

1ST SOURCE CORP
Form 10-Q
April 27, 2007

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

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the quarterly period ended March 31, 2007

OR
Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the transition period from _____ to _____

Commission file number 0-6233

(Exact name of registrant as specified in its charter)

INDIANA

(State or other jurisdiction of
incorporation or organization)

35-1068133
(I.R.S. Employer
Identification No.)

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

(574) 235-2000

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

Large accelerated filer Accelerated filer X Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No X

Number of shares of common stock outstanding as of April 23, 2007 - 22,509,948 shares

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

| | March 31, 2007 | December 31, 2006 |
|--|-------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 70,962 | \$ 118,131 |
| Federal funds sold and interest bearing deposits with other banks | 136,409 | 64,979 |
| Investment securities available-for-sale (amortized cost of \$643,334 and \$709,091 at March 31, 2007 and December 31, 2006, respectively) | 643,915 | 708,672 |
| Mortgages held for sale | 41,649 | 50,159 |
| Loans and leases - net of unearned discount: | | |
| Commercial and agricultural loans | 508,976 | 478,310 |
| Auto, light truck and environmental equipment | 308,341 | 317,604 |
| Medium and heavy duty truck | 336,254 | 341,744 |
| Aircraft financing | 501,838 | 498,914 |
| Construction equipment financing | 326,779 | 305,976 |
| Loans secured by real estate | 644,819 | 632,283 |
| Consumer loans | 124,408 | 127,706 |
| Total loans and leases | 2,751,415 | 2,702,537 |
| Reserve for loan and lease losses | (58,702) | (58,802) |
| Net loans and leases | 2,692,713 | 2,643,735 |
| Equipment owned under operating leases, net | 75,541 | 76,310 |
| Net premises and equipment | 36,925 | 37,326 |
| Accrued income and other assets | 104,971 | 108,003 |
| Total assets | \$ 3,803,085 | \$ 3,807,315 |
| LIABILITIES | | |
| Deposits: | | |
| Noninterest bearing | \$ 404,350 | \$ 339,866 |
| Interest bearing | 2,629,081 | 2,708,418 |
| Total deposits | 3,033,431 | 3,048,284 |
| Federal funds purchased and securities sold under agreements to repurchase | 204,389 | 195,262 |
| Other short-term borrowings | 18,085 | 27,456 |
| Long-term debt and mandatorily redeemable securities | 43,604 | 43,761 |
| Subordinated notes | 59,022 | 59,022 |
| Accrued expenses and other liabilities | 69,496 | 64,626 |
| Total liabilities | 3,428,027 | 3,438,411 |
| 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 23,791,790 at March 31, 2007 | | |

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and 23,781,518 at December 31, 2006, less unearned shares

| | | |
|--|--------------|--------------|
| (273,258 at March 31, 2007 and 262,986 at December 31, 2006) | 8,336 | 8,336 |
| Capital surplus | 280,827 | 280,827 |
| Retained earnings | 105,231 | 99,572 |
| Cost of common stock in treasury (1,008,838 shares at March 31, 2007, and 1,022,435 shares at December 31, 2006) | (19,697) | (19,571) |
| Accumulated other comprehensive income (loss) | 361 | (260) |
| Total shareholders' equity | 375,058 | 368,904 |
| Total liabilities and shareholders' equity | \$ 3,803,085 | \$ 3,807,315 |

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 March 31, | |
|--|---------------------------------|-----------------|
| | 2007 | 2006 |
| Interest income: | | |
| Loans and leases | \$ 48,274 | \$ 40,888 |
| Investment securities, taxable | 5,730 | 3,925 |
| Investment securities, tax-exempt | 1,417 | 1,267 |
| Other | 532 | 316 |
| Total interest income | 55,953 | 46,396 |
| Interest expense: | | |
| Deposits | 25,270 | 17,033 |
| Short-term borrowings | 2,690 | 2,760 |
| Subordinated notes | 1,094 | 1,050 |
| Long-term debt and mandatorily redeemable securities | 627 | 454 |
| Total interest expense | 29,681 | 21,297 |
| Net interest income | 26,272 | 25,099 |
| Recovery of provision for loan and lease losses | (623) | (300) |
| Net interest income after recovery of provision for loan and lease losses | 26,895 | 25,399 |
| Noninterest income: | | |
| Trust fees | 3,643 | 3,391 |
| Service charges on deposit accounts | 4,570 | 4,386 |
| Mortgage banking income | 571 | 1,757 |
| Insurance commissions | 1,638 | 1,682 |
| Equipment rental income | 5,098 | 4,220 |
| Other income | 1,719 | 1,486 |
| Investment securities and other investment gains | 247 | 2,083 |
| Total noninterest income | 17,486 | 19,005 |
| Noninterest expense: | | |
| Salaries and employee benefits | 17,566 | 15,514 |
| Net occupancy expense | 1,936 | 1,867 |
| Furniture and equipment expense | 3,094 | 3,134 |
| Depreciation - leased equipment | 4,076 | 3,382 |
| Supplies and communication | 1,272 | 1,363 |
| Other expense | 3,856 | 4,146 |
| Total noninterest expense | 31,800 | 29,406 |
| Income before income taxes | 12,581 | 14,998 |
| Income tax expense | 4,058 | 5,065 |
| Net income | \$ 8,523 | \$ 9,933 |
| Per common share*: | | |
| Basic net income per common share | \$ 0.38 | \$ 0.44 |
| Diluted net income per common share | \$ 0.37 | \$ 0.43 |

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| | | | | |
|---|----|------------|----|------------|
| Dividends | \$ | 0.140 | \$ | 0.127 |
| Basic weighted average common shares outstanding* | | 22,504,799 | | 22,647,585 |
| Diluted weighted average common shares outstanding* | | 22,797,557 | | 22,960,502 |

