year, would exceed the sum of its net income for the year to date combined with its retained net income for the previous two years. The amount of dividends the Bank may pay may also be limited by certain covenant agreements and by the principles of prudent bank management. See Part II, Item 5, Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities for further discussion of dividend limitations.

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 economic growth, 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 — The Sarbanes-Oxley Act of 2002 (SOA) includes provisions intended to enhance corporate responsibility and protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws, and which increase penalties for accounting and auditing improprieties at public traded companies. The SOA generally applies to all companies that file or are required to file periodic reports with the SEC under the 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 committee, to pay the company’s auditors and any advisors that its audit committee retains. The SOA also requires public companies to prepare an internal control report and assessment by management, along with an attestation to this report prepared by the company’s independent registered public accounting firm, in their annual reports to stockholders.

Consumer Financial Protection Laws — The Bank is subject to a number of federal and state consumer financial protection laws and regulations that extensively govern its transactions with consumers. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, and the Service

Members Civil Relief Act. 1st Source Bank must also comply with applicable state usury laws and other laws prohibiting unfair and deceptive acts and practices. These laws, among other things, require disclosures of the cost of credit and the terms of deposit accounts, prohibit discrimination in credit transactions, regulate the use of credit report information, restrict the Bank’s ability to raise interest rates and subject the Bank to substantial regulatory oversight. Violations of these laws may expose us to liability from potential lawsuits brought by affected customers. Federal bank regulators, state attorneys general and state and local consumer protection agencies may also seek to enforce these consumer financial protection laws, in which case we may be subject to regulatory sanctions, civil money penalties, and customer rescission rights. Failure to comply with these laws may also cause the Federal Reserve or DFI to deny approval of any applications we may file to engage in merger and acquisition transactions with other financial institutions.

Table of Contents

Dodd-Frank Wall Street Reform and Consumer Protection Act — The Dodd-Frank Act, which was signed into law in 2010, significantly changed the regulation of financial institutions and the financial services industry. The Dodd-Frank Act includes provisions affecting large and small financial institutions alike, including several provisions that profoundly affected the regulation of community banks, thrifts, and small bank and thrift holding companies. Among other things, these provisions relaxed rules on interstate branching, allow financial institutions to pay interest on business checking accounts, and impose heightened capital requirements on bank and thrift holding companies. The Dodd-Frank Act also includes several corporate governance provisions that apply to all public companies, not just financial institutions. These include provisions mandating certain disclosures regarding executive compensation and provisions addressing proxy access by shareholders.

The Dodd-Frank Act also establishes the Consumer Financial Protection Bureau (CFPB) as an independent entity within the Federal Reserve and transferred to the CFPB primary responsibility for administering substantially all of the consumer compliance protection laws formerly administered by other federal agencies. The Dodd-Frank Act also authorizes the CFPB to promulgate consumer protection regulations that will apply to all entities, including banks, that offer consumer financial services or products. It also includes a series of provisions covering mortgage loan origination standards affecting, among other things, originator compensation, minimum repayment standards, and pre-payment penalties.

The Dodd-Frank Act contains numerous other provisions affecting financial institutions of all types, including some that may affect our business in substantial and unpredictable ways. We have incurred higher operating costs in complying with the Dodd -Frank Act, and we expect that these higher costs will continue for the foreseeable future. Our management continues to monitor the ongoing implementation of the Dodd-Frank Act and as new regulations are issued, will assess their effect on our business, financial condition, and results of operations.

The Volcker Rule — The Dodd-Frank Act prohibits banks and their affiliates from engaging in proprietary trading and from investing and sponsoring hedge funds and private equity funds. The provision of the statute imposing these restrictions is commonly called the “Volcker Rule.” The regulations implementing the Volcker Rule require institutions to conform their activities to the requirements of the Volcker Rule by July 21, 2015, and to conform their investments in certain “legacy covered funds” by July 21, 2017. These regulations exempt the Bank, as a bank with less than $10 billion in total consolidated assets that does not engage in any covered activities other than trading in certain government, agency, state or municipal obligations, from any significant compliance obligations under the Volcker Rule.

Liquidity Requirements — Historically, the regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III final framework requires banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. One test, referred to as the liquidity coverage ratio, or LCR, is designed to ensure that the banking entity maintains an adequate level of unencumbered high-quality liquid assets equal to the entity’s expected net cash outflow for a 30-day time horizon (or, if greater, 25% of its expected total cash outflow) under an acute liquidity stress scenario. The other test, referred to as the net stable funding ratio, or NSFR, is designed to promote more medium and long-term funding of the assets and activities of banking entities over a one-year time horizon. These requirements are expected to incentivize banking entities to increase their holdings of U.S. Treasury securities and other sovereign debt as a component of assets and increase the use of long-term debt as a funding source.

In September 2015, the federal bank regulators approved final rules implementing the LCR for advanced approaches banking organizations (i.e,. banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in total on-balance sheet foreign exposure) and a modified version of the LCR for bank holding companies with at least $50 billion in total consolidated assets that are not advanced approach banking organizations, neither of which would apply to 1st Source or the Bank. The federal bank regulators have not yet proposed rules to implement the NSFR, but the Federal Reserve has stated its intent to adopt a version of this measure as well.

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.

Item 1A. Risk Factors.

An investment in our common stock is subject to risks inherent to our business. The material risks 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.

Table of Contents

Credit Risks

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 in 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.

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, collateral, and net worth; asset ownership; bank and trade credit references; credit bureau reports; 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, some residential mortgages are sold into the secondary market and serviced by our principal banking subsidiary, 1st Source Bank.

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 slowdowns 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 rapid increases or decreases in fuel costs, terrorist and other 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 and transportation sensitive businesses for which our specialty finance businesses provide financing.

Our aircraft portfolio has foreign exposure, particularly in Mexico and Brazil. We establish exposure limits for each country through a centralized oversight process, and in consideration of relevant economic, political, social and legal risks. We monitor exposures closely and adjust our country limits in response to changing conditions. Currency fluctuations could have a negative impact on our client’s cost of paying dollar denominated debts and, as a result, we could experience higher delinquency in this portfolio. Also, since some of the relationships in this portfolio are large, a slowdown could have a significant adverse impact on our performance.

