1ST SOURCE CORP
Form 10-Q
July 21, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2011

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 (State or other jurisdiction of incorporation or organization)	**35-1068133** (I.R.S. Employer Identification No.)
100 North Michigan Street **South Bend, IN** (Address of principle executive offices)	**46614** (Zip Code)

(574) 235-2000

(Registrant s telephone number, including area code)

Not Applicable

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

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

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

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

Large accelerated filer o	Accelerated filer x
Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

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

Number of shares of common stock outstanding as of July 15, 2011 24,213,142 shares

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1st SOURCE CORPORATION

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Unaudited - Dollars in thousands)

	June 30, 2011	December 31, 2010
ASSETS		
Cash and due from banks	$ 59,249	$ 62,313
Federal funds sold and interest bearing deposits with other banks	100	34,559
Investment securities available-for-sale (amortized cost of $878,401 and $952,101 at June 30, 2011 and December 31, 2010, respectively)	902,742	969,018
Other investments	18,974	21,343
Trading account securities	143	138
Mortgages held for sale	7,805	32,599
Loans and leases - net of unearned discount		
Commercial and agricultural loans	551,820	530,228
Auto, light truck and environmental equipment	473,925	396,500
Medium and heavy duty truck	155,423	162,824
Aircraft financing	607,567	614,357
Construction equipment financing	274,968	285,634
Commercial real estate	568,226	594,729
Residential real estate	390,389	390,951
Consumer loans	95,839	95,400
Total loans and leases	3,118,157	3,070,623
Reserve for loan and lease losses	(85,010)	(86,874)
Net loans and leases	3,033,147	2,983,749
Equipment owned under operating leases, net	77,102	78,138
Net premises and equipment	36,885	33,881
Goodwill and intangible assets	88,325	88,955
Accrued income and other assets	130,479	140,588
Total assets	$ 4,354,951	$ 4,445,281
LIABILITIES		
Deposits:		
Noninterest bearing	$ 516,189	$ 524,564
Interest bearing	3,007,127	3,098,181
Total deposits	3,523,316	3,622,745
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	108,799	136,028
Other short-term borrowings	21,324	19,961
Total short-term borrowings	130,123	155,989
Long-term debt and mandatorily redeemable securities	36,785	24,816
Subordinated notes	89,692	89,692
Accrued expenses and other liabilities	69,441	65,656
Total liabilities	3,849,357	3,958,898
SHAREHOLDERS EQUITY		
Preferred stock; no par value		
Authorized 10,000,000 shares; none issued or outstanding		
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,643,506 at June 30, 2011 and December 31, 2010	346,535	350,282
Retained earnings	175,374	157,875

Cost of common stock in treasury (1,431,804 shares at June 30, 2011 and 1,470,696 shares at December 31, 2010)		(31,437)		(32,284)
Accumulated other comprehensive income		15,122		10,510
Total shareholders equity		505,594		486,383
Total liabilities and shareholders equity	$	4,354,951	$	4,445,281