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

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

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1st SOURCE CORPORATION
CONSOLIDATED STATEMENT OF CHANGES IN
SHAREHOLDERS' EQUITY
(Unaudited - Dollars in thousands, except per share amounts)

| | Total | Common Stock | Capital Surplus | Retained Earnings | Common Stock in Treasury | Net Unrealized Appreciation (Depreciation) of Securities Available- For-Sale |
|---|------------|-----------------|--------------------|----------------------|--------------------------------|---|
| Balance at January 1, 2006 | \$ 345,576 | \$ 7,578 | \$ 214,001 | \$ 139,601 | (\$12,364) | (\$3,240) |
| Comprehensive Income, net of tax: | | | | | | |
| Net Income | 9,933 | - | - | 9,933 | - | - |
| Change in unrealized depreciation of available-for-sale securities, net of tax | 190 | - | - | - | - | 190 |
| Total Comprehensive Income | 10,123 | - | - | - | - | - |
| Issuance of 37,107 common shares under stock based compensation plans, including related tax effects | 402 | - | - | 163 | 239 | - |
| Cost of 229,269 shares of common stock acquired for treasury | (5,857) | - | - | - | (5,857) | - |
| Cash dividend (\$0.127 per share)* | (2,894) | - | - | (2,894) | - | - |
| Balance at March 31, 2006 | \$ 347,350 | \$ 7,578 | \$ 214,001 | \$ 146,803 | (\$17,982) | (\$3,050) |
| Balance at January 1, 2007 | \$ 368,904 | \$ 8,336 | \$ 280,827 | \$ 99,572 | (\$19,571) | (\$260) |
| Comprehensive Income, net of tax: | | | | | | |
| Net Income | 8,523 | - | - | 8,523 | - | - |
| Change in unrealized appreciation | 621 | - | - | - | - | 621 |

| | | | | | | |
|--|-------------------|-----------------|-------------------|-------------------|-------------------|---------------|
| of available-for-sale securities, net of tax | | | | | | |
| Total Comprehensive Income | 9,144 | - | - | - | - | - |
| Issuance of 30,355 common shares under stock based compensation plans, including related tax effects | 340 | - | - | 292 | 48 | - |
| Cost of 16,758 shares of common stock acquired for treasury | (174) | - | - | - | (174) | - |
| Cash dividend (\$0.14 per share) | (3,156) | - | - | (3,156) | - | - |
| Balance at March 31, 2007 | \$ 375,058 | \$ 8,336 | \$ 280,827 | \$ 105,231 | (\$19,697) | \$ 361 |

*Per share data gives retroactive recognition to a 10% stock dividend declared on July 27, 2006.

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

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

| | Three Months Ended March 31, | |
|--|------------------------------|-----------|
| | 2007 | 2006 |
| Operating activities: | | |
| Net income | \$ 8,523 | \$ 9,933 |
| Adjustments to reconcile net income to net cash from/(used in) operating activities: | | |
| Recovery of provision for loan and lease losses | (623) | (300) |
| Depreciation of premises and equipment | 1,215 | 1,263 |
| Depreciation of equipment owned and leased to others | 4,076 | 3,382 |
| Change in investment security premiums and discounts, net | (64) | 358 |
| Amortization of mortgage servicing rights | 639 | 1,576 |
| Mortgage servicing asset impairment recoveries | (1) | (9) |
| Change in deferred income taxes | (1,354) | (815) |
| Realized investment securities gains | (247) | (2,083) |
| Change in mortgages held for sale | 8,510 | 862 |
| Change in interest receivable | 938 | 1,055 |
| Change in interest payable | 1,162 | 2,041 |
| Change in other assets | 1,455 | (1,066) |
| Change in other liabilities | 4,683 | (962) |
| Other | 177 | 361 |
| Net change in operating activities | 29,089 | 15,596 |
| Investing activities: | | |
| Proceeds from sales of investment securities | - | 516 |
| Proceeds from maturities of investment securities | 154,101 | 64,567 |
| Purchases of investment securities | (88,034) | (77,682) |
| Net change in short-term investments | (71,429) | 41,577 |
| Loans sold or participated to others | - | 508 |
| Net change in loans and leases | (48,354) | (15,881) |
| Net change in equipment owned under operating leases | (3,307) | (4,540) |
| Purchases of premises and equipment | (839) | (1,159) |
| Net change in investing activities | (57,862) | 7,906 |
| Financing activities: | | |
| Net change in demand deposits, NOW accounts and savings accounts | (17,684) | (251,123) |
| Net change in certificates of deposit | 2,830 | 183,957 |
| Net change in short-term borrowings | (244) | 3,380 |
| Proceeds from issuance of long-term debt | - | 10,273 |
| Payments on long-term debt | (255) | (194) |
| Net proceeds from issuance of treasury stock | 340 | 402 |
| Acquisition of treasury stock | (174) | (5,856) |
| Cash dividends | (3,209) | (2,946) |

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| | | |
|--|-----------|-----------|
| Net change in financing activities | (18,396) | (62,107) |
| Net change in cash and cash equivalents | (47,169) | (38,605) |
| Cash and cash equivalents, beginning of year | 118,131 | 124,817 |
| Cash and cash equivalents, end of period | \$ 70,962 | \$ 86,212 |

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 have been omitted. The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K (2006 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, 2006 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.

Note 2. Recent Accounting Pronouncements

In February 2007, the Financial Accounting Standards Board (FASB) issued Statement No. 159, "*The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB No. 115*" (SFAS No. 159). This standard permits an entity to choose to measure many financial instruments and certain other items at fair value. The fair value option permits companies to choose to measure eligible items at fair value at specified election dates. Companies will report unrealized gains and losses on items for which the fair value option has been elected in earnings after adoption. SFAS No. 159 requires additional disclosures related to the fair value measurements included in the companies financial statements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007. Early adoption is permitted; however, we will adopt SFAS No. 159 on January 1, 2008. We are evaluating the impact of SFAS No. 159 on the consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. 48 (FIN No. 48), "*Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109*" which clarifies the accounting for uncertainty in tax positions. FIN No. 48 requires that we recognize in our financial statements, the impact of a tax position, if that position is more likely than not of being sustained on audit, based on the technical merits of the position. The provisions of FIN No. 48 are effective as of the beginning of our 2007 fiscal year, with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. We adopted the provisions FIN No. 48 on January 1, 2007. Details related to the adoption of FIN No. 48 and the impact on our financial statements are more fully discussed in Note 6 - Uncertainty in Income Taxes.

