1ST SOURCE CORP
Form 10-K
February 17, 2017
Table of Contents

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

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2016

OR

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

For the transition period from to

Commission file number 0-6233

(Exact name of registrant as specified in its charter)

Indiana	35-1068133
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
100 North Michigan Street, South Bend, Indiana	46601
(Address of principal executive offices)	(Zip Code)

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

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

Title of each class	Name of each exchange on which registered
Common Stock — without par value	The NASDAQ Stock Market LLC

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

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

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.

Large accelerated filer o Accelerated filer x

Non-accelerated filer o Smaller reporting company o

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

The aggregate market value of the voting common stock held by non-affiliates of the registrant as of June 30, 2016 was $623,920,367

The number of shares outstanding of each of the registrant's classes of stock as of February 10, 2017: Common Stock, without par value — 25,907,564 shares

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2017 Proxy Statement for the 2017 annual meeting of shareholders to be held April 20, 2017, are incorporated by reference into Part III.

Table of Contents

TABLE OF CONTENTS

Part I

Item 1.	Business	3
Item 1A.	Risk Factors	10
Item 1B.	Unresolved Staff Comments	14
Item 2.	Properties	14
Item 3.	Legal Proceedings	15
Item 4.	Mine Safety Disclosures	15

Part II

Item 5.	Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	15
Item 6.	Selected Financial Data	16
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	16
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	36
Item 8.	Financial Statements and Supplementary Data	37
	Reports of Independent Registered Public Accounting Firm	37
	Consolidated Statements of Financial Condition	38
	Consolidated Statements of Income	39
	Consolidated Statements of Comprehensive Income	40
	Consolidated Statements of Shareholders' Equity	40
	Consolidated Statements of Cash Flows	41
	Notes to Consolidated Financial Statements	42
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	80
Item 9A.	Controls and Procedures	80
Item 9B.	Other Information	80

Part III

Item 10.	Directors, Executive Officers and Corporate Governance	81
Item 11.	Executive Compensation	81
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	81
Item 13.	Certain Relationships and Related Transactions, and Director Independence	81
Item 14.	Principal Accounting Fees and Services	81

Part IV

Item 15.	Exhibits and Financial Statement Schedules	82
Signatures		84
Certifications		

Table of Contents

Part I

Item 1. Business.

1ST SOURCE CORPORATION

1st Source Corporation, an Indiana corporation incorporated in 1971, is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as “1st Source”, “we”, and “our”), a broad array of financial products and services. 1st Source Bank (“Bank”), its banking subsidiary, offers commercial and consumer banking services, trust and wealth advisory services, and insurance to individual and business clients through most of our 81 banking center locations in 17 counties in Indiana and Michigan. 1st Source Bank’s Specialty Finance Group, with 22 locations nationwide, offers specialized financing services for new and used private and cargo aircraft, automobiles and light trucks for leasing and rental agencies, medium and heavy duty trucks and construction equipment. While our lending portfolio is concentrated in certain equipment types, we serve a diverse client base. We are not dependent upon any single industry or client. At December 31, 2016, we had consolidated total assets of $5.49 billion, total loans and leases of $4.19 billion, total deposits of $4.33 billion, and total shareholders’ equity of $672.65 million.

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

1ST SOURCE BANK

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

Commercial, Agricultural, and Real Estate Loans — 1st Source Bank provides commercial, small business, agricultural, and real estate loans to primarily privately owned business clients mainly located within our regional market area. Loans are made for a wide variety of general corporate purposes, including financing for industrial and commercial properties, financing for equipment, inventories and accounts receivable, renewable energy financing, and acquisition financing. Other services include commercial leasing, treasury management services and retirement planning services.

Consumer Services — 1st Source Bank provides a full range of consumer banking products and services through our banking centers and at 1stsource.com. In a number of our markets 1st Source also offers insurance products through 1st Source Insurance offices. The traditional banking services include checking and savings accounts, certificates of deposits and Individual Retirement Accounts. 1st Source offers a full line of on-line and mobile banking products which includes bill payment. As an added convenience, a strategically located Automated Teller Machine network serves our customers and supports the debit and credit card programs of the bank. Consumers also have the ability to obtain consumer loans, real estate loans and lines of credit in any of our banking centers or on-line. Finally, 1st Source offers a variety of financial planning, financial literacy and other consultative services to our customers.

Trust and Wealth Advisory Services — 1st Source Bank provides a wide range of trust, investment, agency, and custodial services for individual, corporate, and not-for-profit clients. These services include the administration of estates and personal trusts, as well as the management of investment accounts for individuals, employee benefit plans, and charitable foundations.

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

Aircraft financing consists of financings for new and used general aviation aircraft (including helicopters) for private and corporate aircraft users, aircraft distributors and dealers, air charter operators, air cargo carriers, and other aircraft operators. We have for many years, on a limited and selective basis, provided international aircraft financing, primarily in Mexico and Brazil. Aircraft finance receivables generally range from $500,000 to $20 million with fixed or variable interest rates and terms of one to ten years.

The auto and light truck division (including specialty vehicles such as buses, step vans, motor coach's and funeral cars) consists of fleet financings to automobile rental and leasing companies, light truck rental and leasing companies,

and single unit through fleet financing for users of special purpose vehicles. The auto and light truck finance receivables generally range from $100,000 to $20 million with fixed or variable interest rates and terms of one to eight years.

Construction equipment financing includes financing of equipment (i.e., asphalt and concrete plants, bulldozers, excavators, cranes, loaders, and trash and recycling equipment, etc.) to the construction industry. Construction equipment finance receivables generally range from $50,000 to $20 million with fixed or variable interest rates and terms of one to seven years.

Table of Contents

The medium and heavy duty truck division provides fleet financing for highway tractors and trailers and delivery trucks to the commercial trucking industry. Medium and heavy duty truck finance receivables generally range from $500,000 to $15 million with fixed or variable interest rates and terms of three to seven years.

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

SPECIALTY FINANCE GROUP SUBSIDIARIES

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

1ST SOURCE INSURANCE, INC.

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

1ST SOURCE CORPORATION INVESTMENT ADVISORS, INC.

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

OTHER CONSOLIDATED SUBSIDIARIES

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

1ST SOURCE MASTER TRUST

Our unconsolidated subsidiary includes 1st Source Master Trust. This subsidiary was created for the purpose of issuing $57.00 million of trust preferred securities and lending the proceeds to 1st Source. We guarantee, on a limited basis, payments of distributions on the trust preferred securities and payments on redemption of the trust preferred securities.

COMPETITION

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

In addition to competing with other banks within our primary service areas, the Bank also competes with other financial service companies, such as credit unions, industrial loan associations, securities firms, insurance companies, small loan companies, finance companies, mortgage companies, real estate investment trusts, certain governmental agencies, credit organizations, and other enterprises.

Additional competition for depositors’ funds comes from United States Government securities, private issuers of debt obligations, and suppliers of other investment alternatives for depositors. Many of our non-bank competitors are not subject to the same extensive Federal and State regulations that govern bank holding companies and banks. Such non-bank competitors may, as a result, have certain advantages over us in providing some services.

We compete against these financial institutions by being convenient to do business with, and by taking the time to listen and understand our clients’ needs. We deliver personalized, one-on-one banking through knowledgeable local members of the community always keeping the clients' best interest in mind while offering a full array of products and highly personalized services. We rely on our history and our reputation in northern Indiana dating back to 1863.

EMPLOYEES

At December 31, 2016, we had approximately 1,150 employees on a full-time equivalent basis. We provide a wide range of employee benefits and consider employee relations to be good.

4

Table of Contents

ENVIRONMENTAL SUSTAINABILITY

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

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

We are conscious of our paper usage, recognizing that we depend on printed materials for important day-to-day office work, client communications, and acquiring new clients. Increasingly, consumers demand more environmentally sustainable options and prefer online statements and correspondence rather that printed materials. The majority of the paper used in our facilities is recycled through our secure shred program and in 2016, we recycled 393,000 pounds of paper.

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

Embracing opportunities for new products, services and partnerships — In 2016, we increased our focus on renewable energy sources through lending and investment partnerships with renewable energy providers. We recognize the opportunities and complexities associated with energy financing and understand the value of innovative technology that leverages the wind and sun, which are sustainable from an environmental and financial perspective. We will continue to finance and invest in sustainable opportunities, and we will explore new opportunities to develop products and solutions that support our clients and advance sustainability.

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

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

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

REGULATION AND SUPERVISION

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

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

The Bank, as an Indiana state bank and member of the Federal Reserve System, is supervised by the Indiana Department of Financial Institutions (DFI) and the Federal Reserve. As such, 1st Source Bank is regularly examined by and subject to regulations promulgated by the DFI and the Federal Reserve. Because the Federal Deposit Insurance Corporation (FDIC) provides deposit insurance to the Bank, we are also subject to supervision and regulation by the FDIC (even though the FDIC is not our primary Federal regulator).

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

interest in any bank or bank holding company, (ii) acquiring all or substantially all of the assets of another bank or bank holding company, or (iii) merging or consolidating with another bank holding company.

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

Table of Contents

The Federal Deposit Insurance Corporation Improvement Act of 1991 — The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) was adopted to address a wide variety of banking issues. In general, FDICIA provided for the recapitalization of the former Bank Insurance Fund, deposit insurance reform, including the implementation of risk-based deposit insurance premiums, the establishment of five capital levels for financial institutions (“well capitalized,” “adequately capitalized,” “undercapitalized,” “significantly undercapitalized,” and “critically undercapitalized”) that would impose more scrutiny and restrictions on less capitalized institutions, along with a number of other supervisory and regulatory issues. At December 31, 2016, the Bank was categorized as “well capitalized,” meaning that our total risk-based capital ratio exceeded 10.00%, our Tier 1 risk-based capital ratio exceeded 8.00%, our common equity Tier-1 risk-based capital ratio exceeded 6.50%, our leverage ratio exceeded 5.00%, and we are not subject to a regulatory order, agreement, or directive to meet and maintain a specific capital level for any capital measure.

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

The Dodd-Frank Act also provides the FDIC with discretion to determine whether to pay rebates to insured depository institutions when its deposit insurance reserves exceed certain thresholds. Previously, the FDIC was required to give rebates to depository institutions equal to the excess once the reserve ratio exceeded 1.50%, and was required to rebate 50% of the excess over 1.35% but not more than 1.5% of insured deposits. The FDIC adopted a final rule on February 7, 2011 that implements these provisions of the Dodd-Frank Act.

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

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

Gramm-Leach-Bliley Act of 1999 — The GLBA is intended to modernize the banking industry by removing barriers to affiliation among banks, insurance companies, the securities industry, and other financial service providers. It provides financial organizations with the flexibility of structuring such affiliations through a holding company structure or through a financial subsidiary of a bank, subject to certain limitations. The GLBA established a distinct type of bank holding company, known as a financial holding company, which may engage in an expanded list of activities that are “financial in nature,” which include securities and insurance brokerage, securities underwriting, insurance underwriting, and merchant banking. The GLBA also sets forth a system of functional regulation that makes the Federal Reserve the “umbrella supervisor” for holding companies, while providing for the supervision of the holding company’s subsidiaries by other Federal and state agencies. A bank holding company may not become a financial holding company if any of its subsidiary financial institutions are not well-capitalized or well-managed. Further, each bank subsidiary of the holding company must have received at least a satisfactory Community Reinvestment Act (CRA) rating. The GLBA also expands the types of financial activities a national bank may conduct through a financial subsidiary, addresses state regulation of insurance, generally prohibits unitary thrift holding companies

organized after May 4, 1999 from participating in new activities that are not financial in nature, provides privacy protection for nonpublic customer information of financial institutions, modernizes the Federal Home Loan Bank system, and makes miscellaneous regulatory improvements. The Federal Reserve and the Secretary of the Treasury must coordinate their supervision regarding approval of new financial activities to be conducted through a financial holding company or through a financial subsidiary of a bank. While the provisions of the GLBA regarding activities that may be conducted through a financial subsidiary directly apply only to national banks, those provisions indirectly apply to state-chartered banks. In addition, the Bank is subject to other provisions of the GLBA, including those relating to CRA and privacy, regardless of whether we elect to become a financial holding company or to conduct activities through a financial subsidiary. We do not currently intend to file notice with the Board to become a financial holding company or to engage in expanded financial activities through a financial subsidiary.

Table of Contents

Financial Privacy — In accordance with the GLBA, Federal banking regulators adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about customers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. The privacy provisions of the GLBA affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. We are also subject to various state laws that generally require us to notify any customer whose personal financial information may have been released to an unauthorized person as the result of a breach of our data security policies and procedures.

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

Regulations Governing Capital Adequacy — The Federal bank regulatory agencies use capital adequacy guidelines in their examination and regulation of bank holding companies and banks. If capital falls below the minimum levels established by these guidelines, a bank holding company or bank will be required to submit an acceptable plan for achieving compliance with the capital guidelines and will be subject to denial of applications and appropriate supervisory enforcement actions. The various regulatory capital requirements that we are subject to are disclosed in Part II, Item 8, Financial Statements and Supplementary Data — Note 20 of the Notes to Consolidated Financial Statements.

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

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

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

Reserve Requirements — The Federal Reserve requires all depository institutions to maintain reserves against their transaction account deposits. For 2017, the Bank must maintain reserves of 3.00% against net transaction accounts greater than $15.50 million and up to $115.10 million (subject to adjustment by the Federal Reserve) and reserves of 10.00% must be maintained against that portion of net transaction accounts in excess of $115.10 million. These amounts are indexed to inflation and adjusted annually by the Federal Reserve.

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

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

Sarbanes-Oxley Act of 2002 — The Sarbanes-Oxley Act of 2002 (SOA) includes provisions intended to enhance corporate responsibility and protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws, and which increase penalties for accounting and auditing improprieties at public traded companies. The SOA generally applies to all companies that file or are required to file periodic reports with the SEC under the Exchange Act.

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

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

Consumer Financial Protection Laws — The Bank is subject to a number of federal and state consumer financial protection laws and regulations that extensively govern its transactions with consumers. These laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, and the Service Members Civil Relief Act. 1st Source Bank must also comply with applicable state usury laws and other laws prohibiting unfair and deceptive acts and practices. These laws, among other things, require disclosures of the cost of credit and the terms of deposit accounts, prohibit discrimination in credit transactions, regulate the use of credit report information, restrict the Bank's ability to raise interest rates and subject the Bank to substantial regulatory oversight. Violations of these laws may expose us to liability from potential lawsuits brought by affected customers. Federal bank regulators, state attorneys general and state and local consumer protection agencies may also seek to enforce these consumer financial protection laws, in which case we may be subject to regulatory sanctions, civil money penalties, and customer rescission rights. Failure to comply with these laws may also cause the Federal Reserve or DFI to deny approval of any applications we may file to engage in merger and acquisition transactions with other financial institutions.

Dodd-Frank Wall Street Reform and Consumer Protection Act — The Dodd-Frank Act, which was signed into law in 2010, significantly changes the regulation of financial institutions and the financial services industry. The Dodd-Frank

Act includes provisions affecting large and small financial institutions alike, including several provisions that will profoundly affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolish the Office of Thrift Supervision and transfer its functions to the other federal banking agencies, relax rules regarding interstate branching, allow financial institutions to pay interest on business checking accounts, and impose new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also includes several corporate governance provisions that apply to all public companies, not just financial institutions. These include provisions mandating certain disclosures regarding executive compensation and provisions addressing proxy access by shareholders.

Table of Contents

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

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

The Volcker Rule — The Dodd-Frank Act prohibits banks and their affiliates from engaging in proprietary trading and from investing and sponsoring hedge funds and private equity funds. The provision of the statute imposing these restrictions is commonly called the “Volcker Rule.” The regulations implementing the Volcker Rule require institutions to conform their activities to the requirements of the Volcker Rule by July 21, 2015, and to conform their investments in certain “legacy covered funds” by July 21, 2017. These regulations exempt the Bank, as a bank with less than $10 billion in total consolidated assets that does not engage in any covered activities other than trading in certain government, agency, state or municipal obligations, from any significant compliance obligations under the Volcker Rule. In 2016, to comply with the rule, we liquidated certain investments that resulted in gains recorded in the Consolidated Statements of Income.

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

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

These new minimum capital ratios became effective for us on January 1, 2015 and will be fully phased-in on January 1, 2019. Management believes that, as of December 31, 2016, 1st Source and the Bank would meet all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were currently in effect.

Liquidity Requirements — Historically, the regulation and monitoring of bank and bank holding company liquidity has been addressed as a supervisory matter, without required formulaic measures. The Basel III final framework requires

banks and bank holding companies to measure their liquidity against specific liquidity tests that, although similar in some respects to liquidity measures historically applied by banks and regulators for management and supervisory purposes, going forward would be required by regulation. One test, referred to as the liquidity coverage ratio, or LCR, is designed to ensure that the banking entity maintains an adequate level of unencumbered high-quality liquid assets equal to the entity's expected net cash outflow for a 30-day time horizon (or, if greater, 25% of its expected total cash outflow) under an acute liquidity stress scenario. The other test, referred to as the net stable funding ratio, or NSFR, is designed to promote more medium and long-term funding of the assets and activities of banking entities over a one-year time horizon. These requirements are expected to incentivize banking entities to increase their holdings of U.S. Treasury securities and other sovereign debt as a component of assets and increase the use of long-term debt as a funding source.

Table of Contents

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

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

Item 1A. Risk Factors.

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

Credit Risks

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

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

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

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

We offer both fixed-rate and adjustable-rate consumer mortgage loans secured by properties, substantially all of which are located in our primary market area. Adjustable-rate mortgage loans help reduce our exposure to changes in interest rates; however, during periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase as a result of repricing and the increased payments required from the borrower. Additionally, some residential mortgages are sold into the secondary market and serviced by our principal banking subsidiary, 1st Source Bank.

Consumer loans are primarily all other non-real estate loans to individuals in our regional market area. Consumer loans can entail risk, particularly in the case of loans that are unsecured or secured by rapidly depreciating assets. In these cases, any repossessed collateral may not provide an adequate source of repayment of the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower

beyond obtaining a deficiency judgment. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness, or personal bankruptcy.

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

Table of Contents

Our construction and transportation related businesses could be adversely affected by slowdowns in the economy. Clients who rely on the use of assets financed through the Specialty Finance Group to produce income could be negatively affected, and we could experience substantial loan and lease losses. By the nature of the businesses these clients operate in, we could be adversely affected by rapid increases and decreases of fuel costs. Since some of the relationships in these industries are large, a slowdown could have a significant adverse impact on our performance.
Our construction and transportation related businesses could be adversely impacted by the negative effects caused by high fuel costs, terrorist and other potential attacks, and other destabilizing events. These factors could contribute to the deterioration of the quality of our loan and lease portfolio, as they could have a negative impact on the travel and transportation sensitive businesses for which our specialty finance businesses provide financing.
Our aircraft portfolio has foreign exposure, particularly in Mexico and Brazil. We establish exposure limits for each country through a centralized oversight process, and in consideration of relevant economic, political, social and legal risks. We monitor exposures closely and adjust our country limits in response to changing conditions. Currency fluctuations could have a negative impact on our client's cost of paying dollar denominated debts and, as a result, we could experience higher delinquency in this portfolio. Also, since some of the relationships in this portfolio are large, a slowdown could have a significant adverse impact on our performance.
In addition, our leasing and equipment financing activity is subject to the risk of cyclical downturns, industry concentration and clumping, and other adverse economic developments affecting these industries and markets. This area of lending, with transportation in particular, is dependent upon general economic conditions and the strength of the travel, construction, and transportation industries.
Our reserve for loan and lease losses may prove to be insufficient to absorb probable losses in our loan and lease portfolio — In the financial services industry, there is always a risk that certain borrowers may not repay borrowings. The determination of the appropriate level of the reserve for loan and lease losses inherently involves a high degree of subjectivity and requires us to make significant estimates of current credit risks and future trends, all of which may undergo material changes. Our reserve for loan and lease losses may not be sufficient to cover the loan and lease losses that we may actually incur. If we experience defaults by borrowers in any of our businesses, our earnings could be negatively affected. Changes in local economic conditions could adversely affect credit quality, particularly in our local business loan and lease portfolio. Changes in national or international economic conditions could also adversely affect the quality of our loan and lease portfolio and negate, to some extent, the benefits of national or international diversification through our Specialty Finance Group's portfolio. In addition, bank regulatory agencies periodically review our reserve for loan and lease losses and may require an increase in the provision for loan and lease losses or the recognition of further loan or lease charge-offs based upon their judgments, which may be different from ours.
The soundness of other financial institutions could adversely affect us — Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. We have exposure to many different industries and counterparties, and we routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due us. Any such losses could have a material adverse effect on our financial condition and results of operations.
Market Risks
Fluctuations in interest rates could reduce our profitability and affect the value of our assets — Like other financial institutions, we are subject to interest rate risk. Our primary source of income is net interest income, which is the difference between interest earned on loans and leases and investments, and interest paid on deposits and borrowings. We expect that we will periodically experience imbalances in the interest rate sensitivities of our assets and liabilities and the relationships of various interest rates to each other. Over any defined period of time, our interest-earning assets may be more sensitive to changes in market interest rates than our interest-bearing liabilities, or vice-versa. In addition, the individual market interest rates underlying our loan and lease and deposit products may not change to the same degree over a given time period. If market interest rates should move contrary to our position, earnings may be negatively affected. In addition, loan and lease volume and quality and deposit volume and mix can be affected by

market interest rates as can the businesses of our clients. Changes in levels of market interest rates could have a material adverse effect on our net interest spread, asset quality, origination volume, and overall profitability.
Market interest rates are beyond our control, and they fluctuate in response to general economic conditions and the policies of various governmental and regulatory agencies, in particular, the Federal Reserve Board. Changes in monetary policy, including changes in interest rates, may negatively affect our ability to originate loans and leases, the value of our assets and our ability to realize gains from the sale of our assets, all of which ultimately could affect our earnings.

Table of Contents

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

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

Liquidity Risks

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

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

Operational Risks

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

Technology security breaches — Information security risks have increased due to the sophistication and activities of organized crime, hackers, terrorists and other external parties and the use of online, telephone, and mobile banking channels by clients. Any compromise of our security could deter our clients from using our banking services. We rely on security systems to provide the protection and authentication necessary to effect secure transmission of data against damage by theft, fire, power loss, telecommunications failure or similar catastrophic event, as well as from security breaches, denial of service attacks, viruses, worms, and other disruptive problems caused by hackers. Computer break-ins, phishing and other disruptions of customer or vendor systems could also jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure. We maintain a cyber insurance policy that is designed to cover a majority of loss resulting from cyber security breaches. These precautions may not protect our systems from compromises or breaches of our security measures that could result in damage to our reputation and business.

Table of Contents

We depend on the services of a variety of third party vendors to meet data processing and communication needs and we have contracted with third parties to run their proprietary software on our behalf. While we perform reviews of security controls instituted by the vendor in accordance with industry standards and institute our own internal security controls, we rely on continued maintenance of the controls by the outside party to safeguard our customer data. Additionally, we issue debit cards which are susceptible to compromise at the point of sale via the physical terminal through which transactions are processed and by other means of hacking. The security and integrity of these transactions are dependent upon the retailers' vigilance and willingness to invest in technology and upgrades. Issuing debit cards to our clients exposes us to potential losses which, in the event of a data breach at one or more major retailers may adversely affect our business, financial condition, and results of operations.

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

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

We have opened new banking centers — We are selectively expanding our banking center network within our market footprint. Executing this expansion requires a significant investment in both financial and personnel resources. Lower than expected loan and deposit growth can decrease anticipated revenues and net income generated by those banking centers, which could have a material adverse effect on our business, financial condition and results of operations.

Legal/Compliance Risks

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

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

Table of Contents

The Company's investments and/or financings in certain tax-advantaged projects may not generate returns as anticipated and may have an adverse impact on the Company's financial results — The Company invests and/or finances certain tax-advantaged projects promoting affordable housing, community redevelopment and renewable energy sources. The Company's investments in these projects are designed to generate a return primarily through the realization of federal and state income tax credits, and other tax benefits, over specified time periods. The Company is subject to the risk that previously recorded tax credits, which remain subject to recapture by taxing authorities based on compliance features required to be met at the project level, will fail to meet certain government compliance requirements and will not be able to be fully realized. The possible inability to realize these tax credits and other tax benefits can have a negative impact on the Company's financial results. The risk of not being able to realize the tax credits and other tax benefits depends on many factors outside of the Company's control, including changes in the applicable tax code and the ability of the projects to be completed and properly managed.

Substantial ownership concentration — Our directors, executive officers and 1st Source Bank, as trustee, collectively hold a significant ownership concentration of our common shares. Due to this significant level of ownership among our affiliates, our directors, executive officers, and 1st Source Bank, as trustee, may be able to influence the outcome of director elections or impact significant transactions, such as mergers or acquisitions, or any other matter that might otherwise be favored by other shareholders.

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

Reputational Risks

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

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

Item 1B. Unresolved Staff Comments.

None

Item 2. Properties.

Our headquarters building is located in downtown South Bend, Indiana. The building is part of a larger complex, including a 300-room hotel and a 500-car parking garage. In December 2010, we entered into a new 10.5 year lease on our headquarters building which became effective January 1, 2011. As of December 31, 2016, 1st Source leases approximately 69% of the office space in this complex.

At December 31, 2016, we also owned property and/or buildings where 58 of 1st Source Bank's 81 banking centers were located, including the facilities in Allen, Elkhart, Fulton, Huntington, Kosciusko, LaPorte, Marshall, Porter, Pulaski, St. Joseph, Starke, Tippecanoe, Wells, and Whitley Counties in the State of Indiana and Berrien, Cass, and Kalamazoo Counties in the State of Michigan, as well as an operations center and our former headquarters building,

which is utilized for additional business operations. The Bank leases additional property and/or buildings to and from third parties under lease agreements negotiated at arms-length.
During 2016, we continued work on our banking center network by investing approximately $6 million which primarily related
to the opening of a new banking center, relocating a banking center and refurbishing banking centers in various markets. In 2015, we made an investment of approximately $6 million which primarily related to the opening of three new banking centers and relocating two other ones in various markets.

Table of Contents

Item 3. Legal Proceedings.

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

Item 4. Mine Safety Disclosures.

None

Part II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

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

	2016 Sales Price		Cash Dividends	2015 Sales Price		Cash Dividends
Common Stock Prices (quarter ended)	High	Low	Paid	High	Low	Paid
March 31	$ 33.50	$ 27.01	$ 0.180	$ 31.35	$ 26.95	$ 0.164
June 30	34.83	30.32	0.180	31.75	27.69	0.164
September 30	35.99	31.50	0.180	32.37	28.06	0.164
December 31	45.61	33.27	0.180	34.35	29.35	0.180

As of February 10, 2017, there were 824 holders of record of 1st Source common stock.

Comparison of Five Year Cumulative Total Return*

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

* Assumes $100 invested on December 31, 2011, in 1st Source Corporation common stock, NASDAQ market index, and peer group index.

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

*** The peer group is a market-capitalization-weighted stock index of 44 banking companies in Illinois, Indiana, Michigan, Ohio, and Wisconsin.

NOTE: Total return assumes reinvestment of dividends.

Table of Contents

The following table shows our share repurchase activity during the three months ended December 31, 2016.

Period	Total Number of Shares Purchased	Average Price Paid Per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs*	Maximum Number (or Approximate Dollar Value) of Shares that may yet be Purchased Under the Plans or Programs
October 01 - 31, 2016	—	$ —	—	1,387,074
November 01 - 30, 2016	—	—	—	1,387,074
December 01 - 31, 2016	—	—	—	1,387,074

*1st Source maintains a stock repurchase plan that was authorized by the Board of Directors on July 24, 2014. Under the terms of the plan, 1st Source may repurchase up to 2,000,000 shares of its common stock from time to time to mitigate the potential dilutive effects of stock-based incentive plans and other potential uses of common stock for corporate purposes. Since the inception of the plan, 1st Source has repurchased a total of 612,926 shares.

Federal laws and regulations contain restrictions on the ability of 1st Source and the Bank to pay dividends. For information regarding restrictions on dividends, see Part I, Item 1, Business - Regulation and Supervision - Dividends and Part II, Item 8, Financial Statements and Supplementary Data - Note 20 of the Notes to Consolidated Financial Statements.

Item 6. Selected Financial Data.

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

(Dollars in thousands, except per share amounts)	2016	2015	2014	2013	2012
Interest income	$191,760	$184,684	$178,554	$179,585	$182,085
Interest expense	22,101	18,163	18,225	22,768	30,309
Net interest income	169,659	166,521	160,329	156,817	151,776
Provision for loan and lease losses	5,833	2,160	3,733	772	5,752
Net interest income after provision for loan and lease losses	163,826	164,361	156,596	156,045	146,024
Noninterest income	88,945	83,316	77,887	77,212	81,192
Noninterest expense	163,645	159,114	150,040	149,314	151,536
Income before income taxes	89,126	88,563	84,443	83,943	75,680
Income taxes	31,340	31,077	26,374	28,985	26,047
Net income	$57,786	$57,486	$58,069	$54,958	$49,633
Assets at year-end	$5,486,268	$5,187,916	$4,829,958	$4,722,826	$4,550,693
Long-term debt and mandatorily redeemable securities at year-end	74,308	57,379	56,232	58,335	71,021
Shareholders’ equity at year-end	672,650	644,053	614,473	585,378	558,655
Basic net income per common share	2.22	2.17	2.17	2.03	1.83
Diluted net income per common share	2.22	2.17	2.17	2.03	1.83
Cash dividends per common share	0.720	0.671	0.645	0.618	0.600
Dividend payout ratio	32.45 %	30.85 %	29.71 %	30.49 %	32.67 %
Return on average assets	1.08 %	1.15 %	1.21 %	1.19 %	1.11 %
Return on average common shareholders' equity	8.71 %	9.05 %	9.65 %	9.55 %	9.10 %
Average common shareholders' equity to average assets	12.38 %	12.72 %	12.52 %	12.49 %	12.20 %

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

The purpose of this analysis is to provide the reader with information relevant to understanding and assessing our results of operations for each of the past three years and financial condition for each of the past two years. In order to

fully appreciate this analysis the reader is encouraged to review the consolidated financial statements and statistical data presented in this document.