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

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1st SOURCE CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited - Dollars in thousands, except per share amounts)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2011	2010	2011	2010
Interest income:				
Loans and leases	$ 41,710	$ 43,099	$ 83,009	$ 85,369
Investment securities, taxable	4,912	5,279	9,394	10,680
Investment securities, tax-exempt	1,004	1,422	2,190	2,889
Other	247	250	490	524
Total interest income	47,873	50,050	95,083	99,462
Interest expense:				
Deposits	8,162	11,573	16,517	23,978
Short-term borrowings	74	206	163	394
Subordinated notes	1,648	1,647	3,295	3,294
Long-term debt and mandatorily redeemable securities	405	375	664	645
Total interest expense	10,289	13,801	20,639	28,311
Net interest income	37,584	36,249	74,444	71,151
Provision for loan and lease losses	67	5,798	2,265	10,186
Net interest income after provision for loan and lease losses	37,517	30,451	72,179	60,965
Noninterest income:				
Trust fees	4,411	4,062	8,403	7,807
Service charges on deposit accounts	4,638	5,275	8,874	9,895
Mortgage banking income	835	425	1,279	1,202
Insurance commissions	1,062	1,061	2,204	2,526
Equipment rental income	6,009	6,672	12,047	13,417
Other income	3,327	3,012	6,298	5,701
Investment securities and other investment gains	1,142	95	1,272	976
Total noninterest income	21,424	20,602	40,377	41,524
Noninterest expense:				
Salaries and employee benefits	19,135	18,848	37,773	37,658
Net occupancy expense	2,051	1,939	4,371	4,426
Furniture and equipment expense	3,561	3,196	6,910	5,996
Depreciation - leased equipment	4,795	5,304	9,600	10,668
Professional fees	1,080	1,418	2,176	2,932
Supplies and communication	1,316	1,338	2,710	2,707
FDIC and other insurance	958	1,667	2,634	3,341
Business development and marketing expense	864	880	1,486	1,447
Loan and lease collection and repossession expense	1,500	3,267	2,824	4,373
Other expense	683	1,792	3,935	3,211
Total noninterest expense	35,943	39,649	74,419	76,759
Income before income taxes	22,998	11,404	38,137	25,730

Income tax expense		8,133		3,609		12,664		8,256
Net income		14,865		7,795		25,473		17,474
Preferred stock dividends and discount accretion				(1,717)				(3,428)
Net income available to common shareholders	$	14,865	$	6,078	$	25,473	$	14,046
Per common share								
Basic net income per common share	$	0.61	$	0.25	$	1.04	$	0.57
Diluted net income per common share	$	0.61	$	0.25	$	1.04	$	0.57
Dividends	$	0.16	$	0.15	$	0.32	$	0.30
Basic weighted average common shares outstanding		24,254,334		24,284,519		24,262,803		24,247,586
Diluted weighted average common shares outstanding		24,263,596		24,292,491		24,271,527		24,254,098

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

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CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY

(Unaudited - Dollars in thousands, except per share amounts)

	Total	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net
Balance at January 1, 2010	$ 570,320	$ 104,930	$ 350,269	$ 142,407	$ (32,380)	$ 5,094
Comprehensive Income, net of tax:						
Net Income	17,474			17,474		
Change in unrealized appreciation of available-for-sale securities, net of tax	9,411					9,411
Reclassification adjustment for gains included in net income, net of tax	(174)					(174)
Total Comprehensive Income	26,711					
Issuance of 188,470 common shares under stock based compensation awards, including related tax effects	2,884			628	2,256	
Cost of 21,471 shares of common stock acquired for treasury	(362)				(362)	
Preferred stock discount accretion		653		(653)		
Preferred stock dividend (paid and/or accrued)	(2,775)			(2,775)		
Common stock dividend ($0.30 per share)	(7,282)			(7,282)		
Stock based compensation	6		6			
Balance at June 30, 2010	$ 589,502	$ 105,583	$ 350,275	$ 149,799	$ (30,486)	$ 14,331
Balance at January 1, 2011	$ 486,383	$	$ 350,282	$ 157,875	$ (32,284)	$ 10,510
Comprehensive Income, net of tax:						
Net Income	25,473			25,473		
Change in unrealized appreciation of available-for-sale securities, net of tax	5,457					5,457
Reclassification adjustment for gains included in net income, net of tax	(845)					(845)
Total Comprehensive Income	30,085					
Issuance of 148,291 common shares under stock based compensation awards, including related tax effects	2,818			(168)	2,986	
Cost of 109,399 shares of common stock acquired for treasury	(2,139)				(2,139)	
Repurchase of common stock warrant	(3,750)		(3,750)			

Common stock dividend ($0.32 per share)	(7,806)			(7,806)		
Stock based compensation	3		3			
Balance at June 30, 2011	$ 505,594	$	$ 346,535	$ 175,374	$ (31,437)	$ 15,122

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

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CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited - Dollars in thousands)