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SFAS No. 123(R), "*Share-Based Payment*," establishes standards for the accounting for transactions in which an entity (i) exchanges its equity instruments for goods or services, or (ii) incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of the equity instruments. SFAS No. 123(R) eliminates the ability to account for stock-based compensation using APB No. 25 and requires that such transactions be recognized as compensation cost in the income statement based on their fair values on the measurement date, which is generally the date of the grant. We adopted the provisions SFAS No.123(R) on January 1, 2006. Details related to the adoption of SFAS No.123(R) and the impact on our financial statements is more fully discussed in our 2006 Annual Report on Form 10-K in Note K - Employee Stock Benefit Plans.

Reclassifications— Certain amounts in the prior period consolidated financial statements have been reclassified to conform with the current year presentation. These reclassifications had no effect on total assets, shareholders' equity or net income as previously reported. We declared a 10% stock dividend on July 27, 2006; therefore, all share and per share information has been adjusted accordingly.

Note 3. Reserve for Loan and Lease Losses

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. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for identified special attention loans and leases (classified loans and leases and internal watch list credits), percentage allocations for special attention loans and leases without specific reserves, formula reserves for each business lending division portfolio, including a higher percentage reserve allocation for special attention loans and leases without a specific reserve, and reserves for pooled homogeneous loans and leases. Management's evaluation is based upon a continuing review of these portfolios, estimates of future customer performance, collateral values and dispositions and forecasts of future economic and geopolitical events, all of which are subject to judgment and will change.

Note 4. Financial Instruments with Off-Balance-Sheet Risk

To meet the financing needs of our customers, 1st Source Corporation and its subsidiaries are parties to financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate, purchase and sell loans and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statements of financial condition. Our exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan commitments and standby letters of credit is represented by the dollar amount of those instruments. We use the same credit policies and collateral requirements in making commitments and conditional obligations as we do for on-balance-sheet instruments.

We occasionally enter into derivative financial instruments as part of our interest rate risk management strategies. These derivative financial instruments consist of interest rate swaps. As of March 31, 2007, the notional amount of non-hedging interest rate swaps was \$60.00 million.

Trustcorp Mortgage Company and 1st Source Bank (Bank), subsidiaries of 1st Source Corporation, grant mortgage loan commitments to borrowers, subject to normal loan underwriting standards. The interest rate risk associated with these loan commitments is managed by entering into contracts for future deliveries of loans. Loan commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily

represent future cash requirements.

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We issue letters of credit which are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit is essentially the same as that involved in extending loan commitments to customers.

As of March 31, 2007 and December 31, 2006, 1st Source had commitments outstanding to originate and purchase mortgage loans aggregating \$141.16 million and \$113.25 million, respectively. Outstanding commitments to sell mortgage loans aggregated \$87.84 million at March 31, 2007, and \$73.87 million at December 31, 2006. Standby letters of credit totaled \$83.38 million and \$83.15 million at March 31, 2007, and December 31, 2006, respectively. Standby letters of credit have terms ranging from six months to one year.

Note 5. Stock-Based Compensation

As of March 31, 2007, we had five stock-based employee compensation plans, which are more fully described in Note K of the Consolidated Financial Statements in 1st Source's Annual Report on Form 10-K for the year ended December 31, 2006. These plans include two stock option plans, the Employee Stock Purchase Plan, the Executive Incentive Plan, and the Restricted Stock Award Plan.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), using the modified prospective transition method and, therefore, have not restated results for prior periods. Under this transition method, stock-based compensation expense for the first quarter of 2006 included compensation expense for all stock-based compensation awards granted prior to, but that remained unvested as of, January 1, 2006. Compensation expense was based on the grant date fair value estimated in accordance with the original provision of SFAS No. 123.

Prior to January 1, 2006, we accounted for stock-based compensation under the recognition, measurement and pro forma disclosure provisions of APB No. 25, the original provisions of SFAS No. 123, and SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure" (SFAS 148). In accordance with APB No. 25, we generally would have recognized compensation expense for stock awards on the grant date and we generally would have recognized compensation expense for stock options only when we granted options with a discounted exercise price or modified the terms of previously issued options, and would have recognized the related compensation expense ratably over the associated service period, which was generally the option vesting term.

Stock-based compensation expense for all stock-based compensation awards granted after January 1, 2006, is based on the grant-date fair value. For all awards except stock option awards, the grant date fair value is either the fair market value per share or book value per share (corresponding to the type of stock awarded) as of the grant date. For stock option awards, the grant date fair value is estimated using the Black-Scholes option pricing model. For all awards we recognize these compensation costs only for those shares expected to vest on a straight-line basis over the requisite service period of the award, for which we use the related vesting term. We estimate forfeiture rates based on historical employee option exercise and employee termination experience. We have identified separate groups of awardees that exhibit similar option exercise behavior and employee termination experience and have considered them as separate groups in the valuation models and expense estimates.

As a result of our January 1, 2006, adoption of SFAS No.123(R), the impact to the Consolidated Financial Statements on income before income taxes and on net income were additions of \$1.15 million and \$0.71 million at March 31, 2006, respectively. The cumulative effect of the change in accounting for the three months ended March 31, 2006 was \$0.66 million before income taxes and \$0.40 million, after income taxes. The impact on both basic and diluted earnings per share for the three months ended March 31, 2006 was \$0.02 per share. In addition, prior to the adoption of SFAS No. 123(R), we presented the tax benefit of stock option exercises as operating cash flows. Upon the adoption of SFAS No. 123(R), tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options are classified as financing cash flows.

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The stock-based compensation expense recognized in the condensed consolidated statement of operations for the three months ended March 31, 2007 and 2006 was based on awards ultimately expected to vest, and accordingly has been adjusted by the amount of estimated forfeitures. SFAS No. 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Forfeitures were estimated based partially on historical experience.

