

1ST CONSTITUTION BANCORP  
Form 10-Q  
August 10, 2016

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

FORM 10-Q  
(Mark One)

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

For the quarterly period ended June 30, 2016

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file Number: 000-32891

1ST CONSTITUTION BANCORP

(Exact Name of Registrant as Specified in Its Charter)

New Jersey 22-3665653

(State of Other Jurisdiction (I.R.S. Employer Identification No.)  
of Incorporation or Organization)

2650 Route 130, P.O. Box 634, Cranbury, NJ 08512

(Address of Principal Executive Offices) (Zip Code)

(609) 655-4500

(Issuer's Telephone Number, Including Area Code)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§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  No

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

(Do not check if a smaller reporting company)

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

As of July 31, 2016, there were 7,952,794 shares of the registrant's common stock, no par value, outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

1<sup>ST</sup> Constitution Bancorp  
Consolidated Balance Sheets  
(Dollars in thousands)  
(Unaudited)

|  | June 30,<br>2016 | December<br>31, 2015 |
|--|------------------|----------------------|
| <b>ASSETS</b>  |                  |                      |
| Cash and Due From Banks  | \$13,650         | \$11,368             |
| Federal Funds Sold/Short-Term Investments  | —                | —                    |
| Total cash and cash equivalents  | 13,650           | 11,368               |
| Investment Securities:   |                  |                      |
| Available for sale, at fair value  | 111,327          | 91,422               |
| Held to maturity (fair value of \$127,899 and \$127,157<br>at June 30, 2016 and December 31, 2015, respectively)   | 122,635          | 123,261              |
| Total investment securities  | 233,962          | 214,683              |
| Loans Held for Sale  | 3,228            | 5,997                |
| Loans  | 761,572          | 682,121              |
| Less- Allowance for loan losses  | (7,482)          | (7,560)              |
| Net loans  | 754,090          | 674,561              |
| Premises and Equipment, Net  | 10,845           | 11,109               |
| Accrued Interest Receivable  | 3,051            | 2,853                |
| Bank-Owned Life Insurance  | 21,936           | 21,583               |
| Other Real Estate Owned  | 166              | 966                  |
| Goodwill and Intangible Assets   | 13,082           | 13,284               |
| Other Assets   | 14,726           | 11,587               |
| Total assets   | \$1,068,736      | \$967,991            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>  |                  |                      |
| <b>LIABILITIES:</b>  |                  |                      |
| Deposits   |                  |                      |
| Non-interest bearing   | \$170,793        | \$159,918            |
| Interest bearing   | 620,693          | 626,839              |
| Total deposits   | 791,486          | 786,757              |
| Borrowings   | 149,865          | 58,896               |
| Redeemable Subordinated Debt   | 18,557           | 18,557               |
| Accrued Interest Payable   | 846              | 846                  |
| Accrued Expenses and Other Liabilities   | 6,354            | 6,975                |
| Total liabilities  | 967,108          | 872,031              |
| <b>SHAREHOLDERS' EQUITY:</b>   |                  |                      |
| Preferred stock, no par value; 5,000,000 shares authorized, none issued  | —                | —                    |
| Common Stock, no par value; 30,000,000 shares authorized; 7,985,937 and 7,575,492 shares<br>issued and 7,952,639 and 7,545,684 shares outstanding as of June 30, 2016 and December<br>31, 2015, respectively | 71,224           | 70,845               |

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|  |             |           |
|--|-------------|-----------|
| Retained earnings  | 30,125      | 25,589    |
| Treasury Stock, 33,298 shares and 29,808 shares at June 30, 2016 and December 31, 2015, respectively | (368        | ) (344 )  |
| Accumulated other comprehensive income (loss)  | 647         | (130 )    |
| Total shareholders' equity   | 101,628     | 95,960    |
| Total liabilities and shareholders' equity   | \$1,068,736 | \$967,991 |

The accompanying notes are an integral part of these financial statements.

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1<sup>ST</sup> Constitution Bancorp  
Consolidated Statements of Income  
(Dollars in thousands, except per share data)  
(Unaudited)

|  | Three Months<br>Ended June 30, |          | Six Months Ended<br>June 30, |           |
|--|--------------------------------|----------|------------------------------|-----------|
|  | 2016                           | 2015     | 2016                         | 2015      |
| <b>INTEREST INCOME:</b>                                      |                                |          |                              |           |
| Loans, including fees  | \$8,518                        | \$ 9,238 | \$16,825                     | \$ 17,527 |
| Securities:  |                                |          |                              |           |
| Taxable  | 815                            | 790      | 1,632                        | 1,607     |
| Tax-exempt   | 520                            | 530      | 1,040                        | 1,086     |
| Federal funds sold and short-term investments                | 18                             | 6        | 67                           | 31        |
| Total interest income  | 9,871                          | 10,564   | 19,564                       | 20,251    |
| <b>INTEREST EXPENSE:</b>                                     |                                |          |                              |           |
| Deposits   | 988                            | 912      | 1,938                        | 1,844     |
| Borrowings   | 165                            | 153      | 301                          | 279       |
| Redeemable subordinated debentures                           | 104                            | 88       | 203                          | 174       |
| Total interest expense                                       | 1,257                          | 1,153    | 2,442                        | 2,297     |
| Net interest income  | 8,614                          | 9,411    | 17,122                       | 17,954    |
| (CREDIT) PROVISION FOR LOAN LOSSES                           | (100 )                         | —        | (300 )                       | 500       |
| Net interest income after (credit) provision for loan losses | 8,714                          | 9,411    | 17,422                       | 17,454    |
| <b>NON-INTEREST INCOME:</b>                                  |                                |          |                              |           |
| Service charges on deposit accounts                          | 176                            | 190      | 373                          | 429       |
| Gain on sales of loans, net                                  | 747                            | 1,203    | 1,650                        | 2,495     |
| Income on Bank-owned life insurance                          | 157                            | 142      | 301                          | 276       |
| Other income   | 456                            | 453      | 808                          | 917       |
| Total non-interest income                                    | 1,536                          | 1,988    | 3,132                        | 4,117     |
| <b>NON-INTEREST EXPENSES:</b>                                |                                |          |                              |           |
| Salaries and employee benefits                               | 4,291                          | 4,478    | 8,607                        | 8,665     |
| Occupancy expense  | 952                            | 1,048    | 1,941                        | 2,158     |
| Data processing expenses                                     | 314                            | 306      | 627                          | 625       |
| FDIC insurance expense                                       | 105                            | 180      | 223                          | 370       |
| Other real estate owned expenses                             | 35                             | 416      | 65                           | 513       |
| Other operating expenses                                     | 1,126                          | 1,544    | 2,394                        | 2,498     |
| Total non-interest expenses                                  | 6,823                          | 7,972    | 13,857                       | 14,829    |
| Income before income taxes                                   | 3,427                          | 3,427    | 6,697                        | 6,742     |
| INCOME TAXES   | 1,113                          | 1,112    | 2,161                        | 2,167     |
| Net income   | \$2,314                        | \$ 2,315 | \$4,536                      | \$ 4,575  |
| <b>NET INCOME PER COMMON SHARE:</b>                          |                                |          |                              |           |
| Basic  | \$0.29                         | \$ 0.29  | \$0.57                       | \$ 0.58   |
| Diluted  | \$0.28                         | \$ 0.29  | \$0.56                       | \$ 0.57   |

WEIGHTED AVERAGE SHARES OUTSTANDING

|         |           |           |           |           |
|---------|-----------|-----------|-----------|-----------|
| Basic   | 7,947,146 | 7,881,626 | 7,944,069 | 7,880,270 |
| Diluted | 8,151,798 | 8,069,229 | 8,144,458 | 8,058,602 |

The accompanying notes are an integral part of these financial statements.

1<sup>ST</sup> Constitution Bancorp  
Consolidated Statements of Comprehensive Income  
(Dollars in thousands)  
(Unaudited)

|  | Three Months<br>Ended June 30, |         | Six Months<br>Ended June 30, |         |
|--|--------------------------------|---------|------------------------------|---------|
|  | 2016                           | 2015    | 2016                         | 2015    |
| Net Income   | \$2,314                        | \$2,315 | \$4,536                      | \$4,575 |
| Other comprehensive income (loss):   |                                |         |                              |         |
| Unrealized holding gains (losses) on securities available for sale               | 738                            | (765 )  | 1,257                        | (619 )  |
| Tax effect   | (268 )                         | 278     | (457 )                       | 182     |
| Net of tax amount  | 470                            | (487 )  | 800                          | (437 )  |
| Pension liability  | 34                             | 93      | 34                           | 93      |
| Tax effect   | (14 )                          | (38 )   | (14 )                        | (38 )   |
| Net of tax amount  | 20                             | 55      | 20                           | 55      |
| Reclassification adjustment for actuarial (gains) for unfunded pension liability |                                |         |                              |         |
| Income <sup>(1)</sup>  | (46 )                          | (110 )  | (72 )                        | (155 )  |
| Tax effect <sup>(2)</sup>  | 18                             | 44      | 29                           | 62      |
| Net of tax amount  | (28 )                          | (66 )   | (43 )                        | (93 )   |
| Total other comprehensive income (loss)  | 462                            | (498 )  | 777                          | (475 )  |
| Comprehensive income   | \$2,776                        | \$1,817 | \$5,313                      | \$4,100 |

The accompanying notes are an integral part of these financial statements.