FORWARD-LOOKING STATEMENTS

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

Table of Contents

All statements other than statements of historical fact are statements that could be forward-looking statements. Words such as “believe,” “contemplate,” “seek,” “estimate,” “plan,” “project,” “anticipate,” “possible,” “assume,” “expect,” “intend,” “continue,” “remain,” “will,” “should,” “indicate,” “would,” “may” and other similar expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements. Forward-looking statements provide current expectations or forecasts of future events and are not guarantees of future performance, nor should they be relied upon as representing management’s views as of any subsequent date.

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

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

Table of Contents

APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our consolidated financial statements are prepared in accordance with U.S. generally accepted accounting principles (GAAP) and follow general practices within the industries in which we operate. Application of these principles requires management to make estimates or judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates or judgments reflect management's view of the most appropriate manner in which to record and report our overall financial performance. Because these estimates or judgments are based on current circumstances, they may change over time or prove to be inaccurate based on actual experience. As such, changes in these estimates, judgments, and/or assumptions may have a significant impact on our financial statements. All accounting policies are important, and all policies described in Part II, Item 8, Financial Statements and Supplementary Data, Note 1 (Note 1), should be reviewed for a greater understanding of how our financial performance is recorded and reported.

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

Reserve for Loan and Lease Losses — The reserve for loan and lease losses represents management's estimate of probable losses inherent in the loan and lease portfolio and the establishment of a reserve that is sufficient to absorb those losses. In determining an appropriate reserve, management makes numerous judgments, assumptions, and estimates based on continuous review of the loan and lease portfolio, estimates of client performance, collateral values, and disposition, as well as historical loss rates and expected cash flows. In assessing these factors, management benefits from a lengthy organizational history and experience with credit decisions and related outcomes. Nonetheless, if management's underlying assumptions prove to be inaccurate, the reserve for loan and lease losses would have to be adjusted. Our accounting policy related to the reserve is disclosed in Note 1 under the heading "Reserve for Loan and Lease Losses."

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

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

Table of Contents

EARNINGS SUMMARY

Net income in 2016 was $57.79 million, up from $57.49 million in 2015 and down from $58.07 million in 2014. Diluted net income per common share was $2.22 in 2016 and $2.17 in 2015 and 2014. Return on average total assets was 1.08% in 2016 compared to 1.15% in 2015, and 1.21% in 2014. Return on average common shareholders' equity was 8.71% in 2016 versus 9.05% in 2015, and 9.65% in 2014.

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

Net income in 2015 was positively impacted by a $6.19 million or 3.86% increase in net interest income and a $1.57 million or 42.14% decrease in provision for loan and lease losses and a $5.43 million or 6.97% increase in noninterest income, which was offset by $9.07 million or 6.05% increase in noninterest expense and a $4.70 million or 17.83% increase in in income tax expense over 2014.

Dividends paid on common stock in 2016 amounted to $0.720 per share, compared to $0.671 per share in 2015, and $0.645 per share in 2014. The level of earnings reinvested and dividend payouts are determined by the Board of Directors based on management's assessment of future growth opportunities and the level of capital necessary to support them.

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

Net interest margin (the ratio of net interest income to average earning assets) is significantly affected by movements in interest rates and changes in the mix of earning assets and the liabilities that fund those assets. Net interest margin on a fully taxable- equivalent basis was 3.43% in 2016, compared to 3.60% in 2015 and 3.59% in 2014. Net interest income was $169.66 million for 2016, compared to $166.52 million for 2015 and $160.33 million for 2014. Tax-equivalent net interest income totaled $171.48 million for 2016, up $3.27 million from the $168.22 million reported in 2015. Tax-equivalent net interest income for 2015 was up $6.05 million from the $162.17 million reported for 2014.

During 2016, average earning assets increased $335.11 million or 7.18% while average interest-bearing liabilities increased $235.37 million or 6.80% over the comparable period in 2015. The yield on average earning assets decreased 12 basis points to 3.87% for 2016 from 3.99% for 2015 partially due to lower net interest recoveries of $3.16 million or 6 basis points largely related to two commercial loan relationships. Total cost of average interest-bearing liabilities increased 8 basis points to 0.60% during 2016 from 0.52% in 2015 as a result of the current interest rate environment. The result to the net interest margin, or the ratio of net interest income to average earning assets was a decrease of 17 basis points.

The largest contributor to the decrease in the yield on average earning assets in 2016 was the 11 basis point decrease in the loan and lease portfolio yield due to the aforementioned net interest recoveries in 2015 which impacted the yield by 8 basis points. Average net loans and leases increased $276.36 million or 7.20% in 2016 from 2015 while the yield decreased to 4.28%.

During 2016, the tax-equivalent yield on securities available-for-sale decreased 14 basis points to 1.94% while the average balance increased $25.52 million. Average mortgages held for sale increased $1.30 million during 2016 and the yield decreased 19 basis points. Average other investments, which include federal funds sold, time deposits with other banks, Federal Reserve Bank excess balances, Federal Reserve Bank and Federal Home Loan Bank (FHLB) stock and commercial paper increased $31.93 million during 2016 while the yield decreased 107 basis points. The decrease in yield was primarily a result of higher outstanding balances at lower rates.

Average interest-bearing deposits increased $251.84 million during 2016 while the effective rate paid on those deposits increased 8 basis points. The increase in effective rate was primarily the result of higher rates paid on certificates of deposit and accelerated amortization on brokered certificates of deposit called before their maturity. Average noninterest-bearing demand deposits increased $89.80 million during 2016.

Average short-term borrowings decreased $26.06 million during 2016 while the effective rate paid increased 5 basis points. The decrease in short-term borrowings was primarily the result of decreased borrowings with the Federal Home Loan Bank. Average long-term debt increased $9.60 million during 2016 as the effective rate decreased 31 basis points. The decrease in effective rate in 2016 was primarily due to increased borrowings at rates lower than existing debt.

Table of Contents

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

(Dollars in thousands)	2016 Average Balance	Interest Income/Expense	Yield/Rate	2015 Average Balance	Interest Income/Expense	Yield/Rate	2014 Average Balance	Interest Income/Expense	Yield/Rate
ASSETS									
Investment securities available-for-sale:									
Taxable	$684,503	$11,777	1.72%	$664,480	$11,929	1.80%	$694,830	$13,054	1.88%
Tax-exempt[1]	127,998	3,981	3.11%	122,500	4,406	3.60%	127,191	4,834	3.80%
Mortgages held for sale	12,396	467	3.77%	11,099	439	3.96%	11,143	462	4.15%
Loans and leases, net of unearned discount[1]	4,113,508	176,116	4.28%	3,837,149	168,611	4.39%	3,639,985	161,027	4.42%
Other investments	65,517	1,244	1.90%	33,583	997	2.97%	40,482	1,016	2.51%
Total earning assets[1]	5,003,922	193,585	3.87%	4,668,811	186,382	3.99%	4,513,631	180,393	4.00%
Cash and due from banks	60,753			61,400			62,263		
Reserve for loan and lease losses	(90,206)			(87,208)			(86,982)		
Other assets	386,216			351,205			317,893		
Total assets	$5,360,685			$4,994,208			$4,806,805		
LIABILITIES AND SHAREHOLDERS' EQUITY									
Interest-bearing deposits	$3,358,827	$15,267	0.45%	$3,106,990	$11,489	0.37%	$3,015,693	$11,356	0.38%
Short-term borrowings	210,876	525	0.25%	236,940	484	0.20%	263,377	541	0.21%
Subordinated notes	58,764	4,220	7.18%	58,764	4,220	7.18%	58,764	4,220	7.18%
Long-term debt and mandatorily redeemable securities	66,842	2,089	3.13%	57,245	1,970	3.44%	57,757	2,108	3.65%
Total interest-bearing liabilities	3,695,309	22,101	0.60%	3,459,939	18,163	0.52%	3,395,591	18,225	0.54%
Noninterest-bearing deposits	943,874			854,070			762,050		
Other liabilities	57,799			44,702			47,272		
Shareholders' equity	663,703			635,497			601,892		
Total liabilities and shareholders' equity	$5,360,685			$4,994,208			$4,806,805		
Less: Fully tax-equivalent adjustments		(1,825)			(1,698)			(1,839)	
		$169,659	3.39%		$166,521	3.57%		$160,329	3.55%

Net interest income/margin (GAAP-derived)[1]						
Fully tax-equivalent adjustments	1,825		1,698		1,839	
Net interest income/margin - FTE[1]	$171,484	3.43%	$168,219	3.60%	$162,168	3.59%

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

Table of Contents

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

	(Dollars in thousands)	2016	2015	2014
	Calculation of Net Interest Margin			
(A)	Interest income (GAAP)	$191,760	$184,684	$178,554
	Fully tax-equivalent adjustments:			
(B)	- Loans and leases	584	284	274
(C)	- Tax-exempt investment securities	1,241	1,414	1,565
(D)	Interest income - FTE (A+B+C)	193,585	186,382	180,393
(E)	Interest expense (GAAP)	22,101	18,163	18,225
(F)	Net interest income (GAAP) (A-E)	169,659	166,521	160,329
(G)	Net interest income - FTE (D-E)	171,484	168,219	162,168
(H)	Total earning assets	$5,003,922	$4,668,811	$4,513,631
	Net interest margin (GAAP-derived) (F/H)	3.39 %	3.57 %	3.55 %
	Net interest margin - FTE (G/H)	3.43 %	3.60 %	3.59 %

21

Table of Contents

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

	Increase (Decrease) due to		
(Dollars in thousands)	Volume	Rate	Net
2016 compared to 2015			
Interest earned on:			
Investment securities available-for-sale:			
Taxable	$ 353	$ (505)	$ (152)
Tax-exempt	191	(616)	(425)
Mortgages held for sale	50	(22)	28
Loans and leases, net of unearned discount	11,914	(4,409)	7,505
Other investments	700	(453)	247
Total earning assets	$ 13,208	$ (6,005)	$ 7,203
Interest paid on:			
Interest-bearing deposits	$ 987	$ 2,791	$ 3,778
Short-term borrowings	(57)	98	41
Subordinated notes	—	—	—
Long-term debt and mandatorily redeemable securities	311	(192)	119
Total interest-bearing liabilities	$ 1,241	$ 2,697	$ 3,938
Net interest income - FTE	$ 11,967	$ (8,702)	$ 3,265
2015 compared to 2014			
Interest earned on:			
Investment securities available-for-sale:			
Taxable	$ (558)	$ (567)	$ (1,125)
Tax-exempt	(173)	(255)	(428)
Mortgages held for sale	(2)	(21)	(23)
Loans and leases, net of unearned discount	8,715	(1,131)	7,584
Other investments	(187)	168	(19)
Total earning assets	$ 7,795	$ (1,806)	$ 5,989
Interest paid on:			
Interest-bearing deposits	$ 342	$ (209)	$ 133
Short-term borrowings	(54)	(3)	(57)
Subordinated notes	—	—	—
Long-term debt and mandatorily redeemable securities	(18)	(120)	(138)
Total interest-bearing liabilities	$ 270	$ (332)	$ (62)
Net interest income - FTE	$ 7,525	$ (1,474)	$ 6,051

Noninterest Income — Noninterest income increased $5.63 million or 6.76% in 2016 from 2015 following a $5.43 million or 6.97% increase in 2015 over 2014. The following table shows noninterest income for the most recent three years ended December 31.

(Dollars in thousands)	2016	2015	2014
Noninterest income:			
Trust and wealth advisory	$19,256	$19,126	$18,511
Service charges on deposit accounts	9,053	9,313	8,684
Debit card	10,887	10,217	9,585
Mortgage banking	4,496	4,570	5,381
Insurance commissions	5,513	5,465	5,556

Equipment rental	25,863	22,302	17,156
Gains on investment securities available-for-sale	1,796	4	963
Other	12,081	12,319	12,051
Total noninterest income	$88,945	$83,316	$77,887

Table of Contents

Trust and wealth advisory fees (which include investment management fees, estate administration fees, mutual fund fees, annuity fees, and fiduciary fees) increased slightly in 2016 from 2015 compared to an increase of $0.62 million or 3.32% in 2015 over 2014. Trust and wealth advisory fees are largely based on the number and size of client relationships and the market value of assets under management. The market value of trust assets under management at December 31, 2016 and 2015 was $4.19 billion and $3.78 billion, respectively. At December 31, 2016, these trust assets were comprised of $2.68 billion of personal and agency trusts and estate administration assets, $1.05 billion of employee benefit plan assets, $0.37 million of individual retirement accounts, and $0.09 million of custody assets.
Service charges on deposit accounts declined $0.26 million or 2.79% in 2016 from 2015 compared to an increase of $0.63 million or 7.24% in 2015 from 2014. The decrease in service charges on deposit accounts in 2016 primarily reflects a lower volume of nonsufficient fund transactions and a decrease in paper statement fees as clients continue to move to online access for account statements. The growth in service charges on deposit accounts in 2015 was the result of an increase in statement fees and ATM fees due to a change in the fee structure that went into effect January 1, 2015 and higher nonsufficient fund transactions.
Debit card income improved $0.67 million or 6.56% in 2016 from 2015 compared to an increase of $0.63 million or 6.59% in 2015 from 2014. The increase in 2016 and 2015 was the result of an increased volume of debit card transactions.
Mortgage banking income declined slightly in 2016 over 2015, compared to a decrease of $0.81 million or 15.07% in 2015 over 2014. We had no MSR impairment in 2016, 2015 or 2014. During 2016, 2015 and 2014, we determined that no permanent write-down was necessary for previously recorded impairment on MSRs. During 2016, mortgage banking income was negatively impacted by lower loan servicing fees offset by increased gains on loan sales due to increased profit margins. During 2015, mortgage banking income was negatively impacted by decreased gains on loan sales due to reduced profit margins and higher MSR amortization expense.
Insurance commissions were flat in 2016 compared to 2015 and decreased slightly in 2015 compared to 2014.
Equipment rental income generated from operating leases increased by $3.56 million or 15.97% during 2016 from 2015 compared to an increase of $5.15 million or 30.00% during 2015 from 2014. The average equipment rental portfolio increased 25.41% in 2016 over 2015 and 35.13% in 2015 over 2014 as the result of growth in aircraft, medium and heavy duty trucks and construction equipment. In 2016 and 2015 the increase in equipment rental income was offset by a similar increase in depreciation on equipment owned under operating leases.
Sales of investment securities available-for-sale resulted in gains of $1.80 million for the year ended 2016 compared to gains of $4,000 for the year ended 2015 and gains of $0.96 million for the year ended 2014. During 2016, gains were the result of sales of marketable equity securities and U.S. States and political subdivisions securities offset by an other than temporary impairment charge of $0.29 million on a marketable equity security. The gains in 2015 were the result of sales of U.S. States and political subdivisions securities. The gains in 2014 were the result of a sale of a marketable equity security.
Other income decreased $0.24 million or 1.93% in 2016 from 2015 compared to an increase of $0.27 million or 2.22% in 2015 from 2014. The decrease in 2016 was mainly the result of lower monogram fund income, decreased customer swap fees and a reduction in claim proceeds from bank owned life insurance offset by gains on the liquidation of a partnership investment required by the Volcker Rule and higher mutual fund income. The increase in 2015 was mainly the result of lower losses on partnership investments, higher customer swap fees and claim proceeds from bank owned life insurance offset by lower monogram fund income and a one-time valuation adjustment in 2014.

Table of Contents

Noninterest Expense — Noninterest expense increased $4.53 million or 2.85% in 2016 over 2015 following a $9.07 million or 6.05% increase in 2015 from 2014. The following table shows noninterest expense for the most recent three years ended December 31.

(Dollars in thousands)	2016	2015	2014
Noninterest expense:			
Salaries and employee benefits	$86,837	$86,133	$80,488
Net occupancy	9,686	9,768	9,311
Furniture and equipment	19,500	18,348	17,657
Depreciation — leased equipment	21,678	18,280	13,893
Professional fees	5,161	4,682	5,046
Supplies and communications	5,244	6,011	5,589
FDIC and other insurance	3,147	3,412	3,384
Business development and marketing	4,936	4,837	6,049
Loan and lease collection and repossession	1,600	667	1,102
Other	5,856	6,976	7,521
Total noninterest expense	$163,645	$159,114	$150,040

Total salaries and employee benefits increased slightly in 2016 from 2015, following a $5.65 million or 7.01% increase in 2015 from 2014.

Employee salaries increased $1.11 million or 1.61% in 2016 from 2015 compared to an increase of $4.32 million of 6.70% in 2015 from 2014. The increase in 2016 was a result of higher base salaries offset by lower executive incentives. Higher base salary expense was primarily due to normal performance raises. The increase in 2015 was a result of higher base salaries, producer commissions and executive incentives. Higher base salary expense was primarily due to more full-time equivalent employees as a result of opening three new banking centers in 2014 and one new banking center in 2015, filling open positions and normal performance raises. Producer commissions increased primarily in the areas of insurance and trust due to new client relationships.

Employee benefits decreased $0.41 million or 2.35% in 2016 from 2015, compared to a $1.33 million or 8.28% increase in 2015 from 2014. During 2016, group insurance costs decreased as a result of overall lower health insurance claims. During 2015, group insurance costs increased as a result of higher claims experience including the removal of lifetime caps and other various items under the Affordable Care Act.

Occupancy expense was flat in 2016 from 2015, compared to an increase of $0.46 million or 4.91% in 2015 from 2014. The higher expense in 2015 was mainly due to increased real estate taxes as a result of assessments on new banking centers and remodeling to existing banking centers, real estate tax appeal settlements received in 2014 and increased premises repairs.

Furniture and equipment expense, including depreciation, grew by $1.15 million or 6.28% in 2016 from 2015 compared to an increase of $0.69 million or 3.91% in 2015 from 2014. The higher expense in 2016 was due to increased software maintenance costs, depreciation on new equipment with banking center remodels and computer processing charges. The higher expense during 2015 was primarily due to increased software and equipment maintenance costs, computer processing charges and equipment repairs.

Depreciation on equipment owned under operating leases increased $3.40 million or 18.59% in 2016 from 2015, following a $4.39 million or 31.58% increase in 2015 from 2014. In 2016 and 2015, depreciation on equipment owned under operating leases changed in conjunction with the increase in equipment rental income.

Professional fees increased $0.48 million or 10.23% in 2016 from 2015, compared to a $0.36 million or 7.21% decrease in 2015 from 2014. The increase in 2016 was primarily due to higher legal fees and the increased utilization of consulting services. The decrease in 2015 was primarily due to lower audit fees and the reduced utilization of consulting services offset by higher director fees.

Supplies and communications expense decreased $0.77 million or 12.76% in 2016 from 2015, and increased $0.42 million or 7.55% in 2015 from 2014. The reduction in 2016 was mainly the result of costs associated with replacing debit cards with embedded EMV chip cards in 2015 and lower telephone charges. The increase in 2015 was mainly the result of replacing debit cards with the new embedded EMV chip.

FDIC and other insurance expense decreased $0.27 million or 7.76% in 2016 from 2015 and was flat in 2015 from 2014. The decline in 2016 was mainly due to lower assessments as a result of the Deposit Insurance Fund's reserve ratio exceeding the FDIC's established benchmark.

Table of Contents

Business development and marketing expenses increased slightly in 2016 from 2015 compared to a $1.21 million or 20.04% decrease in 2015 from 2014. The lower expense in 2015 was the result of decreased charitable contributions offset by increased marketing promotions.

Loan and lease collection and repossession expenses increased $0.93 million or 139.88% in 2016 from 2015 compared to a decrease of $0.44 million or 39.47% in 2015 from 2014. Loan and lease collection and repossession expense was higher in 2016 mainly due to lower recoveries on repurchased mortgage loans, fewer gains on the sale of other real estate owned and repossessions and an increase in general collection and repossession expenses offset by decreased valuation adjustments. The decrease in 2015 was mainly due to a decrease in general collection and repossession expenses and lower repurchased mortgage loan losses as a result of fewer loan repurchase requests offset by increased valuation adjustments and fewer gains on the sale of other real estate and repossessions.

Other expenses declined $1.12 million or 16.06% in 2016 as compared to 2015 and decreased $0.55 million or 7.25% in 2015 as compared to 2014. The decrease in 2016 was mainly the result of reduced residential mortgage foreclosure expenses, lower provision on unfunded loan commitments, higher gains on the sale of fixed assets, reduced intangible asset amortization as items fully amortize offset by higher fraud losses and reduced gains on the sale of operating lease equipment. The decrease in 2015 was mainly due to lower expenses related to a previously reported proceeding that involved the Bank as trustee, reduced intangible asset amortization as items fully amortize and fewer writedowns on a property held for sale offset by higher mortgage servicing foreclosure expenses, provision on unfunded loan commitments, employment and relocation expenses and increased debit card losses

Income Taxes — 1st Source recognized income tax expense in 2016 of $31.34 million, compared to $31.08 million in 2015, and $26.37 million in 2014. The effective tax rate in 2016 was 35.16% compared to 35.09% in 2015, and 31.23% in 2014. The provision for income taxes included a one-time benefit of $3.30 million for the twelve months ended December 31, 2014 which resulted in a lower effective tax rate for 2014 compared to 2016 and 2015. These benefits were the result of a reduction in uncertain tax positions due to settlements with taxing authorities and the lapse of the applicable statute of limitations.

Effective January 1, 2014, the Indiana Financial Institutions Tax (FIT) rate decreased from 8.5% to 8.0% and will continue to decrease by 0.5% each of the next three years. As a result of the change, we decreased the carrying value of certain state deferred tax assets. The impact of the change was not material and was recorded in the financial statements during the second quarter of 2013. Additionally, on March 25, 2014, FIT tax rate decreases from 6.5% in 2018 to 4.9% in 2023 were enacted. These further decreases did not have an impact on our deferred taxes and as a result, no amount was recorded in our financial statements for this rate change. For a detailed analysis of 1st Source’s income taxes see Part II, Item 8, Financial Statements and Supplementary Data — Note 17 of the Notes to Consolidated Financial Statements.

FINANCIAL CONDITION

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

(Dollars in thousands)	2016	2015	2014	2013	2012
Commercial and agricultural	$812,264	$744,749	$710,758	$679,492	$639,069
Auto and light truck	411,764	425,236	397,902	391,649	396,602
Medium and heavy duty truck	294,790	278,254	247,153	237,854	213,547
Aircraft	802,414	778,012	727,665	738,133	696,479
Construction equipment	495,925	455,565	399,940	333,088	278,974
Commercial real estate	719,170	700,268	616,587	583,997	554,968
Residential real estate and home equity	521,931	490,468	476,504	495,273	474,322
Consumer	129,813	122,140	112,065	89,838	73,592
Total loans and leases	$4,188,071	$3,994,692	$3,688,574	$3,549,324	$3,327,553

At December 31, 2016, there were no concentrations within the loan portfolio of 10% or more of total loans and leases.

Loans and leases, net of unearned discount, at December 31, 2016, were $4.19 billion and were 76.34% of total assets, compared to $3.99 billion and 77.00% of total assets at December 31, 2015. Average loans and leases, net of unearned

discount, increased $193.38 million or 4.84% and increased $197.16 million or 5.42% in 2016 and 2015, respectively.

Table of Contents

Commercial and agricultural lending, excluding those loans secured by real estate, increased $67.52 million or 9.07% in 2016 over 2015. Commercial and agricultural lending outstandings were $812.26 million and $744.75 million at December 31, 2016 and December 31, 2015, respectively. This increase was mainly attributed to an improved economy in our target markets, resulting in greater line of credit usage and the financing of increased capital expenditures by our clients. During 2016, we experienced some volatility in the portfolio as a result of a number of our clients taking advantage of an improved economy by selling their businesses which resulted in loan payoffs. Additionally, in 2016 we funded our first renewable energy solar projects.

Auto and light truck loans decreased $13.47 million or 3.17% in 2016 over 2015. At December 31, 2016, auto and light truck loans had outstandings of $411.76 million and $425.24 million at December 31, 2015. This decrease was primarily attributable to continued industry consolidation and prudent underwriting decisions within the auto rental segment which were partially offset by loan outstandings growth in commercial lessor, bus and funeral vehicles segments.

Medium and heavy duty truck loans and leases grew by $16.54 million or 5.94% in 2016. Medium and heavy duty truck financing at December 31, 2016 and 2015 had outstandings of $294.79 million and $278.25 million, respectively. Most of the increase at December 31, 2016 from December 31, 2015 can be attributed to clients continued replacement of aged equipment.

Aircraft financing at year-end 2016 increased $24.40 million or 3.14% from year-end 2015. Aircraft financing at December 31, 2016 and 2015 had outstandings of $802.41 million and $778.01 million, respectively. The increase during 2016 was mainly due to growth in foreign outstandings of $33.31 million. Additionally, there were domestic outstanding increases in our core aviation segments of personal business and charter operators which were offset by year end reductions in our dealer segment.

Construction equipment financing increased $40.36 million or 8.86% in 2016 compared to 2015. Construction equipment financing at December 31, 2016 had outstandings of $495.93 million, compared to outstandings of $455.57 million at December 31, 2015. The growth in this category was primarily due to new client relationships and continued replacement of aged equipment.

Commercial loans secured by real estate, of which approximately 50% is owner occupied, increased $18.90 million or 2.70% in 2016 over 2015. Commercial loans secured by real estate outstanding at December 31, 2016 were $719.17 million and $700.27 million at December 31, 2015. The increase in 2016 was mainly due to general improvements in the business economy within our markets offset partially by payoffs resulting from clients taking advantage of market conditions to sell their businesses.

Residential real estate and home equity loans were $521.93 million at December 31, 2016 and $493.18 million at December 31, 2015. Residential real estate and home equity loans increased $28.75 million or 5.83% in 2016 from 2015. The increase in residential real estate loans was primarily due to higher demand in home purchase and refinance requests for rate and term reductions along with the retention of more loans in the portfolio instead of selling them in the secondary market.

Consumer loans increased $10.39 million or 8.70% in 2016 over 2015. Consumer loans outstanding at December 31, 2016, were $129.81 million and $119.43 million at December 31, 2015. The increase during 2016 was due to higher demand in personal line of credit loans and other direct installment loans as a result of favorable interest rates.

The following table shows the maturities of loans and leases in the categories of commercial and agricultural, auto and light truck, medium and heavy duty truck, aircraft and construction equipment outstanding as of December 31, 2016.

(Dollars in thousands)	0-1 Year	1-5 Years	Over 5 Years	Total
Commercial and agricultural	$384,190	$347,995	$ 80,079	$812,264
Auto and light truck	172,224	233,006	6,534	411,764
Medium and heavy duty truck	93,850	195,280	5,660	294,790
Aircraft financing	205,417	510,239	86,758	802,414
Construction equipment financing	139,285	342,709	13,931	495,925
Total	$994,966	$1,629,229	$ 192,962	$2,817,157

The following table shows amounts due after one year are also classified according to the sensitivity to changes in interest rates.

Rate Sensitivity (Dollars in thousands)	Fixed Rate	Variable Rate	Total
1 – 5 Years	$1,083,471	$ 545,758	$1,629,229
Over 5 Years	50,046	142,916	192,962
Total	$1,133,517	$ 688,674	$1,822,191

During 2016, approximately 56% of the Bank's residential mortgage originations were sold into the secondary market. Mortgage loans held for sale were $15.85 million at December 31, 2016 and were $9.83 million at December 31, 2015. Although 1st Source Bank participated in the U.S. Treasury Making Home Affordable programs which expired December 30, 2016, we do not feel it had a material effect on our financial condition or results of operations.

Table of Contents

1st Source Bank sells residential mortgage loans to Fannie Mae as well as FHA-insured and VA-guaranteed loans in Ginnie Mae mortgage-backed securities. Additionally, we have sold loans on a service released basis to various other financial institutions in the past. The agreements under which we sell these mortgage loans contain various representations and warranties regarding the acceptability of loans for purchase. On occasion, we may be asked to indemnify the loan purchaser for credit losses on loans that were later deemed ineligible for purchase or we may be asked to repurchase a loan. Both circumstances are collectively referred to as “repurchases.” Within the industry, repurchase demands have decreased during 2015 and 2016. We believe the loans we have underwritten and sold to these entities have met or exceeded applicable transaction parameters. Our exposure risk for repurchases started to reduce in 2016 as a result of the enhancements made by FNMA in 2013 to the selling representations and warranties framework as warranties on loans sold prior to implementation of such changes lapse.