The aggregate intrinsic value in the table below represents the total pretax intrinsic value (the difference between 1st Source's closing stock price on the last trading day of the first quarter of 2007 (March 31, 2007) and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on March 31, 2007, this amount changes based on the fair market value of 1st Source's stock. Total intrinsic value of options exercised for the three months ended March 31, 2007 was \$267 thousand. Total fair value of options vested and expensed was \$21 thousand, net of tax, for the three months ended March 31, 2007.

| | March 31, 2007 | | Average Remaining Contractual Term (in years) | Total Intrinsic Value (in 000's) |
|---|---------------------|---|---|---|
| | Number of Shares | Weighted Average Grant-date Fair Value | | |
| Options outstanding, beginning of quarter | 489,475 | \$ 26.04 | | |
| Granted | 2,696 | 28.40 | | |
| Exercised | (20,654) | 15.63 | | |
| Forfeited | - | - | | |
| Options outstanding, end of quarter | 471,517 | \$ 26.51 | 1.93 | \$ 662 |
| | | | | |
| Vested and expected to vest at March 31, 2007 | 471,517 | \$ 26.51 | 1.93 | \$ 662 |
| Exercisable at March 31, 2007 | 447,628 | \$ 26.99 | 1.69 | \$ 443 |

The following weighted-average assumptions were used to estimate the fair value of options granted during the three months ended March 31, 2007:

| | |
|----------------------------|------------|
| Risk-free interest rate | 4.10% |
| Expected dividend yield | 1.94% |
| Expected volatility factor | 30.46% |
| Expected option life | 4.67 years |

No options were granted during the three months ended March 31, 2006.

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As of March 31, 2007, there was \$611,412 of total unrecognized compensation cost related to nonvested share-based compensation arrangements. That cost is expected to be recognized over a weighted-average period of 7.89 years.

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The following table summarizes information about stock options outstanding at March 31, 2007:

| Range of Exercise Prices | Number of shares Outstanding | Weighted Average Remaining Contractual Life | Weighted Average Exercise Price | Number of shares Exercisable | Weighted Average Exercise Price |
|--------------------------|------------------------------|---|---------------------------------|------------------------------|---------------------------------|
| \$11.31 to \$17.99 | 29,508 | 5.49 | \$13.38 | 15,758 | \$14.55 |
| \$18.00 to \$26.99 | 55,587 | 3.58 | 21.06 | 51,003 | 21.07 |
| \$27.00 to \$28.40 | 386,422 | 1.43 | 28.30 | 380,867 | 28.29 |

The fair value of each stock option was estimated on the date of grant using the Black-Scholes option-pricing model with the weighed average assumptions included on the table above, under the header “Stock Based Option Valuation and Expense Information under SFAS No.123(R).”

Note 6. Uncertainty in Income Taxes

We adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, on January 1, 2007. As a result of the implementation of FIN No. 48, we recognized no change in the liability for unrecognized tax benefits.

The total amount of unrecognized tax benefits at January 1, 2007, was \$5.79 million. Of that amount, \$3.33 million would affect the effective tax rate if recognized. We recognize interest and penalties through the income tax provision. The total amount of interest and penalties on the date of adoption was \$0.87 million.

Tax years that remain open and subject to audit include federal 2003-2006 years and Indiana 2002-2006 years. Additionally, we have an open tax examination with the Indiana Department of Revenue for the tax years 2002-2004. Indiana is currently proposing adjustments for certain apportionment issues. We are appealing these adjustments.

Note 7. Subsequent Events

Definitive Agreement of Merger with FINA Bancorp, Inc.

On February 19, 2007, we entered into a definitive agreement of merger with FINA Bancorp, Inc. (FINA), in which 1st Source will acquire FINA in an exchange of cash and stock. FINA headquartered in Valparaiso, Indiana, owns First National Bank, Valparaiso, a full service bank with approximately \$620.00 million in assets. The merger, approved by the directors of both companies, is valued at approximately \$135.00 million, or \$3,206.57 per FINA share. The price represents approximately 196% of book value and 41.5 times 2006 earnings before securities losses. 1st Source will pay a minimum of 40% and a maximum of 42% of the purchase price in shares of 1st Source common stock, and the remainder of the purchase price will be paid in cash. The precise exchange ratio will be established at closing based on 1st Source’s stock price prior to the completion of the merger. FINA shareholders will be able to choose whether to receive 1st Source common stock or cash pursuant to election procedures described in the definitive agreement, subject to 1st Source’s ability to reallocate elections on a proportionate basis. The merger is subject to customary closing conditions, including regulatory approval. The Federal Reserve Board of Governors has indicated

that as a condition to its approval of the merger, we may be required to divest one or more branches located in Starke County, Indiana so that our market share in Starke County after the merger does not exceed set limits. We do not expect that this condition will have a material impact on the merger transaction which is expected to be completed in the second quarter of 2007. We believe the purchase of FINA is a natural extension of our service area and is consistent with our growth market expansion initiatives.

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Trustcorp Mortgage Company

During the first quarter of 2007 we determined that 1st Source Bank would acquire the business of Trustcorp Mortgage Company; both are wholly owned subsidiaries of 1st Source Corporation. We believe that this will allow us to focus our home mortgage efforts in the Bank's retail footprint in Indiana and Michigan and provide a foundation for broadening direct relationships with our clients. 1st Source Bank and Trustcorp Mortgage Company presently hold a strong mortgage origination market share within the Bank's traditional 15 county market of Northern Indiana and Southwestern Michigan. This market will continue to be the focus of the Bank's home mortgage business. The acquisition is expected to be completed in the second quarter of 2007.

**ITEM 2.
MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Except for historical information contained herein, the matters discussed in this document express "forward-looking statements." Generally, the words "believe," "expect," "intend," "estimate," "anticipate," "project," "will," "should," and similar expressions indicate forward-looking statements. Those statements, including statements, projections, estimates or assumptions concerning future events or performance, and other statements that are other than statements of historical fact, are subject to material risks and uncertainties. We caution readers not to place undue reliance on any forward-looking statements, which speak only as of the date made. We may make other written or oral forward-looking statements from time to time. Readers are advised that various important factors could cause our actual results or circumstances for future periods to differ materially from those anticipated or projected in such forward-looking statements. Such factors include, but are not limited to, changes in law, regulations or U. S. generally accepted accounting principles; our competitive position within the markets we serve; increasing consolidation within the banking industry; unforeseen changes in interest rates; unforeseen changes in loan prepayment assumptions; unforeseen downturns in or major events affecting the local, regional or national economies or the industries in which we have credit concentrations; and other matters discussed in our filings with the SEC, including our Annual Report on Form 10-K for 2006, which filings are available from the SEC. We undertake no obligation to publicly update or revise any forward-looking statements.