	Six Months Ended June 30, 2011	2010
Operating activities:		
Net income	$ 25,473	$ 17,474
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	2,265	10,186
Depreciation of premises and equipment	1,780	2,156
Depreciation of equipment owned and leased to others	9,600	10,668
Amortization of investment security premiums and accretion of discounts, net	965	795
Amortization of mortgage servicing rights	1,458	1,461
Mortgage servicing asset impairment	16	970
Deferred income taxes	(755)	8,637
Investment securities and other investment gains	(1,272)	(976)
Originations/purchases of loans held for sale, net of principal collected	(40,963)	(138,692)
Proceeds from the sales of loans held for sale	66,258	107,651
Net gain on sale of loans held for sale	(500)	(1,394)
Change in trading account securities	(5)	12
Change in interest receivable	918	1,255
Change in interest payable	2,462	3,238
Change in other assets	8,347	(3,482)
Change in other liabilities	(734)	(6,355)
Other	2,620	387
Net change in operating activities	77,933	13,991
Investing activities:		
Proceeds from sales of investment securities	126,805	71,917
Proceeds from maturities of investment securities	107,843	215,792
Purchases of investment securities	(160,641)	(303,604)
Net change in other investments	2,370	2,056
Loans sold or participated to others	11,010	9,886
Net change in loans and leases	(62,674)	(58,893)
Net change in equipment owned under operating leases	(8,564)	(4,952)
Purchases of premises and equipment	(5,589)	(1,041)
Net change in investing activities	10,560	(68,839)
Financing activities:		
Net change in demand deposits, NOW accounts and savings accounts	(108,064)	44,177
Net change in certificates of deposit	8,635	(87,055)
Net change in short-term borrowings	(25,866)	(8,336)
Proceeds from issuance of long-term debt	10,554	10,346
Payments on long-term debt	(256)	(289)
Net proceeds from issuance of treasury stock	2,818	2,884
Acquisition of treasury stock	(2,139)	(362)
Repurchase of common stock warrant	(3,750)	
Cash dividends paid on preferred stock		(2,775)
Cash dividends paid on common stock	(7,948)	(7,408)
Net change in financing activities	(126,016)	(48,818)

Net change in cash and cash equivalents		(37,523)		(103,666)
Cash and cash equivalents, beginning of year		96,872		210,102
Cash and cash equivalents, end of period	$	59,349	$	106,436
Non-cash transactions:				
Loans transferred to other real estate and repossessed assets	$	6,721	$	10,939
Common stock matching contribution to KSOP plan		2,420		2,545

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

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1ST SOURCE CORPORATION

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in shareholders equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted. The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation s Annual Report on Form 10-K (2010 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The balance sheet at December 31, 2010 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform with the current year presentation.

Cash Flow For purposes of the consolidated statements of cash flow, we consider cash and due from banks, federal funds sold and interest bearing deposits with other banks with original maturities of three months or less as cash and cash equivalents.

Note 2. Recent Accounting Pronouncements

Comprehensive Income: In June 2011, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-05 *Comprehensive Income (Topic 220) Presentation of Comprehensive Income.* ASU 2011-05 requires that all nonowner changes in stockholders equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 is effective retrospectively for fiscal years, and interim periods within those years, beginning after December 15, 2011. We are assessing the impact of ASU 2011-05 on our comprehensive income presentation.

Fair Value Measurements: In May 2011, the FASB issued ASU No. 2011-04 *Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs.* ASU 2011-04 changes the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs (International Financial Reporting Standards). ASU 2011-04 is effective prospectively during interim and annual periods beginning on or after December 15, 2011. Early application by public entities is not permitted. We are assessing the impact of ASU 2011-04 on our fair value disclosures.

Transfers and Servicing: In April 2011, the FASB issued ASU No. 2011-03 *Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement.* ASU 2011-03 removes from the assessment of effective control the criterion relating to the transferor s ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should

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be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. We are assessing the impact of ASU 2011-03 on our financial condition, results of operations, and disclosures.