Our liability for repurchases, included in Accrued Expenses and Other Liabilities on the Statements of Financial Condition, was $0.42 million and $0.98 million as of December 31, 2016 and 2015, respectively. Our (recovery) expense for repurchase losses, included in Loan and Lease Collection and Repossession expense on the Statements of Income, was $(0.16) million in 2016 compared to $(0.75) million in 2015 and $(0.27) million in 2014. The mortgage repurchase liability represents our best estimate of the loss that we may incur. The estimate is based on specific loan repurchase requests and a historical loss ratio with respect to origination dollar volume. Because the level of mortgage loan repurchase losses is dependent on economic factors, investor demand strategies and other external conditions that may change over the life of the underlying loans, the level of liability for mortgage loan repurchase losses is difficult to estimate and requires considerable management judgment.

CREDIT EXPERIENCE

Reserve for Loan and Lease Losses — Our reserve for loan and lease losses is provided for by direct charges to operations. Losses on loans and leases are charged against the reserve and likewise, recoveries during the period for prior losses are credited to the reserve. Our management evaluates the reserve quarterly, reviewing all loans and leases over a fixed-dollar amount ($100,000) where the internal credit quality grade is at or below a predetermined classification, actual and anticipated loss experience, current economic events in specific industries, and other pertinent factors including general economic conditions. Determination of the reserve is inherently subjective as it requires significant estimates, including the amounts and timing of expected future cash flows or fair value of collateral on collateral-dependent impaired loans and leases, estimated losses on pools of homogeneous loans and leases based on historical loss experience, and consideration of environmental factors, principally economic risk and concentration risk, all of which may be susceptible to significant and unforeseen changes. We review the status of the loan and lease portfolio to identify borrowers that might develop financial problems in order to aid borrowers in the handling of their accounts and to mitigate losses. See Part II, Item 8, Financial Statements and Supplementary Data — Note 1 of the Notes to Consolidated Financial Statements for additional information on management’s evaluation of the 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.

During 2016, the medium-term portion of the look-back period was eight years given that 2009 through 2016 losses were considerably impacted by the severe recession. Although the recession began in December 2007, its financial consequences were not recognized in the loan portfolios until 2009. We gave the greatest weight to this recent eight year period in our calculation, as we feel it is most consistent with our current expectations for 2017. 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 and global economic and political issues. The U.S. presidential election results increase uncertainty as we contemplate, among other things, the potential impact

of protectionism, tariffs and tax reform. 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.

Geopolitical events may impede the U.S. economic expansion. Current concerns include ongoing corruption scandals and political uncertainty in Latin American countries, the continued slowdown in China, the sharp recession, high unemployment and significant budget deficits in Brazil, the lower economic growth, accelerating inflation and uncertain U.S. trade relationships in Mexico, the continuing geopolitical tensions in Russia, the weak EU economies and the impact of Brexit, and the heightened concerns of terrorist attacks. We include a factor in our loss ratios for global risk, as we are increasingly aware of the threat that global concerns may affect our customers. While we are unable to determine with any precision the impact of global economic and political issues on 1st Source Bank’s loan portfolios, we feel the risks are real and significant. We believe there is a risk of negative consequences for our borrowers that would affect their ability to repay their financial obligations. Therefore, we continue to include a factor for global risk in our analysis for 2016.

Table of Contents

Another area of concern continues to be our aircraft portfolio where we have collateral concentration and $239 million foreign exposure. The aircraft industry was among the sectors affected most by the sluggish economy. We have seen some evidence that depressed private jet markets have stabilized; however, the pre-owned jet market remains soft. The U.S. economic growth and a return to growth in emerging regions may benefit the industry. Nevertheless, we remain concerned about the prolonged low prices for several models, particularly mid and large cabin aircraft and also heavy helicopters whose values have declined as a result of contraction in the energy sector. We also have foreign exposure in this portfolio, particularly in Mexico and Brazil. The recession in Brazil and the currency fluctuations are having a negative impact on our clients’ cost of paying dollar denominated debts and, as a result, we have experienced delinquency in this portfolio and we continue to experience higher default rates in this portfolio than in our other lending segments. We also experienced our first charge-offs of foreign aircraft accounts in 2016. We reassessed our ratios, which were established based on the higher and more volatile loss histories and the anticipation of future losses, and believe they remain appropriate and adequate given our aircraft portfolio risk characteristics.

We experienced ongoing stability in the medium and heavy duty truck portfolio. We recognized sizable losses during 2009 and the first half of 2010; however, since then we have had no charge-offs. Our credit quality is strongest when industry conditions are favorable. Lower gas prices and growth in GDP, and the construction sector, which leads to higher demand for trucking bode well for the industry. Industry concerns include a persistent driver shortage, excess capacity, economic uncertainty and achieving regulatory compliance. Nevertheless, the underlying industry fundamentals are expected to remain relatively stable and the industry is poised to have a good year again in 2017. As a result, we made a modest downward adjustment to our reserve ratio for this portfolio.

Our construction equipment portfolio is characterized by increasing outstanding loan balances and continued strong credit quality in 2016. The construction industry, which was hard hit during the recession, is benefiting from an improving economy, buoyed by growth in private residential and non-residential construction. The Bank has limited exposure to the industry's weakest sector, the sluggish oil and gas sector. Historically, 1st Source has experienced less volatility in this portfolio than the industry as losses have been mitigated by appropriate underwriting and a global market for used construction equipment. Weak global demand and the strong dollar held down used equipment exports, but the U.S. market remains solid. The underlying risk has not changed significantly for this portfolio; our reserve factors are similar to last year.

The auto and light truck portfolio outstanding loan balances declined in 2016 as we lost a number of our larger customers as a result of industry consolidations. Ongoing consolidation remains a threat to portfolio growth. Further negatively impacting the portfolio is a projected decline in used car values as a result of an abundance of available vehicles following several years of record production by the manufacturers. We reviewed our ratios and made an upward adjustment to the reserve ratio for the auto portfolio given the changed portfolio characteristics and the softening collateral values.

There are several industries represented in the commercial and agricultural portfolio. The outlook for the business banking portfolio is guardedly optimistic, generally a continuation of 2016 trends. Consumer and small business confidence remains strong and unemployment is slightly lower than the national average in many of the markets we serve. Our recent foray into solar financing looks promising in terms of both loan growth opportunities and credit quality. An area of concern is our agricultural portfolio. Farm incomes declined sharply in 2015 and 2016 and little improvement is anticipated in 2017, as commodity prices, particularly corn and soybeans, remain low. We anticipate some of our borrowers will be unable to repay their lines of credit in full, resulting in carry-over debt. For the commercial and agricultural portfolio as a whole, we have experienced strong credit quality trends with low delinquencies and minimal charge-offs. We have reviewed the calculated loss ratios and assessed the environmental factors and concentration issues affecting these portfolios and incorporated adjustments which resulted in a slight decrease in our reserve ratio.

Similar to the commercial portfolio, our commercial real estate loans are concentrated in our local market with local customers, with approximately fifty percent of the Bank's exposure being owner occupied facilities where we are the primary relationship bank for our customers. Nevertheless, we were not immune to the dramatic declines in real estate values following the great recession, similar to other U.S. markets and we experienced losses from 2009 through 2011. Furthermore, our recent portfolio growth has been in the more risky non-owner occupied sector. Our recent loss

history is favorable. We made an upward adjustment to our reserve ratio last year as a result of our growth in more risky sectors, which has been stable year-over-year, and we believe the ratio remains appropriate and adequate this year-end.

The reserve for loan and lease losses at December 31, 2016, totaled $88.54 million and was 2.11% of loans and leases, compared to $88.11 million or 2.21% of loans and leases at December 31, 2015 and $85.07 million or 2.31% of loans and leases at December 31, 2014. It is our opinion that the reserve for loan and lease losses was appropriate to absorb probable losses inherent in the loan and lease portfolio as of December 31, 2016.

Charge-offs for loan and lease losses were $7.94 million for 2016, compared to $4.71 million for 2015 and $6.03 million for 2014. We had two large losses in 2016, both in the foreign aircraft portfolio. These were our first foreign losses since our foray into foreign aircraft lending in 2003. The provision for loan and lease losses was $5.83 million for 2016, compared to $2.16 million for 2015 and $3.73 million for 2014.

Table of Contents

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

(Dollars in thousands)	2016	2015	2014	2013	2012
Amounts of loans and leases outstanding at end of period	$4,188,071	$3,994,692	$3,688,574	$3,549,324	$3,327,553
Average amount of net loans and leases outstanding during period	$4,113,508	$3,837,149	$3,639,985	$3,433,938	$3,209,490
Balance of reserve for loan and lease losses at beginning of period	$88,112	$85,068	$83,505	$83,311	$81,644
Charge-offs:					
Commercial and agricultural	547	3,489	5,007	538	524
Auto and light truck	4	24	42	226	3,754
Medium and heavy duty truck	—	—	—	57	41
Aircraft	6,123	244	—	1,308	600
Construction equipment	128	—	4	88	120
Commercial real estate	32	—	99	170	471
Residential real estate and home equity	219	295	46	424	687
Consumer	888	658	833	1,017	1,439
Total charge-offs	7,941	4,710	6,031	3,828	7,636
Recoveries:					
Commercial and agricultural	509	851	929	468	484
Auto and light truck	253	380	1,283	139	230
Medium and heavy duty truck	10	28	142	462	1,185
Aircraft	528	802	240	884	711
Construction equipment	461	434	525	323	268
Commercial real estate	469	2,807	347	627	223
Residential real estate and home equity	31	34	111	22	59
Consumer	278	258	284	325	391
Total recoveries	2,539	5,594	3,861	3,250	3,551
Net charge-offs (recoveries)	5,402	(884)	2,170	578	4,085
Provision for loan and lease losses	5,833	2,160	3,733	772	5,752
Balance at end of period	$88,543	$88,112	$85,068	$83,505	$83,311
Ratio of net charge-offs (recoveries) to average net loans and leases outstanding	0.13 %	(0.02)%	0.06 %	0.02 %	0.13 %
Ratio of reserve for loan and lease losses to net loans and leases outstanding end of period	2.11 %	2.21 %	2.31 %	2.35 %	2.50 %
Coverage ratio of reserve for loan and lease losses to nonperforming loans and leases	435.68 %	686.23 %	239.07 %	225.73 %	226.03 %

The following table shows net charge-offs (recoveries) as a percentage of average loans and leases by portfolio type:

	2016	2015	2014	2013	2012
Commercial and agricultural	— %	0.36 %	0.58 %	0.01 %	0.01 %
Auto and light truck	(0.06)	(0.08)	(0.30)	0.02	0.85
Medium and heavy duty truck	—	(0.01)	(0.06)	(0.19)	(0.53)
Aircraft	0.69	(0.07)	(0.03)	0.06	(0.02)
Construction equipment	(0.07)	(0.10)	(0.14)	(0.08)	(0.05)
Commercial real estate	(0.06)	(0.44)	(0.04)	(0.08)	0.05
Residential real estate and home equity	0.04	0.05	(0.01)	0.08	0.13
Consumer	0.49	0.33	0.56	0.82	1.57
Total net charge-offs (recoveries) to average portfolio loans and leases	0.13 %	(0.02)%	0.06 %	0.02 %	0.13 %

29

Table of Contents

The reserve for loan and lease losses has been allocated according to the amount deemed necessary to provide for the estimated probable losses that have been incurred within the categories of loans and leases set forth in the table below. The following table shows the amount of such components of the reserve at December 31 and the ratio of such loan and lease categories to total outstanding loan and lease balances.

	2016		2015		2014		2013		2012	
(Dollars in thousands)	Reserve Amount	Percentage of Loans and Leases in Each Category to Total Loans and Leases	Reserve Amount	Percentage of Loans and Leases in Each Category to Total Loans and Leases	Reserve Amount	Percentage of Loans and Leases in Each Category to Total Loans and Leases	Reserve Amount	Percentage of Loans and Leases in Each Category to Total Loans and Leases	Reserve Amount	Percentage of Loans and Leases in Each Category to Total Loans and Leases
Commercial and agricultural	$14,668	19.40 %	$15,456	18.64 %	$11,760	19.27 %	$11,515	19.14 %	$12,326	19.21 %
Auto and light truck	8,064	9.83	9,269	10.64	10,326	10.79	9,657	11.04	8,864	11.92
Medium and heavy duty truck	4,740	7.04	4,699	6.97	4,500	6.70	4,212	6.70	3,721	6.42
Aircraft	34,352	19.16	32,373	19.48	32,234	19.73	34,037	20.80	34,205	20.93
Construction equipment	8,207	11.84	7,592	11.40	7,008	10.84	5,972	9.38	5,390	8.38
Commercial real estate	13,677	17.17	13,762	17.53	13,270	16.72	12,406	16.45	13,778	16.68
Residential real estate and home equity	3,550	12.46	3,662	12.28	4,504	12.91	4,539	13.96	4,101	14.25
Consumer	1,285	3.10	1,299	3.06	1,466	3.04	1,167	2.53	926	2.21
Total	$88,543	100.00%	$88,112	100.00%	$85,068	100.00%	$83,505	100.00%	$83,311	100.00%

Nonperforming Assets — Nonperforming assets include loans past due over 90 days, nonaccrual loans, other real estate, repossessions and other nonperforming assets we own. Our policy is to discontinue the accrual of interest on loans and leases where principal or interest is past due and remains unpaid for 90 days or more, or when an individual analysis of a borrower's credit worthiness indicates a credit should be placed on nonperforming status, except for residential mortgage loans, which are placed on nonaccrual at the time the loan is placed in foreclosure and consumer loans that are both well secured and in the process of collection.

Nonperforming assets amounted to $30.43 million at December 31, 2016, compared to $20.62 million at December 31, 2015, and $42.48 million at December 31, 2014. During 2016, interest income on nonaccrual loans and leases would have increased by approximately $1.11 million compared to $1.03 million in 2015 if these loans and leases had earned interest at their full contractual rate.

Nonperforming assets at December 31, 2016 increased from December 31, 2015, mainly due to increases in nonaccrual loans and leases and repossessions. The increase in nonaccrual loans and leases occurred primarily in the commercial real estate, aircraft, construction equipment and residential real estate and home equity portfolios offset partially by a decrease in the commercial and agricultural portfolio. Repossessions consisted mainly of aircraft.

Table of Contents

Nonperforming assets at December 31 (Dollars in thousands)	2016	2015	2014	2013	2012
Loans past due over 90 days	$416	$122	$981	$287	$442
Nonaccrual loans and leases:					
Commercial and agricultural	3,981	4,283	14,284	11,765	9,179
Auto and light truck	166	46	38	3,511	35
Medium and heavy duty truck	—	—	56	188	875
Aircraft	6,110	4,388	12,473	10,365	5,292
Construction equipment	1,248	539	751	1,032	5,285
Commercial real estate	5,555	1,392	4,807	7,064	13,055
Residential real estate and home equity	2,641	1,961	2,094	2,691	2,603
Consumer	206	109	99	91	93
Total nonaccrual loans and leases	19,907	12,718	34,602	36,707	36,417
Total nonperforming loans and leases	20,323	12,840	35,583	36,994	36,859
Other real estate	704	736	1,109	4,539	7,311
Former bank premises held for sale	—	—	626	951	1,034
Repossessions:					
Commercial and agricultural	—	—	—	23	—
Auto and light truck	32	10	25	145	52
Medium and heavy duty truck	—	—	—	—	—
Aircraft	9,335	6,916	5,123	4,082	—
Construction equipment	—	—	—	—	—
Consumer	6	1	8	12	11
Total repossessions	9,373	6,927	5,156	4,262	63
Operating leases	34	121	6	—	—
Total nonperforming assets	$30,434	$20,624	$42,480	$46,746	$45,267
Nonperforming loans and leases to loans and leases, net of unearned discount	0.49 %	0.32 %	0.96 %	1.04 %	1.11 %
Nonperforming assets to loans and leases and operating leases, net of unearned discount	0.70 %	0.50 %	1.13 %	1.29 %	1.25 %

Potential Problem Loans — Potential problem loans consist of loans that are performing but for which management has concerns about the ability of a borrower to continue to comply with repayment terms because of the borrower’s potential operating or financial difficulties. Management monitors these loans closely and reviews their performance on a regular basis. As of December 31, 2016 and 2015, we had $13.63 million and $1.03 million, respectively, in loans of this type which are not included in either of the non-accrual or 90 days past due loan categories. At December 31, 2016, potential problem loans consisted of four credit relationships, the largest of which is a $10.00 million commercial credit relationship. Weakness in these companies’ operating performance and payment patterns have caused us to heighten attention given to these credits.

Foreign Outstandings — Our foreign loan and lease outstandings, all denominated in U.S. dollars, were $239.14 million and $205.83 million as of December 31, 2016 and 2015, respectively. Foreign loans and leases are in aircraft financing. Loan and lease outstandings to borrowers in Brazil and Mexico were $96.31 million and $132.46 million as of December 31, 2016, respectively, compared to $76.79 million and $116.73 million as of December 31, 2015, respectively. Outstanding balances to borrowers in other countries were insignificant.

INVESTMENT PORTFOLIO

The amortized cost of securities at year-end 2016 increased 8.59% from 2015, following a slight increase from year-end 2014 to year-end 2015. The amortized cost of securities at December 31, 2016 was $848.32 million or 15.46% of total assets, compared to $781.23 million or 15.06% of total assets at December 31, 2015.

Table of Contents

The following table shows the amortized cost of securities available-for-sale as of December 31.

(Dollars in thousands)	2016	2015	2014
U.S. Treasury and Federal agencies securities	$424,495	$389,457	$371,878
U.S. States and political subdivisions securities	133,509	120,441	121,510
Mortgage-backed securities — Federal agencies	252,981	234,400	248,299
Corporate debt securities	35,266	34,241	31,677
Foreign government and other securities	800	800	800
Marketable equity securities	1,265	1,893	1,893
Total investment securities available-for-sale	$848,316	$781,232	$776,057

Yields on tax-exempt obligations are calculated on a fully tax-equivalent basis assuming a 35% tax rate. The following table shows the maturities of securities available-for-sale at December 31, 2016, at the amortized costs and weighted average yields of such securities.

(Dollars in thousands)	Amount	Yield
U.S. Treasury and Federal agencies securities		
Under 1 year	$88,623	1.54 %
1 – 5 years	289,501	1.51
5 – 10 years	46,371	1.88
Over 10 years	—	—
Total U.S. Treasury and Federal agencies securities	424,495	1.56
U.S. States and political subdivisions securities		
Under 1 year	16,940	2.78
1 – 5 years	74,076	3.14
5 – 10 years	42,493	2.76
Over 10 years	—	—
Total U.S. States and political subdivisions securities	133,509	2.98
Corporate debt securities		
Under 1 year	11,167	1.99
1 – 5 years	24,099	1.72
5 – 10 years	—	—
Over 10 years	—	—
Total Corporate debt securities	35,266	1.81
Foreign government and other securities		
Under 1 year	600	1.98
1 – 5 years	200	1.86
5 – 10 years	—	—
Over 10 years	—	—
Total Foreign government and other securities	800	1.95
Mortgage-backed securities — Federal agencies	252,981	2.19
Marketable equity securities	1,265	12.74
Total investment securities available-for-sale	$848,316	2.00 %

At December 31, 2016, the residential mortgage-backed securities we held consisted of GNMA, FNMA and FHLMC pass-through certificates (Government Sponsored Enterprise, GSEs). The type of loans underlying the securities were all conforming loans at the time of issuance. The underlying GSEs backing these mortgage-backed securities are rated Aaa or AA+ from the rating agencies. At December 31, 2016, the vintage of the underlying loans comprising our securities are: 40% in the years 2015 and 2016; 17% in the years 2013 and 2014; 26% in the years 2011 and 2012; and 17% in years 2010 and prior.

Table of Contents

DEPOSITS

The following table shows the average daily amounts of deposits and rates paid on such deposits.

(Dollars in thousands)	2016 Amount	2016 Rate	2015 Amount	2015 Rate	2014 Amount	2014 Rate
Noninterest bearing demand	$943,874	— %	$854,070	— %	$762,050	— %
Interest bearing demand	1,395,195	0.17	1,334,850	0.12	1,296,929	0.12
Savings	786,983	0.08	733,848	0.08	710,216	0.08
Time	1,176,649	1.04	1,038,292	0.89	1,008,548	0.91
Total deposits	$4,302,701		$3,961,060		$3,777,743	

See Part II, Item 8, Financial Statements and Supplementary Data — Note 10 of the Notes to Consolidated Financial Statements for additional information on deposits.

SHORT-TERM BORROWINGS

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

(Dollars in thousands)	Federal Funds Purchased and Securities Repurchase Agreements	Commercial Paper	Other Short-Term Borrowings	Total Borrowings
2016				
Balance at December 31, 2016	$162,913	$5,761	$123,269	$291,943
Maximum amount outstanding at any month-end	187,239	8,640	130,822	326,701
Average amount outstanding	171,316	6,929	32,631	210,876
Weighted average interest rate during the year	0.21 %	0.27 %	0.45 %	0.25 %
Weighted average interest rate for outstanding amounts at December 31, 2016	0.17 %	0.27 %	0.57 %	0.34 %
2015				
Balance at December 31, 2015	$130,662	$7,295	$95,272	$233,229
Maximum amount outstanding at any month-end	179,600	14,135	149,783	343,518
Average amount outstanding	145,084	10,722	81,134	236,940
Weighted average interest rate during the year	0.16 %	0.27 %	0.28 %	0.20 %
Weighted average interest rate for outstanding amounts at December 31, 2015	0.29 %	0.28 %	0.38 %	0.33 %
2014				
Balance at December 31, 2014	$138,843	$11,778	$95,201	$245,822
Maximum amount outstanding at any month-end	230,075	17,245	155,573	402,893
Average amount outstanding	143,270	13,137	106,970	263,377
Weighted average interest rate during the year	0.15 %	0.26 %	0.27 %	0.21 %
Weighted average interest rate for outstanding amounts at December 31, 2014	0.13 %	0.27 %	0.29 %	0.20 %

LIQUIDITY

Core Deposits — Our major source of investable funds is provided by stable core deposits consisting of all interest bearing and noninterest bearing deposits, excluding brokered certificates of deposit and certain certificates of deposit over $250,000 based on established FDIC insured deposits. In 2016, average core deposits equaled 74.12% of average total assets, compared to 74.26% in 2015 and 74.85% in 2014. The effective rate of core deposits in 2016 was 0.28%, compared to 0.23% in 2015 and 0.28% in 2014.

Average noninterest bearing core deposits increased 10.51% in 2016 compared to an increase of 12.08% in 2015. These represented 23.76% of total core deposits in 2016, compared to 23.03% in 2015, and 21.18% in 2014.

Table of Contents

Purchased Funds — We use purchased funds to supplement core deposits, which include certain certificates of deposit over $250,000, brokered certificates of deposit, over-night borrowings, securities sold under agreements to repurchase, commercial paper, and other short-term borrowings. Purchased funds are raised from customers seeking short-term investments and are used to manage the Bank's interest rate sensitivity. During 2016, our reliance on purchased funds increased to 10.08% of average total assets from 9.79% in 2015.

Shareholders' Equity — Average shareholders' equity equated to 12.38% of average total assets in 2016, compared to 12.72% in 2015. Shareholders' equity was 12.26% of total assets at year-end 2016, compared to 12.41% at year-end 2015. We include unrealized gains (losses) on available-for-sale securities, net of income taxes, in accumulated other comprehensive income (loss) which is a component of shareholders' equity. While regulatory capital adequacy ratios exclude unrealized gains (losses), it does impact our equity as reported in the audited financial statements. The unrealized gains (losses) on available-for-sale securities, net of income taxes, were $1.34 million and $6.56 million at December 31, 2016 and 2015, respectively.

Other Liquidity — Under Indiana law governing the collateralization of public fund deposits, the Indiana Board of Depositories determines which financial institutions are required to pledge collateral based on the strength of their financial ratings. We have been informed that no collateral is required for our public fund deposits. However, the Board of Depositories could alter this requirement in the future and adversely impact our liquidity. Our potential liquidity exposure if we must pledge collateral is approximately $575 million.

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

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

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

The Bank's liquidity strategy is guided by internal policies and the Interagency Policy Statement on Funding and Liquidity Risk Management. Internal guidelines consist of:

(i) Available Liquidity (sum of short term borrowing capacity) greater than $500 million;

(ii) Liquidity Ratio (total of net cash, short term investments and unpledged marketable assets divided by the sum of net deposits and short term liabilities) greater than 15%;

(iii) Dependency Ratio (net potentially volatile liabilities minus short term investments divided by total earning assets minus short term investments) less than 15%; and

(iv) Loans to Deposits Ratio less than 100%

At December 31, 2016, we were in compliance with the foregoing internal policies and regulatory guidelines.

The Bank also maintains a contingency funding plan that assesses the liquidity needs under various scenarios of market conditions, asset growth and credit rating downgrades. The plan includes liquidity stress testing which measures various sources and uses of funds under the different scenarios. The contingency plan provides for ongoing monitoring of unused borrowing capacity and available sources of contingent liquidity to prepare for unexpected liquidity needs and to cover unanticipated events that could affect liquidity.

We have borrowing sources available to supplement deposits and meet our funding needs. 1st Source Bank has established relationships with several banks to provide short term borrowings in the form of federal funds purchased.

While at December 31, 2016 there was none outstanding, we could borrow approximately $265.00 million in additional funds for a short time from these banks on a collective basis. As of December 31, 2016, we had $173.07 million outstanding in FHLB advances and could borrow an additional $345.49 million. We also had $464.17 million available to borrow from the FRB with no amounts outstanding as of December 31, 2016.

Table of Contents

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

A hypothetical change in net interest income was modeled by calculating an immediate 200 basis point (2.00%) and 100 basis point (1.00%) increase and a 100 basis point (1.00%) decrease in interest rates across all maturities. The following table shows the aggregate hypothetical impact to pre-tax net interest income.

	Percentage Change in Net Interest Income			
	December 31, 2016		December 31, 2015	
Basis Point Interest Rate Change	12 Months	24 Months	12 Months	24 Months
Up 200	3.74%	9.67%	4.41%	9.59%
Up 100	1.61%	4.47%	1.55%	3.95%
Down 100	(3.84)%	(8.04)%	(2.60)%	(6.57)%

The earnings simulation model excludes the earnings dynamics related to how fee income and noninterest expense may be affected by changes in interest rates. Actual results may differ materially from those projected. The use of this methodology to quantify the market risk of the balance sheet should not be construed as an endorsement of its accuracy or the accuracy of the related assumptions.

At December 31, 2016 and 2015, the impact of these hypothetical fluctuations in interest rates on our derivative holdings was not significant, and, as such, separate disclosure is not presented. We manage the interest rate risk related to mortgage loan commitments by entering into contracts for future delivery of loans with outside parties. See Part II, Item 8, Financial Statements and Supplementary Data — Note 18 of the Notes to Consolidated Financial Statements.

OFF-BALANCE SHEET ARRANGEMENTS AND CONTRACTUAL OBLIGATIONS

In the ordinary course of operations, we enter into certain contractual obligations. Such obligations include the funding of operations through debt issuances as well as leases for premises and equipment. The following table summarizes our significant fixed, determinable, and estimated contractual obligations, by payment date, at December 31, 2016, except for obligations associated with short-term borrowing arrangements. Payments for borrowings do not include interest. Further discussion of the nature of each obligation is included in the referenced note to the consolidated financial statements.

The following table shows contractual obligation payments by period.

(Dollars in thousands)	Note	0 – 1 Year	1 – 3 Years	3 – 5 Years	Over 5 Years	Indeterminate maturity	Total
Deposits without stated maturity	—	$3,277,108	$—	$—	$ —	$ —	$3,277,108
Certificates of deposit	10	581,280	369,469	98,329	7,574	—	1,056,652
Long-term debt	11	26,559	2,163	2,151	24,258	19,177	74,308
Subordinated notes	12	—		—	58,764	—	58,764
Operating leases	18	3,517	5,982	4,148	1,377	—	15,024
Purchase obligations	—	23,797	8,388	421	—	—	32,606
Total contractual obligations		$3,912,261	$386,002	$105,049	$ 91,973	$ 19,177	$4,514,462

We routinely enter into contracts for services. These contracts may require payment for services to be provided in the future and may also contain penalty clauses for early termination of the contract. We have made a diligent effort to estimate such payments and penalties, where applicable. Additionally, where necessary, we have made reasonable estimates as to certain purchase obligations as of December 31, 2016. Our management has used the best information available to make the estimations necessary to value the related purchase obligations. Our management is not aware of any additional commitments or contingent liabilities which may have a material adverse impact on our liquidity or capital resources at year-end 2016.

We also enter into derivative contracts under which we are required to either receive cash from, or pay cash to, counterparties depending on changes in interest rates. Derivative contracts are carried at fair value on the consolidated

balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. The fair value of the contracts changes daily as market interest rates change. Because the derivative assets and liabilities recorded on the balance sheet at December 31, 2016 do not necessarily represent the amounts that may ultimately be paid under these contracts, these assets and liabilities are not included in the table of contractual obligations presented above.

Table of Contents

Assets under management and assets under custody are held in fiduciary or custodial capacity for our clients. In accordance with U.S. generally accepted accounting principles, these assets are not included on our balance sheet. We are also party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of our clients. These financial instruments include commitments to extend credit and standby letters of credit. Further discussion of these commitments is included in Part II, Item 8, Financial Statements and Supplementary Data — Note 18 of the Notes to Consolidated Financial Statements.

QUARTERLY RESULTS OF OPERATIONS

The following table sets forth unaudited consolidated selected quarterly statement of operations data for the years ended December 31, 2016 and 2015.