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.

Table of Contents

Our reserve for loan and lease losses may prove to be insufficient to absorb probable losses in our loan and lease portfolio — In the financial services industry, there is always a risk that certain borrowers may not repay borrowings. The determination of the appropriate level of the reserve for loan and lease losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. 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 or international economic conditions could also adversely affect the quality of our loan and lease portfolio and negate, to some extent, the benefits of national or international diversification through our Specialty Finance Group's portfolio. In addition, bank regulatory agencies periodically review our reserve for loan and lease losses and may require an increase in the provision for loan and lease losses or the recognition of further loan or lease charge-offs based upon their judgments, which may be different from ours.

The soundness of other financial institutions could adversely affect us — Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due us. Any such losses could have a material adverse effect on our financial condition and results of operations.

Market Risks

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. 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 effect on our net interest spread, asset quality, origination volume, and overall profitability.

Market interest rates are beyond our control, and they fluctuate in response to general economic conditions and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, 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.

Adverse changes in economic conditions could impair our financial condition and results of operations — We are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, unemployment, and the strength of the U.S. economy and the local economies in which we operate, all of which are beyond our control. A deterioration in economic conditions could result in an increase in loan delinquencies and non-performing assets, decreases in loan collateral values and a decrease in demand for our products and services.

Changes in economic conditions may negatively impact the fees generated by our trust and wealth advisory business — Trust and wealth advisory fees are largely based on the size of client relationships and the market value of assets held under management. Changes in general economic conditions and in the financial and securities markets may negatively impact the value of our clients' wealth management accounts and the market value of assets held under management. Market declines, reductions in the value of our clients' accounts, and the loss of wealth management

clients may negatively impact the fees generated by our trust and wealth management business and could have an adverse effect on our business, financial condition and results of operations.

Table of Contents

Liquidity Risks

We could experience an unexpected inability to obtain needed liquidity — Liquidity measures the ability to meet current and future cash flow needs as they become due. The liquidity of a financial institution reflects its ability to meet loan requests, to accommodate possible outflows in deposits, and to take advantage of interest rate market opportunities and is essential to a financial institution’s business. The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets, and its access to alternative sources of funds. We seek to ensure our funding needs are met by maintaining a level of liquidity through asset and liability management. If we become unable to obtain funds when needed, it could have a material adverse effect on our business, financial condition, and results of operations. Additionally, under Indiana law governing the collateralization of public fund deposits, the Indiana Board for Depositories determines which financial institutions are required to pledge collateral based on the strength of their financial ratings. We have been informed that no collateral is required for our public fund deposits. However, the Board of Depositories could alter this requirement in the future, which could adversely affect our liquidity depending on the amount of collateral we may be required to pledge.

We rely on dividends from our subsidiaries — We receive substantially all of our revenue from dividends from our subsidiaries, including, primarily, the Bank. These dividends are the principal source of funds we use to pay dividends on our common stock and interest and principal on our debt. Various federal and state laws and regulations limit the amount of dividends our subsidiaries may pay to us. In the event our subsidiaries are unable to pay dividends to us, we may not be able to service debt, pay other obligations, or pay dividends on our common stock. Our inability to receive dividends from our subsidiaries could have a material adverse effect on our business, financial condition and results of operations.

Operational Risks

We are dependent upon the services of our management team — Our future success and profitability is substantially dependent upon our management and the banking acumen 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 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 — Information security risks have increased due to the sophistication and activities of organized crime, hackers, terrorists and other external parties and the use of online, telephone, and mobile banking channels by clients. Any compromise of our security could deter our clients from using our banking services. We rely on security systems to provide the protection and authentication necessary to effect secure transmission of data against damage by theft, fire, power loss, telecommunications failure or similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms, and other disruptive problems caused by hackers. Computer break-ins, phishing and other disruptions of customer or vendor systems could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure. We maintain a cyber insurance policy that is designed to cover a majority of loss resulting from cyber security breaches. 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.

We depend on the services of a variety of third party vendors to meet data processing and communication needs and we have contracted with third parties to run their proprietary software on our behalf. While we perform reviews of security controls instituted by the vendor in accordance with industry standards and institute our own internal security controls, we rely on continued maintenance of the controls by the outside party to safeguard our customer data.

Additionally, we issue debit cards which are susceptible to compromise at the point of sale via the physical terminal through which transactions are processed and by other means of hacking. The security and integrity of these transactions are dependent upon the retailers' vigilance and willingness to invest in technology and upgrades. Issuing debit cards to our clients exposes us to potential losses which, in the event of a data breach at one or more major retailers may adversely affect our business, financial condition, and results of operations.

Table of Contents

We continually encounter technological change — The financial services industry is constantly undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better service clients and reduce costs. Our future success depends, in part, upon our ability to address the needs of our clients by using technology to provide products and services that will satisfy client demands, as well as create additional efficiencies within our operations. Many of our large competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services quickly or be successful in marketing these products and services to our clients. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

Our accounting estimates and risk management processes rely on analytical and forecasting models — The processes we use to estimate our probable loan losses and to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on our financial condition and results of operations, depend upon the use of analytical and forecasting models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use for determining our probable loan losses are inadequate, the reserve for loan and lease losses may not be sufficient to support future charge-offs. If the models we use to measure the fair value of financial instruments are inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Any such failure in our analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

Legal/Compliance Risks

We are subject to extensive government regulation and supervision — Our operations are subject to extensive federal and state regulation and supervision. Banking regulations are primarily intended to protect depositors’ funds, federal deposit insurance funds and the banking system as a whole, not security holders. These regulations affect our lending practices, capital structure, investment practices, dividend policy and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations and policies for possible change. Changes to statutes, regulations or regulatory policies, including changes in interpretation or implementation of statutes, regulation or policies, could affect us in substantial and unpredictable ways. Such changes could subject us to additional costs and limit the types of financial services and products we may offer. Failure to comply with laws, regulations or policies could result in sanctions by regulatory agencies, civil money penalties and/or reputation damage, which could have a material adverse effect on our business, financial condition and results of operations. While we have policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur.