Receivables: In April 2011, the FASB issued ASU No. 2011-02 *Receivables (Topic 310) A Creditor s Determination of Whether a Restructuring is a Troubled Debt Restructuring.* ASU 2011-02 clarifies whether loan modifications constitute troubled debt restructuring. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 is effective for the first interim and annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. We are assessing the impact of ASU 2011-02 on our financial condition, results of operations, and disclosures.

Business Combinations: In December 2010, the FASB issued ASU No. 2010-29 *Business Combinations (Topic 805) - Disclosure of Supplementary Pro Forma Information for Business Combinations.* If a public entity presents comparative financial statements, the entity should disclose revenue and earnings of the combined entity as though the business combination that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period only. ASU 2010-29 also expands the supplementary pro forma disclosures. ASU 2010-29 was effective prospectively for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2010. ASU 2010-29 will only affect us if there are future business combinations.

Intangibles - Goodwill and Other: In December 2010, the FASB issued ASU No. 2010-28 *Intangibles - Goodwill and Other (Topic 350) - When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts*. ASU 2010-28 affects all entities that have recognized goodwill and have one or more reporting units whose carrying amount for purposes of performing Step 1 of the goodwill impairment test is zero or negative. ASU 2010-28 was effective for fiscal years and interim periods within those years, beginning after December 15, 2010. ASU 2010-28 did not have an impact on our financial condition, results of operations, or disclosures.

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Note 3. Investment Securities

Investment securities available-for-sale were as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2011				
U.S. Treasury and Federal agencies securities	$ 376,304	$ 6,998	$ (127)	$ 383,175
U.S. States and political subdivisions securities	112,900	5,310	(786)	117,424
Mortgage-backed securities Federal agencies	339,583	9,898	(225)	349,256
Corporate debt securities	40,563	181	(70)	40,674
Foreign government and other securities	6,705	44	(54)	6,695
Total debt securities	876,055	22,431	(1,262)	897,224
Marketable equity securities	2,346	3,176	(4)	5,518
Total investment securities available-for-sale	$ 878,401	$ 25,607	$ (1,266)	$ 902,742
December 31, 2010				
U.S. Treasury and Federal agencies securities	$ 442,612	$ 5,546	$ (849)	$ 447,309
U.S. States and political subdivisions securities	147,679	4,381	(1,753)	150,307
Mortgage-backed securities Federal agencies	309,046	7,854	(232)	316,668
Corporate debt securities	45,778	182	(345)	45,615
Foreign government and other securities	5,732	18	(34)	5,716
Total debt securities	950,847	17,981	(3,213)	965,615
Marketable equity securities	1,254	2,152	(3)	3,403
Total investment securities available-for-sale	$ 952,101	$ 20,133	$ (3,216)	$ 969,018

At June 30, 2011 and December 31, 2010, the residential mortgage-backed securities we held consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (or Government Sponsored Enterprise, GSEs).

The contractual maturities of debt securities available-for-sale at June 30, 2011 are shown below. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)	Amortized Cost	Fair Value
Due in one year or less	$ 45,160	$ 45,550
Due after one year through five years	337,681	344,378
Due after five years through ten years	146,453	151,643
Due after ten years	7,178	6,397
Mortgage-backed securities	339,583	349,256
Total debt securities available-for-sale	$ 876,055	$ 897,224

The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. The gross gains and losses in the first six months of 2011 primarily reflect the sale of municipal, Farmer Mac, FHLB and FFCB debt securities. The sale of municipal securities was to reduce credit risk exposure in certain states. The action to sell agency securities was to improve future yield. There was no impact to other than temporary impairment (OTTI) as a result of the 2011 sales. The gross gains and losses in the first six months of 2010 reflect the disposition of FNMA and FHLMC debt securities. There were no OTTI write-downs in 2011 or 2010.

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(Dollars in thousands)	Three Months Ended June 30, 2011	2010	Six Months Ended June 30, 2011	2010
Gross realized gains	$ 1,153	$	$ 1,598	$ 292
Gross realized losses			(238)	(12)
Net realized gains (losses)	$ 1,153	$	$ 1,360	$ 280

There were net gains of $5 thousand for the six months ended June 30, 2011 and net losses of $11 thousand recorded for the six months ended June 30, 2010 on $0.14 million in trading securities outstanding at June 30, 2011 and at December 31, 2010.