(1)Included in salaries and employee benefits expense on the consolidated statements of income

(2)Included in income taxes on the consolidated statements of income

1<sup>ST</sup> Constitution Bancorp  
Consolidated Statements of Changes in Shareholders' Equity  
For the Six Months Ended June 30, 2016 and 2015  
(Dollars in thousands)  
(Unaudited)

| (Dollars in thousands)                                 | Common<br>Stock | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total<br>Shareholders'<br>Equity |
|--|-----------------|----------------------|-------------------|---|----------------------------------|
| Balance, January 1, 2015                               | \$ 61,448       | \$ 25,730            | \$ (316 )         | \$ 248  | \$ 87,110                        |
| Exercise of stock options (3,313 shares)               | 24              | —                    | —                 | —   | 24                               |
| Share-based compensation                               | 326             | —                    | —                 | —   | 326                              |
| Treasury stock purchased (2,947 shares)                | —               | —                    | (33 )             | —   | (33 )                            |
| 5% Stock dividend declared March 2015 (358,851 shares) | 3,994           | (3,994 )             | —                 | —   | —                                |
| Net income for the six months ended June 30, 2015      | —               | 4,575                | —                 | —   | 4,575                            |
| Other comprehensive loss                               | —               | —                    | —                 | (475 )  | (475 )                           |
| Balance, June 30, 2015                                 | \$ 65,792       | \$ 26,311            | \$ (349 )         | \$ (227 )   | \$ 91,527                        |
| Balance, January 1, 2016                               | \$ 70,845       | \$ 25,589            | \$ (344 )         | \$ (130 )   | \$ 95,960                        |
| Exercise of stock options (3,564 shares)               | 17              | —                    | —                 | —   | 17                               |
| Share-based compensation                               | 362             | —                    | —                 | —   | 362                              |
| Treasury stock purchased (2,000 shares)                | —               | —                    | (24 )             | —   | (24 )                            |
| Net income for the six months ended June 30, 2106      | —               | 4,536                | —                 | —   | 4,536                            |
| Other comprehensive income                             | —               | —                    | —                 | 777   | 777                              |
| Balance, June 30, 2016                                 | \$ 71,224       | \$ 30,125            | \$ (368 )         | \$ 647  | \$ 101,628                       |

The accompanying notes are an integral part of these financial statements.



1<sup>ST</sup> Constitution Bancorp  
Consolidated Statements of Cash Flows  
(Dollars in thousands)  
(Unaudited)

|   | Six Months Ended<br>June 30, |            |
|---|------------------------------|------------|
|   | 2016                         | 2015       |
| <b>OPERATING ACTIVITIES:</b>  |                              |            |
| Net income  | \$4,536                      | \$4,575    |
| Adjustments to reconcile net income to net cash provided by operating activities- |                              |            |
| (Credit) provision for loan losses  | (300 )                       | 500        |
| Provision for loss on other real estate owned                                     | —                            | 382        |
| Depreciation and amortization   | 646                          | 777        |
| Net amortization of premiums and discounts on securities                          | 547                          | 460        |
| Gains on sales of other real estate owned   | (31 )                        | —          |
| Gains on sales of loans held for sale   | (1,650 )                     | (2,495 )   |
| Originations of loans held for sale   | (35,727 )                    | (78,539 )  |
| Proceeds from sales of loans held for sale  | 38,497                       | 77,680     |
| Income on Bank-owned life insurance   | (301 )                       | (276 )     |
| Share-based compensation expense  | 362                          | 326        |
| (Increase) decrease in accrued interest receivable                                | (198 )                       | 120        |
| Decrease in other assets  | 175                          | 1,336      |
| Decrease in accrued interest payable  | —                            | (52 )      |
| Decrease in accrued expenses and other liabilities                                | (621 )                       | (163 )     |
| Net cash provided by operating activities   | 5,935                        | 4,631      |
| <b>INVESTING ACTIVITIES:</b>  |                              |            |
| Purchases of securities -   |                              |            |
| Available for sale  | (26,138 )                    | (7,071 )   |
| Held to maturity  | (13,997 )                    | (7,578 )   |
| Proceeds from maturities and prepayments of securities -                          |                              |            |
| Available for sale  | 7,591                        | 11,093     |
| Held to maturity  | 14,581                       | 24,411     |
| Proceeds from Bank-owned life insurance benefits paid                             | 248                          | —          |
| Net redemption (purchase) of restricted stock                                     | (2,670 )                     | (4,741 )   |
| Net increase in loans   | (79,451 )                    | (104,209 ) |
| Capital expenditures  | (181 )                       | (656 )     |
| Cost of improvement to OREO   | (60 )                        | —          |
| Proceeds from sales of other real estate owned                                    | 1,033                        | —          |
| Purchase of Bank-owned life insurance   | (300 )                       | —          |
| Net cash used in investing activities   | (99,344 )                    | (88,751 )  |
| <b>FINANCING ACTIVITIES:</b>  |                              |            |
| Exercise of stock options   | 17                           | 24         |
| Purchase of treasury stock  | (24 )                        | (33 )      |
| Net increase (decrease) in deposits   | 4,729                        | (19,672 )  |
| Net increase in borrowings  | 90,969                       | 105,620    |
| Net cash provided by financing activities   | 95,691                       | 85,939     |
| Increase in cash and cash equivalents   | 2,282                        | 1,819      |
| CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD                                  | 11,368                       | 14,545     |
| CASH AND CASH EQUIVALENTS AT END OF PERIOD  | \$13,650                     | \$16,364   |

SUPPLEMENTAL DISCLOSURES OF CASHFLOW INFORMATION

Cash paid during the period for -

|  |         |         |
|--|---------|---------|
| Interest   | \$2,442 | \$2,349 |
| Income taxes   | 2,161   | 2,275   |
| Non-cash items: Transfer of loans to other real estate owned | 142     | —       |

The accompanying notes are an integral part of these financial statements.

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1<sup>ST</sup> Constitution Bancorp  
Notes To Consolidated Financial Statements  
June 30, 2016  
(Unaudited)

(1) Summary of Significant Accounting Policies

The accompanying unaudited consolidated financial statements include 1<sup>ST</sup> Constitution Bancorp (the “Company”), its wholly-owned subsidiary, 1<sup>ST</sup> Constitution Bank (the “Bank”), and the Bank’s wholly-owned subsidiaries, <sup>§1</sup> Constitution Investment Company of New Jersey, Inc., FCB Assets Holdings, Inc., 204 South Newman Street Corp., and 249 New York Avenue, LLC. 1st Constitution Capital Trust II, a subsidiary of the Company, is not included in the Company’s consolidated financial statements, as it is a variable interest entity and the Company is not the primary beneficiary. All significant intercompany accounts and transactions have been eliminated in consolidation and certain prior period amounts have been reclassified to conform to current year presentation. The accounting and reporting policies of the Company and its subsidiaries conform to accounting principles generally accepted in the United States of America (“U.S. GAAP”) and pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”), including the instructions to Form 10-Q and Article 8 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements have been condensed or omitted pursuant to such rules and regulations. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in the Company’s Form 10-K for the year ended December 31, 2015, filed with the SEC on March 22, 2016.

In the opinion of the Company, all adjustments (consisting only of normal recurring accruals) which are necessary for a fair presentation of the operating results for the interim periods have been included. The results of operations for periods of less than a year are not necessarily indicative of results for the full year.

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of June 30, 2016 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through the date these financial statements were issued.

On December 18, 2015, the Board of Directors of the Company declared a five percent common stock dividend to common shareholders of record as of the close of business on January 14, 2016, which was paid on February 1, 2016. As appropriate, common shares and per common share data presented in the consolidated financial statements and the accompanying notes below have been adjusted to reflect the common stock dividend.

(2) Net Income Per Common Share

Basic net income per common share is calculated by dividing net income by the weighted average number of common shares outstanding during each period.

Diluted net income per common share is calculated by dividing net income by the weighted average number of common shares outstanding, as adjusted for the assumed exercise of dilutive common stock warrants and common stock options using the treasury stock method.