Three Months Ended (Dollars in thousands, except per share amounts)	March 31	June 30	September 30	December 31
2016				
Interest income	$ 46,799	$ 47,937	$ 48,300	$ 48,724
Interest expense	5,510	5,644	5,606	5,341
Net interest income	41,289	42,293	42,694	43,383
Provision for loan and lease losses	975	2,049	2,067	742
Gains (losses) on investment securities available-for-sale	10	(209)	989	1,006
Income before income taxes	21,236	22,507	22,147	23,236
Net income	13,818	14,479	14,264	15,225
Diluted net income per common share	0.53	0.56	0.55	0.58
2015				
Interest income	$ 43,632	$ 46,214	$ 46,821	$ 48,017
Interest expense	4,196	4,549	4,612	4,806
Net interest income	39,436	41,665	42,209	43,211
Provision for loan and lease losses	357	811	992	—
Gains on investment securities available-for-sale	—	4	—	—
Income before income taxes	20,769	24,144	21,281	22,369
Net income	13,511	15,630	13,928	14,417
Diluted net income per common share	0.51	0.59	0.53	0.55

Net income was $15.23 million for the fourth quarter of 2016, compared to the $14.42 million of net income reported for the fourth quarter of 2015. Diluted net income per common share for the fourth quarter of 2016 amounted to $0.58, compared to $0.55 per common share reported in the fourth quarter of 2015.

Net interest margin was 3.39% for the fourth quarter of 2016 and 3.58% for the fourth quarter of 2015. Net interest income was $43.38 million for the fourth quarter of 2016 up slightly from 2015's fourth quarter. Net interest margin on a fully taxable-equivalent basis was 3.42% for the fourth quarter of 2016 and 3.61% for the fourth quarter of 2015. Tax-equivalent net interest income was $43.84 million for the fourth quarter of 2016, up slightly from 2015’s fourth quarter.

Our provision for loan and lease losses was $0.74 million in the fourth quarter of 2016 compared to zero in the fourth quarter of 2015. Net charge-offs were $1.10 million for the fourth quarter 2016, compared to net recoveries of $0.50 million a year ago.

Noninterest income for the fourth quarter of 2016 was $22.36 million, compared to $20.90 million for the fourth quarter of 2015. Noninterest expense for the fourth quarter of 2016 was $41.76 million and was $41.74 million in the fourth quarter 2015.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk.

For information regarding Quantitative and Qualitative Disclosures about Market Risk, see Part II, Item 7, Management’s Discussion and Analysis of Financial Condition and Results of Operations, Interest Rate Risk Management.

Table of Contents

Item 8. Financial Statements and Supplementary Data.
Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
1st Source Corporation
South Bend, Indiana

We have audited the accompanying consolidated statements of financial condition of 1st Source Corporation (Company) as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, shareholders' equity and cash flows for each of the years then ended. The Company's management is responsible for these financial statements. Our responsibility is to express an opinion on these financial statements based on our audits.
We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. Our audits included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.
In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of 1st Source Corporation as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the year ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.
We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), 1st Source Corporation 's internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2013) and our report dated February 17, 2017 expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.
/s/ BKD, LLP

Fort Wayne, Indiana
February 17, 2017
Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders of 1st Source Corporation
We have audited the accompanying consolidated statements of income, comprehensive income, shareholders' equity and cash flows of 1st Source Corporation (“the Company”) for the year ended December 31, 2014. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.
We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.
In our opinion, the financial statements of 1st Source Corporation referred to above present fairly, in all material respects, the consolidated results of its operations and its cash flows for the year ended December 31, 2014, in conformity with U.S. generally accepted accounting principles.
/s/ Ernst & Young LLP

Chicago, Illinois
February 20, 2015
except for Note 13 as to which the date is
February 19, 2016
Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders
1st Source Corporation
South Bend, Indiana

We have audited 1st Source Corporation's internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2013). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audit also included performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, 1st Source Corporation maintained, in all material respects, effective internal control over financial reporting as of December 31, 2016, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) (2013).

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of 1st Source Corporation and our report dated February 17, 2017, expressed an unqualified opinion thereon.

/s/ BKD, LLP

Fort Wayne, Indiana
February 17, 2017

Table of Contents

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

December 31 (Dollars in thousands)	2016	2015
ASSETS		
Cash and due from banks	$58,578	$65,171
Federal funds sold and interest bearing deposits with other banks	49,726	14,550
Investment securities available-for-sale	850,467	791,727
Other investments	22,458	21,973
Mortgages held for sale	15,849	9,825
Loans and leases, net of unearned discount:		
Commercial and agricultural	812,264	744,749
Auto and light truck	411,764	425,236
Medium and heavy duty truck	294,790	278,254
Aircraft	802,414	778,012
Construction equipment	495,925	455,565
Commercial real estate	719,170	700,268
Residential real estate and home equity	521,931	490,468
Consumer	129,813	122,140
Total loans and leases	4,188,071	3,994,692
Reserve for loan and lease losses	(88,543)	(88,112)
Net loans and leases	4,099,528	3,906,580
Equipment owned under operating leases, net	118,793	110,371
Net premises and equipment	56,708	53,191
Goodwill and intangible assets	84,102	84,676
Accrued income and other assets	130,059	129,852
Total assets	$5,486,268	$5,187,916
LIABILITIES		
Deposits:		
Noninterest-bearing demand	$991,256	$902,364
Interest-bearing deposits:		
Interest-bearing demand	1,471,526	1,350,417
Savings	814,326	745,661
Time	1,056,652	1,140,744
Total interest-bearing deposits	3,342,504	3,236,822
Total deposits	4,333,760	4,139,186
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	162,913	130,662
Other short-term borrowings	129,030	102,567
Total short-term borrowings	291,943	233,229
Long-term debt and mandatorily redeemable securities	74,308	57,379
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	54,843	55,305
Total liabilities	4,813,618	4,543,863
SHAREHOLDERS' EQUITY		
Preferred stock; no par value Authorized 10,000,000 shares; none issued or outstanding	—	—
Common Stock; no par value Authorized 40,000,000 shares; issued 28,205,674 shares at December 31, 2016 and 2015	436,538	436,538

Retained earnings	290,824	251,812
Cost of common stock in treasury (2,329,909 shares at December 31, 2016 and 2,178,090 shares at December 31, 2015)	(56,056)	(50,852)
Accumulated other comprehensive income	1,344	6,555
Total shareholders’ equity	672,650	644,053
Total liabilities and shareholders’ equity	$5,486,268	$5,187,916

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

Table of Contents

CONSOLIDATED STATEMENTS OF INCOME

Year Ended December 31 (Dollars in thousands, except per share amounts)	2016	2015	2014
Interest income:			
Loans and leases	$175,999	$168,766	$161,215
Investment securities, taxable	11,777	11,929	13,054
Investment securities, tax-exempt	2,740	2,992	3,269
Other	1,244	997	1,016
Total interest income	191,760	184,684	178,554
Interest expense:			
Deposits	15,267	11,489	11,356
Short-term borrowings	525	484	541
Subordinated notes	4,220	4,220	4,220
Long-term debt and mandatorily redeemable securities	2,089	1,970	2,108
Total interest expense	22,101	18,163	18,225
Net interest income	169,659	166,521	160,329
Provision for loan and lease losses	5,833	2,160	3,733
Net interest income after provision for loan and lease losses	163,826	164,361	156,596
Noninterest income:			
Trust and wealth advisory	19,256	19,126	18,511
Service charges on deposit accounts	9,053	9,313	8,684
Debit card	10,887	10,217	9,585
Mortgage banking	4,496	4,570	5,381
Insurance commissions	5,513	5,465	5,556
Equipment rental	25,863	22,302	17,156
Gains on investment securities available-for-sale	1,796	4	963
Other	12,081	12,319	12,051
Total noninterest income	88,945	83,316	77,887
Noninterest expense:			
Salaries and employee benefits	86,837	86,133	80,488
Net occupancy	9,686	9,768	9,311
Furniture and equipment	19,500	18,348	17,657
Depreciation — leased equipment	21,678	18,280	13,893
Professional fees	5,161	4,682	5,046
Supplies and communication	5,244	6,011	5,589
FDIC and other insurance	3,147	3,412	3,384
Business development and marketing	4,936	4,837	6,049
Loan and lease collection and repossession	1,600	667	1,102
Other	5,856	6,976	7,521
Total noninterest expense	163,645	159,114	150,040
Income before income taxes	89,126	88,563	84,443
Income tax expense	31,340	31,077	26,374
Net income	$57,786	$57,486	$58,069
Basic net income per common share	$2.22	$2.17	$2.17
Diluted net income per common share	$2.22	$2.17	$2.17

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

Table of Contents

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Year Ended December 31 (Dollars in thousands)	2016	2015	2014
Net income	$57,786	$57,486	$58,069
Other comprehensive (loss) income:			
Change in unrealized (depreciation) appreciation of investment securities available-for-sale	(6,547)	(4,562)	5,488
Reclassification adjustment for realized (gains) losses included in net income	(1,796)	(4)	(963)
Income tax effect	3,132	1,714	(1,699)
Other comprehensive (loss) income, net of tax	(5,211)	(2,852)	2,826
Comprehensive income	$52,575	$54,634	$60,895

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

CONSOLIDATED STATEMENTS OF SHAREHOLDERS’ EQUITY

(Dollars in thousands, except per share amounts)	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net	Total
Balance at January 1, 2014	$ —	$346,535	$261,626	$(29,364)	$ 6,581	$585,378
Net income	—	—	58,069	—	—	58,069
Other comprehensive income	—	—	—	—	2,826	2,826
Issuance of 91,675 common shares under stock based compensation awards, including related tax effects	—	—	(243)	1,995	—	1,752
Cost of 597,747 shares of common stock acquired for treasury	—	—	—	(16,342)	—	(16,342)
Common stock dividend ($0.645 per share)	—	—	(17,210)	—	—	(17,210)
Balance at December 31, 2014	$ —	$346,535	$302,242	$(43,711)	$ 9,407	$614,473
Net income	—	—	57,486	—	—	57,486
Other comprehensive loss	—	—	—	—	(2,852)	(2,852)
Issuance of 118,281 common shares under stock based compensation awards, including related tax effects	—	—	(245)	2,829	—	2,584
Cost of 338,985 shares of common stock acquired for treasury	—	—	—	(9,970)	—	(9,970)
Common stock dividend ($0.671 per share)	—	—	(17,655)	—	—	(17,655)
10% common stock dividend ($13 cash paid in lieu of fractional shares)	—	90,003	(90,016)	—	—	(13)
Balance at December 31, 2015	$ —	$436,538	$251,812	$(50,852)	$ 6,555	$644,053
Net income	—	—	57,786	—	—	57,786
Other comprehensive loss	—	—	—	—	(5,211)	(5,211)
Issuance of 118,559 common shares under stock based compensation awards, including related tax effects	—	—	(18)	2,826	—	2,808
Cost of 270,378 shares of common stock acquired for treasury	—	—	—	(8,030)	—	(8,030)
Common stock dividend ($0.720 per share)	—	—	(18,756)	—	—	(18,756)
Balance at December 31, 2016	$ —	$436,538	$290,824	$(56,056)	$ 1,344	$672,650

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

Table of Contents

CONSOLIDATED STATEMENTS OF CASH FLOWS

Year Ended December 31 (Dollars in thousands)	2016	2015	2014
Operating activities:			
Net income	$57,786	$57,486	$58,069
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan and lease losses	5,833	2,160	3,733
Depreciation of premises and equipment	5,245	4,780	4,748
Depreciation of equipment owned and leased to others	21,678	18,280	13,893
Stock-based compensation	2,884	3,843	3,179
Amortization of investment securities premiums and accretion of discounts, net	5,861	4,652	4,351
Amortization of mortgage servicing rights	1,478	1,424	1,278
Deferred income taxes	2,856	1,620	4,341
Gains on investment securities available-for-sale	(1,796)	(4)	(963)
Originations of loans held for sale, net of principal collected	(119,134)	(113,029)	(121,440)
Proceeds from the sales of loans held for sale	116,397	120,138	117,447
Net gain on sale of loans held for sale	(3,287)	(3,330)	(3,532)
Net gain on sale of other real estate and repossessions	(228)	(814)	(1,624)
Change in trading account securities	—	205	(13)
Change in interest receivable	(1,326)	(549)	(603)
Change in interest payable	570	798	(917)
Change in other assets	2,145	(8,230)	(9,848)
Change in other liabilities	648	8,010	(2,481)
Other	450	3,168	2,733
Net change in operating activities	98,060	100,608	72,351
Investing activities:			
Proceeds from sales of investment securities available-for-sale	23,784	1,299	1,236
Proceeds from maturities and paydowns of investment securities available-for-sale	217,613	136,649	190,323
Purchases of investment securities available-for-sale	(313,074)	(147,771)	(148,841)
Proceeds from liquidation of partnership investment	2,903	423	570
Net change in other investments	(485)	(1,172)	1,599
Loans sold or participated to others	5,926	1,962	16,889
Net change in loans and leases	(209,668)	(315,938)	(165,463)
Net change in equipment owned under operating leases	(30,100)	(54,508)	(27,069)
Purchases of premises and equipment	(8,935)	(9,498)	(8,489)
Proceeds from sales of other real estate and repossessions	2,189	6,941	10,418
Net change in investing activities	(309,847)	(381,613)	(128,827)
Financing activities:			
Net change in demand deposits and savings accounts	278,666	173,508	102,130
Net change in time deposits	(84,092)	162,818	47,080
Net change in short-term borrowings	58,714	(12,593)	(68,309)
Proceeds from issuance of long-term debt	20,837	—	7,161
Payments on long-term debt	(6,429)	(1,250)	(11,660)
Stock issued under stock purchase plans	120	149	197
Acquisition of treasury stock	(8,030)	(9,970)	(16,342)
Cash dividends paid on common stock	(19,416)	(18,126)	(17,643)
Net change in financing activities	240,370	294,536	42,614
Net change in cash and cash equivalents	28,583	13,531	(13,862)
Cash and cash equivalents, beginning of year	79,721	66,190	80,052
Cash and cash equivalents, end of year	$108,304	$79,721	$66,190

Supplemental Information:			
Non-cash transactions:			
Loans transferred to other real estate and repossessions	$4,961	$8,742	$7,154
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan	800	500	—
Stock dividend paid on common stock	—	90,003	—
Cash paid for:			
Interest	$21,531	$17,364	$19,143
Income taxes	19,866	30,429	29,211

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

Table of Contents

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 — Accounting Policies

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as "1st Source" or "the Company"), a broad array of financial products and services. 1st Source Bank ("Bank"), its banking subsidiary, offers commercial and consumer banking services, trust and wealth advisory services, and insurance to individual and business clients in Indiana and Michigan. The following is a summary of significant accounting policies followed in the preparation of the consolidated financial statements.

Basis of Presentation — The financial statements consolidate 1st Source and its subsidiaries (principally the Bank). All significant intercompany balances and transactions have been eliminated. For purposes of the parent company only financial information presented in Note 22, investments in subsidiaries are carried at equity in the underlying net assets.

Use of Estimates in the Preparation of Financial Statements — Financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) require the Company to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates.

Business Combinations — Business combinations are accounted for under the purchase method of accounting. Under the purchase method, assets and liabilities of the business acquired are recorded at their estimated fair values as of the date of acquisition with any excess of the cost of the acquisition over the fair value of the net tangible and intangible assets acquired recorded as goodwill. Results of operations of the acquired business are included in the income statement from the date of acquisition.

Cash Flows — For purposes of the consolidated and parent company only statements of cash flows, the Company considers 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.

Securities — Securities that the Company has the ability and positive intent to hold to maturity are classified as investment securities held-to-maturity. Held-to-maturity investment securities, when present, are carried at amortized cost. As of December 31, 2016 and 2015, the Company held no securities classified as held-to-maturity. Securities that may be sold in response to, or in anticipation of, changes in interest rates and resulting prepayment risk, or for other factors, are classified as available-for-sale and are carried at fair value. Unrealized gains and losses on these securities are reported, net of applicable taxes, as a separate component of accumulated other comprehensive income (loss) in shareholders' equity.

The initial indication of potential other-than-temporary impairment (OTTI) for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, any 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, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to sell any such securities before an anticipated recovery of cost.

Debt and equity securities that are purchased and held principally for the purpose of selling them in the near term are classified as trading account securities and are carried at fair value with unrealized gains and losses reported in earnings. Realized gains and losses on the sales of all securities are reported in earnings and computed using the specific identification cost basis.

Other investments consist of shares of Federal Home Loan Bank of Indianapolis (FHLBI) and Federal Reserve Bank stock. As restricted member stocks, these investments are carried at cost. Both cash and stock dividends received on the stocks are reported as income. Quarterly, the Company reviews its investment in FHLBI for impairment. Factors considered in determining impairment are: history of dividend payments; determination of cause for any net loss; adequacy of capital; and review of the most recent financial statements. As of December 31, 2016 and 2015, it was

determined that the Company’s investment in FHLBI stock is appropriately valued at cost, which equates to par value. In addition, other investments include interest bearing deposits with other banks with original maturities of greater than three months. These investments are in denominations, including accrued interest, that are fully insured by the FDIC.

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

Direct financing leases are carried at the aggregate of lease payments plus estimated residual value of the leased property, net of unamortized deferred lease origination fees and costs and unearned income. Interest income on direct financing leases is recognized over the term of the lease to achieve a constant periodic rate of return on the outstanding investment.

Table of Contents

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

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

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

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

The Company sells mortgage loans to the Government National Mortgage Association (GNMA) in the normal course of business and retains the servicing rights. The GNMA programs under which the loans are sold allow the Company to repurchase individual delinquent loans that meet certain criteria from the securitized loan pool. At its option, and without GNMA's prior authorization, the Company may repurchase a delinquent loan for an amount equal to 100% of the remaining principal balance on the loan. Once the Company has the unconditional ability to repurchase a delinquent loan, the Company is deemed to have regained effective control over the loan and the Company is required to recognize the loan on its balance sheet and record an offsetting liability, regardless of its intent to repurchase the loan. At December 31, 2016 and 2015, residential real estate portfolio loans included $3.27 million and $5.27 million, respectively, of loans available for repurchase under the GNMA optional repurchase programs with the offsetting liability recorded within other short-term borrowings.

Mortgage Banking Activities — Loans held for sale are composed of performing one-to-four family residential mortgage loans originated for resale. Mortgage loans originated with the intent to sell are carried at fair value.

The Company recognizes the rights to service mortgage loans for others as separate assets, whether the servicing rights are acquired through a separate purchase or through the sale of originated loans with servicing rights retained. The Company allocates a portion of the total proceeds of a mortgage loan to servicing rights based on the relative fair value. These assets are amortized as reductions of mortgage servicing fee income over the estimated servicing period

in proportion to the estimated servicing income to be received. Gains and losses on the sale of MSRs are recognized in Noninterest Income on the Statements of Income in the period in which such rights are sold.

MSRs are evaluated for impairment at each reporting date. For purposes of impairment measurement, MSRs are stratified based on the predominant risk characteristics of the underlying servicing, principally by loan type. If temporary impairment exists within a tranche, a valuation allowance is established through a charge to income equal to the amount by which the carrying value exceeds the fair value. If it is later determined all or a portion of the temporary impairment no longer exists for a particular tranche, the valuation allowance is reduced through a recovery of income.

Table of Contents

MSRs are also reviewed for other-than-temporary impairment. Other-than-temporary impairment exists when recoverability of a recorded valuation allowance is determined to be remote considering historical and projected interest rates, prepayments, and loan pay-off activity. When this situation occurs, the unrecoverable portion of the valuation allowance is applied as a direct write-down to the carrying value of the MSRs. Unlike a valuation allowance, a direct write-down permanently reduces the carrying value of the MSRs and the valuation allowance, precluding subsequent recoveries.

As part of mortgage banking operations, the Company enters into commitments to originate loans whereby the interest rate on these loans is determined prior to funding ("rate lock commitments"). Similar to loans held for sale, the fair value of rate lock commitments is subject to change primarily due to changes in interest rates. Under the Company's risk management policy, these fair values are hedged primarily by selling forward contracts on agency securities. The rate lock commitments on mortgage loans intended to be sold and the related hedging instruments are recorded at fair value with changes in fair value recorded in current earnings.

Reserve for Loan and Lease Losses — The reserve for loan and lease losses is maintained at a level believed to be appropriate by the Company to absorb probable losses inherent in the loan and lease portfolio. The determination of the reserve requires significant judgment reflecting the Company's best estimate of probable loan and lease losses related to specifically identified impaired loans and leases as well as probable losses in the remainder of the various loan and lease portfolios. For purposes of determining the reserve, the Company has segmented loans and leases into classes based on the associated risk within these segments. The Company has determined that eight classes exist within the loan and lease portfolio. The methodology for assessing the appropriateness of the reserve consists of several key elements, which include: specific reserves for impaired loans, formula reserves for each business lending division portfolio including percentage allocations for special attention loans and leases not deemed impaired, and reserves for pooled homogenous loans and leases. The Company's evaluation is based upon a continuing review of these portfolios, estimates of customer performance, collateral values and dispositions, and assessments of economic and geopolitical events, all of which are subject to judgment and will change.

Specific reserves are established for certain business and specialty finance credits based on a regular analysis of special attention loans and leases. This analysis is performed by the Credit Policy Committee (CPC), the Loan Review Department, Credit Administration, and the Loan Workout Departments. The specific reserves are based on an analysis of underlying collateral values, cash flow considerations and, if applicable, guarantor capacity. Sources for determining collateral values include appraisals, evaluations, auction values and industry guides. Generally, for loans secured by commercial real estate and dependent on cash flows from the underlying collateral to service the debt, a new appraisal is obtained at the time the credit is deemed to be impaired. For non-income producing commercial real estate, an appraisal or evaluation is ordered depending on an analysis of the underlying factors, including an assessment of the overall credit worthiness of the borrower, the value of non-real estate collateral supporting the transaction and the date of the most recent existing appraisal or evaluation. An evaluation may be performed in lieu of obtaining a new appraisal for less complex transactions secured by local market properties. Values based on evaluations are discounted more heavily than those determined by appraisals when calculating loan impairment. Appraisals, evaluations and industry guides are used to determine aircraft values. Appraisals, industry guides and auction values are used to determine construction equipment, truck and auto values.

The formula reserves determined for each business lending division portfolio are calculated quarterly by applying loss factors to outstanding loans and leases based upon a review of historical loss experience and qualitative factors, which include but are not limited to, economic trends, current market risk assessment by industry, recent loss experience in particular segments of the portfolios, movement in equipment values collateralizing specialized industry portfolios, concentrations of credit, delinquencies, trends in volume, experience and depth of relationship managers and division management, and the effects of changes in lending policies and practices, including changes in quality of the loan and lease origination, servicing and risk management processes. Special attention loans and leases without specific reserves receive a higher percentage allocation ratio than credits not considered special attention.

Pooled loans and leases are smaller credits and are homogenous in nature, such as consumer credits and residential mortgages. Pooled loan and lease loss reserves are based on historical net charge-offs, adjusted for delinquencies, the effects of lending practices and programs and current economic conditions, and current trends in the geographic

markets which the Company serves.

A comprehensive analysis of the reserve is performed on a quarterly basis by reviewing all loans and leases over a fixed dollar amount ($100,000) where the internal credit quality grade is at or below a predetermined classification. Although the Company determines the amount of each element of the reserve separately and relies on this process as an important credit management tool, the entire reserve is available for the entire loan and lease portfolio. The actual amount of losses incurred can vary significantly from the estimated amounts both positively and negatively. The Company's methodology includes several factors intended to minimize the difference between estimated and actual losses. These factors allow the Company to adjust its estimate of losses based on the most recent information available.

Table of Contents

Impaired loans are reviewed quarterly to assess the probability of being able to collect the portion considered impaired. When a review and analysis of the underlying credit and collateral indicates ultimate collection is improbable, the deficiency is charged-off and deducted from the reserve. Loans and leases, which are deemed uncollectible or have a low likelihood of collection, are charged-off and deducted from the reserve, while recoveries of amounts previously charged-off are credited to the reserve. A (recovery of) provision for loan and lease losses is credited or charged to operations based on the Company's periodic evaluation of the factors previously mentioned, as well as other pertinent factors.

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

Other Real Estate — Other real estate acquired through partial or total satisfaction of nonperforming loans is included in Other Assets and recorded at fair value less anticipated selling costs based upon the property's appraised value at the date of transfer, with any difference between the fair value of the property less cost to sell, and the carrying value of the loan charged to the reserve for loan losses or other income, if a positive adjustment. Subsequent fair value write-downs or write-ups, to the extent of previous write-downs, property maintenance costs, and gains or losses recognized upon the sale of other real estate are recognized in Noninterest Expense on the Statements of Income. Gains or losses resulting from the sale of other real estate are recognized on the date of sale. As of December 31, 2016 and 2015, other real estate had carrying values of $0.70 million and $0.74 million, respectively, and is included in Other Assets in the Statements of Financial Condition.

Repossessed Assets — Repossessed assets may include fixtures and equipment, inventory and receivables, aircraft, construction equipment, and vehicles acquired from business banking and specialty finance activities. Repossessed assets are included in Other Assets at fair value of the equipment or vehicle less estimated selling costs. At the time of repossession, the recorded amount of the loan or lease is written down to the fair value of the equipment or vehicle by a charge to the reserve for loan and lease losses or other income, if a positive adjustment. Subsequent fair value write-downs or write-ups, to the extent of previous write-downs, equipment maintenance costs, and gains or losses recognized upon the sale of repossessions are recognized in Noninterest Expense on the Statements of Income. Gains or losses resulting from the sale of repossessed assets are recognized on the date of sale. Repossessed assets totaled $9.37 million and $6.93 million, as of December 31, 2016 and 2015, respectively, and are included in Other Assets in the Statements of Financial Condition.

Premises and Equipment — Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation is computed by the straight-line method, primarily with useful lives ranging from three to 31.5 years. Maintenance and repairs are charged to expense as incurred, while improvements, which extend the useful life, are capitalized and depreciated over the estimated remaining life.

Goodwill and Intangibles — Goodwill represents the excess of the cost of businesses acquired over the fair value of the net assets acquired. Other intangible assets represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset, or liability. Goodwill is reviewed for impairment at least annually or on an interim basis if an event occurs or circumstances change that would more likely than not reduce the carrying amount. Goodwill is allocated into two reporting units. Fair value for each reporting unit

is estimated using stock price multiples or earnings before interest, tax, depreciation and amortization (EBITDA) multiples. Intangible assets that have finite lives are amortized over their estimated useful lives and are subject to impairment testing. All of the Company's other intangible assets have finite lives and are amortized on a straight-line basis over varying periods not exceeding twenty-five years. The Company performed the required annual impairment test of goodwill during the fourth quarter of 2016 and determined that no impairment exists.

Table of Contents

Partnership Investments — The Company accounts for its investments in partnerships for which it owns three percent or more of the partnership on the equity method. The partnerships in which the Company has investments account for their investments at fair value. As a result, the Company's investments in these partnerships reflect the underlying fair value of the partnerships' investments. The Company accounts for its investments in partnerships of which it owns less than three percent at the lower of cost or fair value. The Company uses the hypothetical liquidation book value (HLBV) method for equity investments when the liquidation rights and priorities as defined by an equity investment agreement differ from what is reflected by the underlying percentage ownership interests. The HLBV method is commonly applied to equity investments in the renewable energy industry, where cash percentages vary at different points in time and are not directly linked to an investor's ownership percentage. A calculation is prepared at each balance sheet date to determine the amount that the Company would receive if an equity investment entity were to liquidate all of its assets (as valued in accordance with GAAP) and distribute that cash to the investors based on the contractually defined liquidation priorities. The difference between the calculated liquidation distribution amounts at the beginning and the end of the reporting period, after adjusting for capital contributions and distributions, is 1st Sources' share of the earnings or losses from the equity investment for the period. Investments in partnerships are included in Other Assets in the Statements of Financial Condition. The balances as of December 31, 2016 and 2015 were $12.17 million and $11.99 million, respectively.

Short-Term Borrowings — Short-term borrowings consist of Federal funds purchased, securities sold under agreements to repurchase, commercial paper, Federal Home Loan Bank notes, and borrowings from non-affiliated banks. Federal funds purchased, securities sold under agreements to repurchase, and other short-term borrowings mature within one to 365 days of the transaction date. Commercial paper matures within seven to 270 days. Other short-term borrowings in the Statements of Financial Condition include the Company's liability related to mortgage loans available for repurchase under GNMA optional repurchase programs.

Securities purchased under agreements to resell and securities sold under agreements to repurchase are treated as collateralized financing transactions and are recorded at the amounts at which the securities were acquired or sold plus accrued interest. The fair value of collateral either received from or provided to a third party is continually monitored and additional collateral obtained or requested to be returned to the Company as deemed appropriate.

Trust and Wealth Advisory Fees — Trust and wealth advisory fees are recognized on the accrual basis.

Income Taxes — 1st Source and its subsidiaries file a consolidated Federal income tax return. The provision for incomes taxes is based upon income in the consolidated financial statements, rather than amounts reported on the income tax return. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized as income or expense in the period that includes the enactment date. A valuation allowance, if needed, reduces deferred tax assets to the expected amount most likely to be realized. Realization of deferred tax assets is dependent upon the generation of a sufficient level of future taxable income and recoverable taxes paid in prior years. Although realization is not assured, the Company believes it is more likely than not that all of the deferred tax assets will be realized.