The following tables summarize our gross unrealized losses and fair value by investment category and age:

	Less than 12 Months		12 months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2011						
U.S. Treasury and Federal agencies securities	$ 39,869	$ (127)	$	$	$ 39,869	$ (127)
U.S. States and political subdivisions securities	1,582	(34)	6,426	(752)	8,008	(786)
Mortgage-backed securities - Federal agencies	50,235	(201)	4,215	(24)	54,450	(225)
Corporate debt securities	17,090	(70)			17,090	(70)
Foreign government and other securities	940	(54)			940	(54)
Total debt securities	109,716	(486)	10,641	(776)	120,357	(1,262)
Marketable equity securities	1		4	(4)	5	(4)
Total investment securities available-for-sale	$ 109,717	$ (486)	$ 10,645	$ (780)	$ 120,362	$ (1,266)
December 31, 2010						
U.S. Treasury and Federal agencies securities	$ 158,497	$ (849)	$	$	$ 158,497	$ (849)
U.S. States and political subdivisions securities	9,226	(246)	9,055	(1,507)	18,281	(1,753)
Mortgage-backed securities - Federal agencies	23,351	(213)	4,887	(19)	28,238	(232)
Corporate debt securities	26,407	(345)			26,407	(345)
Foreign government and other securities	3,015	(34)			3,015	(34)
Total debt securities	220,496	(1,687)	13,942	(1,526)	234,438	(3,213)
Marketable equity securities			5	(3)	5	(3)
Total investment securities available-for-sale	$ 220,496	$ (1,687)	$ 13,947	$ (1,529)	$ 234,443	$ (3,216)

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

At June 30, 2011, we do not have the intent to sell any of the available-for-sale securities in the table above and believe that it is more likely than not that we will not have to sell any such securities before an anticipated recovery of cost. The unrealized losses are due to increases in market interest rates over the yields available at the time the underlying securities were purchased and market illiquidity on auction rate securities which are reflected in U.S. States and Political subdivisions securities. The fair value is expected to recover on all debt securities as they approach their maturity date or repricing date or if market yields for such investments decline. We do not believe any of the securities are impaired due to reasons of credit quality. Accordingly, as of June 30, 2011, we believe the impairments detailed in the table above are temporary and no impairment loss has been

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realized in our consolidated statements of income.

At June 30, 2011 and December 31, 2010, investment securities with carrying values of $255.75 million and $299.88 million, respectively, were pledged as collateral to secure government deposits, security repurchase agreements, and for other purposes.

Note 4. Loan and Lease Financings

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

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

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

	Credit Quality Grades		
(Dollars in thousands)	1-6	7-12	Total
June 30, 2011			
Commercial and agricultural loans	$ 504,680	$ 47,140	$ 551,820
Auto, light truck and environmental equipment	468,911	5,014	473,925
Medium and heavy duty truck	140,418	15,005	155,423
Aircraft financing	560,855	46,712	607,567
Construction equipment financing	249,834	25,134	274,968
Commercial real estate	508,983	59,243	568,226
Total	$ 2,433,681	$ 198,248	$ 2,631,929
December 31, 2010			
Commercial and agricultural loans	$ 483,603	$ 46,625	$ 530,228
Auto, light truck and environmental equipment	389,774	6,726	396,500
Medium and heavy duty truck	143,431	19,393	162,824
Aircraft financing	555,106	59,251	614,357
Construction equipment financing	246,644	38,990	285,634
Commercial real estate	532,581	62,148	594,729
Total	$ 2,351,139	$ 233,133	$ 2,584,272

The table below presents the recorded investment in residential real estate and consumer loans by performing or non-performing status. Non-performing loans are those loans which are on nonaccrual status or are 90 days or more past due.