The following tables illustrate the reconciliation of the numerators and denominators of the basic and diluted earnings per common share (EPS) calculations. Dilutive securities in the tables below exclude common stock options and warrants with exercise prices that exceed the average market price of the Company’s common stock during the periods presented. Inclusion of these common stock options and warrants would be anti-dilutive to the diluted earnings per common share calculation.

| (Dollars in thousands, except per share data) | Three Months Ended June 30, 2016 |                          |                  |
|---|----------------------------------|--------------------------|------------------|
|   | Net Income                       | Weighted- average shares | Per share amount |
| Basic earnings per common share:              |                                  |                          |                  |
| Net income                                    | \$2,314                          | 7,947,146                | \$ 0.29          |
| Effect of dilutive securities:                |                                  |                          |                  |
| Stock options and warrants                    |                                  | 204,650                  |                  |

Diluted EPS:

Net income plus assumed conversion                    \$2,314 8,151,796 \$ 0.28

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| (Dollars in thousands, except per share data) | Three Months Ended June 30, 2015 |                         |                  |
|---|----------------------------------|-------------------------|------------------|
|   | Net Income                       | Weighted-average shares | Per share amount |
| Basic earnings per common share:              |                                  |                         |                  |
| Net income                                    | \$2,315                          | 7,881,626               | \$ 0.29          |
| Effect of dilutive securities:                |                                  |                         |                  |
| Stock options and warrants                    |                                  | 187,603                 |                  |
| Diluted EPS:                                  |                                  |                         |                  |
| Net income plus assumed conversion            | \$2,315                          | 8,069,229               | \$ 0.29          |

For the three months ended June 30, 2016 and 2015, 20,060 and 32,049 options, respectively, were anti-dilutive and were not included in the computation of diluted earnings per common share.

| (Dollars in thousands, except per share data) | Six Months Ended June 30, 2016 |                         |                  |
|---|--------------------------------|-------------------------|------------------|
|   | Net Income                     | Weighted-average shares | Per share amount |
| Basic earnings per common share:              |                                |                         |                  |
| Net income                                    | \$4,536                        | 7,944,069               | \$ 0.57          |
| Effect of dilutive securities:                |                                |                         |                  |
| Stock options and warrants                    |                                | 200,389                 |                  |
| Diluted EPS:                                  |                                |                         |                  |
| Net income plus assumed conversion            | \$4,536                        | 8,144,458               | \$ 0.56          |

| (Dollars in thousands, except per share data) | Six Months Ended June 30, 2015 |                         |                  |
|---|--------------------------------|-------------------------|------------------|
|   | Net Income                     | Weighted-average shares | Per share amount |
| Basic earnings per common share:              |                                |                         |                  |
| Net income                                    | \$4,575                        | 7,880,270               | \$ 0.58          |
| Effect of dilutive securities:                |                                |                         |                  |
| Stock options and warrants                    |                                | 178,332                 |                  |
| Diluted EPS:                                  |                                |                         |                  |
| Net income plus assumed conversion            | \$4,575                        | 8,058,602               | \$ 0.57          |

For the six months ended June 30, 2016 and 2015, 20,060 and 44,192 options, respectively, were anti-dilutive and were not included in the computation of diluted earnings per common share.

## (3) Investment Securities

Amortized cost, carrying value, gross unrealized gains and losses, and the fair value by security type are as follows:  
(Dollars in thousands)

| June 30, 2016  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains  | Gross<br>Unrealized<br>Losses | Fair<br>Value                |                               |               |
|--|-------------------|---|-------------------------------|------------------------------|-------------------------------|---------------|
| Available for sale   |                   |   |                               |                              |                               |               |
| U. S. Treasury securities and obligations of U.S. Government sponsored corporations (“GSE”) and agencies | \$ 5,519          | \$ 39   | \$ —                          | \$ 5,558                     |                               |               |
| Residential collateralized mortgage obligations- GSE   | 17,685            | 181   | (34 )                         | 17,832                       |                               |               |
| Residential mortgage backed securities – GSE   | 34,912            | 888   | (21 )                         | 35,779                       |                               |               |
| Obligations of state and political subdivisions  | 20,966            | 706   | —                             | 21,672                       |                               |               |
| Trust preferred debt securities – single issuer  | 2,476             | —   | (388 )                        | 2,088                        |                               |               |
| Corporate debt securities  | 27,334            | 288   | (179 )                        | 27,443                       |                               |               |
| Other debt securities  | 975               | —   | (20 )                         | 955                          |                               |               |
|  | \$ 109,867        | \$ 2,102  | \$ (642 )                     | \$ 111,327                   |                               |               |
| June 30, 2016  | Amortized<br>Cost | Other-Than-<br>Temporary<br>Impairment<br>Recognized<br>In<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Carrying<br>Value             | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Held to maturity-  |                   |   |                               |                              |                               |               |
| U. S. Treasury securities and obligations of U.S. Government sponsored corporations (“GSE”) and agencies | 4,082             | —   | 4,082                         | 31                           | —                             | 4,113         |
| Residential collateralized mortgage obligations – GSE  | 14,254            | —   | 14,254                        | 509                          | —                             | 14,763        |
| Residential mortgage backed securities – GSE   | 45,118            | —   | 45,118                        | 1,750                        | —                             | 46,868        |
| Obligations of state and political subdivisions  | 58,485            | —   | 58,485                        | 2,707                        | (1 )                          | 61,191        |
| Trust preferred debt securities-pooled   | 656               | (501 )  | 155                           | 272                          | —                             | 427           |
| Other debt securities  | 541               | —   | 541                           | —                            | (4 )                          | 537           |
|  | \$ 123,136        | \$ (501 )   | \$ 122,635                    | \$ 5,269                     | \$ (5 )                       | \$ 127,899    |

| December 31, 2015  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| (Dollars in thousands)   |                   |                              |                               |               |
| Available for sale-  |                   |                              |                               |               |
| U. S. Treasury securities and obligations of U.S. Government sponsored corporations ("GSE") and agencies | \$ 5,523          | \$ —                         | \$ (42 )                      | \$ 5,481      |
| Residential collateralized mortgage obligations- GSE   | 8,255             | 68                           | (36 )                         | 8,287         |
| Residential mortgage backed securities - GSE   | 32,279            | 541                          | (185 )                        | 32,635        |
| Obligations of state and political subdivisions  | 21,125            | 365                          | (54 )                         | 21,436        |
| Trust preferred debt securities-single issuer  | 2,474             | —                            | (338 )                        | 2,136         |
| Corporate debt securities  | 20,510            | 65                           | (153 )                        | 20,422        |
| Other debt securities  | 1,053             | —                            | (28 )                         | 1,025         |
|  | \$ 91,219         | \$ 1,039                     | \$ (836 )                     | \$ 91,422     |

| December 31, 2015                                   | Amortized<br>Cost | Other-Than-<br>Temporary<br>Impairment<br>Recognized In<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Carrying<br>Value | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---|-------------------|--|-------------------|------------------------------|-------------------------------|---------------|
| Held to maturity-                                   |                   |  |                   |                              |                               |               |
| Residential collateralized mortgage obligations-GSE | 13,630            | —  | 13,630            | 404                          | —                             | 14,034        |
| Residential mortgage backed securities - GSE        | 47,718            | —  | 47,718            | 928                          | (46 )                         | 48,600        |
| Obligations of state and political subdivisions     | 61,135            | —  | 61,135            | 2,294                        | (14 )                         | 63,415        |
| Trust preferred debt securities - pooled            | 657               | (501 )   | 156               | 341                          | —                             | 497           |
| Other debt securities                               | 622               | —  | 622               | —                            | (11 )                         | 611           |
|   | \$ 123,762        | \$ (501 )  | \$ 123,261        | \$ 3,967                     | \$ (71 )                      | \$ 127,157    |

Restricted stock is included in other assets at June 30, 2016 and December 31, 2015 and totaled \$6.0 million and \$3.3 million, respectively, and consisted of \$5.9 million of Federal Home Loan Bank of New York stock and \$65,000 of Atlantic Community Bankers Bank stock at June 30, 2016 and \$3.2 million of Federal Home Loan Bank of New York stock and \$65,000 of Atlantic Community Bankers Bank stock at December 31, 2015.

Gross unrealized losses on available for sale and held to maturity securities and the fair value of the related securities aggregated by security category and length of time that individual securities have been in a continuous unrealized loss position at June 30, 2016 and December 31, 2015 were as follows:

| June 30, 2016   |                      | Less than 12 months |                   | 12 months or longer |                   | Total      |                   |
|---|----------------------|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
| (Dollars in thousands)  | Number of Securities | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government sponsored corporations (GSE) and agencies | —                    | \$—                 | \$ —              | \$—                 | \$ —              | \$—        | \$ —              |
| Residential collateralized mortgage obligations –GSE  | 2                    | 5,407               | (34 )             | —                   | —                 | 5,407      | (34 )             |
| Residential mortgage backed securities-GSE  | 3                    | —                   | —                 | 3,593               | (21 )             | 3,593      | (21 )             |
| Obligations of state and political subdivisions   | 4                    | 1,396               | (1 )              | —                   | —                 | 1,396      | (1 )              |
| Trust preferred debt securities-single issuer   | 4                    | —                   | —                 | 2,088               | (388 )            | 2,088      | (388 )            |
| Corporate debt securities   | 5                    | 5,178               | (87 )             | 6,967               | (92 )             | 12,145     | (179 )            |
| Other debt securities   | 3                    | —                   | —                 | 1,468               | (24 )             | 1,468      | (24 )             |
| Total temporarily impaired securities   | 21                   | \$11,981            | \$ (122 )         | \$14,116            | \$ (525 )         | \$26,097   | \$ (647 )         |
| December 31, 2015   |                      | Less than 12 months |                   | 12 months or longer |                   | Total      |                   |
| (Dollars in thousands)  | Number of Securities | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Treasury securities and obligations of U.S. Government sponsored corporations (GSE) and agencies | 3                    | \$5,481             | \$ (42 )          | \$—                 | \$ —              | \$5,481    | \$ (42 )          |
| Residential collateralized mortgage obligations –GSE  | 2                    | 5,894               | (36 )             | —                   | —                 | 5,894      | (36 )             |
| Residential mortgage backed securities - GSE  | 19                   | 20,911              | (175 )            | 3,980               | (56 )             | 24,891     | (231 )            |
| Obligations of state and political subdivisions   | 32                   | 2,760               | (19 )             | 6,465               | (49 )             | 9,225      | (68 )             |
| Trust preferred debt securities- single issuer  | 4                    | —                   | —                 | 2,136               | (338 )            | 2,136      | (338 )            |
| Corporate debt securities   | 4                    | 9,214               | (153 )            | —                   | —                 | 9,214      | (153 )            |
| Other debt securities   | 3                    | 586                 | (11 )             | 1,025               | (28 )             | 1,611      | (39 )             |
| Total temporarily impaired securities   | 67                   | \$44,846            | \$ (436 )         | \$13,606            | \$ (471 )         | \$58,452   | \$ (907 )         |



The following table sets forth certain information regarding the amortized cost, carrying value, fair value, weighted average yields and contractual maturities of the Company's investment portfolio as of June 30, 2016. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|  | June 30, 2016     |               |       |
|--|-------------------|---------------|-------|
|  | Amortized<br>Cost | Fair<br>Value | Yield |
| Available for sale                     |                   |               |       |
| Due in one year or less                | \$8,817           | \$8,855       | 2.57% |
| Due after one year through five years  | 16,106            | 16,239        | 1.75% |
| Due after five years through ten years | 43,248            | 44,307        | 2.61% |
| Due after ten years                    | 41,696            | 41,926        | 2.64% |
| Total                                  | \$109,867         | \$111,327     | 2.48% |
|  |                   |               |       |
|  | Carrying<br>Value | Fair<br>Value | Yield |
| Held to maturity                       |                   |               |       |
| Due in one year or less                | \$15,974          | \$15,991      | 1.16% |
| Due after one year through five years  | 16,076            | 16,806        | 4.15% |
| Due after five years through ten years | 27,633            | 29,203        | 3.58% |
| Due after ten years                    | 62,952            | 65,899        | 3.29% |
| Total                                  | \$122,635         | \$127,899     | 3.21% |

U.S. Treasury securities and obligations of U.S. Government sponsored corporations and agencies: The unrealized losses on investments in these securities were caused by increases in market interest rates. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. The Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell these investments before a market price recovery or maturity. Therefore, these investments are not considered other-than-temporarily impaired.

Residential collateralized mortgage obligations and residential mortgage backed securities: The unrealized losses on investments in residential collateralized mortgage obligations and mortgage backed securities were caused by increases in market interest rates. The contractual cash flows of these securities are guaranteed by the issuers, which are primarily government or government sponsored agencies. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. The decline in fair value is attributable to changes in interest rates and not credit quality. The Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell these investments before a market price recovery or maturity. Therefore, these investments are not considered other-than-temporarily impaired.

Obligations of state and political subdivisions: The unrealized losses on investments in these securities were caused by increases in market interest rates. It is expected that the securities would not be settled at a price less than the amortized cost of the investment. None of the issuers have defaulted on interest payments. These investments are not considered to be other than temporarily impaired because the decline in fair value is attributable to changes in interest rates and not credit quality. The Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell these investments before a market price recovery or maturity. Therefore, these investments are not considered other-than-temporarily impaired.

Corporate debt securities: The unrealized losses on investments in corporate debt securities were caused by increases in market interest rates. None of the corporate issuers have defaulted on interest payments. The decline in fair value is attributable to changes in interest rates and not a decline in credit quality. The Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell these investments before a market price recovery or maturity. Therefore, these investments are not considered other-than-temporarily impaired.

Trust preferred debt securities – single issuer: The investments in these securities with unrealized losses are comprised of four corporate trust preferred securities issued by two large financial institutions that mature in 2027. The contractual terms of the trust preferred securities do not allow the issuer to settle the securities at a price less than the face value of the trust preferred securities, which is greater than the amortized cost of the trust preferred securities. One of the issuers continues to maintain an investment grade credit rating and neither has defaulted on interest payments. The decline in fair value is attributable to the widening of interest rate spreads and the lack of an active trading market for these securities and market concerns about the issuers' credit quality. The Company does not intend to sell these investments and it is not more likely than not that the Company will be required to sell these investments before a market price recovery or maturity. Therefore, these investments are not considered other-than-temporarily impaired.

Trust preferred debt securities – pooled: This trust preferred debt security was issued by a two issuer pool (Preferred Term Securities XXV, Ltd. co-issued by Keefe, Bruyette and Woods, Inc. and First Tennessee (“PRETSL XXV”)) consisting primarily of trust preferred debt securities issued by financial institution holding companies. During 2009, the Company recognized an other-than-temporary impairment of \$865,000, of which \$364,000 was determined to be a credit loss and charged to operations and \$501,000 was recognized in the other comprehensive income (loss) component of shareholders' equity.

The primary factor used to determine the credit portion of the impairment loss recognized in the income statement for this security was the discounted present value of projected cash flow where that present value of cash flow was less than the amortized cost basis of the security. The present value of cash flow was developed using an EITF 99-20 model that considered performing collateral ratios, the level of subordination to senior tranches of the security, and credit ratings of and projected credit defaults in the underlying collateral.

On a quarterly basis, management evaluates the security to determine if any additional other-than-temporary impairment is required. As of June 30, 2016, management concluded that no additional other-than-temporary

impairment had occurred.

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## (4) Allowance for Loan Losses and Credit Quality Disclosure

The Company's primary lending emphasis is the origination of commercial and commercial real estate loans and mortgage warehouse lines of credit. Based on the composition of the loan portfolio, the inherent primary risks are deteriorating credit quality, a decline in the economy, and a decline in New Jersey real estate market values. Any one, or a combination, of these events may adversely affect the loan portfolio and may result in increased delinquencies, loan losses and increased future provision levels.

The following table provides an aging of the loan portfolio by loan class at June 30, 2016:

| (Dollars in thousands)   | 30-59<br>Days | 60-89<br>Days | Greater<br>than 90<br>Days | Total<br>Past<br>Due | Current   | Total<br>Loans<br>Receivable | Recorded<br>Investment<br>> 90 Days<br>Accruing | Nonaccrual<br>Loans |
|--------------------------|---------------|---------------|----------------------------|----------------------|-----------|------------------------------|---|---------------------|
| Commercial               |               |               |                            |                      |           |                              |   |                     |
| Construction             | \$—           | \$—           | \$186                      | \$186                | \$93,035  | \$93,221                     | \$—   | —\$ 186             |
| Commercial Business      | 148           | 68            | 104                        | 320                  | 104,783   | 105,103                      | —   | 213                 |
| Commercial Real Estate   | 1,829         | —             | 2,707                      | 4,536                | 218,588   | 223,124                      | —   | 3,199               |
| Mortgage Warehouse Lines | —             | —             | —                          | —                    | 264,344   | 264,344                      | —   | —                   |
| Residential Real Estate  | —             | —             | 1,298                      | 1,298                | 47,789    | 49,087                       | —   | 1,298               |
| Consumer                 |               |               |                            |                      |           |                              |   |                     |
| Loans to Individuals     | —             | —             | 263                        | 263                  | 24,467    | 24,730                       | —   | 263                 |
| Other                    | —             | —             | —                          | —                    | 197       | 197                          | —   | —                   |
| Total loans              | 1,977         | 68            | 4,558                      | 6,603                | 753,203   | 759,806                      | —   | 5,159               |
| Deferred loan costs, net | —             | —             | —                          | —                    | 1,766     | 1,766                        | —   | —                   |
| Total loans, net         | \$1,977       | \$ 68         | \$4,558                    | \$6,603              | \$754,969 | \$761,572                    | \$—   | —\$ 5,159           |