The following management's discussion and analysis is presented to provide information concerning our financial condition as of March 31, 2007, as compared to December 31, 2006, and the results of operations for the three months ended March 31, 2007 and 2006. This discussion and analysis should be read in conjunction with our consolidated financial statements and the financial and statistical data appearing elsewhere in this report and our 2006 Annual Report.

FINANCIAL CONDITION

Our total assets at March 31, 2007, were \$3.80 billion, relatively unchanged from December 31, 2006. Total loans and leases increased 1.81% and total deposits remained stable over the comparable figures at the end of 2006.

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On February 19, 2007, we announced the agreement and plan of merger with FINA Bancorp, Inc., the parent company of First National Bank, Valparaiso. Pending customary closing conditions, including regulatory approval, we expect the merger to be complete in the second quarter of 2007. We believe this acquisition provides us with an opportunity to join two strong local banks with similar values, history, and legacies. First National Bank, Valparaiso is located in the fastest growing area of our retain market and will serve as a platform for future expansion.

Nonperforming assets at March 31, 2007, were \$14.02 million, which was a 20.67% improvement over the \$17.67 million reported at December 31, 2006. During the first quarter of 2007 nonperforming assets decreased as compared to year-end 2006, across all loan and lease portfolios with the exception of loans secured by real estate. The most significant improvement in 2007 year-to-date nonperforming loans and leases was in aircraft financing compared to December 31, 2006. At March 31, 2007, nonperforming assets were 0.50% of net loans and leases compared to 0.64% at December 31, 2006.

Accrued income and other assets were as follows:

(Dollars in Thousands)

| | March 31, 2007 | December 31, 2006 |
|--|-------------------|----------------------|
| Accrued income and other assets: | | |
| Bank owned life insurance cash surrender value | \$ 36,507 | \$ 36,157 |
| Accrued interest receivable | 17,058 | 17,997 |
| Mortgage servicing assets | 7,255 | 7,572 |
| Other real estate | 534 | 800 |
| Repossessions | 1,019 | 975 |
| Intangible assets | 19,313 | 19,418 |
| All other assets | 23,285 | 25,084 |
| Total accrued income and other assets | \$ 104,971 | \$ 108,003 |

CAPITAL

As of March 31, 2007, total shareholders' equity was \$375.06 million, up 1.67% from the \$368.90 million at December 31, 2006. In addition to net income of \$8.52 million, other significant changes in shareholders' equity during the first three months of 2007 included \$0.17 million in treasury stock purchases, and \$3.16 million of dividends paid. The accumulated other comprehensive income/(loss) component of shareholders' equity totaled \$0.36 million at March 31, 2007, compared to \$(0.26) million at December 31, 2006. The improvement in accumulated other comprehensive income/(loss) for the first quarter of 2007 over the same period of 2006 was primarily a result of changes in unrealized gain/(loss) on securities in the available-for-sale portfolio. Our equity-to-assets ratio was 9.86% as of March 31, 2007, compared to 9.69% at December 31, 2006. Book value per common share rose to \$16.66 at March 31, 2007, up from \$16.40 at December 31, 2006.

We declared and paid dividends per common share of \$0.14 during the first quarter of 2007. The trailing four quarters dividend payout ratio, representing dividends per share divided by diluted earnings per share, was 32.95%. The dividend payout is continually reviewed by management and the Board of Directors.

The banking regulators have established guidelines for leverage capital requirements, expressed in terms of Tier 1 or core capital as a percentage of average assets, to measure the soundness of a financial institution. In addition, banking regulators have established risk-based capital guidelines for U.S. banking organizations. The actual capital amounts and ratios of 1st Source and our largest subsidiary, the Bank, as of March 31, 2007, are presented in the table below:

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| (Dollars in thousands) | Actual | | Minimum Capital Adequacy | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--|------------|--------|--------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total Capital (To Risk-Weighted Assets): | | | | | | |
| 1st Source | \$ 454,286 | 14.32% | \$ 253,806 | 8.00% | \$ 317,258 | 10.00% |
| Bank | 433,180 | 13.82 | 250,824 | 8.00 | 313,531 | 10.00 |
| Tier 1 Capital (to Risk-Weighted Assets): | | | | | | |
| 1st Source | 412,634 | 13.01 | 126,903 | 4.00 | 190,355 | 6.00 |
| Bank | 392,743 | 12.53 | 125,412 | 4.00 | 188,118 | 6.00 |
| Tier 1 Capital (to Average Assets): | | | | | | |
| 1st Source | 412,634 | 11.27 | 146,491 | 4.00 | 183,113 | 5.00 |
| Bank | 392,743 | 10.90 | 144,103 | 4.00 | 180,129 | 5.00 |

LIQUIDITY AND INTEREST RATE SENSITIVITY

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

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

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

The ALCO monitors and manages the relationship of earning assets to interest bearing liabilities and the responsiveness of asset yields, interest expense, and interest margins to changes in market interest rates. At March 31, 2007, the consolidated statement of financial condition was rate sensitive by \$370.10 million more liabilities than assets scheduled to reprice within one year, or approximately 0.85%.

RESULTS OF OPERATIONS

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Net income for the three month period ended March 31, 2007, was \$8.52 million, compared to \$9.93 million for the same period in 2006. Diluted net income per common share was \$0.37 for the three month period ended March 31, 2007, compared to \$0.43 for the same period in 2006. Return on average common shareholders' equity was 9.24% for the three months ended March 31, 2007, compared to 11.53% in 2006. The return on total average assets was 0.94% for the three months ended March 31, 2007, compared to 1.18% in 2006.