(Dollars in thousands)	Performing	Nonperforming	Total
June 30, 2011			
Residential real estate	$ 385,901	$ 4,488	$ 390,389
Consumer	95,427	412	95,839
Total	$ 481,328	$ 4,900	$ 486,228
December 31, 2010			
Residential real estate	$ 385,729	$ 5,222	$ 390,951
Consumer	94,973	427	95,400
Total	$ 480,702	$ 5,649	$ 486,351

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

(Dollars in thousands)	Current	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due and Accruing	Total Accruing Loans	Nonaccrual	Total Financing Receivables
June 30, 2011							
Commercial and agricultural loans	$ 545,602	$ 792	$ 160	$	$ 546,554	$ 5,266	$ 551,820
Auto, light truck and environmental equipment	470,680	468	240		471,388	2,537	473,925
Medium and heavy duty truck	151,076	138	3		151,217	4,206	155,423
Aircraft financing	586,772	3,640	124		590,536	17,031	607,567
Construction equipment financing	267,846	1,364	1,482		270,692	4,276	274,968
Commercial real estate	538,707	1,682	796		541,185	27,041	568,226
Residential real estate	382,960	2,222	719	272	386,173	4,216	390,389
Consumer	94,220	935	272	65	95,492	347	95,839
Total	$ 3,037,863	$ 11,241	$ 3,796	$ 337	$ 3,053,237	$ 64,920	$ 3,118,157
December 31, 2010							
Commercial and agricultural loans	$ 521,363	$ 760	$ 22	$	$ 522,145	$ 8,083	$ 530,228
Auto, light truck and environmental equipment	391,925	528	715		393,168	3,332	396,500
Medium and heavy duty truck	157,723	33			157,756	5,068	162,824
Aircraft financing	580,174	16,097	188		596,459	17,898	614,357
Construction equipment financing	275,204	1,254	601		277,059	8,575	285,634
Commercial real estate	567,254	759	94		568,107	26,622	594,729
Residential real estate	381,368	3,781	580	264	385,993	4,958	390,951
Consumer	93,290	1,152	531	98	95,071	329	95,400
Total	$ 2,968,301	$ 24,364	$ 2,731	$ 362	$ 2,995,758	$ 74,865	$ 3,070,623

A loan or lease is considered impaired, based on current information and events, if it is probable that we will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan or lease agreement. The table below presents impaired loans and leases, segregated by class, and the corresponding reserve for impaired loan and lease losses.

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(Dollars in thousands)	Recorded Investment	Unpaid Principal Balance	Related Allowance
June 30, 2011			
With no related allowance recorded:			
Commercial and agricultural loans	$ 2,771	$ 2,771	$
Auto, light truck and environmental equipment	1,387	1,387	
Medium and heavy duty truck	3,244	3,244	
Aircraft financing	13,938	13,938	
Construction equipment financing	3,670	3,670	
Commercial real estate	22,080	22,084	
Total with no related allowance recorded	47,090	47,094	
With an allowance recorded:			
Commercial and agricultural loans	7,477	7,477	3,051
Auto, light truck and environmental equipment	446	446	105
Medium and heavy duty truck	989	989	172
Aircraft financing	3,008	3,008	817
Construction equipment financing	562	562	20
Commercial real estate	6,717	6,716	639
Total with an allowance recorded	19,199	19,198	4,804
Total impaired loans	$ 66,289	$ 66,292	$ 4,804
December 31, 2010			
With no related allowance recorded:			
Commercial and agricultural loans	$ 4,930	$ 4,930	$
Auto, light truck and environmental equipment	1,596	1,597	
Medium and heavy duty truck	1,748	1,748	
Aircraft financing	4,509	4,509	
Construction equipment financing	5,534	5,535	
Commercial real estate	21,071	21,071	
Total with no related allowance recorded	39,388	39,390	
With an allowance recorded:			
Commercial and agricultural loans	8,282	8,281	4,190
Auto, light truck and environmental equipment	1,136	1,136	377
Medium and heavy duty truck	3,347	3,347	1,049
Aircraft financing	13,913	13,913	2,050
Construction equipment financing	3,374	3,379	648
Commercial real estate	8,625	8,630	893
Total with an allowance recorded	38,677	38,686	9,207
Total impaired loans	$ 78,065	$ 78,076	$ 9,207

Average recorded investment and interest income recognized on impaired loans and leases, segregated by class, is shown in the table below.