The following table provides an aging of the loan portfolio by loan class at December 31, 2015:

| (Dollars in thousands)   | 30-59<br>Days | 60-89<br>Days | Greater<br>than<br>90<br>Days | Total<br>Past<br>Due | Current   | Total<br>Loans<br>Receivable | Recorded<br>Investment<br>> 90 Days<br>Accruing | Nonaccrual<br>Loans |
|--------------------------|---------------|---------------|-------------------------------|----------------------|-----------|------------------------------|---|---------------------|
| Commercial               |               |               |                               |                      |           |                              |   |                     |
| Construction             | \$—           | \$—           | \$—                           | \$—                  | \$93,745  | \$93,745                     | \$—   | —\$ —               |
| Commercial Business      | 530           | 5             | 186                           | 721                  | 98,556    | 99,277                       | —   | 304                 |
| Commercial Real Estate   | 789           | —             | 3,996                         | 4,785                | 202,465   | 207,250                      | —   | 4,321               |
| Mortgage Warehouse Lines | —             | —             | —                             | —                    | 216,572   | 216,572                      | —   | —                   |
| Residential Real Estate  | —             | 166           | 1,132                         | 1,298                | 39,446    | 40,744                       | —   | 1,132               |
| Consumer                 |               |               |                               |                      |           |                              |   |                     |
| Loans to Individuals     | 400           | —             | 263                           | 663                  | 22,411    | 23,074                       | —   | 263                 |
| Other                    | —             | —             | —                             | —                    | 233       | 233                          | —   | —                   |
| Total loans              | 1,719         | 171           | 5,577                         | 7,467                | 673,428   | 680,895                      | —   | 6,020               |
| Deferred loan costs, net | —             | —             | —                             | —                    | 1,226     | 1,226                        | —   | —                   |
| Total loans, net         | \$1,719       | \$171         | \$5,577                       | \$7,467              | \$674,654 | \$682,121                    | \$—   | —\$ 6,020           |

As provided by ASC 310-30, the excess of cash flows expected at acquisition over the initial investment in the loan is recognized as interest income over the life of the loan. Accordingly, loans acquired in the merger with Rumson-Fair Haven Bank and Trust Company ("Rumson") with evidence of deteriorated credit quality of \$464,000 at June 30, 2016 and \$489,000 at December 31, 2015 were not classified as non-performing loans.

The Company's internal credit risk grades are based on the definitions currently utilized by the banking regulatory agencies. The grades assigned and definitions are as follows, and loans graded excellent, above average, good and watch list are treated as "pass" for grading purposes:

1. Excellent - Loans that are based upon cash collateral held at the Bank and adequately margined. Loans that are based upon "blue chip" stocks listed on the major exchanges and adequately margined.
2. Above Average - Loans to companies whose balance sheets show excellent liquidity and long-term debt is on well-spread schedules of repayment easily covered by cash flow. Such companies have been consistently profitable and have diversification in their product lines or sources of revenue. The continuation of profitable operations for the foreseeable future is likely. Management is comprised of a mix of ages, experience, and backgrounds and management succession is in place. Sources of raw materials are abundant, and for service companies, the source of revenue is abundant. Future needs have been planned for. Character and ability of individuals or company principals are excellent. Loans to individuals are supported by high net worths and liquid assets.
3. Good - Loans to companies whose balance sheets show good liquidity and cash flow adequate to meet maturities of long-term debt with a comfortable margin. Such companies have established profitable records over a number of years, and there has been growth in net worth. Operating ratios are in line with those of the industry, and expenses are in proper relationship to the volume of business done and the profits achieved. Management is well-balanced and competent in their responsibilities. Economic environment is favorable; however, competition is strong. The prospects for growth are good. Loans in this category do not meet the collateral requirements of loans in categories 1 and 2 above. Loans to individuals are supported by good net worths but whose supporting assets are illiquid.
- 3w. Watch - Included in this category are loans evidencing problems identified by Bank management that require closer supervision. Such problem has not developed to the point which requires a Special Mention rating. This category also covers situations where the Bank does not have adequate current information upon which credit quality can be determined. The Bank's account officer has the obligation to correct these deficiencies within 30 days from the time of notification.
4. Special Mention - A "special mention" loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date. Special mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.
5. Substandard - A "substandard" loan is inadequately protected by the current sound net worth and paying capacity of the obligor or by the collateral pledged, if any. Loans so classified must have a well-defined weakness, or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.
6. Doubtful - A loan classified "doubtful" has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.
7. Loss - A loan classified "loss" is considered uncollectible and of such little value that its continuance on the books is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless loan even though partial recovery may be affected in the future.



The following table provides a breakdown of the loan portfolio by credit quality indicator at June 30, 2016:  
(Dollars in thousands)

| Commercial Credit Exposure - By Internally Assigned Grade | Construction         | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate |
|---|----------------------|---------------------|------------------------|--------------------------|-------------------------|
| Grade:  |                      |                     |                        |                          |                         |
| Pass  | \$ 92,904            | \$ 96,318           | \$ 206,197             | \$ 264,344               | \$ 48,225               |
| Special Mention   | 131                  | 8,357               | 12,249                 | —                        | 260                     |
| Substandard   | 186                  | 428                 | 4,678                  | —                        | 602                     |
| Doubtful  | —                    | —                   | —                      | —                        | —                       |
| Total   | \$ 93,221            | \$ 105,103          | \$ 223,124             | \$ 264,344               | \$ 49,087               |
| Consumer Credit Exposure - By Payment Activity            | Loans To Individuals | Other               |                        |                          |                         |
| Performing  | \$ 24,467            | \$ 197              |                        |                          |                         |
| Nonperforming   | 263                  | —                   |                        |                          |                         |
| Total   | \$ 24,730            | \$ 197              |                        |                          |                         |

The following table provides a breakdown of the loan portfolio by credit quality indicator at December 31, 2015:  
(Dollars in thousands)

| Commercial Credit Exposure - By Internally Assigned Grade | Construction         | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate |
|---|----------------------|---------------------|------------------------|--------------------------|-------------------------|
| Grade:  |                      |                     |                        |                          |                         |
| Pass  | \$ 93,558            | \$ 90,856           | \$ 191,754             | \$ 216,572               | \$ 39,878               |
| Special Mention   | 187                  | 7,768               | 9,311                  | —                        | 260                     |
| Substandard   | —                    | 653                 | 6,185                  | —                        | 606                     |
| Doubtful  | —                    | —                   | —                      | —                        | —                       |
| Total   | \$ 93,745            | \$ 99,277           | \$ 207,250             | \$ 216,572               | \$ 40,744               |
| Consumer Credit Exposure - By Payment Activity            | Loans To Individuals | Other               |                        |                          |                         |
| Performing  | \$ 22,811            | \$ 233              |                        |                          |                         |
| Nonperforming   | 263                  | —                   |                        |                          |                         |
| Total   | \$ 23,074            | \$ 233              |                        |                          |                         |

## Impaired Loans Disclosures

Loans are considered to be impaired when, based on current information and events, it is determined that the Company will not be able to collect all amounts due according to the loan contract, including scheduled interest payments. When a loan is placed on nonaccrual status, it is also considered to be impaired. Loans are placed on nonaccrual status when: (1) the full collection of interest or principal becomes uncertain or (2) they are contractually past due 90 days or more as to interest or principal payments unless the loans are both well secured and in the process of collection.

The following tables summarize the distribution of the allowance for loan losses and loans receivable by loan class and impairment method at June 30, 2016 and December 31, 2015:

## Period-End Allowance for Loan Losses by Impairment Method as of June 30, 2016

(Dollars in thousands)

|   | Construction | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate | Loans to Individuals | Other | Unallocated | Deferred Loan Fees | Total    |
|---|--------------|---------------------|------------------------|--------------------------|-------------------------|----------------------|-------|-------------|--------------------|----------|
| Allowance for loan losses:                      |              |                     |                        |                          |                         |                      |       |             |                    |          |
| Individually evaluated for impairment           | \$ —         | \$ —                | \$ 130                 | \$ —                     | \$ —                    | \$ —                 | \$ —  | \$ —        | \$ —               | \$ 130   |
| Loans acquired with deteriorated credit quality | —            | —                   | —                      | —                        | —                       | —                    | —     | —           | —                  | —        |
| Collectively evaluated for impairment           | 975          | 1,230               | 3,020                  | 1,190                    | 294                     | 119                  | —     | 524         | —                  | 7,352    |
| Ending Balance                                  | \$ 975       | \$ 1,230            | \$ 3,150               | \$ 1,190                 | \$ 294                  | \$ 119               | \$ —  | \$ 524      | \$ —               | \$ 7,482 |

Loans receivables:

|   |           |            |            |            |           |           |        |      |          |            |
|---|-----------|------------|------------|------------|-----------|-----------|--------|------|----------|------------|
| Individually evaluated for impairment           | \$ 317    | \$ 231     | \$ 4,072   | \$ —       | \$ 1,298  | \$ 263    | \$ —   | \$ — | \$ —     | \$ 6,181   |
| Loans acquired with deteriorated credit quality | —         | 225        | 959        | —          | —         | —         | —      | —    | —        | 1,184      |
| Collectively evaluated for impairment           | 92,904    | 104,647    | 218,093    | 264,344    | 47,789    | 24,467    | 197    | —    | 1,766    | 754,207    |
| Ending Balance                                  | \$ 93,221 | \$ 105,103 | \$ 223,124 | \$ 264,344 | \$ 49,087 | \$ 24,730 | \$ 197 | \$ — | \$ 1,766 | \$ 761,572 |