The decrease in net income for the three months ended March 31, 2007, over the first three months of 2006, was primarily the result of a decrease in total noninterest income and an increase in total noninterest expense. These negative impacts to net income were somewhat offset by an increase in net interest income and a decrease in the income tax provision. Details of the changes in the various components of net income are discussed further below.

NET INTEREST INCOME

The taxable equivalent net interest income for the three months ended March 31, 2007, was \$26.97 million, an increase of 4.83% over the same period in 2006. The net interest margin on a fully taxable equivalent basis was 3.17% for the three months ended March 31, 2007, compared to 3.29% for the three months ended March 31, 2006.

During the first quarter of 2007, average earning assets increased \$279.72 million or 8.82% while average interest-bearing liabilities increased \$294.64 million or 11.19% over the comparable period one year ago. The yield on average earning assets increased 65 basis points to 6.66% for the first quarter of 2007 from 6.01% for the first quarter of 2006. The rate earned on assets continued to experience positive impacts from the increases in short-term market interest rates from a year ago. Total cost of average interest-bearing liabilities increased 83 basis points to 4.11% as of March 31, 2007 from 3.28% at March 31, 2006, as liabilities were also affected by short-term market interest rates. The result was a decrease of 12 basis points to the net interest margin, or the difference between interest income on earning assets and expense on interest-bearing liabilities.

The largest contributor to the increase in the yield on average earning assets for the first three months of 2007, on a volume-weighted basis, was the \$249.38 million or 10.15% increase in net loans and leases as compared to the first three months of 2006. Total average investment securities increased 4.97% for the three month period over one year ago due mainly to an increase in federal agency, mortgage-backed, municipal securities, and market valuation adjustments. Average mortgages held for sale decreased 25.67% primarily due to a decrease in demand resulting in an approximate 29.00% decrease in production volume. Other investments, which include federal funds sold, time deposits with other banks and commercial paper, increased 43.00% for the three month period over one year ago as excess funds were invested.

Average interest-bearing deposits increased \$325.18 million or 14.45% for the first three months of 2007 over the same period in 2006. The effective rate paid on average interest-bearing deposits increased 91 basis points to 3.98% as of March 31, 2007 compared to 3.07% as of March 31, 2006. The increase in the average cost of interest-bearing deposits during the first three months of 2007 as compared to the first three months of 2006 was primarily the result of increases in interest rates offered on deposit products due to increases in market interest rates and increased competition for deposits across all markets. Interest paid on short-term and trust preferred borrowings increased 58 basis points due to the interest rate increase in adjustable rate borrowings. Average long-term debt increased \$12.58 million or 40.61% during the first three months of 2007 as compared to the first three months of 2006. The majority of the increase in long-term debt was made up of Federal Home Loan Bank borrowings.

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Average demand deposits decreased \$49.08 million as of March 31, 2007 from the same period one year ago. Much of the decline was due to the reclassification of some of our deposit products from noninterest bearing to interest bearing and a decrease in escrow deposit accounts concurrent with the reduction in our mortgage servicing portfolio.

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

**DISTRIBUTION OF ASSETS, LIABILITIES AND SHAREHOLDERS' EQUITY
INTEREST RATES AND INTEREST DIFFERENTIAL
(Dollars in thousands)**

| | Three months ended March 31, 2007 | | | 2006 | | |
|--|--------------------------------------|--------------------------------|----------------|---------------------|--------------------------------|----------------|
| | Average Balance | Interest Income/ Expense | Yield/ Rate | Average Balance | Interest Income/ Expense | Yield/ Rate |
| ASSETS: | | | | | | |
| Investment securities: | | | | | | |
| Taxable | \$ 484,489 | \$ 5,730 | 4.80% | \$ 458,812 | \$ 3,925 | 3.47% |
| Tax exempt | 180,861 | 2,018 | 4.53% | 175,027 | 1,827 | 4.23% |
| Mortgages - held for sale | 38,969 | 638 | 6.64% | 52,425 | 827 | 6.40% |
| Net loans and leases | 2,706,462 | 47,728 | 7.15% | 2,457,080 | 40,125 | 6.62% |
| Other investments | 40,832 | 532 | 5.28% | 28,553 | 316 | 4.49% |
| Total Earning Assets | 3,451,613 | 56,646 | 6.66% | 3,171,897 | 47,020 | 6.01% |
| Cash and due from banks | 70,166 | | | 79,943 | | |
| Reserve for loan and lease losses | (58,800) | | | (58,702) | | |
| Other assets | 218,817 | | | 211,914 | | |
| Total | \$ 3,681,796 | | | \$ 3,405,052 | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY: | | | | | | |
| Interest-bearing deposits | \$ 2,576,261 | \$ 25,270 | 3.98% | \$ 2,251,083 | \$ 17,033 | 3.07% |
| Short-term borrowings | 248,871 | 2,690 | 4.38% | 291,993 | 2,760 | 3.83% |
| Subordinated notes | 59,022 | 1,094 | 7.52% | 59,022 | 1,050 | 7.21% |
| Long-term debt and mandatorily redeemable securities | 43,575 | 627 | 5.84% | 30,990 | 454 | 5.94% |
| Total Interest-Bearing Liabilities | 2,927,729 | 29,681 | 4.11% | 2,633,088 | 21,297 | 3.28% |
| Noninterest-bearing deposits | 314,124 | | | 363,201 | | |

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| | | |
|---|--------------|--------------|
| Other liabilities | 65,749 | 59,460 |
| Shareholders' equity | 374,194 | 349,303 |
| Total | \$ 3,681,796 | \$ 3,405,052 |
| Net Interest Income | \$ 26,965 | \$ 25,723 |
| Net Yield on Earning Assets on a Taxable Equivalent Basis | 3.17% | 3.29% |

Table of Contents**PROVISION AND RESERVE FOR LOAN AND LEASE LOSSES**

The recovery of provision for loan and lease losses for the three month periods ended March 31, 2007 and 2006 was \$0.62 million and \$0.30 million, respectively. Net recoveries of \$0.52 million were recorded for the first quarter 2007, compared to net recoveries of \$0.70 million for the same quarter a year ago.