	Three Months Ended June 30,			Six Months Ended June 30,		
	2011		2010	2011		2010
(Dollars in thousands)	Average Recorded Investment	Interest Income	Interest Income	Average Recorded Investment	Interest Income	Interest Income
Commercial and agricultural loans	$ 11,342	$ 114	$ 181	$ 12,156	$ 230	$ 206
Auto, light truck and environmental equipment	1,774			2,005	1	
Medium and heavy duty truck	4,350	1	2	4,580	3	3

Aircraft financing	17,070	6	103	16,673	15	103
Construction equipment financing	6,289	8	81	7,300	16	169
Commercial real estate	30,448	49	20	30,156	114	44
Total	$ 71,273	$ 178	$ 387	$ 72,870	$ 379	$ 525

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As of June 30, 2011 and December 31, 2010, we had $6.61 million and $7.31 million, respectively of performing loans classified as troubled debt restructuring.

Note 5. Reserve for Loan and Lease Losses

The reserve for loan and lease loss methodology has been consistently applied for several years, with enhancements instituted periodically. Reserve ratios are reviewed quarterly and revised periodically to reflect recent loss history and to incorporate current risks and trends which may not be recognized in historical data. As we update our historical charge-off analysis, we review the look-back periods for each business loan portfolio. Furthermore, we perform a thorough analysis of charge-offs, non-performing asset levels, special attention outstandings and delinquency in order to review portfolio trends and other factors, including specific industry risks and economic conditions, which may have an impact on the reserves and reserve ratios applied to various portfolios. We adjust the calculated historical based ratio as a result of our analysis of environmental factors, principally economic risk and concentration risk. Key economic factors affecting our portfolios are growth in gross domestic product, unemployment rates, housing market trends, commodity prices, inflation, national and international economic volatility, global debt and capital markets and political stability or lack thereof. Concentration risk is impacted primarily by geographic concentration in Northern Indiana and Southwestern Lower Michigan in our business banking and commercial real estate portfolios and by collateral concentration in our specialty finance portfolios and exposure to foreign markets by geographic risk.

The reserve for loan and lease losses is maintained at a level believed to be adequate by management to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting management s best estimate of probable loan and lease losses related to specifically identified loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. For purposes of determining the reserve, we have segmented our loans and leases into classes based on the associated risks within these segments. We have determined that eight classes exist within our loan and lease portfolio. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for impaired loans, percentage allocations for special attention loans and leases (classified loans and leases and internal watch list credits) without specific reserves, formula reserves (calculated by applying loss factors based upon a review of historical loss experience and qualitative factors) for each business lending division portfolio, and reserves for pooled homogeneous loans and leases. Management s evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

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Changes in the reserve for loan and lease losses, segregated by class, for the three months ended June 30, 2011 and 2010 are shown below.

(Dollars in thousands)	Commercial and agricultural loans	Auto, light truck and environmental equipment	Medium and heavy duty truck	Aircraft financing	Construction equipment financing	Commercial real estate	Residential real estate	Consumer loans	Total
June 30, 2011									
Reserve for loan and lease losses									
Balance, beginning of period	$ 16,305	$ 7,924	$ 5,065	$ 30,903	$ 6,798	$ 15,535	$ 2,542	$ 1,088	$ 86,160
Charge-offs	535	257		530	268	1,234	120	257	3,201
Recoveries	1,492	25		90	63	181	31	102	1,984
Net charge-offs (recoveries)	(957)	232		440	205	1,053	89	155	1,217
Provision (recovery of provision)	(448)	1,349	(481)	(1,902)	209	918	204	218	67
Balance, end of period	$ 16,814	$ 9,041	$ 4,584	$ 28,561	$ 6,802	$ 15,400	$ 2,657	$ 1,151	$ 85,010
Ending balance: individually evaluated for impairment	$ 3,051	$ 105	$ 172	$ 817					