## Period-End Allowance for Loan Losses by Impairment Method as of December 31, 2015

(Dollars in thousands)

|                            | Construction | Commercial Business | Commercial Real Estate | Mortgage Warehouse Lines | Residential Real Estate | Loans to Individuals | Other | Unallocated | Deferred Loan Fees | Total |
|----------------------------|--------------|---------------------|------------------------|--------------------------|-------------------------|----------------------|-------|-------------|--------------------|-------|
| Allowance for loan losses: |              |                     |                        |                          |                         |                      |       |             |                    |       |



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|   |           |           |            |            |           |           |        |        |          |            |
|---|-----------|-----------|------------|------------|-----------|-----------|--------|--------|----------|------------|
| Individually evaluated for impairment           | \$—       | \$ 68     | \$ 125     | \$—        | \$ 69     | \$—       | \$—    | \$—    | \$—      | \$262      |
| Loans acquired with deteriorated credit quality | —         | —         | 64         | —          | —         | —         | —      | —      | —        | 64         |
| Collectively evaluated for impairment           | 1,025     | 1,937     | 2,860      | 866        | 219       | 109       | —      | 218    | —        | 7,234      |
| Ending Balance                                  | \$ 1,025  | \$ 2,005  | \$ 3,049   | \$ 866     | \$ 288    | \$ 109    | \$—    | \$ 218 | \$—      | \$ 7,560   |
| Loans receivables:                              |           |           |            |            |           |           |        |        |          |            |
| Individually evaluated for impairment           | \$ 494    | \$ 458    | \$ 4,833   | \$—        | \$ 1,132  | \$ 263    | \$—    | \$—    | \$—      | \$ 7,180   |
| Loans acquired with deteriorated credit quality | —         | 241       | 1,359      | —          | —         | —         | —      | —      | —        | 1,600      |
| Collectively evaluated for impairment           | 93,251    | 98,578    | 201,058    | 216,572    | 39,612    | 22,811    | 233    | —      | 1,226    | 673,341    |
| Ending Balance                                  | \$ 93,745 | \$ 99,277 | \$ 207,250 | \$ 216,572 | \$ 40,744 | \$ 23,074 | \$ 233 | \$—    | \$ 1,226 | \$ 682,121 |

The activity in the allowance for loan loss by loan class for the three and six months ended June 30, 2016 and 2015 was as follows:

| (Dollars in thousands)                     | Construction | Commercial<br>Business | Commercial<br>Real<br>Estate | Mortgage<br>Warehouse<br>Lines | Residential<br>Real<br>Estate | Loans to<br>Individuals | Other | Unallocated | Total    |
|--|--------------|------------------------|------------------------------|--------------------------------|-------------------------------|-------------------------|-------|-------------|----------|
| Balance - December 31, 2015                | \$ 1,025     | \$ 2,005               | \$ 3,049                     | \$ 866                         | \$ 288                        | \$ 109                  | \$ —  | \$ 218      | \$ 7,560 |
| Provision charged (credited) to operations | (44 )        | (392 )                 | 46                           | 1                              | (79 )                         | 4                       | —     | 264         | (200 )   |
| Loans charged off                          | —            | —                      | (60 )                        | —                              | —                             | —                       | —     | —           | (60 )    |
| Recoveries of loans charged off            | —            | 1                      | —                            | —                              | —                             | 1                       | —     | —           | 2        |
| Balance - March 31, 2016                   | \$ 981       | \$ 1,614               | \$ 3,035                     | \$ 867                         | \$ 209                        | \$ 114                  | \$ —  | \$ 482      | \$ 7,302 |
| Provision charged (credited) to operations | (6 )         | (284 )                 | (263 )                       | 323                            | 85                            | 3                       | —     | 42          | (100 )   |
| Loans charged off                          | —            | (101 )                 | —                            | —                              | —                             | —                       | —     | —           | (101 )   |
| Recoveries of loans charged off            | —            | 1                      | 378                          | —                              | —                             | 2                       | —     | —           | 381      |
| Balance - June 30, 2016                    | \$ 975       | \$ 1,230               | \$ 3,150                     | \$ 1,190                       | \$ 294                        | \$ 119                  | \$ —  | \$ 524      | \$ 7,482 |
| (Dollars in thousands)                     | Construction | Commercial<br>Business | Commercial<br>Real<br>Estate | Mortgage<br>Warehouse<br>Lines | Residential<br>Real<br>Estate | Loans to<br>Individuals | Other | Unallocated | Total    |
| Balance - December 31, 2014                | \$ 1,215     | \$ 1,761               | \$ 2,393                     | \$ 896                         | \$ 197                        | \$ 129                  | \$ 2  | \$ 332      | \$ 6,925 |
| Provision charged (credited) to operations | (98 )        | 62                     | (4 )                         | 152                            | 13                            | (13 )                   | —     | 388         | 500      |
| Loans charged off                          | —            | (62 )                  | —                            | —                              | —                             | —                       | —     | —           | (62 )    |
| Recoveries of loans charged off            | —            | —                      | —                            | —                              | —                             | 1                       | —     | —           | 1        |
| Balance - March 31, 2015                   | \$ 1,117     | \$ 1,761               | \$ 2,389                     | \$ 1,048                       | \$ 210                        | \$ 117                  | \$ 2  | \$ 720      | \$ 7,364 |
| Provision charged (credited) to operations | (27 )        | (81 )                  | 49                           | 71                             | (8 )                          | 3                       | (1 )  | (6 )        | —        |
| Loans charged off                          | —            | (26 )                  | —                            | —                              | —                             | —                       | —     | —           | (26 )    |
| Recoveries of loans charged off            | —            | 5                      | 7                            | —                              | —                             | 1                       | —     | —           | 13       |
| Balance - June 30, 2015                    | \$ 1,090     | \$ 1,659               | \$ 2,445                     | \$ 1,119                       | \$ 202                        | \$ 121                  | \$ 1  | \$ 714      | \$ 7,351 |

When a loan is identified as impaired, the measurement of impairment is based on the present value of expected future cash flows, discounted at the loan's effective interest rate, except when the sole remaining source of repayment for the loan is the liquidation of the collateral. In such cases, the current fair value of the collateral less selling costs is used. If the value of the impaired loan is less than the recorded investment in the loan, the impairment is recognized through an allowance estimate or a charge to the allowance.

## Impaired Loans Receivables (By Class) – June 30, 2016

| (Dollars in thousands)   | Recorded Investment | Unpaid Principal Balance | Related Allowance | Three Months Ended June 30, 2016 |                            | Six Months Ended June 30, 2016 |                            |
|--------------------------|---------------------|--------------------------|-------------------|----------------------------------|----------------------------|--------------------------------|----------------------------|
|                          |                     |                          |                   | Average Recorded Investment      | Interest Income Recognized | Average Recorded Investment    | Interest Income Recognized |
| With no allowance:       |                     |                          |                   |                                  |                            |                                |                            |
| Construction             | \$ 317              | \$ 317                   | \$ —              | \$317                            | \$ 2                       | \$255                          | \$ 4                       |
| Commercial Business      | 446                 | 606                      | —                 | 448                              | 10                         | 434                            | 21                         |
| Commercial Real Estate   | 1,247               | 1,247                    | —                 | 1,251                            | 20                         | 1,545                          | 30                         |
| Mortgage Warehouse Lines | —                   | —                        | —                 | —                                | —                          | —                              | —                          |
| Subtotal                 | 2,010               | 2,170                    | —                 | 2,016                            | 32                         | 2,234                          | 55                         |
| Residential Real Estate  | 1,298               | 1,313                    | —                 | 1,298                            | —                          | 1,198                          | (2 )                       |
| Consumer                 |                     |                          |                   |                                  |                            |                                |                            |
| Loans to Individuals     | 263                 | 263                      | —                 | 263                              | —                          | 263                            | —                          |
| Other                    | —                   | —                        | —                 | —                                | —                          | —                              | —                          |
| Subtotal                 | 263                 | 263                      | —                 | 263                              | —                          | 263                            | —                          |
| With no allowance:       | \$ 3,571            | \$ 3,746                 | \$ —              | \$3,577                          | \$ 32                      | \$3,695                        | \$ 53                      |
| With an allowance:       |                     |                          |                   |                                  |                            |                                |                            |
| Construction             | \$ —                | \$ —                     | \$ —              | \$—                              | \$ —                       | \$—                            | \$ —                       |
| Commercial Business      | 10                  | 21                       | —                 | 143                              | —                          | 177                            | —                          |
| Commercial Real Estate   | 3,784               | 3,968                    | 130               | 3,888                            | 22                         | 3,836                          | 38                         |
| Mortgage Warehouse Lines | —                   | —                        | —                 | —                                | —                          | —                              | —                          |
| Subtotal                 | 3,794               | 3,989                    | 130               | 4,031                            | 22                         | 4,013                          | 38                         |
| Residential Real Estate  | —                   | —                        | —                 | —                                | —                          | 100                            | —                          |
| Consumer                 |                     |                          |                   |                                  |                            |                                |                            |
| Loans to Individuals     | —                   | —                        | —                 | —                                | —                          | —                              | —                          |
| Other                    | —                   | —                        | —                 | —                                | —                          | —                              | —                          |
| Subtotal                 | —                   | —                        | —                 | —                                | —                          | —                              | —                          |
| With an allowance:       | \$ 3,794            | \$ 3,989                 | \$ 130            | \$4,031                          | \$ 22                      | \$4,113                        | \$ 38                      |
| Total:                   |                     |                          |                   |                                  |                            |                                |                            |
| Construction             | 317                 | 317                      | —                 | 317                              | 2                          | 255                            | 4                          |
| Commercial Business      | 456                 | 627                      | —                 | 591                              | 10                         | 611                            | 21                         |
| Commercial Real Estate   | 5,031               | 5,215                    | 130               | 5,139                            | 42                         | 5,381                          | 68                         |
| Mortgage Warehouse Lines | —                   | —                        | —                 | —                                | —                          | —                              | —                          |
| Residential Real Estate  | 1,298               | 1,313                    | —                 | 1,298                            | —                          | 1,298                          | (2 )                       |
| Consumer                 | 263                 | 263                      | —                 | 263                              | —                          | 263                            | —                          |
| Total                    | \$ 7,365            | \$ 7,735                 | \$ 130            | \$7,608                          | \$ 54                      | \$7,808                        | \$ 91                      |