In the first quarter 2007, loan and lease delinquencies were 0.25% as compared to 0.76% on March 31, 2006, and 0.17% at the end of 2006. For comparative purposes the rise and fall in delinquencies for the first quarter of 2007, year-end 2006, and the first quarter of 2006, were mainly in the turbine aircraft portfolio. The reserve for loan and lease losses as a percentage of loans and leases outstanding at the end of the period was 2.13% as compared to 2.38% one year ago and 2.18% at December 31, 2006. A summary of loan and lease loss experience during the three month periods ended March 31, 2007 and 2006 is provided below.

| | Summary of Reserve for Loan and Lease Losses (Dollars in Thousands) Three Months Ended March 31, | |
|--|---|--------------|
| | 2007 | 2006 |
| Reserve for loan and lease losses - beginning balance | \$ 58,802 | \$ 58,697 |
| Charge-offs | (1,345) | (780) |
| Recoveries | 1,868 | 1,480 |
| Net recoveries | 523 | 700 |
| Recovery of provision for loan and lease losses | (623) | (300) |
| Reserve for loan and lease losses - ending balance | \$ 58,702 | \$ 59,097 |
| Loans and leases outstanding at end of period | \$ 2,751,415 | \$ 2,479,504 |
| Average loans and leases outstanding during period | 2,706,462 | 2,457,080 |
| Reserve for loan and lease losses as a percentage of loans and leases outstanding at end of period | 2.13% | 2.38% |
| Ratio of net recoveries during period to average loans and leases outstanding | (0.08)% | (0.12)% |

Table of Contents**NONPERFORMING ASSETS**

Nonperforming assets were as follows:

(Dollars in thousands)

| | March 31, 2007 | December 31, 2006 | March 31, 2006 |
|--|-------------------|----------------------|-------------------|
| Loans and leases past due 90 days or more | \$ 75 | \$ 116 | \$ 121 |
| Nonaccrual and restructured loans and leases | 12,275 | 15,575 | 15,071 |
| Other real estate | 534 | 800 | 1,192 |
| Repossessions | 1,019 | 975 | 4,640 |
| Equipment owned under operating leases | 112 | 201 | 48 |
| Total nonperforming assets | \$ 14,015 | \$ 17,667 | \$ 21,072 |

Nonperforming assets totaled \$14.02 million at March 31, 2007, a 20.67% improvement over the \$17.67 million reported at December 31, 2006, and a 33.49% improvement from the \$21.07 million reported at March 31, 2006. The improvement during the first quarter 2007 compared to year-end 2006 was primarily related to a decrease in nonaccrual loans and leases in all areas, whereas the improvement compared to the first quarter of 2006 was primarily related to a decrease in nonaccrual loans and leases in all areas with the exception of increases in the medium and heavy duty truck portfolio, loans secured by real estate, and aircraft financing. Nonperforming assets as a percentage of total loans and leases improved to 0.50% at March 31, 2007, from 0.64% at December 31, 2006, and 0.83% at March 31, 2006.

Repossessions consisted mainly of aircraft, automobiles, light trucks, and construction equipment at March 31, 2007. At the time of repossession, the recorded amount of the loan or lease is written down, if necessary, to the estimated value of the equipment or vehicle by a charge to the reserve for loan and lease losses, unless the equipment is in the process of immediate sale. Any subsequent write-downs are included in noninterest expense.

Supplemental Loan and Lease Information as of March 31, 2007

(Dollars in thousands)

| | Loans and leases outstanding | Nonaccrual and restructured loans | Other real estate owned and repossessions | Year-to-date net credit losses/ (recoveries) |
|---|---------------------------------|--|---|---|
| Commercial and agricultural loans | \$ 508,976 | \$ 866 | \$ - | \$ (721) |
| Auto, light truck and environmental equipment | 308,341 | 426 | 48 | (39) |
| Medium and heavy duty truck | 336,254 | 1,617 | - | (38) |
| Aircraft financing | 501,838 | 5,119 | 300 | (323) |
| Construction equipment financing | 326,779 | 523 | 597 | 439 |

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| | | | | |
|------------------------------|--------------|-----------|----------|----------|
| Loans secured by real estate | 644,819 | 3,744 | 534 | 4 |
| Consumer loans | 124,408 | 92 | 74 | 53 |
| Total | \$ 2,751,415 | \$ 12,387 | \$ 1,553 | \$ (625) |

For financial statements purposes, nonaccrual loans and leases are included in loan and lease outstandings, whereas repossessions and other real estate are included in other assets. Net credit losses include net charge-offs on loans and leases and valuation adjustments and gains and losses on disposition of repossessions and defaulted operating leases.

Table of Contents**NONINTEREST INCOME**

Noninterest income for the three-month periods ended March 31, 2007 and 2006 was \$17.49 million and \$19.01 million, respectively. The predominant factor behind the decrease in 2007 was a significant decrease in market value adjustments resulting in lower gains on venture capital investments and a decline in mortgage banking income, partially offset by an increase in equipment rental income.

| (Dollars in thousands) | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Noninterest income: | | |
| Trust fees | \$ 3,643 | \$ 3,391 |
| Service charges on deposit accounts | 4,570 | 4,386 |
| Mortgage banking income | 571 | 1,757 |
| Insurance commissions | 1,638 | 1,682 |
| Equipment rental income | 5,098 | 4,220 |
| Other income | 1,719 | 1,486 |
| Investment securities and other investment gains | 247 | 2,083 |
| Total noninterest income | \$ 17,486 | \$ 19,005 |

Gains on venture partnership investment, due to market value adjustments, totaled \$0.03 million for the first quarter of 2007 compared to gains of \$2.05 million for the first quarter of 2006. Mortgage banking income decreased in the first quarter of 2007 as compared to the first quarter of 2006 primarily due a decline in production volume of approximately 29.00% which resulted in lower gains on sales of mortgage servicing assets and a decline in loan servicing fee income due to a reduction in the portfolio from servicing sales in the second and third quarters of 2006.