Changes in accounting standards could impact reported earnings — Current accounting and tax rules, standards, policies and interpretations influence the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. These laws, regulations, rules, standards, policies and interpretations are constantly evolving and may change significantly over time. Events that may not have a direct impact on us, such as bankruptcy of major U.S. companies, have resulted in legislators, regulators, and authoritative bodies, such as the Financial Accounting Standards Board, the Securities and Exchange Commission, the Public Company Accounting Oversight Board and various taxing authorities, responding by adopting and/or proposing substantive revision to laws, regulations, rules, standards, policies and interpretations. New accounting pronouncements and varying interpretations of accounting pronouncements have occurred and may occur in the future. A change in accounting standards may adversely affect our reported financial condition and results of operations.

Our investments and/or financings in certain tax-advantaged projects may not generate returns as anticipated and may have an adverse impact on our financial results — We invest and/or finance certain tax-advantaged projects promoting

affordable housing, community redevelopment and renewable energy sources. Our investments in these projects are designed to generate a return primarily through the realization of federal and state income tax credits, and other tax benefits, over specified time periods. We are subject to the risk that previously recorded tax credits, which remain subject to recapture by taxing authorities based on compliance features required to be met at the project level, will fail to meet certain government compliance requirements and will not be able to be fully realized. The possible inability to realize these tax credits and other tax benefits can have a negative impact on our financial results. The risk of not being able to realize the tax credits and other tax benefits depends on many factors outside of our control, including changes in the applicable tax code and the ability of the projects to be completed and properly managed.
Substantial ownership concentration — Our directors, executive officers and 1st Source Bank, as trustee, collectively hold a significant ownership concentration of our common shares. Due to this significant level of ownership among our affiliates, our directors, executive officers, and 1st Source Bank, as trustee, may be able to influence the outcome of director elections or impact significant transactions, such as mergers or acquisitions, or any other matter that might otherwise be favored by other shareholders.

Table of Contents

The fact that certain significant shareholders have additional shares registered for sale may depress market prices of our common stock — We have filed a registration statement with the SEC covering the potential sale by 1st Source Bank as trustee of certain trusts established for the benefit of the extended families of two of the children of Ernestine Raclin. Such holders may choose to sell their remaining registered shares at any time. Some market participants may assume that such remaining shares will become available to the market and choose to defer purchasing our shares on the market. This may, in turn have an effect of depressing the market price for our common stock. In addition, the future sale of substantial amounts of common stock by the holders of such registered shares may also depress the market price of our common stock.

Reputational Risks

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 wealth advisory, 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.

Managing reputational risk is important to attracting and maintaining customers, investors, and employees — Threats to our reputation can come from many sources, including adverse sentiment about financial institutions generally, unethical practices, employee misconduct, failure to deliver minimum standards of service or quality, compliance deficiencies, and questionable or fraudulent activities of our customers. We have policies and procedures in place that seek to protect our reputation and promote ethical conduct. Nonetheless, negative publicity may arise regarding our business, employees, or customers, with or without merit, and could result in the loss of customers, investors, or employees, costly litigation, a decline in revenues, and increased government regulation.

Item 1B. Unresolved Staff Comments.

None

Item 2. Properties.

Our headquarters building is located in downtown South Bend, Indiana. The building is part of a larger complex, including a 300-room hotel and a 500-car parking garage. In December 2010, we entered into a new 10.5 year lease on our headquarters building which became effective January 1, 2011. As of December 31, 2017, 1st Source leases approximately 69% of the office space in this complex.

At December 31, 2017, we owned or leased property and/or buildings where 1st Source Bank's 79 banking centers were located. Our facilities are located in Allen, Elkhart, Fulton, Huntington, Kosciusko, LaPorte, Marshall, Porter, Pulaski, St. Joseph, Starke, Tippecanoe, Wells, and Whitley Counties in the State of Indiana, Berrien, Cass, and Kalamazoo Counties in the State of Michigan, and Sarasota County in the state of Florida. Additionally, we utilize an operations center and our former headquarters building for 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 other 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. Mine Safety Disclosures.

None

Part II

Table of Contents

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.

	2017 Sales Price		Cash Dividends	2016 Sales Price		Cash Dividends
Common Stock Prices (quarter ended)	High	Low	Paid	High	Low	Paid
March 31	$49.11	$42.15	$ 0.18	$33.50	$27.01	$ 0.18
June 30	50.78	43.58	0.19	34.83	30.32	0.18
September 30	51.80	44.59	0.19	35.99	31.50	0.18
December 31	53.29	47.16	0.20	45.61	33.27	0.18

As of February 9, 2018, there were 818 holders of record of 1st Source common stock.

Comparison of Five Year Cumulative Total Return*

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

* Assumes $100 invested on December 31, 2012, in 1st Source Corporation common stock, NASDAQ market index, and peer group index.

** The Morningstar Weighted NASDAQ Index Return is calculated using all companies which trade as NASD Capital Markets, NASD Global Markets or NASD Global Select. It includes both domestic and foreign companies. The index is weighted by the then current shares outstanding and assumes dividends reinvested. The return is calculated on a monthly basis.

*** The peer group is a market-capitalization-weighted stock index of 41 banking companies in Illinois, Indiana, Michigan, Ohio, and Wisconsin. The following companies included in this peer group in last year’s annual report have not been included this year, all due to being acquired during 2017: Baylake Corp, Cheviot Financial Corporation, Firstmerit Corp, Private Bancorp and Your Community Bancshares, Inc.

NOTE: Total return assumes reinvestment of dividends.

Table of Contents

The following table shows our share repurchase activity during the three months ended December 31, 2017.

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, 2017	—	$ —	—	1,386,174
November 01 - 30, 2017	—	—	—	1,386,174
December 01 - 31, 2017	—	—	—	1,386,174

*1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on July 24, 2014. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock from time to time to mitigate the potential dilutive effects of stock-based incentive plans and other potential uses of common stock for corporate purposes. Since the inception of the plan, 1st Source has repurchased a total of 613,826 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 20 of the Notes to Consolidated Financial Statements.

Item 6. Selected Financial Data.