## Impaired Loans Receivables (By Class) –December 31, 2015

(Dollars in thousands)

For the year ended  
December 31, 2015

|                          | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average Interest<br>Recorded<br>Investment | Income<br>Recognized |
|--------------------------|------------------------|--------------------------------|----------------------|--|----------------------|
| With no allowance:       |                        |                                |                      |  |                      |
| Construction             | \$ 494                 | \$ 494                         | \$ —                 | \$477                                      | \$ 27                |
| Commercial Business      | 488                    | 847                            | —                    | 492  | 23                   |
| Commercial Real Estate   | 2,417                  | 2,683                          | —                    | 2,998                                      | 94                   |
| Mortgage Warehouse Lines | —                      | —                              | —                    | —  | —                    |
| Subtotal                 | 3,399                  | 4,024                          | —                    | 3,967                                      | 144                  |
| Residential Real Estate  | 831                    | 831                            | —                    | 981  | —                    |
| Consumer                 |                        |                                |                      |  |                      |
| Loans to Individuals     | 263                    | 280                            | —                    | 88   | —                    |
| Other                    | —                      | —                              | —                    | —  | —                    |
| Subtotal                 | 263                    | 280                            | —                    | 88   | —                    |
| With no allowance        | \$ 4,493               | \$ 5,135                       | \$ —                 | \$5,036                                    | \$ 144               |
| With an allowance:       |                        |                                |                      |  |                      |
| Construction             | \$ —                   | \$ —                           | \$ —                 | \$—  | \$ —                 |
| Commercial Business      | 211                    | 237                            | 68                   | 307  | 5                    |
| Commercial Real Estate   | 3,775                  | 3,788                          | 189                  | 4,200                                      | 154                  |
| Mortgage Warehouse Lines | —                      | —                              | —                    | —  | —                    |
| Subtotal                 | 3,986                  | 4,025                          | 257                  | 4,507                                      | 159                  |
| Residential Real Estate  | 301                    | 316                            | 69                   | 100  | —                    |
| Consumer                 |                        |                                |                      |  |                      |
| Loans to Individuals     | —                      | —                              | —                    | 175  | —                    |
| Other                    | —                      | —                              | —                    | —  | —                    |
| Subtotal                 | —                      | —                              | —                    | 175  | —                    |
| With an allowance        | \$ 4,287               | \$ 4,341                       | \$ 326               | \$4,782                                    | \$ 159               |
| Total:                   |                        |                                |                      |  |                      |
| Construction             | 494                    | 494                            | —                    | 477  | 27                   |
| Commercial Business      | 699                    | 1,084                          | 68                   | 799  | 28                   |
| Commercial Real Estate   | 6,192                  | 6,471                          | 189                  | 7,198                                      | 248                  |
| Mortgage Warehouse Lines | —                      | —                              | —                    | —  | —                    |
| Residential Real Estate  | 1,132                  | 1,147                          | 69                   | 1,081                                      | —                    |
| Consumer                 | 263                    | 280                            | —                    | 263  | —                    |
| Total                    | \$ 8,780               | \$ 9,476                       | \$ 326               | \$9,818                                    | \$ 303               |

## Impaired Loans Receivables (By Class)-June 30, 2015

| (Dollars in thousands)   | Three Months Ended<br>June 30, 2015 |                          | Six Months Ended<br>June 30, 2015 |                          |
|--------------------------|-------------------------------------|--------------------------|-----------------------------------|--------------------------|
|                          | Average Interest<br>Recorded        | Investment<br>Recognized | Average Interest<br>Recorded      | Investment<br>Recognized |
| With no allowance:       |                                     |                          |                                   |                          |
| Construction             | \$471                               | \$ 6                     | \$461                             | \$ 13                    |
| Commercial Business      | 487                                 | 3                        | 510                               | 7                        |
| Commercial Real Estate   | 2,666                               | 28                       | 2,702                             | 61                       |
| Mortgage Warehouse Lines | —                                   | —                        | —                                 | —                        |
| Subtotal                 | 3,624                               | 37                       | 3,673                             | 81                       |
| Residential Real Estate  | 1,361                               | —                        | 1,361                             | —                        |
| Consumer                 |                                     |                          |                                   |                          |
| Loans to Individuals     | —                                   | —                        | —                                 | —                        |
| Other                    | —                                   | —                        | —                                 | —                        |
| Subtotal                 | —                                   | —                        | —                                 | —                        |
| With no allowance:       | \$4,985                             | \$ 37                    | \$5,034                           | \$ 81                    |
| With an allowance:       |                                     |                          |                                   |                          |
| Construction             | \$—                                 | \$ —                     | \$—                               | \$ —                     |
| Commercial Business      | 354                                 | 1                        | 363                               | 1                        |
| Commercial Real Estate   | 4,784                               | 87                       | 4,754                             | 158                      |
| Mortgage Warehouse Lines | —                                   | —                        | —                                 | —                        |
| Subtotal                 | 5,138                               | 88                       | 5,117                             | 159                      |
| Residential Real Estate  | —                                   | —                        | —                                 | —                        |
| Consumer                 |                                     |                          |                                   |                          |
| Loans to Individuals     | 263                                 | —                        | 263                               | —                        |
| Other                    | —                                   | —                        | —                                 | —                        |
| Subtotal                 | 263                                 | —                        | 263                               | —                        |
| With an allowance:       | \$5,401                             | \$ 88                    | \$5,380                           | \$ 159                   |
| Total:                   |                                     |                          |                                   |                          |
| Construction             | 471                                 | 6                        | 461                               | 13                       |
| Commercial Business      | 841                                 | 4                        | 873                               | 8                        |
| Commercial Real Estate   | 7,450                               | 115                      | 7,456                             | 219                      |
| Mortgage Warehouse Lines | —                                   | —                        | —                                 | —                        |
| Residential Real Estate  | 1,361                               | —                        | 1,361                             | —                        |
| Consumer                 | 263                                 | —                        | 263                               | —                        |
| Total                    | \$10,386                            | \$ 125                   | \$10,414                          | \$ 240                   |

## Purchased Credit-Impaired Loans

Purchased Credit-Impaired loans (“PCI”) are loans acquired at a discount that are due in part to credit quality. The following table presents additional information regarding acquired credit-impaired loans at June 30, 2016 and December 31, 2015:

(Dollars in thousands)

|                     | June 30, December 31, |          |
|---------------------|-----------------------|----------|
|                     | 2016                  | 2015     |
| Outstanding balance | \$ 1,523              | \$ 1,964 |
| Carrying amount     | \$ 1,184              | \$ 1,600 |

Changes in accretable discount for purchased credit-impaired loans for the three and six months ended June 30, 2016 and June 30, 2015 were as follows:

|                                | Three months ended June 30, |        | Six months ended June 30, |        |
|--------------------------------|-----------------------------|--------|---------------------------|--------|
|                                | 2016                        | 2015   | 2016                      | 2015   |
| (Dollars in thousands)         |                             |        |                           |        |
| Balance at beginning of period | \$ 52                       | \$ 115 | \$ 73                     | \$ 135 |
| Acquisition of impaired loans  | —                           | —      | —                         | —      |
| Accretion of discount          | (8 )                        | (14 )  | (29 )                     | (34 )  |
| Balance at end of period       | \$ 44                       | \$ 101 | \$ 44                     | \$ 101 |

## Consumer Mortgage Loans Secured by Residential Real Estate in Process of Foreclosure

The following table summarizes the recorded investment in consumer mortgage loans secured by residential real estate in the process of foreclosure:

(Dollars in thousands)

|                 | June 30,            |                 |                     |
|-----------------|---------------------|-----------------|---------------------|
|                 | 2016                | 2015            |                     |
| Number of loans | Recorded Investment | Number of loans | Recorded Investment |
| 4               | \$ 840              | 5               | \$ 1,809            |

In the normal course of business, the Bank may consider modifying loan terms for various reasons. These reasons may include as a retention strategy to compete in the current interest rate environment or as a re-amortization or extension of a loan term to better match the loan’s repayment stream with the borrower’s cash flow. A modified loan would be considered a troubled debt restructuring (“TDR”) if the Bank grants a concession to a borrower and has determined that the borrower is troubled (i.e., experiencing financial difficulties).