The Company uses the deferral method of accounting on investments that generate investment tax credits. Under this method, the investment tax credits are recognized as a reduction to the related asset. Beginning January 1, 2015, the Company presents the expense on certain qualified affordable housing investments in tax expense rather than noninterest expense.

Positions taken in the tax returns may be subject to challenge by the taxing authorities upon examination. Uncertain tax positions are initially recognized in the financial statements when it is more likely than not the position will be sustained upon examination by the tax authorities. Such tax positions are both initially and subsequently measured as the largest amount of tax benefit that is greater than 50% likely of being realized upon settlement with the tax authority, assuming full knowledge of the position and all relevant facts. The Company provides for interest and, in some cases, penalties on tax positions that may be challenged by the taxing authorities. Interest expense is recognized beginning in the first period that such interest would begin accruing. Penalties are recognized in the period that the

Company claims the position in the tax return. Interest and penalties on income tax uncertainties are classified within Income Tax Expense in the Statements of Income.

Net Income Per Common Share — Basic earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of shares of common stock outstanding. Diluted earnings per common share is computed by dividing net income available to common shareholders by the weighted-average number of shares of common stock outstanding, plus the dilutive effect of outstanding stock options, stock warrants and nonvested stock-based compensation awards.

Stock-Based Employee Compensation — The Company recognizes stock-based compensation as compensation cost in the Statements of Income based on their fair values on the measurement date, which, for its purposes, is the date of grant.

Table of Contents

Segment Information — 1st Source has one principal business segment, commercial banking. While our chief decision makers monitor the revenue streams of various products and services, the identifiable segments' operations are managed and financial performance is evaluated on a company-wide basis. Accordingly, all of the Company's financial service operations are considered to be aggregated in one reportable operating segment.
Derivative Financial Instruments — The Company occasionally enters into derivative financial instruments as part of its interest rate risk and foreign currency risk management strategies. These derivative financial instruments consist primarily of interest rate swaps and foreign currency forward contracts. All derivative instruments are recorded on the Statements of Financial Condition, as either an asset or liability, at their fair value. The accounting for the gain or loss resulting from the change in fair value depends on the intended use of the derivative. For a derivative used to hedge changes in fair value of a recognized asset or liability, or an unrecognized firm commitment, the gain or loss on the derivative will be recognized in earnings together with the offsetting loss or gain on the hedged item. This results in an earnings impact only to the extent that the hedge is ineffective in achieving offsetting changes in fair value. If it is determined that the derivative instrument is not highly effective as a hedge, hedge accounting is discontinued and the adjustment to fair value of the derivative instrument is recorded in earnings. For a derivative used to hedge changes in cash flows associated with forecasted transactions, the gain or loss on the effective portion of the derivative will be deferred, and reported as accumulated other comprehensive income, a component of shareholders' eque

in Years

Amount

Location

Asset

Liability

Derivatives designated as cash flow hedges:

Pay-fixed interest rate swaps

Variability of interest cash flows on certificates of deposit

3.11%

12-Month Libor

3.9

$

225,000

Other liabilities

$

$

(15,854

)

Purchased interest rate forward-starting swaps

Variability of interest cash flows on variable rate borrowings

3.65%

3-Month Libor

4.4

405,000

Other liabilities

(47,593

)

Derivatives not designated as hedges:

Pay-fixed interest rate swaps

5.15%

Indexed to 1-month Libor

5.6

53,018

Other liabilities

(3,731

)

Pay-variable interest rate swaps

Indexed to 1 month Libor

5.15%

5.6

53,018

Other assets

3,731

$

736,036

$

3,731

$

(67,178

)

The following table provides information about gains and losses recognized, included in interest expense in the accompanying consolidated statements of operations, related to interest rate contract derivative instruments designated as cash flow hedges for the three months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31,			
		2012		**2011**
Amount of loss included in AOCI at end of period, net of tax	$	(35,062)	$	(19,311)
Amount of loss reclassified from AOCI into income during the period (effective portion)	$	(4,430)	$	(4,701)
Amount of gain recognized in income during the period (ineffective portion)	$		$	427

28

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

During the three months ended March 31, 2012 and 2011, no derivative positions designated as cash flow hedges were discontinued and none of the gains and losses reported in AOCI were reclassified into earnings as a result of the discontinuance of cash flow hedges or because of the early extinguishment of debt. As of March 31, 2012, the amount expected to be reclassified from AOCI into income during the next twelve months was $17.8 million.

At March 31, 2012, investment securities available for sale with a carrying amount of $74.6 million and cash on deposit of $10.7 million were pledged as collateral for interest rate swaps. The amount of collateral required to be posted by the Company varies based on the settlement value of outstanding swaps, which approximates their carrying amount at March 31, 2012.

The Company enters into commitments to fund residential mortgage loans with the intention that these loans will subsequently be sold into the secondary market. A mortgage loan commitment binds the Company to lend funds to a potential borrower at a specified interest rate within a specified period of time, generally 30 to 90 days. These commitments are considered derivative instruments. The notional amount of outstanding mortgage loan commitment derivatives was $11.2 million and $8.4 million at March 31, 2012 and December 31, 2011, respectively. Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the commitments might decline from inception of the commitment to funding of the loan. To protect against the price risk inherent in derivative loan commitments, the Company utilizes best efforts forward loan sale commitments. Under a best efforts contract, the Company commits to deliver an individual mortgage loan to an investor if the loan to the underlying borrower closes. Generally, the price the investor will pay the Company for a loan is specified prior to the loan being funded. These commitments are considered derivative instruments once the underlying loans are funded. All of the Company s loans held for sale at March 31, 2012 and December 31, 2011 were subject to forward sale commitments. The notional amount of forward loan sale commitment derivatives was $2.2 million and $4.0 million at March 31, 2012 and December 31, 2011, respectively. The fair value of derivative loan commitments and forward sale commitments was nominal at March 31, 2012 and December 31, 2011.

Note 9 Stockholders Equity

In February, 2012, the Company created a series of 5,416,000 shares of preferred stock designated Series A Nonvoting Convertible Preferred Stock , par value $0.01 per share. The preferred stock ranks *pari passu* with the Company s common stock with respect to the payment of dividends or distributions and has a liquidation preference of $0.01 per share. Subject to certain restrictions, each share of preferred stock is convertible into one share of common stock at the option of the holder or upon written request of the Company.

On February 2, 2011, the Company closed the initial public offering (IPO) of 33,350,000 shares of its common stock at $27.00 per share. In the offering, the Company sold 4,000,000 shares and selling stockholders sold 29,350,000 shares. Proceeds received by the Company on the sale of the 4,000,000 shares amounted to $102.6 million, net of underwriting discounts. The Company incurred direct costs of the stock issuance of $4.0 million, which were charged to paid-in capital. Prior to the IPO, BankUnited, Inc. was a wholly-owned subsidiary of BU Financial Holdings, LLC (BUFH). Immediately prior to the completion of the IPO, a reorganization was effected in accordance with BUFH s LLC agreement, pursuant to which all equity interests in BankUnited, Inc. were distributed to the members of BUFH and BUFH was liquidated.

Effective January 10, 2011, the Board of Directors of BankUnited, Inc. (the Board of Directors), authorized a 10-for-1 split of the Company s outstanding common shares. Stockholders equity has been retroactively adjusted to give effect to this stock split for all periods presented by reclassifying from paid-in capital to common stock the par value of the additional shares issued. All share and per share data have been retroactively restated for all periods presented to reflect this stock split.

Accumulated Other Comprehensive Income

Changes in accumulated other comprehensive income for the three months ended March 31, 2012 and 2011are summarized as follows (in thousands):

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

	Three Months Ended March 31,					
	2012			2011		
	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Unrealized gains (losses) on investment securities available for sale:						
Net unrealized holding gain (loss) arising during the period	$ 40,073	$ (15,458)	$ 24,615	$ (798)	$ 308	$ (490)
Reclassification adjustment for net securities gains realized in income	(16)	6	(10)	(3)	1	(2)
Net change in unrealized gains (losses) on securities available for sale	40,057	(15,452)	24,605	(801)	309	(492)
Unrealized gains (losses) on derivative instruments:						
Net unrealized holding gain (loss) arising during the period	(1,027)	396	(631)	2,820	(1,088)	1,732
Reclassification adjustment for net losses realized in income	4,430	(1,709)	2,721	4,701	(1,813)	2,888
Net change in unrealized losses on derivative instruments	3,403	(1,313)	2,090	7,521	(2,901)	4,620
Other comprehensive income	$ 43,460	$ (16,765)	$ 26,695	$ 6,720	$ (2,592)	$ 4,128

Note 10 Equity Based Compensation

During the three months ended March 31, 2012, the Company granted 27,250 shares of unvested stock under the BankUnited 2010 Omnibus Equity Incentive Plan (the 2010 Plan). The shares granted were valued at the closing price of the Company s common stock on the date of grant, ranging from $23.08 to $24.66, for a weighted average per share value on the date of grant of $24.35 and an aggregate fair value of $0.7 million. During the three months ended March 31, 2011, the Company granted 265,840 shares of unvested stock under the 2010 Plan valued at the closing price of the Company s common stock on the date of grant of $28.05 per share, for an aggregate fair value of $7.5 million. The majority of these shares vest in equal annual installments over a period of three years. Unvested shares participate in dividends declared on the Company s common stock on a one-for-one basis.

Prior to the IPO, BUFH had a class of authorized membership interests identified as Profits Interest Units (PIUs) which were awarded to certain management members of the Company. In conjunction with the IPO, the PIUs outstanding were exchanged for a combination of vested and unvested shares of the Company s common stock and vested and unvested stock options. The vested and unvested shares and vested stock options participate in dividends declared on the Company s common stock on a one-for-one basis. The unvested stock options participate on a one-for-one basis in dividends declared on common stock until they vest. In conjunction with the IPO, the Company recorded approximately $110.4 million in compensation expense related to the exchange and vesting of PIUs. This expense, which is not deductible for tax purposes, resulted in an offsetting increase in paid-in capital.

Note 11 Fair Value Measurements

Assets and liabilities measured at fair value on a recurring basis

Following is a description of the methodologies used to estimate the fair values of assets and liabilities measured at fair value on a recurring basis and the level within the fair value hierarchy in which those measurements are typically classified.

Investment securities available for sale Fair value measurements are based on quoted prices in active markets when available; these measurements are classified within level 1 of the fair value hierarchy. These securities typically include U.S. treasury securities, certain preferred stocks and mutual funds. If quoted market prices in active markets are not available, fair values are estimated using quoted prices of securities with similar characteristics, quoted prices of identical securities in less active markets, discounted cash flow techniques, or matrix pricing models. Investment securities available for sale that are generally classified within level 2 of the fair value hierarchy include U.S. government agency debentures, U.S. government agency mortgage-backed securities, preferred stock investments for which level 1 valuations are not available, corporate debt securities, certain non-mortgage asset-backed securities, Re-Remics, commercial mortgage-backed securities, state and municipal obligations and U.S. Small Business Administration securities. Pricing of these securities is generally spread driven. Observable inputs that may impact the valuation of these securities include benchmark yield curves, credit spreads, reported trades, dealer quotes, bids, issuer spreads, current rating, historical constant prepayment rates, historical voluntary prepayment rates, structural and waterfall features of individual securities, published collateral data, and for certain securities, historical constant default rates and default severities. Investment securities available for sale generally classified within level 3 of the fair value hierarchy include private label mortgage-backed securities, certain non-mortgage asset-backed securities and trust preferred securities. The Company typically values these securities using internally developed or third-party proprietary pricing models, primarily discounted cash flow valuation techniques, which incorporate

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

both observable and unobservable inputs. Unobservable inputs that may impact the valuation of these securities include risk adjusted discount rates, projected prepayment rates, projected default rates and projected loss severity.

Derivative financial instruments Interest rate swaps are predominantly traded in over-the-counter markets and, as such, values are determined using widely accepted discounted cash flow modeling techniques. These discounted cash flow models use projections of future cash payments and receipts that are discounted at mid-market rates. Observable inputs that may impact the valuation of these instruments include LIBOR swap rates, LIBOR forward yield curves and counterparty credit risk spreads. These fair value measurements are generally classified within level 2 of the fair value hierarchy. Loan commitment derivatives are priced based on a bid pricing convention adjusted based on the Company s historical fallout rates. Fallout rates are a significant unobservable input; therefore, these fair value measurements are classified within level 3 of the fair value hierarchy. The fair value of loan commitment derivatives is nominal.

The following table presents assets and liabilities measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011 (in thousands):

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

	March 31, 2012			
	Level 1	Level 2	Level 3	Total
Investment Securities Available for Sale:				
U.S. Treasury and Government agency securities	$ 19,898	$ 44,525	$	$ 64,423
U.S. Government agency and sponsored enterprise mortgage-backed securities		2,057,034		2,057,034
Re-Remics		690,228		690,228
Private label residential mortgage-backed securities and CMOs			444,417	444,417
Private label commercial mortgage-backed securities		290,610		290,610
Non-mortgage asset-backed securities		368,915	78,010	446,925
Mutual funds and preferred stocks	272,362	20		272,382
State and municipal obligations		23,776		23,776
Small Business Administration securities		356,983		356,983
Other debt securities		11,852	3,315	15,167
Derivative assets		3,726		3,726
Total assets at fair value	$ 292,260	$ 3,847,669	$ 525,742	$ 4,665,671
Derivative liabilities		64,871	37	64,908
Total liabilities at fair value	$	$ 64,871	$ 37	$ 64,908

	December 31, 2011			
	Level 1	Level 2	Level 3	Total
Investment Securities Available for Sale:				
U.S. Government agency and sponsored enterprise mortgage-backed securities	$	$ 1,985,713	$	$ 1,985,713
Re-Remics		546,310		546,310
Private label residential mortgage-backed securities and CMOs			387,687	387,687
Private label commercial mortgage-backed securities		262,562		262,562
Non-mortgage asset-backed securities		331,015	79,870	410,885
Mutual funds and preferred stocks	253,778	39		253,817
State and municipal obligations		25,270		25,270
Small Business Administration securities		303,677		303,677
Other debt securities		2,897	3,159	6,056
Derivative assets		3,731		3,731
Total assets at fair value	$ 253,778	$ 3,461,214	$ 470,716	$ 4,185,708
Derivative liabilities		67,178		67,178
Total liabilities at fair value	$	$ 67,178	$	$ 67,178

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

There were no transfers of financial assets between levels of the fair value hierarchy during the three months ended March 31, 2012 and 2011.

The following tables reconcile changes in the fair value of assets and liabilities measured at fair value on a recurring basis and classified in level 3 of the fair value hierarchy for the three months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31, 2012			
	Private Label Residential Mortgage-Backed Securities	Non-Mortgage Asset-Backed Securities	Other Debt Securities	Derivative Liabilities
Balance at beginning of period	$ 387,687	$ 79,870	$ 3,159	$
Gains (losses) for the period included in:				
Net income				(37)
Other comprehensive income	8,072	328	162	
Purchases or issuances	73,308			
Sales				
Settlements	(24,650)	(2,188)	(6)	
Transfers into level 3				
Transfers out of level 3				
Balance at end of period	$ 444,417	$ 78,010	$ 3,315	$ (37)

	Three Months Ended March 31, 2011						
	Re-Remics	Private Label Residential Mortgage-Backed Securities	Non-Mortgage Asset-Backed Securities	Other Debt Securities	FDIC Warrant	PIU Liability	Derivative Liabilities
Balance, beginning of period	$ 612,631	$ 382,920	$ 130,610	$ 3,943	$ (25,000)	$ (44,964)	$ (78)
Gains (losses) for the period included in:							
Net income							44
Other comprehensive income	(1,861)	(6,467)	1,094	576			
Purchases or issuances			46,658				
Sales							
Settlements	(45,129)	(14,605)	(3,130)	9	25,000	44,964	

Transfers into (out of) level 3							
Balance, end of period	$ 565,641	$ 361,848	$ 175,232	$ 4,528	$	$	$ (34)

Changes in the fair value of derivative liabilities are included in the consolidated statement of operations line item Other non-interest expense .

The following table provides information about the valuation techniques and unobservable inputs used in the valuation of financial instruments falling within level 3 of the fair value hierarchy as of March 31, 2012 (in thousands):

33

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS   UNAUDITED

March 31, 2012

	Fair Value at March 31, 2012	Valuation Technique	Unobservable Input	Range (Weighted Average)
Private label residential mortgage-backed securities and CMOs - Covered	$ 212,732	Discounted cash flow	Voluntary prepayment rate Probability of default Loss severity	1.00% - 29.66% (8.91%) 0.00% - 46.74% (6.53%) 0.00% - 88.86% (4.37%)
Private label residential mortgage-backed securities and CMOs - Non-covered	$ 231,685	Discounted cash flow	Voluntary prepayment rate Probability of default Loss severity	2.78% - 60.80% (10.31%) 0.00% - 10.01% (1.20%) 0.00% - 50.00% (7.51%)
Non-mortgage asset-backed securities secured by commercial loans	$ 78,010	Discounted cash flow	Voluntary prepayment rate Probability of default Loss severity	2.00% - 3.00% (2.31%) 0.00% - 5.00% (2.74%) 50.00% - 85.00% (61.01%)

The significant unobservable inputs used in the fair value measurement of private label residential mortgage-backed securities and many non-mortgage asset-backed securities include voluntary prepayment rates, probability of default and loss severity given default. Generally, significant increases in any of those inputs would result in a lower fair value measurement. Alternatively, decreases in any of those inputs would result in a higher fair value measurement. The fair value measurements of those securities with higher levels of subordination will be less sensitive to changes in these unobservable inputs, while securities with lower levels of subordination will show a higher degree of sensitivity to changes in these unobservable inputs. Generally, a change in the assumption used for probability of default is accompanied by a directionally similar change in the assumption used for loss severity given default and a directionally opposite change in the assumption used for voluntary prepayment rate.

Non-mortgage asset-backed securities for which fair value measurements are categorized in level 3 of the fair value hierarchy at March 31, 2012 consisted of two groups of securities collateralized by small balance commercial loans. The first group is comprised of 2003 issue senior floating rate bonds with a coupon of LIBOR + 0.43%, rated AAA/AA+/Aaa (Fitch/S&P/Moody s) with a current subordination level of 25.11%. The second group is comprised of AAA rated 2011 issue senior fixed rate bonds with a coupon of 5% and a current subordination level of 30.94%.

Non-covered private label residential mortgage-backed securities for which fair value measurements are classified in level 3 of the fair value hierarchy at March 31, 2012 can be categorized into three groups. The first group, with an aggregate fair of $134.8 million, is comprised of AAA securities issued from 2010 to 2012, collateralized by prime jumbo fixed rate and hybrid 1-4 single family mortgages with collateral origination dates ranging from 2009 to 2012. The coupon rates on these bonds range from 3.5% to 4.1% and current subordination levels range from 7.2% to 19.0%. The second group, with an aggregate fair value of $44.0 million, consists of securities issued in 2010 collateralized by Alt-a, fixed rate 1-4 single family mortgages originated from 2005 to 2008. The securities in this group are senior and senior subordinate tranches with ratings ranging from Aaa to A1 and current subordination levels ranging from 55.9% to 65.3%. The third group, with an aggregate fair value of $52.9 million, is comprised of senior tranches issued from 2003 to 2005 collateralized by prime fixed rate and hybrid 1-4 single family mortgages originated from 2002 to 2004. These securities have coupons ranging from 2.7% to 5.5%, ratings ranging from Aaa to A2 and current subordination levels ranging from 4.9% to 12.9%.

The covered securities for which fair value measurements are categorized in level 3 of the fair value hierarchy at March 31, 2012 consisted of pooled trust preferred securities with a fair value of $3.3 million and private label residential mortgage-backed securities with a fair value of $212.7 million. The trust preferred securities are not material to the Company s financial statements. The private label mortgage-backed securities were acquired in the FSB Acquisition and vary significantly with respect to seniority, subordination, collateral type and collateral performance; however, because of the Loss Sharing Agreements, the Company has minimal risk with respect to fluctuations in the value of these securities.

The Company uses third-party pricing services in determining fair value measurements for investment securities that are categorized in level 3 of the fair value hierarchy. To obtain an understanding of the methodologies and assumptions used, management may review written documentation provided by the pricing services, conduct interviews with valuation desk personnel, perform on-site walkthroughs and review model results and detailed assumptions used to value selected securities as considered necessary. Management has established a price challenge process that includes a review by the treasury front office of all prices provided on a monthly basis. Any price evidencing unexpected month over month fluctuations or deviations from expectations is challenged. If considered necessary to resolve any discrepancies, a price will be obtained from an additional independent valuation source. The

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

Company does not typically adjust the prices provided, other than through this established challenge process. The results of price challenges are subject to review by executive management. The Company has also established a quarterly process whereby prices provided by our primary pricing service for a sample of securities are validated. When there are price discrepancies, the final determination of fair value is based on careful consideration of the assumptions and inputs employed by each of the pricing sources.

Assets and liabilities measured at fair value on a non-recurring basis

Following is a description of the methodologies used to estimate the fair values of assets and liabilities measured at fair value on a non-recurring basis, and the level within the fair value hierarchy in which those measurements are typically classified.

Impaired loans and OREO The carrying amount of collateral dependent impaired loans is typically based on the fair value of the underlying collateral, which may be real estate or other business assets, less estimated costs to sell. The carrying value of OREO is initially measured based on the fair value of the real estate acquired in foreclosure and subsequently adjusted to the lower of cost or estimated fair value, less estimated cost to sell. Fair values of real estate collateral are typically based on real estate appraisals which utilize market and income approaches to valuation incorporating both observable and unobservable inputs. When current appraisals are not available, the Company may use brokers price opinions, home price indices or other available information about changes in real estate market conditions to adjust the latest appraised value available. These adjustments to appraised values may be subjective and involve significant management judgment. The fair value of collateral consisting of other business assets is generally based on appraisals that use market approaches to valuation incorporating primarily unobservable inputs. Fair value measurements related to collateral dependent impaired loans and OREO are classified within level 3 of the fair value hierarchy.

The following table presents assets for which nonrecurring changes in fair value have been recorded for the three months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31, 2012				
	Level 1	**Level 2**	**Level 3**	**Total**	**Gains (Losses) From Fair Value Changes**
Other real estate owned	$	$	$ 106,950	$ 106,950	$ (3,547)
Impaired loans	$	$	$ 3,110	$ 3,110	$ (500)

	Three Months Ended March 31, 2011				
	Level 1	**Level 2**	**Level 3**	**Total**	**Gains (Losses) from Fair Value Changes**

Other real estate owned	$		$		$	182,482	$	182,482	$	(9,599)

The following table presents the carrying value and fair value of financial instruments as of March 31, 2012 and December 31, 2011 (in thousands):

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

	March 31, 2012		December 31, 2011	
	Carrying Value	**Fair Value**	**Carrying Value**	**Fair Value**
Assets:				
Cash and cash equivalents	$ 312,061	$ 312,061	$ 303,742	$ 303,742
Investment securities available for sale	4,661,945	4,661,945	4,181,977	4,181,977
Non-marketable equity securities	176,041	176,041	147,055	147,055
Loans held for sale	2,173	2,193	3,952	3,994
Loans:				
Covered	2,288,387	2,807,043	2,398,737	2,856,268
Non-covered	2,364,422	2,383,254	1,689,919	1,725,313
FDIC Indemnification asset	1,786,512	1,671,518	2,049,151	1,950,446
Accrued interest receivable	22,682	22,682	19,133	19,133
Derivative assets	3,726	3,726	3,731	3,731
Liabilities:				
Deposits	$ 8,085,481	$ 8,118,571	$ 7,364,714	$ 7,399,404
Securities sold under repurchase agreements and short-term borrowings	11,199	11,199	206	206
Federal Home Loan Bank advances	2,231,412	2,280,913	2,236,131	2,294,265
Income taxes payable	80,215	80,215	53,171	53,171
Accrued interest payable	8,044	8,044	8,519	8,519
Advance payments by borrowers for taxes and insurance	30,803	30,803	21,838	21,838
Derivative liabilities	64,908	64,908	67,178	67,178

The following methods and assumptions were used to estimate the fair value of each class of financial instruments, other than those described above:

The carrying amounts of certain financial instruments approximate fair value due to their short-term nature and generally negligible credit risk. These financial instruments include cash and cash equivalents, accrued interest receivable, securities sold under repurchase agreements and short-term borrowings, income taxes payable, accrued interest payable and advance payments by borrowers for taxes and insurance.

Non-marketable equity securities:

Non-marketable equity securities include FHLB and Federal Reserve Bank stock. There is no market for these securities, which can be liquidated only by redemption by the issuer. These securities are carried at par, which has historically represented the redemption price and is therefore considered to approximate fair value. Non-marketable equity securities are evaluated quarterly for potential impairment.

Loans held for sale:

The fair value of loans held for sale is based on pricing currently available to the Company in the secondary market. This fair value measurement typically falls within level 2 of the fair value hierarchy.

ACI and non-ACI loans:

Fair values are estimated based on a discounted cash flow analysis. Estimates of future cash flows incorporate various factors that may include the type of loan and related collateral, collateral values, estimated default probability and loss severity given default, internal risk rating, whether the interest rate is fixed or variable, term of loan, whether or not the loan is amortizing and loan specific net realizable value analyses for certain commercial and commercial real estate loans. The fair values of loans accounted for in pools are estimated on a pool basis. Other loans may be grouped based on risk characteristics and fair value estimated in the aggregate when applying discounted cash flow valuation techniques. Discount rates are based on current market rates for new originations of comparable loans adjusted for liquidity and credit risk premiums that the Company believes would be required by market participants. These fair value measurements fall within level 3 of the fair value hierarchy.

New loans:

Fair values are estimated using a discounted cash flow analysis with a discount rate based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. The ALLL is considered a reasonable estimate of the required adjustment to fair value to reflect the impact of credit risk. These fair value measurements fall within level 3 of the fair value hierarchy. This estimate may not represent an exit value as defined in ASC 820.

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

FDIC indemnification asset:

The fair value of the FDIC indemnification asset has been estimated using a discounted cash flow technique incorporating assumptions about the timing and amount of future projected cash payments from the FDIC related to the resolution of covered assets. The factors that impact estimates of future cash flows are similar to those impacting estimated cash flows from ACI and non-ACI loans described above. The discount rate is determined by adjusting the risk free rate to incorporate uncertainty in the estimate of the timing and amount of future cash flows and illiquidity. This fair value measurement falls within level 3 of the fair value hierarchy.

Deposits:

The fair value of demand deposits, savings accounts and money market deposits is the amount payable on demand at the reporting date. The fair value of time deposits is estimated using a discounted cash flow analysis based on rates currently offered for deposits of similar remaining maturities. This fair value measurement falls within level 2 of the fair value hierarchy.

Federal Home Loan Bank advances:

Fair value is estimated by discounting contractual future cash flows using the current rate at which borrowings with similar terms and remaining maturities could be obtained by the Company. This fair value measurement falls within level 2 of the fair value hierarchy.

Note 12 Commitments and Contingencies

The Company issues off-balance sheet financial instruments to meet the financing needs of its customers. These financial instruments include commitments to fund loans, unfunded commitments under existing lines of credit, and commercial and standby letters of credit. These commitments expose the Company to varying degrees of credit and market risk which are essentially the same as those involved in extending loans to customers, and are subject to the same credit policies used in underwriting loans. Collateral may be obtained based on the Company s credit evaluation of the counterparty. The Company s maximum exposure to credit loss is represented by the contractual amount of these commitments. Amounts funded under non-cancelable commitments in effect at the date of the FSB Acquisition are covered under the Loss Sharing Agreements if certain conditions are met.

Commitments to fund loans:

These are agreements to lend funds to customers as long as there is no violation of any condition established in the contract. Commitments to fund loans generally have fixed expiration dates or other termination clauses and may require payment of a fee. Many of these commitments are expected to expire without being funded and, therefore, the total commitment amounts do not necessarily represent future liquidity requirements.

Unfunded commitments under lines of credit:

Unfunded commitments under lines of credit include consumer, home equity, commercial and commercial real estate lines of credit to existing customers. Some of these commitments may mature without being fully funded.

Commercial and standby letters of credit:

Letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support trade transactions or guarantee arrangements. Fees collected on standby letters of credit represent the fair value of those commitments and are deferred and amortized over their term, which is typically one year or less. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

Total lending related commitments outstanding at March 31, 2012 were as follows (in thousands):

Table of Contents

BANKUNITED, INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS UNAUDITED

March 31, 2012

	Covered	Non-Covered	Total
Commitments to fund loans	$	$ 135,812	$ 135,812
Commitments to purchase loans		47,222	47,222
Unfunded commitments under lines of credit	82,286	405,695	487,981
Commercial and standby letters of credit		34,771	34,771
	$ 82,286	$ 623,500	$ 705,786

Legal Proceedings

The Company is involved as plaintiff or defendant in various legal actions arising in the normal course of business. In the opinion of management, based upon advice of legal counsel, the likelihood is remote that the impact of these proceedings, either individually or in the aggregate, would be material to the Company s consolidated financial position, results of operations or cash flows.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis is intended to focus on significant changes in the financial condition and results of operations of the Company during the three months ended March 31, 2012 and should be read in conjunction with the consolidated financial statements and notes thereto included in this Quarterly Report on Form 10-Q and BKU s 2011 Annual Report on Form 10-K for the year ended December 31, 2011 (the 2011 Annual Report on Form 10-k).

Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 that reflect the Company s current views with respect to, among other things, future events and financial performance. Words such as anticipates, expects, intends, plans, believes, seeks, estimates, and similar expressions identify forward-looking statements. These forward-looking statements are based on the historical performance of the Company or on the Company s current plans, estimates and expectations. The inclusion of this forward-looking information should not be regarded as a representation by the Company that the future plans, estimates or expectations so contemplated will be achieved. Such forward-looking statements are subject to various risks and uncertainties and assumptions relating to the Company s operations, financial results, financial condition, business prospects, growth strategy and liquidity. If one or more of these or other risks or uncertainties materialize, or if the Company s underlying assumptions prove to be incorrect, the Company s actual results may vary materially from those indicated in these statements. A number of important factors could cause actual results to differ materially from those indicated by the forward-looking statements. Factors that may cause actual results to differ materially from these forward-looking statements include but are not limited to, the risk factors described in Part I, Item 1A of 2011 Annual Report on Form 10-K. The Company does not undertake any obligation to publicly update or review any forward-looking statement, whether as a result of new information, future developments or otherwise.

Quarterly Highlights

- The Company completed the acquisition of Herald on February 29, 2012 for a total purchase price of $65.0 million. The Company recorded loans of $306.0 million, investment securities of $161.0 million and deposits of $435.5 million in conjunction with this acquisition.

- Net income for the quarter ended March 31, 2012 was $50.3 million, or $0.49 per share, as compared to a net loss of ($67.7) million, or ($0.72) per share, for the quarter ended March 31, 2011. Results of operations for the quarter ended March 31, 2012 include a $5.3 million gain from the acquisition of Herald, with no related tax impact, and pre-tax acquisition costs of $1.2 million. The net loss for the quarter ended March 31, 2011 included $110.4 million in equity based compensation expense recorded in conjunction with the IPO of the Company s common stock which was not deductible for income tax purposes.

- Net interest income increased by $25.5 million to $137.8 million for the quarter ended March 31, 2012 from $112.3 for the quarter ended March 31, 2011. The net interest margin increased to 5.99% from 5.76%. The primary drivers of the increase in net interest income were an increase in interest income on loans of $21.6 million and a decrease in interest expense on deposits of $3.3 million. The yield on loans increased to 12.77% for the quarter ended March 31, 2012 from 12.10% for the quarter ended March 31, 2011, reflecting an increase in the yield on covered loans partially offset by a decline in the yield on new loans and an increase in the proportion of the portfolio comprised of new

loans. The average rate paid on interest-bearing deposits declined to 1.02% for the quarter ended March 31, 2012 from 1.27% for the quarter ended March 31, 2011 as a result of a shift in deposit mix away from time deposits toward lower cost deposit products coupled with declines in market interest rates.

- Loans, net of discount, premiums and deferred fees and costs, grew $572.2 million to $4.7 billion at March 31, 2012, including loans acquired in the purchase of Herald. Excluding loans acquired from Herald, new loans grew by $368.1 million during the quarter ended March 31, 2012 to $2.1 billion.

- Asset quality remained strong, with a ratio of non-performing assets to total assets of 1.14%, a ratio of non-performing loans to total loans of 0.69% and an annualized net charge-off ratio (net charge-offs to average loans) of 0.07%. All OREO and substantially all non-performing loans are covered assets at March 31, 2012.

- For the quarter ended March 31, 2012, deposits grew $720.8 million to $8.1 billion, including deposits acquired from Herald. Demand deposits increased to 19.0% of total deposits at March 31, 2012 from 16.6% of total deposits at

Table of Contents

December 31, 2011 while time deposits declined to 32.4% of total deposits at March 31, 2012 from 35.1% at December 31, 2011.

- The Company s capital ratios continue to exceed the requirements to be considered well capitalized under applicable regulatory guidelines, with a Tier 1 leverage ratio of 13.4%, a Tier 1 risk-based capital ratio of 36.8% and a Total risk-based capital ratio of 38.2% at March 31, 2012.

Results of Operations

Net Interest Income

Net interest income is the difference between interest earned on interest earning assets and interest incurred on interest bearing liabilities and is the primary driver of core earnings. Net interest income is impacted by the relative mix of interest earning assets and interest bearing liabilities, the ratio of interest earning assets to total assets and of interest bearing liabilities to total funding sources, movements in market interest rates, levels of non-performing assets and pricing pressure from competitors.

The mix of interest earning assets is influenced by loan demand and by management s continual assessment of the rate of return and relative risk associated with various classes of earning assets. The mix of interest bearing liabilities is influenced by management s assessment of the need for lower cost funding sources weighed against relationships with customers and growth requirements and is impacted by competition for deposits in the Company s markets and the availability and pricing of other sources of funds.

Net interest income is also impacted by the accounting for ACI loans and to a declining extent, the accretion of fair value adjustments recorded in conjunction with the FSB Acquisition. ACI loans were initially recorded at fair value, measured based on the present value of expected cash flows. The excess of expected cash flows over carrying value, known as accretable yield, is being recognized as interest income over the lives of the underlying loans. Accretion related to ACI loans has a positive impact on our net interest income, net interest margin and interest rate spread. The impact of accretion related to ACI loans on net interest income, the net interest margin and the interest rate spread is expected to decline in the future as ACI loans comprise a declining percentage of total loans. The proportion of total loans represented by ACI loans will decline as the ACI loans are resolved and new loans are added to the portfolio. ACI loans represented 42.6% and 50.8% of total loans, net of discounts, premiums and deferred costs and fees, at March 31, 2012 and December 31, 2011, respectively.

Payments received in excess of expected cash flows may result in a pool of ACI residential loans becoming fully amortized and its carrying value reduced to zero even though outstanding contractual balances remain related to loans in the pool. Once the carrying value of a pool is reduced to zero, any future proceeds from the remaining loans are recognized as interest income upon receipt. The carrying value of one pool was reduced to zero in late 2011. Future expected cash flows from this pool total $184.4 million as of March 31, 2012. The UPB of loans remaining in this pool was $385.2 million at March 31, 2012. We expect that future proceeds from loans in this pool will result in an increase in interest income from the pool. To some extent, the increase in interest income will be offset by a reduction in non-interest income reported in the consolidated statement of operations line item Income (loss) from resolution of covered assets, net. The timing of receipt of proceeds from loans in this pool may be unpredictable, leading to increased volatility in the yield on the pool.

Fair value adjustments of interest earning assets and interest bearing liabilities recorded at the time of the FSB Acquisition are accreted to interest income or expense over the lives of the related assets or liabilities. Generally, accretion of fair value adjustments increases interest income and decreases interest expense, and thus has a positive impact on our net interest income, net interest margin and interest rate spread. The impact of accretion of fair value adjustments on interest income and interest expense will continue to decline as these assets and liabilities mature or are repaid and constitute a smaller portion of total interest earning assets and interest bearing liabilities.

The impact of accretion and ACI loan accounting on net interest income makes it difficult to compare our net interest margin and interest rate spread to those reported by other financial institutions.

The following table presents, for the periods indicated, information about (i) average balances, the total dollar amount of interest income from earning assets and the resultant average yields; (ii) average balances, the total dollar amount of interest expense on interest bearing liabilities and the resultant average rates; (iii) net interest income; (iv) the interest rate spread; and (v) the net interest margin. Nonaccrual and restructured loans are included in the average balances presented in this table; however, interest income foregone on nonaccrual loans is not included. Yields have been calculated on a pre-tax basis (dollars in thousands):

Table of Contents

	Three Months Ended March 31,					
	2012			2011		
	Average Balance	Interest	Yield/ Rate(1)	Average Balance	Interest	Yield/ Rate(1)
Assets:						
Interest earning assets:						
Investment securities available for sale	$ 4,398,697	$ 33,039	3.00%	$ 3,201,208	$ 32,549	4.07%
Other interest earning assets	524,710	954	0.73%	792,540	1,006	0.51%
Loans	4,275,406	136,297	12.77%	3,802,786	114,651	12.10%
Total interest earning assets	9,198,813	170,290	7.42%	7,796,534	148,206	7.63%
Allowance for loan losses	(49,857)			(58,443)		
Noninterest earning assets	2,441,365			3,175,098		
Total assets	$ 11,590,321			$ 10,913,189		
Liabilities and Stockholders Equity:						
Interest bearing liabilities:						
Interest bearing demand deposits	$ 474,898	$ 767	0.65%	$ 349,822	$ 553	0.64%
Savings and money market deposits	3,660,944	6,433	0.71%	3,252,484	7,226	0.90%
Time deposits	2,578,826	9,760	1.52%	2,893,837	12,527	1.76%
Total interest bearing deposits	6,714,668	16,960	1.02%	6,496,143	20,306	1.27%
Borrowings:						
FHLB advances	2,234,426	15,520	2.79%	2,253,222	15,572	2.80%
Short term borrowings	1,209	1	0.45%	286	1	0.28%
Total interest bearing liabilities	8,950,303	32,481	1.46%	8,749,651	35,879	1.66%
Non-interest bearing demand deposits	863,131			525,622		
Other non-interest bearing liabilities	191,816			277,786		
Total liabilities	10,005,250			9,553,059		
Stockholders equity	1,585,071			1,360,130		
Total liabilities and stockholders equity	$ 11,590,321			$ 10,913,189		
Net interest income		$ 137,809			$ 112,327	
Interest rate spread			5.96%			5.97%
Net interest margin			5.99%			5.76%

(1) Annualized

Three months ended March 31, 2012 compared to three months ended March 31, 2011

Net interest income was $137.8 million for the three months ended March 31, 2012 compared to $112.3 million for the three months ended March 31, 2011, an increase of $25.5 million. The increase in net interest income was comprised of an increase in interest income of $22.1 million and a decrease in interest expense of $3.4 million.

The increase in interest income was driven primarily by a $21.6 million increase in interest income from loans. Increased interest income from loans was reflective of an increase in the average yield to 12.77% for the three months ended March 31, 2012 from 12.10% for the comparable

period in 2011 and a $472.6 million increase in the average balance outstanding. The increase in the average balance of loans was the result of new loan originations and purchases by BankUnited as well as the acquisition of loans from Herald. The yield on loans acquired in the FSB Acquisition was 19.48% for the three months ended March 31, 2012 as compared to 13.20% for the three months ended March 31, 2011. This increase resulted primarily from (i) covered loans being resolved at a faster rate than expected, resulting in higher accretion, (ii) improved default frequency rates leading to an increase in expected cash flows, (iii) favorable resolutions of commercial ACI loans and (iv) recognition of all proceeds from resolution of loans in one residential pool with a carrying value of zero as interest income as discussed above. The increased yield on loans acquired in the FSB Acquisition was in part offset by a decline in the yield on new loans to 4.50% for the three months ended March 31, 2012 from 5.50% for the three months ended March 31, 2011, coupled with an increase in the proportion of the total portfolio represented by new loans. The decline in yield on new loans was a function of lower market rates of interest. New loans represented 44.8% of average loans outstanding for the three months ended March 31, 2012 as compared to 14.3% of average loans outstanding for the three months ended March 31, 2011.

Table of Contents

While the average volume of investment securities available for sale increased by $1.2 billion for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011, the yield declined to 3.00% for the three months ended March 31, 2012 from 4.07% for the three months ended March 31, 2011 reflecting the impact of new purchases at lower market rates of interest.

The primary component of the decrease in interest expense for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011 was a $3.3 million decline in interest expense on deposits. This decline was attributable primarily to a decrease in the average rate resulting from (i) a shift in deposit mix from time deposits to lower cost products, (ii) declining market rates of interest and (iii) a $2.3 million reduction in accretion of fair value adjustments.

The net interest margin for the three months ended March 31, 2012 was 5.99% as compared to 5.76% for the three months ended March 31, 2011, an increase of 23 basis points. The primary factors impacting the increase in the net interest margin were (i) an increase in average interest earning assets as a percentage of average total assets, (ii) the decline in the average rate paid on deposits and (iii) the decreased yield on investment securities, partially offset by the increased yield on loans. The net interest spread declined to 5.96% for the three months ended March 31, 2012 from 5.97% for the three months ended March 31, 2011. An improvement in the average rate paid on interest bearing deposits to 1.02% for the quarter ended March 31, 2012 from 1.27% for the quarter ended March 31, 2011 was offset by a decline in the average yield on interest earning assets to 7.42% from 7.63% for those same periods. The decline in the average yield on interest earning assets resulted from the lower yield on investment securities, partially offset by an increased yield on loans as discussed above.

Provision for Loan Losses

The provision for loan losses is the amount of expense that, based on our judgment, is required to maintain the ALLL at an adequate level to absorb probable losses inherent in the loan portfolio at the balance sheet date and that, in management s judgment, is appropriate under U.S. generally accepted accounting principles. The determination of the amount of the ALLL is complex and involves a high degree of judgment and subjectivity. Our determination of the amount of the allowance and corresponding provision for loan losses considers ongoing evaluations of the various segments of the loan portfolio and of individually significant credits, levels of non-performing loans and charge-offs, statistical trends and economic and other relevant factors. See Analysis of the Allowance for Loan and Lease Losses below for more information about how we determine the appropriate level of the allowance.

Because the determination of fair value at which the loans acquired in the FSB acquisition were initially recorded encompassed assumptions about expected future cash flows and credit risk, no ALLL was recorded at the date of acquisition. An allowance related to ACI loans is recorded only when estimates of future cash flows related to these loans are revised downward, indicating further deterioration in credit quality. An allowance for non-ACI loans may be established if factors considered relevant by management indicate that the credit quality of the non-ACI loans has deteriorated.

Since the recognition of a provision for loan losses on covered loans represents an increase in the amount of reimbursement we ultimately expect to receive from the FDIC, we also record an increase in the FDIC indemnification asset for the present value of the projected increase in reimbursement, with a corresponding increase in non-interest income, recorded in Net gain on indemnification asset as discussed below in the section entitled Non-interest income. Therefore, the impact on our results of operations of any provision for loan losses on covered loans is significantly mitigated by an increase in non-interest income. For the three months ended March 31, 2012 and 2011, we recorded provisions for loan losses on covered loans of $1.6 million and $10.0 million, respectively. For the three months ended March 31, 2012 and 2011, the impact on earnings from these provisions was significantly mitigated by recording non-interest income of $1.6 million and $6.6 million, respectively.

For the three months ended March 31, 2012 and 2011, we recorded provisions for loan losses of $7.2 million and $1.4 million, respectively, related to new loans. The increase in the provision for losses on new loans related primarily to growth in the new loan portfolio. These loans are not protected by the Loss Sharing Agreements and as such, these provisions are not offset by an increase in non-interest income.

Table of Contents

Non-Interest Income

The Company reported non-interest income of $36.4 million and $64.3 million for the three months ended March 31, 2012 and March 31, 2011, respectively. The majority of our non-interest income resulted from the resolution of assets covered by our Loss Sharing Agreements with the FDIC and accretion of discount on the FDIC indemnification asset. Non-interest income related to transactions in covered assets represented 57% and 87% of total non-interest income for the quarters ended March 31, 2012 and 2011, respectively. The following table presents a comparison of the categories of non-interest income for the three months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31,	
	2012	**2011**
Accretion of discount on FDIC indemnification asset	$ 6,787	$ 19,570
Income (loss) from resolution of covered assets, net	7,282	(710)
Net gain on indemnification asset	134	26,322
FDIC reimbursement of costs of resolution of covered assets	6,516	10,500
Non-interest income from covered assets	20,719	55,682
Service charges and fees	3,055	2,684
Mortgage insurance income	3,690	1,301
Investment services income	1,132	2,404
Other non-interest income	7,802	2,191
	$ 36,398	$ 64,262

Non-interest income related to transactions in the covered assets

Accretion of discount on the FDIC indemnification asset totaled $6.8 million and $19.6 million for the three months ended March 31, 2012 and 2011, respectively. Accretion is a result of discounting and may increase or decrease from period to period due to changes in expected cash flows from the ACI loans.

The FDIC indemnification asset was recorded in conjunction with the FSB Acquisition at its estimated fair value, representing the present value of estimated future cash payments from the FDIC for probable losses on covered assets. If projected cash flows from the ACI loans increase, the yield on the loans will increase accordingly and the discount rate of accretion on the FDIC indemnification asset will decrease as less cash flow is expected to be recovered from the indemnification asset. For the three months ended March 31, 2012 and 2011, the average rate at which discount was accreted on the FDIC indemnification asset was 1.46% and 3.20%, respectively.

The decrease in total accretion for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011 related both to the decrease in the average discount rate and to the decrease in the average balance of the indemnification asset. The average balance of the indemnification asset decreased primarily as a result of the submission of claims and receipt of cash from the FDIC under the terms of the Loss Sharing Agreements. We expect the amount of accretion to continue to decline in future periods because our projected cash flows from ACI loans have continued to increase, and as a result we expect to collect less cash flow from the indemnification asset. Additionally, as we continue to submit claims under the Loss Sharing Agreements, the remaining balance of the indemnification asset will continue to decline.

The balance of the FDIC indemnification asset is also reduced or increased as a result of decreases or increases in estimated cash flows to be received from the FDIC related to the gains or losses recorded in our consolidated financial statements from transactions in the covered assets. When these transaction gains or losses are recorded, we also record an offsetting amount in the statement of operations line item Net gain on indemnification asset. This line item includes the significantly mitigating impact of FDIC indemnification related to the following types of transactions in covered assets:

- gains or losses from the resolution of covered assets;
- provisions for losses on covered loans;
- gains or losses on the sale of OREO; and
- impairment of OREO.

Each of these types of transactions is discussed further below.

Table of Contents

A rollforward of the FDIC indemnification asset for the year ended December 31, 2011 and the three months ended March 31, 2012 follows (in thousands):

Balance, December 31, 2010	$	2,667,401
Accretion		55,901
Reduction for claims filed		(753,963)
Net gain on indemnification asset		79,812
Balance, December 31, 2011		2,049,151
Accretion		6,787
Reduction for claims filed		(269,560)
Net gain on indemnification asset		134
Balance, March 31, 2012	$	1,786,512

Covered loans may be resolved through prepayment, short sale of the underlying collateral, foreclosure, or, for the non-residential portfolio, charge-off. The difference between consideration received in resolution of covered loans and the amount of projected losses from resolution of those loans is recorded in the consolidated statement of operations line item Income (loss) from resolution of covered assets, net. Both gains and losses on individual resolutions are included in this line item. Losses from the resolution of covered loans increase the amount recoverable from the FDIC under the Loss Sharing Agreements. Gains from the resolution of covered loans reduce the amount recoverable from the FDIC under the Loss Sharing Agreements. These additions to or reductions in amounts recoverable from the FDIC related to the resolution of covered loans are recorded in non-interest income in the line item Net gain on indemnification asset and reflected as corresponding increases or decreases in the FDIC indemnification asset. The amount of income recorded in any period will be impacted by the number and UPB of ACI loans resolved, the amount of consideration received, and our ability to accurately project cash flows from ACI loans in future periods.

The following table provides further detail of the components of income (loss) from resolution of covered assets, net for the three months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31,			
		2012		**2011**
Payments in full	$	15,167	$	21,245
Foreclosures		(6,903)		(13,131)
Short sales		(1,889)		(7,701)
Charge-offs		(975)		(1,969)
Recoveries		1,882		846
Income (loss) from resolution of covered assets, net	$	7,282	$	(710)

As expected, the impact of payments in full on income (loss) from resolution of covered assets declined for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011. As covered loans continue to be resolved, the number of paid-in-full resolutions declines. The net average gain per paid in full transaction has also declined as additional history with the performance of covered loans has been reflected in our updated cash flow forecasts. The decrease in the impact on income (loss) from resolution of covered assets from foreclosures and short sales for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011 relates primarily to a decline in the level of foreclosure and short sale activity. Charge-offs for the three months ended March 31, 2011 exceeded those for the three months ended March 31, 2012 due primarily to a higher number and dollar amount of charge-offs of home equity lines of credit recognized during the quarter ended March 31, 2011. As expected, with the passage of time, the number and amount of recoveries has increased.

Additional impairment arising since the FSB Acquisition related to covered loans is recorded in earnings through the provision for losses on covered loans. Under the terms of the Loss Sharing Agreements, the Company is entitled to recover from the FDIC a portion of losses on these loans; therefore, the discounted amount of additional expected cash flows from the FDIC related to these losses is recorded in non-interest income in the line item Net gain on indemnification asset and reflected as a corresponding increase in the FDIC indemnification asset.

Table of Contents

The Company records impairment charges related to declines in the net realizable value of OREO properties subject to the Loss Sharing Agreements and recognizes additional gains or losses upon the eventual sale of such OREO properties. These amounts are included in non-interest expense in the consolidated financial statements. The estimated increase or reduction in amounts recoverable from the FDIC with respect to these gains and losses is reflected as an increase or decrease in the FDIC indemnification asset and in non-interest income in the line item Net gain on indemnification asset.

Net gain on indemnification asset of $0.1 million and $26.3 million was recorded for the three months ended March 31, 2012 and 2011 respectively, representing the net change in the FDIC indemnification asset from increases or decreases in cash flows estimated to be received from the FDIC related to gains and losses from covered assets as discussed in the preceding paragraphs. The net impact on earnings before taxes of transactions related to covered assets was $0.9 million and $(6.2) million, respectively, for the three months ended March 31, 2012 and 2011 as detailed in the table below (in thousands):

	Three Months Ended March 31, 2012			Three Months Ended March 31, 2011		
	Transaction Income (Loss)	Net Gain (Loss) on Indemnification Asset	Net Impact on Pre-tax Earnings	Transaction Income (Loss)	Net Gain (Loss) on Indemnification Asset	Net Impact on Pre-tax Earnings
Provision for losses on covered loans	$ (1,600)	$ 1,595	$ (5)	$ (10,017)	$ 6,639	$ (3,378)
Income (loss) from resolution of covered assets, net	7,282	(5,450)	1,832	(710)	3,103	2,393
Loss on sale of OREO	(1,401)	1,152	(249)	(12,210)	8,943	(3,267)
Impairment of OREO	(3,547)	2,837	(710)	(9,599)	7,637	(1,962)
Net OREO gain (loss)	(4,948)	3,989	(959)	(21,809)	16,580	(5,229)
	$ 734	$ 134	$ 868	$ (32,536)	$ 26,322	$ (6,214)

Certain OREO and foreclosure related expenses, including fees paid to attorneys and other service providers, property preservation costs, maintenance and repair costs, advances for taxes and insurance, appraisal costs and inspection costs are also reimbursed under the terms of the Loss Sharing Agreements. Such expenses are recorded in non-interest expense when incurred, and the reimbursement is recorded as FDIC reimbursement of costs of resolution of covered assets in non-interest income when submitted to the FDIC, generally upon ultimate resolution of the underlying covered asset. This may result in the expense and the related income from reimbursements being recorded in different periods. For the three months ended March 31, 2012 and 2011, non-interest expense includes approximately $5.0 million and $8.8 million, respectively, of expenses subject to reimbursement at the 80% level under the Loss Sharing Agreements. For those same periods, claims of $6.5 million and $10.5 million, respectively, were submitted to the FDIC for reimbursement. As of March 31, 2012, $18.0 million of expenses remain to be submitted for reimbursement from the FDIC in future periods.

Other components of non-interest income

Mortgage insurance income represents mortgage insurance proceeds received with respect to covered loans in excess of the portion of losses on those loans that is recoverable from the FDIC. Mortgage insurance proceeds up to the amount of losses on covered loans reimbursable by the

FDIC offsets amounts otherwise recoverable from the FDIC. The increase in mortgage insurance income for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011 is primarily a result of continuing efforts by the Company to file and collect insurance claims.

Other non-interest income for the three months ended March 31, 2012 included a gain of $5.3 million on the acquisition of Herald. For further discussion, see Note 3 to the consolidated financial statements.

Non-Interest Expense

The Company reported non-interest expense of $84.1 million for the three months ended March 31, 2012 as compared to $204.3 million for the three months ended March 31, 2011. The following table presents the components of non-interest expense for the three months ended March 31, 2012 and 2011 (in thousands):

Table of Contents

	Three Months Ended March 31,			
		2012		2011
Employee compensation and benefits	$	46,625	$	149,306
Occupancy and equipment		11,822		7,605
Impairment of other real estate owned		3,547		9,599
Foreclosure expense		2,719		4,470
Loss on sale of other real estate owned		1,401		12,210
Other real estate owned expense		2,276		4,343
Deposit insurance expense		1,150		4,189
Professional fees		3,649		3,229
Telecommunications and data processing		3,230		3,448
Other non-interest expense		7,699		5,940
	$	84,118	$	204,339

Employee compensation and benefits

Employee compensation and benefits expense decreased by $102.7 million to $46.6 million for the three months ended March 31, 2012 as compared to $149.3 million for the three months ended March 31, 2011. Employee compensation and benefits for the three months ended March 31, 2011 included a one-time equity based compensation charge of $110.4 million recorded in conjunction with the consummation of the IPO as discussed in Note 10 to the consolidated financial statements. This charge to compensation expense was offset by a credit to paid-in capital and therefore did not impact the Company s capital position. Excluding the impact of this one-time charge, employee compensation and benefits increased by $7.7 million for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011. An increase in equity based compensation, exclusive of the $110.4 million one-time charge, accounted for $3.7 million of this increase. The remainder of the increase was attributable to the continued enhancement of our management team and other personnel.

Occupancy and equipment

Occupancy and equipment costs increased by $4.2 million to $11.8 million for the quarter ended March 31, 2012 as compared to $7.6 million for the quarter ended March 31, 2011. This increase was related primarily to the expansion and refurbishment of our branch network.

OREO and foreclosure related expenses and losses

At March 31, 2012 as well as during the quarters ended March 31, 2012 and 2011, all of our OREO properties were covered by the Loss Sharing Agreements. Therefore, losses from sale or impairment of OREO are substantially offset by non-interest income related to indemnification by the FDIC. Generally, OREO and foreclosure related expenses are also reimbursed under the terms of the Loss Sharing Agreements.

In the aggregate, impairment of OREO and losses on the sale of OREO declined by $16.9 million to $4.9 million for the three months ended March 31, 2012 from $21.8 million for the three months ended March 31, 2011. In total, foreclosure and OREO related expenses decreased by $3.8 million to $5.0 million for the three months ended March 31, 2012 from $8.8 million for the three months ended March 31, 2011. These declines were primarily attributable to decreases in the levels of foreclosure activity and OREO inventory. At March 31, 2012 there were 2,084

units in the foreclosure pipeline and 647 units in OREO as compared to 4,170 units in the foreclosure pipeline and 1,104 units in OREO at March 31, 2011.

We have performed an internal assessment of our foreclosure practices and procedures and of our vendor management processes related to outside vendors that assist us in the foreclosure process. This assessment did not reveal any deficiencies in processes and procedures that we believe to be of significance.

Other components of non-interest expense

Deposit insurance expense decreased by $3.0 million for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011. A change in the assessment base coupled with a relatively low assigned risk rating resulted in a reduction of premiums.

Table of Contents

Other non-interest expense increased by $1.8 million for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011. Other non-interest expense for the quarter ended March 31, 2012 included $1.2 million in transaction costs related to the acquisition of Herald.

Income Taxes

The provision for income taxes was $31.1 million and $28.5 million for the three months ended March 31, 2012 and 2011, respectively. The Company s effective tax rate was 38.2% and (72.6) % for the three months ended March 31, 2012 and 2011, respectively. The Company s effective income tax rate for the three months ended March 31, 2012 differed from the statutory federal income tax rate of 35%, primarily due to the impact of state income taxes, non-deductible equity based compensation and a non-taxable gain on the acquisition of Herald. For the three months ended March 31, 2011, the effective income tax rate differed from the statutory federal income tax rate primarily due to the impact of $110.4 million in non-deductible equity based compensation expense and the provision for uncertain state tax positions. At March 31, 2012 and December 31, 2011, the Company had net deferred tax assets of $83.8 million and $19.5 million, respectively.

Financial Condition

Average interest-earning assets increased $1.4 billion to $9.2 billion for the three months ended March 31, 2012 from $7.8 billion for the three months ended March 31, 2011. This increase was driven primarily by a $1.2 billion increase in the average balance of investment securities. Average non-interest earning assets declined by $733.7 million, largely due to the decrease in the FDIC indemnification asset from claims paid.

Average interest bearing liabilities increased by $200.7 million to $9.0 billion for the three months ended March 31, 2012 from $8.7 billion for the three months ended March 31, 2011, due primarily to an increase of $218.5 million in average interest-bearing deposits. Reflecting a continued shift from time deposits to generally lower cost deposit products, average time deposits declined by $315.0 million while average interest bearing demand, savings and money market deposits grew by $533.5 million. Average non-interest bearing liabilities increased by $251.5 million, primarily as a result of an increase in non-interest bearing demand deposits. Average stockholders equity increased by $224.9 million, due largely to the retention of earnings.