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

(Dollars in thousands, except per share amounts)	2017	2016	2015	2014	2013
Interest income	$212,385	$191,760	$184,684	$178,554	$179,585
Interest expense	26,754	22,101	18,163	18,225	22,768
Net interest income	185,631	169,659	166,521	160,329	156,817
Provision for loan and lease losses	8,980	5,833	2,160	3,733	772
Net interest income after provision for loan and lease losses	176,651	163,826	164,361	156,596	156,045
Noninterest income	98,706	88,945	83,316	77,887	77,212
Noninterest expense	173,997	163,645	159,114	150,040	149,314
Income before income taxes	101,360	89,126	88,563	84,443	83,943
Income taxes	33,309	31,340	31,077	26,374	28,985
Net income	$68,051	$57,786	$57,486	$58,069	$54,958
Assets at year-end	$5,887,284	$5,486,268	$5,187,916	$4,829,958	$4,722,826
Long-term debt and mandatorily redeemable securities at year-end	70,060	74,308	57,379	56,232	58,335
Shareholders’ equity at year-end	718,537	672,650	644,053	614,473	585,378
Basic net income per common share	2.60	2.22	2.17	2.17	2.03
Diluted net income per common share	2.60	2.22	2.17	2.17	2.03
Cash dividends per common share	0.760	0.720	0.671	0.645	0.618
Dividend payout ratio	29.23 %	32.45 %	30.85 %	29.71 %	30.49 %
Return on average assets	1.21 %	1.08 %	1.15 %	1.21 %	1.19 %
Return on average common shareholders’ equity	9.69 %	8.71 %	9.05 %	9.65 %	9.55 %
Average common shareholders’ equity to average assets	12.46 %	12.38 %	12.72 %	12.52 %	12.49 %

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

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 you are 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.

Table of Contents

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," "possible," "assume," "expect," "intend," "continue," "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.

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. The results or outcomes indicated by our 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 changes 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.
- The ability to expand effectively into new markets that we target.
- 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.

Table of Contents

APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP) and follow general practices within the industries in which we operate. Application of these principles requires management to make estimates or judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates or judgments reflect 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 1 (Note 1), should be reviewed for a greater understanding of how our financial performance is recorded and reported.

We have identified the following three policies as being critical because they require 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, fair value measurements, and the valuation of mortgage servicing rights. Management believes it 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. Management has reviewed the application of these policies with the Audit Committee of the Board of Directors. Following is a discussion of the areas we view as our most critical accounting policies.

Reserve for Loan and Lease Losses — The reserve for loan and lease losses represents 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 appropriate reserve, management makes numerous judgments, assumptions, and estimates based on continuous review of the loan and lease portfolio, estimates of client performance, collateral values, and disposition, as well as historical loss rates and expected cash flows. In assessing these factors, management benefits from a lengthy organizational history and experience with credit decisions and related outcomes. Nonetheless, if 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 1 under the heading "Reserve for Loan and Lease Losses."

Fair Value Measurements — We use fair value measurements to record certain financial instruments and to determine fair value disclosures. Available-for-sale securities, trading account securities, mortgage loans held for sale, and interest rate swap agreements are financial instruments recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other financial assets on a nonrecurring basis. These nonrecurring fair value adjustments typically involve write-downs of, or specific reserves against, individual assets. GAAP establishes a three-level hierarchy for disclosure of assets and liabilities recorded at fair value. The classification of assets and liabilities within the hierarchy is based on whether the inputs to the valuation methodology used in the measurement are observable or unobservable. Observable inputs reflect market-driven or market-based information obtained from independent sources, while unobservable inputs reflect our estimates about market data. The degree of management judgment involved in determining the fair value of a financial instrument is dependent upon the availability of quoted market prices or observable market data. For financial instruments that trade actively and have quoted market prices or observable market data, there is minimal subjectivity involved in measuring fair value. When observable market prices and data are not fully available, management judgment is necessary to estimate fair value. In addition, changes in the market conditions may reduce the availability of quoted prices or observable data. For example, reduced liquidity in the capital markets or changes in secondary market activities could result in observable market inputs becoming unavailable. Therefore, when market data is not available, we use valuation techniques that require more management judgment to estimate the appropriate fair value measurement. Fair value is discussed further in Note 1 under the heading "Fair Value Measurements" and in Note 21, "Fair Value Measurements."

Mortgage Servicing Rights Valuation — We recognize as assets the rights to service mortgage loans for others, known as mortgage servicing rights (MSRs), whether the servicing rights are acquired through purchases or through originated loans. MSRs do not trade in an active open market with readily observable market prices. Although sales of MSRs do occur, the precise terms and conditions may not be readily available. As such, the value of MSRs is established and valued using discounted cash flow modeling techniques which require management to make estimates regarding future net servicing cash flows, taking into consideration actual and expected mortgage loan prepayment rates, discount rates, servicing costs, and other economic factors. The estimated rates of mortgage loan prepayments are the most significant factors driving the value of MSRs. 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 MSRs, mortgage interest rates (which are used to determine prepayment rates), and discount rates are held constant over the estimated life of the portfolio. Estimated mortgage loan prepayment rates are derived from a third-party. MSRs are carried at the lower of amortized cost 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 MSRs is discussed further in Note 21, “Fair Value Measurements.”

Table of Contents

EARNINGS SUMMARY

Net income in 2017 was $68.05 million, up from $57.79 million in 2016 and up from $57.49 million in 2015. Diluted net income per common share was $2.60 in 2017, $2.22 in 2016, and $2.17 in 2015. Return on average total assets was 1.21% in 2017 compared to 1.08% in 2016, and 1.15% in 2015. Return on average common shareholders' equity was 9.69% in 2017 versus 8.71% in 2016, and 9.05% in 2015.

Net income in 2017, as compared to 2016, was positively impacted by a $15.97 million or 9.41% increase in net interest income and a $9.76 million or 10.97% increase in noninterest income, which was offset by a $3.15 million or 53.95% increase in provision for loan and lease losses and a $10.35 million or 6.33% increase in noninterest expense. Net income in 2016 was positively impacted by a $3.14 million or 1.88% increase in net interest income and a $5.63 million or 6.76% increase in noninterest income, which was offset by a $3.67 million or 170.05% increase in provision for loan and lease losses and a $4.53 million or 2.85% increase in noninterest expense over 2015.