Equipment rental income generated from operating leases increased during the first quarter of 2007 as compared to the first quarter of 2006 primarily due to an increase of 29.00% in the operating lease portfolio from one year ago. Other income increased from the three-month period ended March 31, 2007 as compared to the same period of 2006, mainly due to fees generated from customer related interest rate swaps and mutual fund income. Additionally, trust fees and service charges on deposit accounts increased during the first quarter of 2007 as compared to the first quarter 2006.

NONINTEREST EXPENSE

Noninterest expense for the three-month periods ended March 31, 2007 and 2006 was \$31.80 million and \$29.41 million, respectively.

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(Dollars in thousands)

| | Three Months Ended March 31, | |
|--|---------------------------------|-----------|
| | 2007 | 2006 |
| Noninterest expense: | | |
| Salaries and employee benefits | \$ 17,566 | \$ 15,514 |
| Net occupancy expense | 1,936 | 1,867 |
| Furniture and equipment expense | 3,094 | 3,134 |
| Depreciation - leased equipment | 4,076 | 3,382 |
| Professional fees | 900 | 885 |
| Supplies and communication | 1,272 | 1,363 |
| Business development and marketing expense | 858 | 642 |
| Intangible asset amortization | 106 | 666 |
| Loan and lease collection and repossession expense | 165 | 90 |
| Other expense | 1,827 | 1,863 |
| Total noninterest expense | \$ 31,800 | \$ 29,406 |

The leading factor in the overall increase in noninterest expense in the first quarter of 2007 as compared to 2006 was in salaries and employee benefits. During the first quarter of 2006 we benefited from the reversal of previously recognized stock-based compensation expense under historical accounting methods related to the estimated forfeiture of stock awards. This one-time expense reversal, combined with the adoption of SFAS No. 123(R) estimated forfeiture accounting requirements, resulted in a reduction in stock-based compensation of \$2.07 million, pre-tax. Leased equipment depreciation expense increased in conjunction with the increase in equipment rental income from first quarter of 2006 to first quarter of 2007. Business development and marketing expense increased for the first three months of 2007 as compared to the first three months of 2006 due to strong marketing efforts related to the opening of new branches during 2006 and de novo expansion into the Kalamazoo and West Lafayette areas. Additionally, increases were experienced in loan and lease collection and repossession expense, net occupancy expense, and professional fees in the first quarter of 2007, as compared to the first quarter of 2006.

These increases in noninterest expense were slightly offset by decreases in intangible asset amortization (due mainly to the effects of the complete amortization of intangible assets associated with acquisitions which occurred during 2001) supplies and communication, furniture and equipment expense, and other expense for the period ending March 31, 2006 from March 31, 2007.

INCOME TAXES

The provision for income taxes for the three months ended March 31, 2007, was \$4.06 million, compared to \$5.07 million for the same period in 2006. The effective tax rate was 32.25% for the quarter ended March 31, 2007, compared to 33.77% for the same quarter in 2006. The effective tax rate decreased 152 basis points from March 2006 to March 2007. This decrease was due to a combination of lower pretax income and higher tax-exempt income for the first three months of 2007. Both of these changes have the impact of lowering the effective tax rate. The provision for income taxes for the three months ended March 31, 2007 and 2006, is at a rate which management believes approximates the effective rate for the year.

ITEM 3.**QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

There have been no material changes in market risks faced by 1st Source since December 31, 2006. For information regarding our market risk, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2006.

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Table of Contents**ITEM 4.****CONTROLS AND PROCEDURES**

As of the end of the period covered by this report an evaluation was carried out, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) pursuant to Exchange Act Rule 13a-14. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, at March 31, 2007, our disclosure controls and procedures were effective in accumulating and communicating to management (including such officers) the information relating to 1st Source (including its consolidated subsidiaries) required to be included in our periodic SEC filings.

In addition, there were no changes in our internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f)) during the first fiscal quarter of 2007 that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION**ITEM 1. Legal Proceedings.**

1st Source and its subsidiaries are involved in various legal proceedings incidental to the conduct of our businesses. Management does not expect that the outcome of any such proceedings will have a material adverse effect on our consolidated financial position or results of operations.

ITEM 1A. Risk Factors.

There have been no material changes in risks faced by 1st Source since December 31, 2006. For information regarding our risk factors, refer to 1st Source's Annual Report on Form 10-K for the year ended December 31, 2006.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period | Total number of shares purchased | Average price paid per share | Total number of shares purchased as part of publicly announced plans or programs (1) | Maximum number (or approximate dollar value) of shares that may yet be purchased under the plans or programs* |
|---------------------------|---|---|---|--|
| January 01 - 31, 2007 | - | - | - | 948,689 |
| February 01 - 28, 2007 | 11,288 | \$28.34 | 11,288 | 937,401 |
| March 01 - 31, 2007 | 5,470 | \$27.01 | 5,470 | 931,931 |

⁽¹⁾1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on April 27, 2006. Under the terms of the plan, 1st Source may repurchase up to 1,025,248* shares of its common stock when favorable conditions exist on the open market or through private transactions at various prices from time to time. Since the inception of the plan, 1st Source has repurchased a total of 93,317 shares.

*Unadjusted for 10% stock dividend declared on July 27, 2006.

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ITEM 3. Defaults Upon Senior Securities.

None

ITEM 4. Submission of Matters to a Vote of Security Holders.

None

ITEM 5. Other Information.

None

ITEM 6. Exhibits

The following exhibits are filed with this report:

1. Exhibit 31.1 Certification of Chief Executive Officer required by Rule 13a-14(a).
2. Exhibit 31.2 Certification of Chief Financial Officer required by Rule 13a-14(a).
3. Exhibit 32.1 Certification pursuant to 18 U.S.C. Section 1350 of Chief Executive Officer.
4. Exhibit 32.2 Certification pursuant to 18 U.S.C. Section 1350 of Chief Financial Officer.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

1st Source Corporation

DATE April 27, 2007

/s/CHRISTOPHER J. MURPHY III
Christopher J. Murphy III
Chairman of the Board, President and
CEO

DATE April 27, 2007

/s/LARRY E. LENTYCH
Larry E. Lentych
Treasurer and Chief Financial Officer
Principal Accounting Officer

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