Investment Securities Available for Sale

The following tables show, as of March 31, 2012 and December 31, 2011, the amortized cost and fair value of investment securities available for sale and the breakdown of covered and non-covered securities (in thousands):

	March 31, 2012									
	Covered Securities				Non-Covered Securities				Total	
	Amortized	Gross Unrealized		Fair	Amortized	Gross Unrealized		Fair	Amortized	Fair
	Cost	Gains	Losses	Value	Cost	Gains	Losses	Value	Cost	Value

U.S. Treasury and Government agency securities	$	$	$	$	$ 64,526	$ 28	$ (131)	$ 64,423	$ 64,526	$ 64,423
U.S. Government agency and sponsored enterprise mortgage-backed securities					2,007,075	50,776	(817)	2,057,034	2,007,075	2,057,034
Re-Remics					686,865	6,535	(3,172)	690,228	686,865	690,228
Private label residential mortgage-backed securities and CMOs	161,794	51,207	(269)	212,732	229,863	2,050	(228)	231,685	391,657	444,417
Private label commercial mortgage-backed securities					281,157	9,810	(357)	290,610	281,157	290,610
Non-mortgage asset-backed securities					446,098	2,825	(1,998)	446,925	446,098	446,925
Mutual funds and preferred stocks	16,382	479	(554)	16,307	247,722	8,362	(9)	256,075	264,104	272,382
State and municipal obligations					23,501	280	(5)	23,776	23,501	23,776
Small Business Administration securities					354,074	3,299	(390)	356,983	354,074	356,983
Other debt securities	3,880	2,257		6,137	9,066	17	(53)	9,030	12,946	15,167
	$ 182,056	$ 53,943	$ (823)	$ 235,176	$ 4,349,947	$ 83,982	$ (7,160)	$ 4,426,769	$ 4,532,003	$ 4,661,945

Table of Contents

	December 31, 2011									
	Covered Securities				Non-Covered Securities				Total	
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value	Amortized Cost	Fair Value
U.S. Government agency and sponsored enterprise mortgage-backed securities	$	$	$	$	$ 1,952,095	$ 34,823	$ (1,205)	$ 1,985,713	$ 1,952,095	$ 1,985,713
Resecuritized real estate mortgage investment conduits (Re-Remics)					544,924	4,972	(3,586)	546,310	544,924	546,310
Private label residential mortgage-backed securities and CMOs	165,385	44,746	(310)	209,821	177,614	1,235	(983)	177,866	342,999	387,687
Private label commercial mortgage-backed securities					255,868	6,694		262,562	255,868	262,562
Non-mortgage asset-backed securities					414,274	2,246	(5,635)	410,885	414,274	410,885
Mutual funds and preferred stocks	16,382	491	(556)	16,317	235,705	3,071	(1,276)	237,500	252,087	253,817
State and municipal obligations					24,994	278	(2)	25,270	24,994	25,270
Small Business Administration securities					301,109	2,664	(96)	303,677	301,109	303,677
Other debt securities	3,868	2,188		6,056					3,868	6,056
	$ 185,635	$ 47,425	$ (866)	$ 232,194	$ 3,906,583	$ 55,983	$ (12,783)	$ 3,949,783	$ 4,092,218	$ 4,181,977

Investment securities available for sale grew by $480.0 million to $4.7 billion at March 31, 2012 from $4.2 billion at December 31, 2011. Growth of the investment portfolio reflects the acquisition of Herald as well as continued deployment of cash generated from loan resolution activity and claims paid by the FDIC. Our investment strategy has focused on providing liquidity necessary for day-to-day operations, adding a suitable balance of high credit quality, diversifying assets to the consolidated balance sheet, managing interest rate risk, and generating acceptable returns given our established risk parameters. We have sought to maintain liquidity and manage interest rate risk by investing a significant portion of the portfolio in high quality liquid securities consisting primarily of U.S. Government agency floating rate mortgage-backed securities. We have also invested in highly rated structured products including private label residential and commercial mortgage-backed securities and Re-Remics, bank preferred stocks, U.S. Small Business Administration securities and non-mortgage asset-backed securities collateralized primarily by auto loans, credit card receivables, student loans, servicer advances and small balance commercial loans that, while somewhat less liquid, provide us with higher yields. Relatively short effective portfolio duration helps mitigate interest rate risk arising from the currently low level of market interest rates. The weighted average expected life of the investment portfolio as of March 31, 2012 was 4.7 years and the effective duration was 1.7 years.

Covered securities include private label residential mortgage-backed securities, mortgage-backed security mutual funds, trust preferred collateralized debt obligations, U.S. government sponsored enterprise preferred stocks and corporate debt securities covered under the commercial shared loss agreement. To date, the Company has not submitted any claims for reimbursement related to the covered securities. As the investment portfolio has grown, covered securities have represented a declining percentage of the total portfolio. Covered securities represented 5.0% and 5.6% of the fair value of the investment portfolio at March 31, 2012 and December 31, 2011, respectively. We expect this percentage to continue to decline.

The following table shows the scheduled maturities, carrying values and current yields for our investment portfolio as of March 31, 2012. Scheduled maturities have been adjusted for anticipated prepayments of mortgage-backed and other pass through securities. Yields on tax-exempt securities have been calculated on a pre-tax basis (dollars in thousands):

48

Table of Contents

	Within One Year		After One Year Through Five Years		After Five Years Through Ten Years		After Ten Years		Total	
	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield	Carrying Value	Weighted Average Yield
U.S. Treasury and Government agency securities	$ 24,482	1.53%	$ 39,941	0.43%	$	0.00%	$	0.00%	$ 64,423	0.85%
U.S. Government agency and sponsored enterprise mortgage-backed securities	278,158	2.06%	823,270	2.29%	645,172	2.60%	310,434	2.33%	2,057,034	2.36%
Re-Remics	73,167	3.81%	256,503	3.28%	228,295	2.93%	132,263	2.94%	690,228	3.16%
Private label residential mortgage-backed securities and CMOs	100,452	5.80%	217,467	6.06%	83,939	7.40%	42,559	8.50%	444,417	6.49%
Private label commercial mortgage-backed securities	26,834	2.63%	137,548	2.72%	126,228	3.98%		0.00%	290,610	3.26%
Non mortgage asset-backed securities	124,900	2.46%	222,984	2.73%	88,728	3.00%	10,313	4.28%	446,925	2.74%
State and municipal obligations	5,923	1.80%	16,303	2.06%	1,348	2.61%	202	0.12%	23,776	2.01%
Small Business Administration securities	78,536	1.64%	175,380	1.64%	75,713	1.62%	27,354	1.56%	356,983	1.63%
Other debt securities		0.00%	5,440	3.84%	3,626	8.05%	6,101	8.67%	15,167	6.47%
Total investment portfolio	$ 712,452	2.75%	$ 1,894,836	2.81%	$ 1,253,049	3.07%	$ 529,226	2.98%	$ 4,389,563	2.89%
Mutual funds and preferred stocks with no scheduled maturity									272,382	5.81%
Total investment securities available for sale									$ 4,661,945	3.06%

As of March 31, 2012, 87.3% of the non-covered securities were backed by the U.S. government, U.S. government agencies or sponsored enterprises or were rated AAA. The remaining non-covered securities were investment grade. The investment portfolio was in a net unrealized gain position of $129.9 million at March 31, 2012 with aggregate fair value equal to 103% of amortized cost. Net unrealized gains included $137.9 million of gross unrealized gains and $8.0 million of gross unrealized losses. Securities in unrealized loss positions for 12 months or more had an aggregate fair value of $40.4 million, representing less than 1% of the fair value of the portfolio, with total unrealized losses of $0.8 million at March 31, 2012.

We evaluate the credit quality of individual securities in the portfolio quarterly to determine whether any of the investments in unrealized loss positions are other-than-temporarily impaired. This evaluation considers, but is not necessarily limited to, the following factors, the relative significance of which varies depending on the circumstances pertinent to each individual security:

- our intent to hold the security until maturity or for a period of time sufficient for a recovery in value;

- whether it is more likely than not that we will be required to sell the security before recovery of its amortized cost basis;
- the length of time and extent to which fair value has been less than amortized cost;
- adverse changes in expected cash flows;
- available information about the value and performance of underlying collateral;
- the payment structure of the security, including levels of subordination or over-collateralization;
- the general market condition of the geographic area or industry of the issuer;
- the issuer s financial condition, performance and business prospects; and
- credit ratings of issuers and individual securities.

No securities were determined to be other-than-temporarily impaired during the three months ended March 31, 2012 or 2011.

The majority of the unrealized losses in the portfolio at March 31, 2012 were driven by widening spreads on certain private label Re-Remics and non-mortgage asset-backed securities. We believe these factors to be consistent with temporary impairment.

We do not intend to sell securities in significant unrealized loss positions. Based on an assessment of our liquidity position and internal and regulatory guidelines for permissible investments and concentrations, it is not more likely than not that we will be required to sell securities in unrealized loss positions prior to recovery of amortized cost basis. The severity and duration of impairment of individual securities in the portfolio is generally not material. The timely repayment of principal and interest on U.S. Government, government agency and government sponsored enterprise securities in unrealized loss positions is explicitly or implicitly

Table of Contents

guaranteed by the full faith and credit of the U.S. Government. Management engaged a third party to perform projected cash flow analyses of the private label mortgage-backed securities, Re-Remics and non-mortgage asset-backed securities, incorporating CUSIP level collateral default rate, voluntary prepayment rate, severity and delinquency assumptions. Based on the results of this analysis, no credit losses were projected. Given the expectation of timely repayment of principal and interest and the limited duration and severity of impairment, we concluded that none of the debt securities were other-than-temporarily impaired. Given the limited severity of impairment, we considered the impairment of the equity securities to be temporary.

For further discussion of our analysis of investment securities for OTTI, see Note 4 to the consolidated financial statements.

We use third-party pricing services to assist us in estimating the fair value of investment securities. We perform a variety of procedures to ensure that we have a thorough understanding of the methodologies and assumptions used by the pricing services including obtaining and reviewing written documentation of the methods and assumptions employed, conducting interviews with valuation desk personnel, performing on-site walkthroughs and reviewing model results and detailed assumptions used to value selected securities as considered necessary. Our classification of prices within the fair value hierarchy is based on an evaluation of the nature of the significant assumptions impacting the valuation of each type of security in the portfolio. We have established a robust price challenge process that includes a review by our treasury front office of all prices provided on a monthly basis. Any price evidencing unexpected month over month fluctuations or deviations from our expectations based on recent observed trading activity and other information available in the marketplace that would impact the value of the security is challenged. Responses to the price challenges, which generally include specific information about inputs and assumptions incorporated in the valuation and their sources, are reviewed in detail. If considered necessary to resolve any discrepancies, a price will be obtained from an additional independent valuation specialist. We do not typically adjust the prices provided, other than through this established challenge process. Our primary pricing services utilize observable inputs when available, and employ unobservable inputs and propriety models only when observable inputs are not available. As a matter of course, the services validate prices by comparison to recent trading activity whenever such activity exists. Quotes obtained from the pricing services are typically non-binding.

We have also established a quarterly price validation process whereby we verify the prices provided by our primary pricing service for a sample of securities in the portfolio. Sample sizes vary based on the type of security being priced, with higher sample sizes applied to more difficult to value security types. Verification procedures may consist of obtaining prices from an additional outside source or internal modeling, generally based on Intex. We have established acceptable percentage deviations from the price provided by the initial pricing source. If deviations fall outside the established parameters, we will obtain and evaluate more detailed information about the assumptions and inputs used by each pricing source or, if considered necessary, employ an additional valuation specialist to price the security in question. When there are price discrepancies, the final determination of fair value is based on careful consideration of the assumptions and inputs employed by each of the pricing sources given our knowledge of the market for each individual security and may include interviews with the outside pricing sources utilized. Depending on the results of the validation process, sample sizes may be extended for particular classes of securities. Results of the validation process are reviewed by the treasury front office and by senior management.

The majority of our investment securities are classified within level 2 of the fair value hierarchy. Certain preferred stocks and U.S. Treasury securities are classified within level 1 of the hierarchy. At March 31, 2012 and December 31, 2011, 11.3% of our investment securities were classified within level 3 of the fair value hierarchy. Securities classified within level 3 of the hierarchy included primarily private label residential mortgage-backed securities and certain non-mortgage asset-backed securities. The non-mortgage asset-backed securities consisted of securities backed by small balance commercial loans. These securities were classified within level 3 of the hierarchy because proprietary assumptions related to voluntary prepayment rates, default probabilities and loss severities were considered significant to the valuation.

For additional discussion of the fair values of investment securities, see Note 11 to the consolidated financial statements.

Table of Contents

Loans

The loan portfolio comprises the Company s primary interest-earning assetThe following tables show the composition of the loan portfolio and the breakdown of the portfolio between covered ACI loans, covered non-ACI loans, non-covered ACI loans and new loans at March 31, 2012 and December 31, 2011(dollars in thousands):

	March 31, 2012					
	Covered Loans		Non-Covered Loans			Percent of
	ACI	Non-ACI	ACI	New Loans	Total	Total
Residential:						
1-4 single family residential	$ 1,611,942	$ 110,925	$	$ 588,251	$ 2,311,118	48.9%
Home equity loans and lines of credit	66,972	177,167		1,722	245,861	5.2%
	1,678,914	288,092		589,973	2,556,979	54.1%
Commercial:						
Multi-family	62,353	773		167,457	230,583	4.9%
Commercial real estate	208,023	32,602	4,196	508,118	752,939	15.9%
Construction	4,546			25,259	29,805	0.6%
Land	25,894	161		23,335	49,390	1.0%
Commercial loans and leases	21,111	17,757		1,061,124	1,099,992	23.2%
	321,927	51,293	4,196	1,785,293	2,162,709	45.6%
Consumer	2,726			10,942	13,668	0.3%
Total loans	2,003,567	339,385	4,196	2,386,208	4,733,356	100.0%
Premiums, discounts and deferred costs and fees, net		(29,059)		4,986	(24,073)	
Loans net of discounts, premiums, deferred costs and fees	2,003,567	310,326	4,196	2,391,194	4,709,283	
Allowance for loan and lease losses	(14,591)	(10,915)		(30,968)	(56,474)	
Loans, net	$ 1,988,976	$ 299,411	$ 4,196	$ 2,360,226	$ 4,652,809	

	December 31, 2011					
	Covered Loans		Non-Covered Loans			Percent of
	ACI	Non-ACI	ACI	New Loans	Total	Total
Residential:						
1-4 single family residential	$ 1,681,866	$ 117,992	$	$ 461,431	$ 2,261,289	54.1%
Home equity loans and lines of credit	71,565	182,745		2,037	256,347	6.1%
	1,753,431	300,737		463,468	2,517,636	60.2%
Commercial:						
Multi-family	61,710	791		108,178	170,679	4.1%
Commercial real estate	219,136	32,678	4,220	311,434	567,468	13.6%
Construction	4,102			23,252	27,354	0.7%
Land	33,018	163		7,469	40,650	1.0%
Commercial loans and leases	24,007	20,382		799,978	844,367	20.2%
	341,973	54,014	4,220	1,250,311	1,650,518	39.6%
Consumer	2,937			3,372	6,309	0.2%
Total loans	2,098,341	354,751	4,220	1,717,151	4,174,463	100.0%
Premiums, discounts and deferred costs and fees, net		(30,281)		(7,124)	(37,405)	

Loans net of discounts, premiums, deferred costs and fees		2,098,341		324,470		4,220		1,710,027		4,137,058
Allowance for loan and lease losses		(16,332)		(7,742)				(24,328)		(48,402)
Loans, net	$	2,082,009	$	316,728	$	4,220	$	1,685,699	$	4,088,656

Total loans, before discounts, premiums and deferred origination fees and costs, increased by $558.9 million to $4.7 billion at March 31, 2012, from $4.2 billion at December 31, 2011. Loans acquired in the FSB Acquisition declined by $110.2 million from December 31, 2011 to March 31, 2012 while new loans grew by $669.1 million. New residential loans grew by $126.5 million and new commercial loans grew by $535.0 million during the three months ended March 31, 2012. Residential loan growth was attributable primarily to purchases of residential mortgages. Commercial loans at March 31, 2012 included $313.2 million of loans acquired from Herald.

Table of Contents

At March 31, 2012 and December 31, 2011, respectively, 49% and 59% of loans, net of discounts, premiums and deferred origination fees and costs, were covered loans. Covered loans are declining and new loans increasing as a percentage of the total portfolio as covered loans are repaid or resolved and new loan originations and purchases increase. This trend is expected to continue.

Residential Mortgages

Residential mortgages, including 1-4 single family residential mortgages and home equity loans and lines of credit, have historically represented the majority of the total loan portfolio, although, consistent with our strategy of emphasizing commercial loan production, this portfolio segment is declining as a percentage of total loans. Residential mortgages constituted 24.7% of total new loans and 83.8% of total loans acquired in the FSB Acquisition at March 31, 2012. Residential mortgages totaled $2.6 billion, or 54.1% of total loans and $2.5 billion, or 60.2% of total loans at March 31, 2012 and December 31, 2011, respectively. The decline in this portfolio segment as a percentage of loans is a result of the resolution of covered loans, including transfers to OREO, and an emphasis on commercial loan origination. The dollar amount of residential loans in the portfolio increased from December 31, 2011 to March 31, 2012 due largely to purchases of single family residential loans during the first quarter of 2012.

The new residential loan portfolio includes both loans originated and purchased since the FSB Acquisition. We currently originate 1-4 single family residential mortgage loans with terms ranging from 10 to 40 years, with either fixed or adjustable interest rates, primarily to customers in the state of Florida. New residential mortgage loans are primarily closed-end first lien loans for the purchase or re-finance of owner occupied property. At March 31, 2012 and December 31, 2011, $69.4 million or 11.8% and $58.2 million or 12.6%, respectively, of our new 1-4 single family residential loans were originated loans; $518.9 million or 88.2% and $403.2 million or 87.4% of our new 1-4 single family residential loans were purchased loans. We have purchased loans to supplement our mortgage origination platform and to geographically diversify our loan portfolio given the current credit environment and limited demand for non-agency mortgage product in Florida. The number of newly originated residential mortgage loans that are re-financings of covered loans is not significant.

Home equity loans and lines of credit are not significant to the new loan portfolio.

We do not originate option adjustable rate mortgages (ARMs) no-doc or reduced-doc mortgages and do not utilize wholesale mortgage origination channels although the covered loan portfolio contains loans with these characteristics. All of these loans are covered loans; therefore, the Company s exposure to future losses on these mortgage loans is mitigated by the Loss Sharing Agreements.

Commercial loans

The commercial portfolio segment includes loans secured by multi-family properties, loans secured by both owner-occupied and non-owner occupied commercial real estate, construction, land, commercial and industrial loans and leases.

Commercial real estate loans include term loans secured by owner and non-owner occupied income producing properties including rental apartments, industrial properties, retail shopping centers, office buildings, warehouses and hotels as well as real estate secured lines of credit.

Loans secured by commercial real estate typically have shorter repayment periods and re-price more frequently than 1-4 single family residential loans. The Company s underwriting standards generally provide for loan terms of five years, with amortization schedules of no more than twenty-five years. Loan to value (LTV) ratios are typically limited to no more than 80%. In addition, the Company usually obtains personal guarantees of the principals as additional security for commercial real estate loans.

Commercial loans are typically made to growing companies and middle market businesses and include equipment loans, working capital lines of credit, asset-backed loans, acquisition finance credit facilities, lease financing and Small Business Administration product offerings. These loans may be structured as term loans, typically with maturities of five years or less, or revolving lines of credit which typically mature annually. Lease financing consists primarily of municipal leases.

Management s loan origination strategy is heavily focused on the commercial portfolio segment, which comprised 74.8% and 72.8% of new loans as of March 31, 2012 and December 31, 2011, respectively. New commercial loans that represent re-financings of covered loans are not significant.

Consumer Loans

Consumer loans include loans secured by certificates of deposit, auto loans, demand deposit account overdrafts and unsecured personal lines of credit and are not a material component of the loan portfolio.

Table of Contents

Asset Quality

In discussing asset quality, a distinction must be made between covered loans and new loans. New loans were underwritten under significantly different and generally more conservative standards than the covered loans. In particular, credit approval policies have been strengthened, wholesale mortgage origination channels have been eliminated, no-doc and option ARM loan products have been eliminated, and real estate appraisal policies have been improved. Although the risk profile of covered loans is higher than that of new loans, our exposure to loss related to the covered loans is significantly mitigated by the Loss Sharing Agreements and by the fair value basis recorded in these loans resulting from the application of acquisition accounting.

We have established a robust credit risk management framework and put in place an experienced team to lead the workout and recovery process for the commercial and commercial real estate portfolios. We have also implemented a dedicated internal loan review function that reports directly to our Audit Committee. We have an experienced resolution team in place for covered residential mortgage loans, and have implemented outsourcing arrangements with industry leading firms in certain areas such as OREO resolution.

Loan performance is monitored by our credit administration, workout and recovery and loan review departments. Commercial loans are regularly reviewed by our internal loan review department. Relationships with committed balances greater than $250,000 are reviewed at least annually. The Company utilizes an internal asset risk classification system as part of its efforts to monitor and improve commercial asset quality. Loans exhibiting potential credit weaknesses that deserve management s close attention and that if left uncorrected may result in deterioration of the repayment capacity of the borrower are categorized as special mention. These borrowers may exhibit negative financial trends or erratic financial performance, strained liquidity, marginal collateral coverage, declining industry trends or weak management. Loans with well defined credit weaknesses that may result in a loss if the deficiencies are not corrected are assigned a risk rating of substandard. These borrowers may exhibit payment defaults, insufficient cash flows, operating losses, negative financial trends, or declining collateral values. Loans with weaknesses so severe that collection in full is highly questionable or improbable, but because of certain reasonably specific pending factors have not been charged off, are assigned risk ratings of doubtful.

Residential mortgage loans and consumer loans are not individually risk rated. Delinquency status is the primary measure we use to monitor the credit quality of these loans.

New Loans

At March 31, 2012, thirty-seven new commercial loans with an aggregate balance of $17.7 million were rated special mention and fifty-six new commercial loans totaling $23.6 million were classified substandard or doubtful. At December 31, 2011, forty-seven new commercial loans aggregating $7.7 million were rated special mention and forty-three new commercial loans aggregating $13.7 million were classified substandard or doubtful.

At March 31, 2012, new 1-4 single family residential loans totaling $142 thousand were 90 days or more past due. New 1-4 single family residential loans past due less than 90 days totaled $1.6 million at March 31, 2012. At December 31, 2011, no new 1-4 single family residential loans were 90 days or more past due. New 1-4 single family residential loans past due less than 90 days totaled $15.9 million at December 31, 2011. There were no past due home equity loans and lines of credit in the new portfolio at March 31, 2012. Past due home equity loans and lines

of credit in the new loan portfolio at December 31, 2011were not significant. At March 31, 2012, 13.4% of the new home equity portfolio were first liens, and 86.6% were second or third liens.

The majority of our new residential mortgage portfolio consists of purchased loans. The credit parameters for purchasing loans are similar to the underwriting guidelines in place for our mortgage origination platform. For purchasing seasoned loans, good payment history is required. In general, we purchase performing jumbo mortgage pools which have average FICO scores above 700, primarily are owner-occupied and full documentation, and have a current LTV of less than 80%. We perform due diligence on the purchased loans for credit, compliance, counterparty, payment history and property valuation.

At March 31, 2012, the purchased loan portfolio had the following characteristics: 57.5% were fixed rate loans, substantially all were full documentation and had an average FICO score of 766 and average LTV of 66.3%. The majority of this portfolio was owner-occupied, with 94.3% primary residence and 5.7% second homes or investment properties. In terms of vintage, 4.3% of the portfolio was originated pre-2008, 4.2% in 2008, 1.3% in 2009, 4.0% in 2010, 71.0% in 2011 and 15.2% in 2012.

Similarly, the originated loan portfolio had the following characteristics at March 31, 2012: 68.8% were fixed rate loans, 100% were full documentation and had an average FICO score of 766 and average LTV of 62.4%. The majority of this portfolio was owner-occupied, with 96.0% primary residence and 4.0% second home. In terms of vintage, 32.1% of the portfolio was originated in 2010, 42.3% in 2011 and 25.6% in 2012.

Table of Contents

Delinquent consumer loans in the new portfolio were insignificant as of March 31, 2012 and December 31, 2011.

Covered Loans

Covered loans consist of both ACI loans and non-ACI loans. At March 31, 2012, covered ACI loans totaled $2.0 billion and covered non-ACI loans totaled $310.3 million, net of discounts, premiums and deferred fees and costs.

Residential

Covered residential loans were placed into homogenous pools at the time of the FSB Acquisition and the ongoing credit quality and performance of these loans is monitored on a pool basis. The fair value of the pools was initially measured based on the expected cash flows to be derived from each pool. Initial cash flow expectations incorporated significant assumptions regarding prepayment rates, frequency of default and loss severity. For ACI pools, the difference between total contractual payments due and the cash flows expected to be received at acquisition was recognized as non-accretable difference. The excess of expected cash flows over the recorded fair value of each ACI pool at acquisition, known as the accretable yield, is being recognized as interest income over the life of each pool. We monitor the pools quarterly to determine whether any significant changes have occurred in expected cash flows that would be indicative of impairment or necessitate reclassification between non-accretable difference and accretable yield. Generally, improvements in expected cash flows less than 1% of the expected cash flows from a pool are not recorded. This materiality threshold may be revised as we gain greater experience. Generally, commercial and commercial real estate loans are monitored individually due to their size and other unique characteristics.

Residential mortgage loans, including home equity loans, comprised 87.8% of the UPB of the acquired loan portfolio at the FSB Acquisition date. We performed a detailed analysis of the portfolio to determine the key loan characteristics influencing performance. Key characteristics influencing the performance of the residential mortgage portfolio, including home equity loans, were determined to be delinquency status; product type, in particular, amortizing as opposed to option ARM products; current indexed LTV ratio; and original FICO score. The ACI loans in the residential mortgage portfolio were grouped into ten homogenous static pools based on these characteristics, and the non-ACI residential loans were grouped into two homogenous static pools.

At March 31, 2012 the carrying value of 1-4 single family residential non-ACI loans was $86.5 million; $9.1 million or 10.5% of these loans were 30 days or more past due and $6.8 million or 7.9% were 90 days or more past due. At March 31, 2012, ACI 1-4 single family residential loans totaled $1.6 billion; $374.6 million or 23.2% of these loans were delinquent by 30 days or more and $294.3 million or 18.3% were delinquent by 90 days or more.

At March 31, 2012 non-ACI home equity loans and lines of credit had an aggregate carrying value of $173.6 million; $13.7 million or 7.9% of these loans were 30 days or more past due and $10.1 million or 5.8% were 90 days or more past due. ACI home equity loans and lines of credit had a carrying amount of $67.0 million at March 31, 2012. At March 31, 2012, $13.7 million or 20.4% of ACI home equity loans and lines of credit were 30 days or more contractually delinquent and $11.0 million or 16.4% were delinquent by 90 days or more. At March 31, 2012, 4.6% and 6.0%, respectively, of the non-ACI and ACI home equity loans and lines of credit were first liens while 95.4% and 94.0%, respectively, of the non-ACI and ACI home equity loans and lines of credit were second or third liens. Expected loss severity given default is significantly higher for home equity loans that are not first liens.

Although delinquencies in the covered residential portfolio are high, potential future losses to the Company related to these loans are significantly mitigated by the Loss Sharing Agreements.

Commercial

The ongoing asset quality of significant commercial loans is monitored on an individual basis through our regular credit review and risk rating process. We believe internal risk rating is the best indicator of the credit quality of commercial loans. Homogenous groups of smaller balance commercial loans may be monitored collectively.

At March 31, 2012 non-ACI commercial loans had an aggregate UPB of $51.3 million and a carrying value, net of discounts of $50.2 million; 85.3% of these loans were rated pass and this portfolio segment has limited delinquency history. At March 31, 2012, seven loans with a carrying value totaling $0.8 million were rated special mention, twenty-eight loans with a carrying value totaling $6.1 million were rated substandard and thirteen loans with a carrying value of $0.5 million were rated doubtful.

At March 31, 2012, ACI commercial loans had a carrying value of $326.1 million, of which $321.9 million are covered under the Loss Sharing Agreements. At March 31, 2012, loans with carrying values of $13.0 million, $129.2 million and $0.9 million were internally risk rated special mention, substandard and doubtful, respectively.

Table of Contents

Potential future losses to the Company related to the covered loans are significantly mitigated by the Loss Sharing Agreements.

Impaired Loans and Non-Performing Assets

Non-performing assets consist of (i) non-accrual loans, including loans that have been restructured in TDRs and placed on nonaccrual status or that have not yet exhibited a consistent six month payment history since modification, (ii) accruing loans that are more than 90 days contractually past due as to interest or principal, excluding ACI loans, and (iii) OREO. Impaired loans also include loans modified in TDRs that are performing according to their modified terms and ACI loans for which expected cash flows have been revised downward since acquisition. Because of discount accretion, these ACI loans have not been classified as nonaccrual loans and we do not consider them to be non-performing assets. As of March 31, 2012 and December 31, 2011, substantially all of the non-performing loans and all of the OREO were covered assets. The Company s exposure to loss related to covered assets is significantly mitigated by the Loss Sharing Agreements and by the fair value basis recorded in these assets resulting from the application of acquisition accounting.

The following table summarizes the Company s impaired loans and other non-performing assets at March 31, 2012 and December 31, 2011 (in thousands):

		March 31, 2012		December 31, 2011
Nonaccrual loans:				
Residential:				
1-4 single family residential	$	7,061	$	7,410
Home equity loans and lines of credit		11,845		10,478
Total residential loans		18,906		17,888
Commercial:				
Multi-family				
Commercial real estate		255		295
Construction		3		3
Land		340		332
Commercial loans and leases		11,917		9,164
Total commercial loans		12,515		9,794
Total nonaccrual loans		31,421		27,682
Non-ACI and new loans past due 90 days and still accruing		276		375
TDRs		749		824
Total non-performing loans		32,446		28,881
Other real estate owned		106,950		123,737
Total non-performing assets		139,396		152,618
Impaired ACI loans on accrual status		103,063		94,536
TDRs in compliance with their modified terms		4,322		583
Total impaired loans and non-performing assets	$	246,781	$	247,737
Non-performing loans to total loans (1)		0.69%		0.70%
Non-performing assets to total assets		1.14%		1.35%
ALLL to total loans (1)		1.20%		1.17%
ALLL to non-performing loans		174.06%		167.59%
Net charge-offs to average loans		0.07%		0.62%

(1) Total loans for purposes of calculating these ratios is net of unearned discounts and deferred fees and costs.