Dividends paid on common stock in 2017 amounted to $0.760 per share, compared to $0.720 per share in 2016, and $0.671 per share in 2015. The level of earnings reinvested and dividend payouts are determined by the Board of Directors based on management's assessment of future growth opportunities and the level of capital necessary to support them.

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 significantly 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 3.57% in 2017, compared to 3.43% in 2016 and 3.60% in 2015. Net interest income was $185.63 million for 2017, compared to $169.66 million for 2016 and $166.52 million for 2015. Tax-equivalent net interest income totaled $187.43 million for 2017, up $15.94 million from the $171.48 million reported in 2016. Tax-equivalent net interest income for 2016 was up $3.27 million from the $168.22 million reported for 2015.

During 2017, average earning assets increased $247.17 million or 4.94% while average interest-bearing liabilities increased $193.86 million or 5.25% over the comparable period in 2016. The yield on average earning assets increased 21 basis points to 4.08% for 2017 from 3.87% for 2016 primarily due to higher rates on loans and leases and investment securities available-for-sale. Total cost of average interest-bearing liabilities increased 9 basis points to 0.69% during 2017 from 0.60% in 2016 as a result of the rising interest rate environment. The result to the net interest margin was an increase of 14 basis points.

The largest contributor to the increase in the yield on average earning assets in 2017 was the 22 basis point improvement in the loan and lease portfolio yield primarily due to market conditions as a result of Federal interest rate increases. Average net loans and leases increased $219.87 million or 5.34% in 2017 from 2016 while the yield increased to 4.50%.

During 2017, the tax-equivalent yield on investment securities available-for-sale increased 10 basis points to 2.04% while the average balance grew $42.38 million. Average mortgages held for sale decreased $1.64 million during 2017 and the yield increased 22 basis points. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank (FHLB) stock and commercial paper decreased $13.43 million during 2017 while the yield increased 77 basis points. The increase in yield for mortgages held for sale and other investments was primarily a result of lower outstanding balances at higher rates.

Average interest-bearing deposits increased $151.37 million during 2017 while the effective rate paid on those deposits increased 10 basis points. The increase in the average cost of interest-bearing deposits was primarily the result of higher rates and a slight shift in the deposit mix. Average noninterest-bearing demand deposits increased $39.18 million during 2017.

Average short-term borrowings increased $34.36 million during 2017 while the effective rate paid increased 20 basis points. The increase in short-term borrowings was primarily the result of increased borrowings with the Federal Home Loan Bank. Average long-term debt increased $8.13 million during 2017 as the effective rate increased 12 basis points. The increase in effective rate in 2017 was primarily due to increased borrowings at rates higher than existing debt.

Table of Contents

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.

	2017			2016			2015		
(Dollars in thousands)	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate	Average Balance	Interest Income/Expense	Yield/Rate
ASSETS									
Investment securities available-for-sale:									
Taxable	$728,501	$13,693	1.88%	$684,503	$11,777	1.72%	$664,480	$11,929	1.80%
Tax-exempt[1]	126,378	3,747	2.96%	127,998	3,981	3.11%	122,500	4,406	3.60%
Mortgages held for sale	10,754	429	3.99%	12,396	467	3.77%	11,099	439	3.96%
Loans and leases, net of unearned discount[1]	4,333,375	194,918	4.50%	4,113,508	176,116	4.28%	3,837,149	168,611	4.39%
Other investments	52,086	1,393	2.67%	65,517	1,244	1.90%	33,583	997	2.97%
Total earning assets[1]	5,251,094	214,180	4.08%	5,003,922	193,585	3.87%	4,668,811	186,382	3.99%
Cash and due from banks	62,137			60,753			61,400		
Reserve for loan and lease losses	(92,187)			(90,206)			(87,208)		
Other assets	417,278			386,216			351,205		
Total assets	$5,638,322			$5,360,685			$4,994,208		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest-bearing deposits	$3,510,197	$19,202	0.55%	$3,358,827	$15,267	0.45%	$3,106,990	$11,489	0.37%
Short-term borrowings	245,235	1,115	0.45%	210,876	525	0.25%	236,940	484	0.20%
Subordinated notes	58,764	4,002	6.81%	58,764	4,220	7.18%	58,764	4,220	7.18%
Long-term debt and mandatorily redeemable securities	74,973	2,435	3.25%	66,842	2,089	3.13%	57,245	1,970	3.44%
Total interest-bearing liabilities	3,889,169	26,754	0.69%	3,695,309	22,101	0.60%	3,459,939	18,163	0.52%
Noninterest-bearing deposits	983,050			943,874			854,070		
Other liabilities	63,684			57,799			44,702		
Shareholders' equity	702,419			663,703			635,497		
Total liabilities and shareholders' equity	$5,638,322			$5,360,685			$4,994,208		
Less: Fully tax-equivalent adjustments		(1,795)			(1,825)			(1,698)	
		$185,631	3.54%		$169,659	3.39%		$166,521	3.57%

Net interest income/margin (GAAP-derived)[1]						
Fully tax-equivalent adjustments	1,795		1,825		1,698	
Net interest income/margin - FTE[1]	$187,426	3.57%	$171,484	3.43%	$168,219	3.60%

(1) See "Reconciliation of Non-GAAP Financial Measures" for more information on this performance measure/ratio.

20

Table of Contents

Reconciliation of Non-GAAP Financial Measures — Our accounting and reporting policies conform to GAAP in the United States and prevailing practices in the banking industry. However, certain non-GAAP performance measures are used by management to evaluate and measure the Company's performance. These include taxable-equivalent net interest income (including its individual components) and net interest margin (including its individual components). Management believes that these measures provide users of the Company's financial information a more meaningful view of the performance of the interest-earning assets and interest-bearing liabilities.
Management reviews yields on certain asset categories and the net interest margin of the Company and its banking subsidiaries on a fully taxable-equivalent ("FTE") basis. In this non-GAAP presentation, net interest income is adjusted to reflect tax-exempt interest income on an equivalent before-tax basis. This measure ensures comparability of net interest income arising from both taxable and tax-exempt sources. The following table shows the reconciliation of non-GAAP financial measures for the most recent three years ended December 31.

	(Dollars in thousands)	2017	2016	2015
	Calculation of Net Interest Margin			
(A)	Interest income (GAAP)	$212,385	$191,760	$184,684
	Fully tax-equivalent adjustments:			
(B)	- Loans and leases	621	584	284
(C)	- Tax-exempt investment securities	1,174	1,241	1,414
(D)	Interest income - FTE (A+B+C)	214,180	193,585	186,382
(E)	Interest expense (GAAP)	26,754	22,101	18,163
(F)	Net interest income (GAAP) (A-E)	185,631	169,659	166,521
(G)	Net interest income - FTE (D-E)	187,426	171,484	168,219
(H)	Total earning assets	$5,251,094	$5,003,922	$4,668,811
	Net interest margin (GAAP-derived) (F/H)	3.54 %	3.39 %	3.57 %
	Net interest margin - FTE (G/H)	3.57 %	3.43 %	3.60 %

Table of Contents

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
2017 compared to 2016			
Interest earned on:			
Investment securities available-for-sale:			
Taxable	$ 786	$ 1,130	$1,916
Tax-exempt	(50)	(184)	(234)
Mortgages held for sale	(64)	26	(38)
Loans and leases, net of unearned discount	9,658	9,144	18,802
Other investments	(290)	439	149
Total earning assets	$ 10,040	$ 10,555	$20,595
Interest paid on:			
Interest-bearing deposits	$ 713	$ 3,222	$3,935
Short-term borrowings	97	493	590
Subordinated notes	—	(218)	(218)
Long-term debt and mandatorily redeemable securities	262	84	346
Total interest-bearing liabilities	$ 1,072	$ 3,581	$4,653
Net interest income - FTE	$ 8,968	$ 6,974	$15,942
2016 compared to 2015			
Interest earned on:			
Investment securities available-for-sale:			
Taxable	$ 353	$ (505)	$(152)
Tax-exempt	191	(616)	(425)
Mortgages held for sale	50	(22)	28
Loans and leases, net of unearned discount	11,914	(4,409)	7,505
Other investments	700	(453)	247
Total earning assets	$ 13,208	$ (6,005)	$7,203
Interest paid on:			
Interest-bearing deposits	$ 987	$ 2,791	$3,778
Short-term borrowings	(57)	98	41
Subordinated notes	—	—	—
Long-term debt and mandatorily redeemable securities	311	(192)	119
Total interest-bearing liabilities	$ 1,241	$ 2,697	$3,938
Net interest income - FTE	$ 11,967	$ (8,702)	$3,265

Noninterest Income — Noninterest income increased $9.76 million or 10.97% in 2017 from 2016 following a $5.63 million or 6.76% increase in 2016 over 2015. The following table shows noninterest income for the most recent three years ended December 31.

(Dollars in thousands)	2017	2016	2015
Noninterest income:			
Trust and wealth advisory	$20,980	$19,256	$19,126
Service charges on deposit accounts	9,564	9,053	9,313
Debit card	11,809	10,887	10,217
Mortgage banking	4,796	4,496	4,570
Insurance commissions	5,889	5,513	5,465

Equipment rental	30,381	25,863	22,302
Gains on investment securities available-for-sale	4,340	1,796	4
Other	10,947	12,081	12,319
Total noninterest income	$98,706	$88,945	$83,316

Table of Contents

Trust and wealth advisory fees (which include investment management fees, estate administration fees, mutual fund fees, annuity fees, and fiduciary fees) increased $1.72 million or 8.95% in 2017 from 2016 compared to a slight increase in 2016 over 2015. Trust and wealth advisory fees are largely based on the number and size of client relationships and the market value of assets under management. The market value of trust assets under management at December 31, 2017 and 2016 was $4.63 billion and $4.19 billion, respectively. At December 31, 2017, these trust assets were comprised of $3.00 billion of personal and agency trusts and estate administration assets, $1.12 billion of employee benefit plan assets, $0.40 million of individual retirement accounts, and $0.11 million of custody assets.
Service charges on deposit accounts increased $0.51 million or 5.64% in 2017 from 2016 compared to a decrease of $0.26 million or 2.79% in 2016 from 2015. The growth in service charges on deposit accounts in 2017 was primarily due to a higher volume of nonsufficient fund transactions and an increase in fees for deposit accounts that went into effect during the first quarter of 2017. The decrease in service charges on deposit accounts in 2016 primarily reflects a lower volume of nonsufficient fund transactions and a decrease in paper statement fees as clients continue to move to online access for account statements.
Debit card income improved $0.92 million or 8.47% in 2017 from 2016 compared to an increase of $0.67 million or 6.56% in 2016 from 2015. The increase in 2017 and 2016 was the result of an increased volume of debit card transactions.
Mortgage banking income increased $0.30 million or 6.67% in 2017 over 2016, compared to a slight decline in 2016 over 2015. We had no MSR impairment in 2017, 2016 or 2015. During 2017, 2016 and 2015, we determined that no permanent write-down was necessary for previously recorded impairment on MSRs. During 2017, mortgage banking income was positively impacted by higher loan servicing fees, offset by lower gains on loan sales due to reduced profit margins and lower secondary market production. During 2016, mortgage banking income was negatively impacted by lower loan servicing fees offset by increased gains on loan sales due to increased profit margins.
Insurance commissions grew $0.38 million or 6.82% in 2017 compared to 2016 and were flat in 2016 compared to 2015. The increase in insurance commissions during 2017 was mainly due to an increase in the book of business and higher contingent commissions received resulting from increased sales and lower client claims.
Equipment rental income generated from operating leases increased by $4.52 million or 17.47% during 2017 from 2016 compared to an increase of $3.56 million or 15.97% during 2016 from 2015. The average equipment rental portfolio increased 20.01% in 2017 over 2016 and 25.41% in 2016 over 2015 as the result of growth in construction equipment and auto and light trucks. In 2017 and 2016, the increase in equipment rental income was offset by a similar increase in depreciation on equipment owned under operating leases.
Sales of investment securities available-for-sale resulted in net gains of $4.34 million for the year ended 2017 compared to gains of $1.80 million for the year ended 2016 and gains of $4,000 for the year ended 2015. During 2017, gains of $7.43 million were the result of sales of marketable equity securities. These gains were offset by losses of $2.90 million on sales of federal agencies and mortgage-backed securities from repositioning the investment portfolio and an other than temporary impairment charge of $0.19 million on a marketable equity security. The gains in 2016 were the result of sales of marketable equity securities and U.S. States and political subdivisions securities offset by an other than temporary impairment charge of $0.29 million on a marketable equity security.
Other income decreased $1.13 million or 9.39% in 2017 from 2016 compared to a decline of $0.24 million or 1.93% in 2016 from 2015. The reduction in 2017 was mainly a result of gains on the liquidation of a partnership investment that occurred during 2016. Other items contributing to the decrease included lower monogram fund income and reduced brokerage fees and commissions. These decreases were offset by higher customer swap fees. The decrease in 2016 was mainly the result of lower monogram fund income, decreased customer swap fees and a reduction in claim proceeds from bank owned life insurance offset by gains on the liquidation of a partnership investment required by the Volcker Rule and higher brokerage fees and commissions.