At March 31, 2012 and December 31, 2011 substantially all of the nonaccrual loans are non-ACI loans. Contractually delinquent ACI loans are not reflected as nonaccrual loans because discount continues to be accreted. Discount accretion continues to be recorded as there continues to be an expectation of future cash flows in excess of carrying amount from these loans. The carrying

Table of Contents

value of ACI loans contractually delinquent by more than 90 days but still accruing was $336.0 million and $361.2 million at March 31, 2012 and December 31, 2011, respectively.

The decline in the ratio of non-performing assets to total assets at March 31, 2012 as compared to December 31, 2011 was primarily attributable to the decrease in OREO.

Except for ACI loans, commercial loans are placed on nonaccrual status when (i) management has determined that full payment of all contractual principal and interest is in doubt, or (ii) the loan is past due 90 days or more as to principal and/or interest, unless the loan is well-secured and in the process of collection. Residential loans are placed on nonaccrual status when there is 90 days of interest due and uncollected. Residential loans are returned to accrual status when less than 90 days of interest is due and unpaid. Commercial loans are returned to accruing status only after all past due principal and interest has been collected. Except for ACI loans accounted for in pools, loans that are the subject of troubled debt restructurings are generally placed on nonaccrual status at the time of the modification unless the borrower has no history of missed payments for six months prior to the restructuring. If borrowers perform pursuant to the modified loan terms for at least six months and the remaining loan balances are considered collectable, the loans are returned to accrual status.

A loan modification is considered a TDR if the Company, for economic or legal reasons related to the borrower s financial difficulties, grants a concession to the borrower that the Company would not otherwise grant. These concessions may take the form of temporarily or permanently reduced interest rates, payment abatement periods, extensions of maturity, or in some cases, partial forgiveness of principal. Under generally accepted accounting principles, modified ACI loans accounted for in pools are not accounted for as troubled debt restructurings and are not separated from their respective pools when modified. As of March 31, 2012 impaired loans included five non-ACI commercial relationships with a total carrying value of $0.3 million and two new commercial relationships with a carrying value of $3.9 million that had been modified in TDRs. Additionally, at March 31, 2012 impaired loans included eleven non-ACI residential loans with a total carrying value of $1.5 million that were the subject of the U.S. Treasury Department s Home Affordable Modification Program (HAMP) modifications and classified as TDRs.

At March 31, 2012, impaired loans included four ACI commercial relationships with an aggregate carrying value of $1.4 million that had been modified in TDRs.

During the three months ended March 31, 2012, two new commercial loans with a total carrying value of $3.9 million were modified in TDRs. No non-ACI or ACI loans were modified in TDRs during the three months ended March 31, 2012.

Additional interest income that would have been recognized on nonaccrual loans and TDRs had they performed in accordance with their original contractual terms is not material.

Loss Mitigation Strategies

Although our exposure to loss on covered assets is mitigated by the Loss Sharing Agreements, we have implemented strategies designed to minimize losses on these assets. We evaluate each loan in default to determine the most effective loss mitigation strategy, which may be

modification, short sale, or foreclosure. We offer loan modifications under HAMP to eligible borrowers in the residential portfolio. HAMP is a uniform loan modification process that provides eligible borrowers with sustainable monthly mortgage payments equal to a target 31% of their gross monthly income. As of March 31, 2012, 11,539 borrowers had been counseled regarding their participation in HAMP; 8,178 of those borrowers were initially determined to be potentially eligible for loan modifications under the program. As of March 31, 2012, 1,387 borrowers who did not elect to participate in the program had been sent termination letters and 2,687 borrowers had been denied due to ineligibility. At March 31, 2012, there were 3,233 permanent loan modifications. Substantially all of these modified loans were of ACI loans accounted for in pools.

Analysis of the Allowance for Loan and Lease Losses

The ALLL relates to (i) new loans, (ii) estimated additional losses arising on non-ACI loans subsequent to the FSB Acquisition, and (iii) additional impairment recognized as a result of decreases in expected cash flows on ACI loans due to further credit deterioration. The impact of any additional provision for losses on covered loans is significantly mitigated by an increase in the FDIC indemnification asset. The determination of the amount of the ALLL is, by nature, highly complex and subjective. Future events that are inherently uncertain could result in material changes to the level of the ALLL. General economic conditions such as unemployment rates, real estate values in our primary market areas and the level of interest rates, as well as a variety of other factors that affect the ability of borrowers businesses to generate cash flows sufficient to service their debts will impact the future performance of the portfolio.

Table of Contents

New and non-ACI Loans

Based on an analysis of historical performance of the non-ACI residential mortgage and home equity portfolio, OREO and short sale losses and recent trending data, we have concluded that LTV ratio is the leading predictive indicator of loss severity for this portfolio. The non-ACI residential mortgage and home equity portfolios have therefore been divided into homogenous groups and stratified based on LTV for purposes of calculating the ALLL. Calculated frequency of roll to loss and severity percentages are applied to the dollar value of loans in each group to calculate an overall loss allowance. LTV ratios at the individual loan level are updated quarterly using the appropriate Case-Shiller quarterly metropolitan statistical area (MSA) Home Price Index to adjust the original appraised value of the underlying collateral. Frequency is calculated for each group using a four month roll to loss percentage, based on the assumption that if an event has occurred with a borrower that will ultimately result in a loss, this will manifest itself as a loan in default and in process of foreclosure within four months. Loss severity given default is estimated based on internal data about OREO sales and short sales from the portfolio. The ALLL calculation incorporates a 100% loss severity assumption for home equity loans at 120 days delinquency.

Due to the lack of similarity between the risk characteristics of new loans and covered loans in the residential and home equity portfolios, management does not believe it is appropriate to use the historical performance of the covered residential mortgage portfolio as a basis for calculating the ALLL applicable to new loans. The new loan portfolio is not seasoned and has not yet developed an observable loss trend. Therefore, the ALLL for new residential loans is based primarily on peer group average historical loss rates as discussed further below.

Since the new commercial loan portfolio is not yet seasoned enough to exhibit a loss trend and the non-ACI commercial portfolio has limited delinquency history, the ALLL for new and non-ACI commercial loans is based primarily on the Company s internal credit risk rating system and peer group average historical loss rates by loan class. The allowance is comprised of specific reserves for significant classified loans that are individually evaluated and determined to be impaired as well as general reserves for individually evaluated loans determined not to be impaired and loans that do not meet our established threshold for individual evaluation. Commercial relationships graded substandard or doubtful and on nonaccrual status with committed credit facilities greater than or equal to $500,000 are individually evaluated for impairment. A quarterly net realizable value analysis is prepared for each of these relationships. This analysis forms the basis for establishing specific reserves. Loans modified in TDRs are also evaluated individually for impairment. We believe that loans rated substandard or doubtful that are not individually evaluated for impairment exhibit characteristics indicative of a heightened level of credit risk. We group these loans by product type and performance status and establish general reserve percentages based on our analysis of the risks characterizing each group. Factors that impact our judgment as to the appropriate loss percentage to assign may include the underwriting criteria applied to a particular product type, whether the loans are secured or unsecured, the type of collateral, and delinquency status.

The peer group used to calculate the average historical loss rates that form the basis for our general reserve calculations is a group of 20 banks in the U.S. southeast region determined by management to be the most comparable to BankUnited. Factors that impacted the selection of the peer group included asset size, composition of the loan portfolio and credit quality ratios including net charge-offs to average loans, ALLL to total loans, ALLL to noncurrent loans and noncurrent loans to total loans. Peer bank data is obtained from the Statistics on Depository Institutions Report published by the FDIC for the most recent quarter available. For new loans, a six quarter average of peer group historical loss rates is used as this period corresponds to the vintage of the majority of loans in this portfolio segment. For the non-ACI portfolio, a twelve quarter average of peer group historical loss rates is used as this period is considered more representative of expected loss experience for the more seasoned loans in this segment.

Our internal risk rating system comprises 13 credit grades; grades 1 through 8 are pass grades. The risk ratings are driven largely by debt service coverage. Peer group average historical loss rates are adjusted upward for loans rated special mention or assigned a lower pass rating. Peer group average historical loss rates are adjusted downward for loans assigned the highest pass grades.

In addition to the quantitative calculations described above, adjustments are made to the allowance for relevant qualitative factors when there is a material observable trend in those factors not already taken into account in the quantitative calculations. Qualitative factors that may result in an adjustment to the allowance have been grouped into four categories:

- portfolio trends,
- policy and credit guidelines,
- economic factors, and
- credit concentrations.

Table of Contents

At March 31, 2012, qualitative adjustments were made to historical loss percentages related to the current economic climate, portfolio trends and for certain classes of small business commercial loans, policy and credit guidelines. Adjustments related to the current economic climate were driven by uncertainty about general economic conditions including unemployment rates and real estate prices. The adjustments related to portfolio trends resulted from the rapid growth rate of the new loan portfolio. Adjustments related to policy and credit guidelines impacted certain small business commercial loan products and related to the underwriting criteria applied to those particular products. Qualitative adjustments did not have a material impact on the ALLL as of March 31, 2012.

For non-ACI loans, the allowance is initially calculated based on UPB. The total of UPB, less the calculated allowance, is then compared to the carrying amount of the loans, net of unamortized credit related fair value adjustments established at acquisition. If the calculated balance net of the allowance is less than the carrying amount, an additional allowance is established. Any such increase in the allowance for non-ACI loans will result in a corresponding increase in the FDIC indemnification asset.

As of March 31, 2012, the Herald loan portfolio has not had a significant impact on our analysis of the ALLL. The Herald portfolio was acquired on February 29, 2012 and recorded at estimated fair value at that date.

ACI Loans

For ACI loans, a valuation allowance is established when periodic evaluations of expected cash flows reflect a decrease resulting from credit related factors from the level of cash flows that were estimated to be collected at acquisition plus any additional expected cash flows arising from revisions in those estimates. We perform a quarterly analysis of expected cash flows for ACI loans.

The analysis of expected cash flows for residential ACI pools incorporates updated pool level expected prepayment rates, default rates, and delinquency levels, and loan level loss severity given default assumptions. Prepayment, delinquency and default curves used for this purpose are derived from roll rates generated from the historical performance of the ACI residential loan portfolio observed over the immediately preceding four quarters. Given the static nature of the pools and unique characteristics of the loans, we believe that regularly updated historical information from the Company s own portfolio is the best available indicator of future performance. Estimates of default probability and severity of loss given default also incorporate updated LTV ratios. Historic and projected values for the Case-Shiller Home Price Index for the relevant MSA are utilized at the individual loan level to project current and future property values. Costs and fees represent an additional component of loss on default, and are projected using the Making Home Affordable cost factors provided by the Federal government.

Based on our projected cash flows, no ALLL related to home equity and 1-4 single family residential ACI pools was recorded at March 31, 2012 or December 31, 2011.

The primary assumptions underlying estimates of expected cash flows for ACI commercial loans are default probability and severity of loss given default. Updated assumptions for large balance and delinquent loans in the commercial ACI portfolio are based on net realizable value analyses prepared at the individual loan level by the Company s workout and recovery department. Updated assumptions for smaller balance commercial loans are based on a combination of the Company s own historical delinquency and severity data and industry level data. Delinquency data is used as a proxy for defaults as the Company s experience has been that few of these loans return to performing status after being delinquent greater than 60 days. An additional multiplier is also applied in developing assumptions for loans rated special mention,

substandard, or doubtful based on the Company s historical loss experience with classified loans.

Based on our loan level analysis, we recorded a recovery of the provision for loan losses on ACI commercial loans of ($1.0) million for the three months ended March 31, 2012 and a provision for loan losses on ACI commercial loans of $11.7 million for the three months ended March 31, 2011.

The following table provides an analysis of the ALLL, provision for loan losses and net charge-offs for the period from December 31, 2011 through March 31, 2012 (in thousands):

Table of Contents

	Covered Loans			
	ACI Loans	Non-ACI Loans	New Loans	Total
Balance at December 31, 2011	$ 16,332	$ 7,742	$ 24,328	$ 48,402
Provision for loan losses:				
1-4 single family residential		1,232	1,244	2,476
Home equity loans and lines of credit		2,558	(2)	2,556
Multi-family	818	(9)	(71)	738
Commercial real estate	(1,970)	91	1,853	(26)
Construction	135		67	202
Land	110	(62)	130	178
Commercial loans and leases	(104)	(1,199)	3,955	2,652
Consumer			(9)	(9)
Total Provision	(1,011)	2,611	7,167	8,767
Charge-offs:				
1-4 single family residential		(26)		(26)
Home equity loans and lines of credit		(477)		(477)
Multi-family	(32)			(32)
Commercial real estate	(180)			(180)
Commercial loans and leases	(518)	(103)	(583)	(1,204)
Total Charge-offs	(730)	(606)	(583)	(1,919)
Recoveries:				
Home equity loans and lines of credit		2		2
Multi-family		9		9
Commercial real estate		5		5
Commercial loans and leases		1,152	55	1,207
Consumer			1	1
Total Recoveries		1,168	56	1,224
Balance at March 31, 2012	$ 14,591	$ 10,915	$ 30,968	$ 56,474

The following table shows the distribution of the ALLL, broken out between covered and new loans, as of March 31, 2012 and December 31, 2011 (dollars in thousands):

	March 31, 2012					December 31, 2011				
	Covered		New			Covered		New		
	ACI	Non-ACI	Loans	Total	% (1)	ACI	Non-ACI	Loans	Total	% (1)
Residential:										
1-4 single family residential	$	$ 1,799	$ 5,259	$ 7,058	48.9%	$	$ 593	$ 4,015	$ 4,608	54.1%
Home equity loans and lines of credit		7,632	16	7,648	5.2%		5,549	18	5,567	6.1%
Total		9,431	5,275	14,706	54.1%		6,142	4,033	10,175	60.2%
Commercial:										
Multi-family	1,849	5	858	2,712	4.9%	1,063	5	929	1,997	4.1%
Commercial real estate	8,522	380	6,382	15,284	15.9%	10,672	284	4,529	15,485	13.6%
Construction	1,126		333	1,459	0.6%	991		266	1,257	0.7%
Land	1,429		201	1,630	1.0%	1,319	62	71	1,452	1.0%
Commercial loans and leases	1,665	1,099	17,876	20,640	23.2%	2,287	1,249	14,449	17,985	20.2%
Total	14,591	1,484	25,650	41,725	45.6%	16,332	1,600	20,244	38,176	39.6%
Consumer			43	43	0.3%			51	51	0.2%

Total ALLL	$ 14,591	$ 10,915	$ 30,968	$ 56,474	100.0%	$ 16,332	$ 7,742	$ 24,328	$ 48,402	100.0%

(1) Represents percentage of loans receivable in each category to total loans receivable.

Table of Contents

Significant components of the change in the ALLL at March 31, 2012 as compared to December 31, 2011, include:

- Increases in the allowance for most loan classes in the new portfolio, including increases of $1.2 million for 1-4 single family residential loans, $1.9 million for new commercial real estate loans and $3.4 million for new commercial loans and leases, all primarily attributable to growth in the new loan portfolio;

- Increases of $1.2 million and $2.1 million in the allowance for non-ACI 1-4 single family residential and home equity loans, respectively, resulting from increases in loss rates for these loan classes; and

- A $2.2 million decrease in the allowance for ACI commercial real estate loans resulting from improvements in expected cash flows from this portfolio class.

Other Real Estate Owned

All of the OREO properties owned by the Company are covered assets. The following table presents the changes in OREO for the three months ended March 31, 2012 and 2011 (in thousands):

	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Balance, beginning of period	$ 123,737	$ 206,680
Transfers from loan portfolio	47,078	111,682
Decrease from resolution of covered loans	(2,896)	(6,592)
Sales	(57,422)	(119,689)
Impairment	(3,547)	(9,599)
Balance, end of period	$ 106,950	$ 182,482

Deposits

The following table presents information about our deposits for the three months ended March 31, 2012 and 2011 (dollars in thousands):

	Three Months Ended March 31,			
	2012		2011	
	Average Balance	Average Rate	Average Balance	Average Rate
Demand deposits:				
Non-interest bearing	$ 863,131		$ 525,622	
Interest bearing	474,898	0.65%	349,822	0.64%
Money market	2,534,543	0.71%	1,986,058	0.92%
Savings	1,126,401	0.69%	1,266,426	0.88%
Time	2,578,826	1.52%	2,893,837	1.76%

$	7,577,799	0.90%	$	7,021,765	1.17%

Total deposits increased by $720.8 million to $8.1 billion at March 31, 2012 from $7.4 billion at December 31, 2011. Deposits acquired from Herald accounted for a portion of this increase, totaling $420.2 million at March 31, 2012. The distribution of deposits reflected in the table above reflects the continued run-off of time deposits and increases in lower rate deposit products, consistent with management s business strategy.

The following table shows scheduled maturities of certificates of deposit with denominations equal to or greater than $100,000 as of March 31, 2012 (in thousands):

Table of Contents

Three months or less	$	69,875
Over three through six months		126,147
Over six through twelve months		539,065
Over twelve months		665,634
	$	1,400,721

Borrowed Funds

The following table sets forth information regarding our short-term borrowings, consisting of securities sold under agreements to repurchase and overnight FHLB advances as of and for the three months ended March 31, 2012 and 2011 (dollars in thousands):

	Three Months Ended March 31,			
		2012		2011
Maximum outstanding at any month-end	$	11,199	$	257
Balance outstanding at end of period	$	11,199	$	105
Average outstanding during the period	$	1,209	$	286
Average interest rate during the period		0.45%		0.28%
Average interest rate at end of period		0.36%		0.01%

The Company also utilizes FHLB advances to finance its operations. The contractual balance of FHLB advances outstanding at March 31, 2012 totaled $2.2 billion, with $1.1 billion, $565.0 million, $505.0 million and $0.4 million maturing in 2012, 2013, 2014 and 2015, respectively.

Liquidity and Capital Resources

Stockholders equity increased $109.7 million to $1.6 billion at March 31, 2012 from $1.5 billion at December 31, 2011, due primarily to the retention of earnings and the impact of equity consideration issued in the Herald acquisition. To a lesser extent, stockholders equity was impacted by the payment of dividends.

Federal banking regulators have adopted regulations setting forth a five-tier system for measuring the capital adequacy of the financial institutions they supervise. At March 31, 2012 and December 31, 2011, the Company had capital levels that exceeded well capitalized guidelines. In addition, subsequent to its conversion to a national bank charter, BankUnited is required to maintain a Tier 1 leverage ratio at no less than eight percent. To date, BankUnited has exceeded that requirement.

The following table presents the Company s capital ratios as of March 31, 2012 (dollars in thousands):

March 31, 2012

Actual

	Amount	Ratio	Required to be Considered Well Capitalized Amount	Ratio	Required to be Considered Adequately Capitalized Amount	Ratio
Tier 1 leverage capital	$ 1,529,891	13.41%	N/A	N/A(1)	$ 456,328	4.00%
Tier 1 risk-based capital	$ 1,529,891	36.84%	$ 249,182	6.00%	$ 166,121	4.00%
Total risk-based capital	$ 1,585,585	38.18%	$ 415,303	10.00%	$ 332,243	8.00%

(1) There is no Tier 1 leverage ratio component in the definition of a well capitalized bank holding company.

Liquidity involves our ability to raise funds to support asset growth or reduce assets to meet deposit withdrawals and other borrowing needs, to maintain reserve requirements and to otherwise conduct ongoing operations. BankUnited s liquidity needs are primarily met by growth in transaction deposit accounts, its cash position, cash flow from its amortizing investment and loan portfolios and reimbursements under the Loss Sharing Agreements. If necessary, BankUnited has the ability to raise liquidity through collateralized borrowings, FHLB advances or the sale of its available for sale investment portfolio. The asset/liability committee (ALCO) policy has established several measures of liquidity which are reviewed monthly by ALCO and quarterly by the Company s Board of Directors. The primary measurement of liquidity monitored by management is liquid assets (defined as cash and cash equivalents, and pledgeable securities) to total assets. BankUnited s liquidity is considered acceptable if liquid assets divided by total assets exceeds 2.5%. At March 31, 2012, BankUnited s liquid assets divided by total assets was 11.6%. In addition, management

Table of Contents

monitors a one year liquidity ratio, defined as cash and cash equivalents, pledgeable securities, unused borrowing capacity at the FHLB, and loans and non-agency securities maturing within one year, divided by deposits and borrowings maturing within one year. The maturity of deposits, excluding certificate of deposits, is based on retention rates derived from the most recent external core deposit analysis obtained by the Company. This ratio allows management to monitor liquidity over a longer time horizon. At March 31, 2012, BankUnited exceeded the acceptable limit established by ALCO for this ratio.

As a holding company, BankUnited, Inc. is a corporation separate and apart from our banking subsidiaries, and therefore, provides for its own liquidity. BankUnited, Inc. s main sources of funding include management fees and dividends paid by its subsidiaries, and access to capital markets. There are regulatory limitations that affect the ability of subsidiaries to pay dividends to BankUnited, Inc. Management believes that such limitations will not impact our ability to meet our ongoing short-term cash obligations.

We expect that our cash and liquidity requirements will continue to be generated by operations, including reimbursements under the Loss Sharing Agreements, and we intend to satisfy our capital requirements over the next 12 months through these sources of liquidity.

Interest Rate Sensitivity

The principal component of the Company s risk of loss arising from adverse changes in the fair value of financial instruments, or market risk, is interest rate risk, including the risk that assets and liabilities with similar repricing characteristics may not reprice at the same time or to the same degree. The primary objective of the Company s asset/liability management activities is to maximize net interest income, while maintaining acceptable levels of interest rate risk. The ALCO is responsible for establishing policies to limit exposure to interest rate risk, and to ensure procedures are established to monitor compliance with these policies. The guidelines established by ALCO are reviewed and approved by the Company s Board of Directors.

Management believes that the simulation of net interest income in different interest rate environments provides the most meaningful measure of interest rate risk. Income simulation analysis is designed to capture not only the potential of all assets and liabilities to mature or reprice, but also the probability that they will do so. Income simulation also attends to the relative interest rate sensitivities of these items, and projects their behavior over an extended period of time. Finally, income simulation permits management to assess the probable effects on the balance sheet not only of changes in interest rates, but also of proposed strategies for responding to them.

The income simulation model analyzes interest rate sensitivity by projecting net interest income over the next twenty-four months in a most likely rate scenario based on forward interest rate curves versus net interest income in alternative rate scenarios. Management continually reviews and refines its interest rate risk management process in response to the changing economic climate. Currently, our model projects a plus 100, plus 200 and plus 300 basis point change (with rates increasing 25 basis points per month until the applicable limit is reached) as well as a modified flat scenario incorporating a more flattened yield curve. We did not simulate a decrease in interest rates at March 31, 2012 due to the extremely low rate environment.

The Company s ALCO policy has established that interest income sensitivity will be considered acceptable if forecast net interest income in the plus 200 basis point scenario is within 5% of forecast net interest income in the most likely rate scenario over the next twelve months and within 10% in the second year. At March 31, 2012, the impact on BankUnited s projected net interest income in a plus 200 basis point scenario is 1.7%

in the first twelve months and 8.1% in the second year.

These forecasts are within an acceptable level of interest rate risk per the policies established by ALCO. In the event the model indicates an unacceptable level of risk, the Company could undertake a number of actions that would reduce this risk, including the sale of a portion of its available for sale investment portfolio or the use of risk management strategies such as interest rate swaps and caps.

Many assumptions were used by the Company to calculate the impact of changes in interest rates, including the change in rates. Actual results may not be similar to the Company s projections due to several factors including the timing and frequency of rate changes, market conditions and the shape of the yield curve. Actual results may also differ due to the Company s actions, if any, in response to the changing rates.

Table of Contents

Off-Balance Sheet Arrangements

Commitments

We routinely enter into commitments to extend credit to our customers, including commitments to fund loans or lines of credit and commercial and standby letters of credit. The credit risk associated with these commitments is essentially the same as that involved in extending loans to customers and they are subject to our normal credit policies and approval processes. While these commitments represent contractual cash requirements, a significant portion of commitments to extend credit may expire without being drawn upon. The following table details our outstanding commitments to extend credit as of March 31, 2012 (in thousands):

	Covered	Non-Covered	Total
Commitments to fund loans	$	$ 135,812	$ 135,812
Commitments to purchase loans		47,222	47,222
Unfunded commitments under lines of credit	82,286	405,695	487,981
Commercial and standby letters of credit		34,771	34,771
	$ 82,286	$ 623,500	$ 705,786

Derivative Financial Instruments

Interest rate swaps are one of the tools we use to manage interest rate risk. These derivative instruments are used to mitigate exposure to changes in interest rates on FHLB advances and time deposits. These interest rate swaps are designated as cash flow hedging instruments. The fair value of these instruments is included in other liabilities in our consolidated balance sheets and changes in fair value are reported in accumulated other comprehensive income. At March 31, 2012, outstanding interest rate swaps designated as cash flow hedges had an aggregate notional amount of $630.0 million. The aggregate fair value of interest rate swaps designated as cash flow hedges included in other liabilities at March 31, 2012 was $61.1 million.

Interest rate swaps not designated as cash flow hedges had an aggregate notional amount of $108.0 million at March 31, 2012. The aggregate fair value of these interest rate swaps included in other assets was $3.7 million and the aggregate fair value included in other liabilities was $3.7 million.

Critical Accounting Policies and Estimates

The Company has made no significant changes in its critical accounting policies and significant estimates from those disclosed in the 2011 Annual Report on Form 10-K.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

See the section entitled Interest Rate Sensitivity included in Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations .

Item 4. Controls and Procedures

An evaluation of the effectiveness of the Company s disclosure controls and procedures as of March 31, 2012 was carried out under the supervision, and with the participation of, the Chief Executive Officer (CEO) and Chief Financial Officer (CFO). Based on that evaluation, the CEO and CFO have concluded that the Company s disclosure controls and procedures were effective in alerting them in a timely manner to material information required to be disclosed by the Company in reports that it files or submits under the Securities Exchange Act of 1934 (the Exchange Act).

Disclosure controls and procedures are designed to ensure that information required to be disclosed in reports filed by the Company under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Disclosure controls are also designed with the objective of ensuring that such information is accumulated and communicated to the Company s management, including the CEO and the CFO, as appropriate, to allow timely decisions regarding required disclosures. Disclosure controls include review of internal controls that are designed to provide reasonable assurance that transactions are properly authorized, assets are safeguarded against unauthorized or improper use and transactions are properly recorded and reported. There was no significant change in the Company s internal controls over financial reporting during the last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the internal control over financial reporting.

Any control system, no matter how well conceived and operated, can provide only reasonable assurance that its objectives are achieved. The design of a control system inherently has limitations, including the controls cost relative to their benefits.

Table of Contents

Additionally, controls can be circumvented. No cost-effective control system can provide absolute assurance that all control issues and instances of fraud, if any, will be detected.

PART II. OTHER INFORMATION

Item 1.   Legal Proceedings

The Company is involved as plaintiff or defendant in various legal actions arising in the normal course of business. In the opinion of management, based upon advice of legal counsel, the likelihood is remote that the impact of these proceedings, either individually or in the aggregate, would be material to the Company s consolidated financial position, results of operations or cash flows.

Item 1A.   Risk Factors

There have been no material changes in the risk factors disclosed by the Company in its 2011 Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 28, 2012.

Item 2.   Unregistered Sales of Equity Securities and Use of Proceeds

Other than as previously disclosed in the Company's Current Report on Form 8-K filed with the SEC on March 6, 2012, the Company has not completed any unregistered sales of equity securities during the quarter ended March 31, 2012.

Item 3.   Defaults Upon Senior Securities

Not applicable

Item 4.   Mine Safety Disclosures

Not applicable

Item 5. Other Information

None

Item 6. Exhibits

Exhibit Number	Description	Location
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
101.INS*	XBRL Instance Document	Filed herewith
101.SCH*	XBRL Taxonomy Extension Schema	Filed herewith
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase	Filed herewith
101.DEF*	XBRL Taxonomy Extension Definition Linkbase	Filed herewith
101.LAB*	XBRL Taxonomy Extension Label Linkbase	Filed herewith
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase	Filed herewith

Table of Contents

*Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

Table of Contents

SIGNATURE

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 this 10th day of May 2012.

/s/ John A. Kanas
John A. Kanas
Chairman, President and Chief Executive Officer

/s/ Douglas J. Pauls
Douglas J. Pauls
Chief Financial Officer

Table of Contents

EXHIBIT INDEX

Number	Description	Location
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002	Filed herewith
101.INS*	XBRL Instance Document	Filed herewith
101.SCH*	XBRL Taxonomy Extension Schema	Filed herewith
101.CAL	XBRL Taxonomy Extension Calculation Linkbase	Filed herewith
101.DEF*	XBRL Taxonomy Extension Definition Linkbase	Filed herewith
101.LAB*	XBRL Taxonomy Extension Label Linkbase	Filed herewith
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase	Filed herewith

*Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.