Table of Contents

Noninterest Expense — Noninterest expense increased $10.35 million or 6.33% in 2017 over 2016 following a $4.53 million or 2.85% increase in 2016 from 2015. The following table shows noninterest expense for the most recent three years ended December 31.

(Dollars in thousands)	2017	2016	2015
Noninterest expense:			
Salaries and employee benefits	$86,912	$86,837	$86,133
Net occupancy	10,624	9,686	9,768
Furniture and equipment	20,769	19,500	18,348
Depreciation — leased equipment	25,215	21,678	18,280
Professional fees	6,810	5,161	4,682
Supplies and communications	5,355	5,244	6,011
FDIC and other insurance	2,537	3,147	3,412
Business development and marketing	7,477	4,936	4,837
Loan and lease collection and repossession	2,724	1,600	667
Other	5,574	5,856	6,976
Total noninterest expense	$173,997	$163,645	$159,114

Total salaries and employee benefits increased slightly in 2017 from 2016, following a slight increase in 2016 from 2015.

Employee salaries increased $0.87 million or 1.25% in 2017 from 2016 compared to an increase of $1.11 million of 1.61% in 2016 from 2015. The increase in 2017 was mainly a result of higher base salaries and executive incentives. Higher base salary expense was primarily due to normal performance raises. The increase in 2016 was mainly a result of higher base salaries offset by lower executive incentives. Higher base salary expense was primarily due to normal performance raises.

Employee benefits decreased $0.80 million or 4.70% in 2017 from 2016, compared to a $0.41 million or 2.35% decrease in 2016 from 2015. During 2017 and 2016, group insurance costs declined as a result of overall lower health insurance claims experience.

Occupancy expense increased $0.94 million or 9.68% in 2017 from 2016, compared to being flat in 2016 from 2015. The higher expense in 2017 was mainly attributed to higher depreciation resulting from the demolition and rebuild of a banking center, increased repair and maintenance costs, and increased rent expense.

Furniture and equipment expense, including depreciation, grew by $1.27 million or 6.51% in 2017 from 2016 compared to an increase of $1.15 million or 6.28% in 2016 from 2015. The higher expense in 2017 was primarily due to increased software maintenance costs and software costs related to a customer relationship management project. The higher expense in 2016 was mainly due to increased software maintenance costs, depreciation on new equipment with banking center remodels and computer processing charges.

Depreciation on equipment owned under operating leases increased $3.54 million or 16.32% in 2017 from 2016, following a $3.40 million or 18.59% increase in 2016 from 2015. In 2017 and 2016, depreciation on equipment owned under operating leases correlates with the growth in equipment rental income.

Professional fees grew $1.65 million or 31.95% in 2017 from 2016, compared to a $0.48 million or 10.23% increase in 2016 from 2015. The higher expense in 2017 was primarily due to increased utilization of consulting services related to a customer relationship management project and information technology projects offset by lower legal fees. The increase in 2016 was primarily due to higher legal fees and the increased utilization of consulting services.

Supplies and communications expense increased slightly in 2017 from 2016, and decreased $0.77 million or 12.76% in 2016 from 2015. The reduction in 2016 was mainly the result of costs associated with replacing debit cards with embedded EMV chip cards in 2015 and lower telephone charges.

FDIC and other insurance expense decreased $0.61 million or 19.38% in 2017 from 2016 and decreased $0.27 million or 7.76% in 2016 from 2015. The decline in 2017 and 2016 was mainly due to lower assessments as a result of the Deposit Insurance Fund’s reserve ratio exceeding the FDIC’s established benchmark.

Business development and marketing expenses increased $2.54 million or 51.48% in 2017 from 2016 compared to a slight increase in 2016 from 2015. The higher expense in 2017 was mainly the result of higher charitable contributions

of $2.01 million and additional marketing expenses. The lower expense in 2016 was the result of decreased charitable contributions offset by increased marketing promotions.

Table of Contents

Loan and lease collection and repossession expenses increased $1.12 million or 70.25% in 2017 from 2016 compared to an increase of $0.93 million or 139.88% in 2016 from 2015. Loan and lease collection and repossession expense was higher in 2017 primarily due to higher general collection and repossession expenses and increased valuation adjustments. The increase in 2016 was mainly due to lower recoveries on repurchased mortgage loans, fewer gains on the sale of other real estate owned and repossessions and an increase in general collection and repossession expenses offset by decreased valuation adjustments.

Other expenses declined $0.28 million or 4.82% in 2017 as compared to 2016 and decreased $1.12 million or 16.06% in 2016 as compared to 2015. The decrease in 2017 was mainly the result of higher gains on sale of operating leased equipment and fixed assets and reduced intangible asset amortization as items fully amortize offset by higher provision on unfunded loan commitments and increased training expenses. The decrease in 2016 was mainly the result of reduced residential mortgage foreclosure expenses, lower provision on unfunded loan commitments, higher gains on the sale of fixed assets, reduced intangible asset amortization as items fully amortize offset by higher fraud losses and reduced gains on the sale of operating lease equipment.

Income Taxes — 1st Source recognized income tax expense in 2017 of $33.31 million, compared to $31.34 million in 2016, and $31.08 million in 2015. The effective tax rate in 2017 was 32.86% compared to 35.16% in 2016, and 35.09% in 2015. The 2017 provision for income taxes included a one-time benefit of $2.61 million from the revaluation of net deferred tax liabilities. This benefit was a result of federal tax legislation enacted in December 2017 that reduced the corporate income tax rate from 35% to 21%, effective January 1, 2018.

For a detailed analysis of 1st Source's income taxes see Part II, Item 8, Financial Statements and Supplementary Data — Note 17 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)	2017	2016	2015	2014	2013
Commercial and agricultural	$929,997	$812,264	$744,749	$710,758	$679,492
Auto and light truck	496,816	411,764	425,236	397,902	391,649
Medium and heavy duty truck	296,935	294,790	278,254	247,153	237,854
Aircraft	844,657	802,414	778,012	727,665	738,133
Construction equipment	563,437	495,925	455,565	399,940	333,088
Commercial real estate	741,568	719,170	700,268	616,587	583,997
Residential real estate and home equity	526,122	521,931	490,468	476,504	495,273
Consumer	128,146	129,813	122,140	112,065	89,838
Total loans and leases	$4,527,678	$4,188,071	$3,994,692	$3,688,574	$3,549,324

At December 31, 2017, there were no concentrations within the loan portfolio of 10% or more of total loans and leases.

Loans and leases, net of unearned discount, at December 31, 2017, were $4.53 billion and were 76.91% of total assets, compared to $4.19 billion and 76.34% of total assets at December 31, 2016. Average loans and leases, net of unearned discount, increased $219.87 million or 5.34% and increased $276.36 million or 7.20% in 2017 and 2016, respectively.

Commercial and agricultural lending, excluding those loans secured by real estate, increased $117.73 million or 14.49% in 2017 over 2016. Commercial and agricultural lending outstandings were $930.00 million and $812.26 million at December 31, 2017 and December 31, 2016, respectively. This increase was mainly attributed to growth in our new solar financing initiatives and an improved economy in our target markets, resulting in greater line of credit usage and the financing of increased capital expenditures by our clients. During 2017, we grew our solar loan and lease outstandings by $56.77 million or 288.08% to $76.48 million.

Auto and light truck loans increased $85.05 million or 20.66% in 2017 over 2016. At December 31, 2017, auto and light truck loans had outstandings of $496.82 million and $411.76 million at December 31, 2016. This increase was primarily attributable to targeted growth in the motor coach and shuttle bus segments of $52.46 million, continued growth in the commercial lessor segment and deeper penetration in the car rental segment.

Medium and heavy duty truck loans and leases grew slightly in 2017. Medium and heavy duty truck financing at December 31, 2017 and 2016 had outstandings of $296.94 million and $294.79 million, respectively. Most of the increase at December 31, 2017 from December 31, 2016 can be attributed to clients continued replacement of aged equipment.

Table of Contents

Aircraft financing at year-end 2017 increased $42.24 million or 5.26% from year-end 2016. Aircraft financing at December 31, 2017 and 2016 had outstandings of $844.66 million and $802.41 million, respectively. The increase during 2017 was mainly due to growth in domestic outstandings of $49.20 million offset by decreased foreign outstandings of $5.77 million, primarily in Mexico. The domestic outstanding increases were in our core aviation segments of personal business and contract operators. Our foreign loan and lease outstandings, all denominated in U.S. dollars were $233.37 million and $239.14 million as of December 31, 2017 and 2016, respectively. Loan and lease outstandings to borrowers in Brazil and Mexico were $101.35 million and $121.02 million as of December 31, 2017, respectively, compared to $96.31 million and $132.46 million as of December 31, 2016, respectively. Outstanding balances to other borrowers in other countries were insignificant.

Construction equipment financing increased $67.51 million or 13.61% in 2017 compared to 2016. Construction equipment financing at December 31, 2017 had outstandings of $563.44 million, compared to outstandings of $495.93 million at December 31, 2016. The growth in this category was primarily due to new client relationships and continued replacement of aged equipment.

Commercial loans secured by real estate, of which approximately 60% is owner occupied, increased $22.40 million or 3.11% in 2017 over 2016. Commercial loans secured by real estate outstanding at December 31, 2017 were $741.57 million and $719.17 million at December 31, 2016. The increase in 2017 was primarily in owner occupied financing driven by general improvements in the business economy within our markets. Our non-owner occupied real estate portfolio experienced lower growth as new business was largely offset by payoffs resulting from clients taking advantage of market conditions to sell their real estate properties or to refinance them via long term secondary market financing.

Residential real estate and home equity loans were $526.12 million at December 31, 2017 and $521.93 million at December 31, 2016. Residential real estate and home equity loans increased $4.19 million in 2017 from 2016. Residential mortgage outstandings remain relatively stable due to lower demand for refinance combined with purchase mortgages hampered by limited housing inventory in our markets. We experienced a higher demand for residential home equity loans.

Consumer loans decreased $1.67 million or 1.28% in 2017 over 2016. Consumer loans outstanding at December 31, 2017, were $128.15 million and $129.81 million at December 31, 2016. The decrease during 2017 was due to lower demand for personal lines of credit as consumers utilized their home equity lines more for interest deduction.

The following table shows the maturities of loans and leases in the categories of commercial and agricultural, auto and light truck, medium and heavy duty truck, aircraft and construction equipment outstanding as of December 31, 2017.

(Dollars in thousands)	0-1 Year	1-5 Years	Over 5 Years	Total
Commercial and agricultural	$455,843	$362,247	$ 111,907	$929,997
Auto and light truck	184,292	291,130	21,394	496,816
Medium and heavy duty truck	102,308	191,501	3,126	296,935
Aircraft	186,171	561,101	97,385	844,657
Construction equipment	177,803	359,082	26,552	563,437
Total	$1,106,417			