If the Bank restructures a loan to a troubled borrower, the loan terms (i.e., interest rate, payment, amortization period and maturity date) may be modified in various ways to enable the borrower to cover the modified debt service payments based on current financial statements and cash flow adequacy. If a borrower’s hardship is thought to be temporary, then modified terms may only be offered for that time period. Where possible, the Bank would attempt to obtain additional collateral and/or secondary repayment sources at the time of the restructuring in order to put the Bank in the best possible position if the borrower is not able to meet the modified terms. The Bank will not offer modified terms if it believes that modifying the loan terms will only delay an inevitable permanent default. In evaluating whether a restructuring constitutes a troubled debt restructuring, applicable guidance requires that a creditor must separately conclude that the restructuring constitutes a concession and the borrower is experiencing financial difficulties.

There were no loans modified that were TDRs during the three and six months ended June 30, 2016. For the year ended December 31, 2015, there was 1 loan with a recorded investment of \$288,000 that was modified as a TDR. There were no troubled debt restructurings that subsequently defaulted within twelve months of restructuring

during the three and six months ended June 30, 2016 and the year ended December 31, 2015.

## (5) Share-Based Compensation

The Company's share-based incentive plans ("Stock Plans") authorize the issuance of an aggregate of 459,322 shares of the Company's common stock (as adjusted for stock dividends) pursuant to awards that may be granted in the form of stock options to purchase common stock ("Options") and awards of shares of common stock ("Stock Awards"). The purpose of the Stock Plans is to attract and retain personnel for positions of substantial responsibility and to provide additional incentive to certain officers, directors, employees and other persons to promote the success of the Company. Under the Stock Plans, options may have a term of not more than ten years after the date of grant, subject to earlier termination in certain circumstances. Options are granted with an exercise price at the closing price of the Company's common stock on the date of grant or otherwise as provided for in the Stock Plans. The grant date fair value is calculated using the Black – Scholes option valuation model.

As of June 30, 2016, there were 230,865 shares of common stock available for future grants under the Stock Plans, of which 191,155 shares were available for future grants under the 2013 Equity Incentive Plan and 39,710 shares were available for future grant under the 2015 Directors Stock Plan.

Share-based compensation expense related to options was \$22,000 and \$23,000 for the six months ended June 30, 2016 and 2015, respectively.

Transactions under the Stock Plans during the six months ended June 30, 2016 are summarized as follows:

| (Dollars in thousands, except share amounts) | Number of | Weighted<br>Average<br>Exercise<br>Price | Weighted  | Aggregate |
|--|-----------|--|---|-----------|
|  |           |  | Average<br>Remaining<br>Contractual<br>Term (years) |           |
| Stock Options                                | Shares    |  |   |           |
| Outstanding at January 1, 2016               | 177,594   | \$ 7.41                                  |   |           |
| Granted                                      | 11,655    | 11.98                                    |   |           |
| Exercised                                    | (3,564)   | 6.49                                     |   |           |
| Forfeited                                    | —         | —  |   |           |
| Expired                                      | —         | —  |   |           |
| Outstanding at June 30, 2016                 | 185,685   | \$ 7.65                                  | 4.9   | \$ 811    |
| Exercisable at June 30, 2016                 | 167,631   | \$ 7.64                                  | 4.7   | \$ 735    |

The fair value of each option and the significant weighted average assumptions used to calculate the fair value of the options granted for the six months ended June 30, 2016 are as follows:

January  
2016

|                                   |         |
|-----------------------------------|---------|
| Fair value of options granted     | \$4.65  |
| Risk-free rate of return          | 2.25 %  |
| Expected option life in years     | 7       |
| Expected volatility               | 30.66 % |
| Expected dividends <sup>(1)</sup> | —       |

(1) To date, the Company has not paid cash dividends on its common stock.

As of June 30, 2016, there was approximately \$89,000 of unrecognized compensation cost related to non-vested stock option-based compensation arrangements granted under the Stock Plans. That cost is expected to be recognized over the next four years.



The following table summarizes the activity in non-vested restricted shares for the six months ended June 30, 2016:

|                               | Number<br>of<br>Shares | Average<br>Grant-Date<br>Fair Value |
|-------------------------------|------------------------|-------------------------------------|
| Non-vested at January 1, 2016 | 143,879                | \$ 8.32                             |
| Granted                       | 45,950                 | 12.16                               |
| Vested                        | (23,742 )              | 10.41                               |
| Forfeited                     | (3,000 )               | 12.69                               |
| Non-vested at June 30, 2016   | 163,087                | \$ 9.04                             |

The value of restricted shares is based upon the closing price of the common stock on the date of grant. The shares generally vest over a 4 year service period for employees and a 2 year service period for non-employee directors with compensation expense recognized on a straight-line basis.

Share-based compensation expense related to stock grants was \$340,000 and \$303,000 for the six months ended June 30, 2016 and 2015, respectively.

As of June 30, 2016, there was approximately \$1.3 million of unrecognized compensation cost related to non-vested stock grants. Compensation costs related to non-vested stock grants are recognized over four years for employees and two years for non-employee directors from the date of grant.

#### (6) Benefit Plans

The Bank has a 401(k) plan which covers substantially all employees with six months or more of service. The Bank's 401(k) plan permits all eligible employees to make contributions to the plan up to the IRS salary deferral limit. The Bank's contributions to the 401(k) plan are expensed as incurred.

The Company also provides retirement benefits to certain employees under supplemental executive retirement plans. The plans are unfunded and the Company accrues actuarially determined benefit costs over the estimated service period of the employees in the plans. The Company recognizes the over-funded or under-funded status of a defined benefit post-retirement plan as an asset or liability on its balance sheet and recognizes changes in that funded status in the year in which the changes occur, through comprehensive income.

In connection with the benefit plans, the Bank has life insurance policies on the lives of its executives, directors and divisional officers. The Bank is the owner and beneficiary of the policies. The cash surrender values of the policies totaled approximately \$21.9 million and \$21.6 million at June 30, 2016 and December 31, 2015, respectively.

The components of net periodic expense for the Company's supplemental executive retirement plans for the three and six months ended June 30, 2016 and 2015 were as follows:

| (Dollars in thousands)    | Three<br>Months<br>Ended<br>June 30, |        | Six Months<br>Ended<br>June 30, |        |
|---------------------------|--------------------------------------|--------|---------------------------------|--------|
|                           | 2016                                 | 2015   | 2016                            | 2015   |
| Service cost              | \$56                                 | \$91   | 104                             | 165    |
| Interest cost             | 47                                   | 78     | 85                              | 124    |
| Actuarial gain recognized | (46 )                                | (110 ) | (72 )                           | (155 ) |
|                           | \$57                                 | \$59   | \$117                           | \$134  |

## (7) Other Comprehensive Income (Loss) and Accumulated Other Comprehensive Income (Loss)

Other comprehensive income (loss) is the total of (1) net income (loss), and (2) all other changes in equity from non-shareholder sources, which are referred to as other comprehensive income (loss). The components of accumulated other comprehensive income (loss), and the related tax effects, are as follows:

|  | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
|--|----------------------|-------------------------|----------------------|
| (Dollars in thousands)   |                      |                         |                      |
| June 30, 2016  |                      |                         |                      |
| Unrealized holding gains on available-for-sale securities            | \$ 1,460             | \$(570)                 | \$ 890               |
| Unrealized impairment (loss) on held to maturity security            | (501 )               | 170                     | (331 )               |
| Unfunded pension liability:  |                      |                         |                      |
| Plan actuarial gains (losses) included in other comprehensive income | 148                  | (60 )                   | 88                   |
| Accumulated other comprehensive income                               | \$ 1,107             | \$(460)                 | \$ 647               |
|  | Before-Tax<br>Amount | Income<br>Tax<br>Effect | Net-of-Tax<br>Amount |
| June 30, 2015  |                      |                         |                      |
| Unrealized holding (losses) on available-for-sale securities         | \$ (192 )            | \$ 31                   | \$ (161 )            |
| Unrealized impairment (loss) on held to maturity security            | (501 )               | 170                     | (331 )               |
| Unfunded pension liability:  |                      |                         |                      |
| Plan actuarial gains (losses) included in other comprehensive income | 443                  | (178 )                  | 265                  |
| Accumulated other comprehensive (loss) income                        | \$ (250 )            | \$ 23                   | \$ (227 )            |

Changes in the components of accumulated other comprehensive income (loss) are as follows and are presented net of tax:

|   | Unrealized<br>Holding<br>Gains<br>(Losses)<br>on<br>Available<br>for Sale<br>Securities | Unrealized<br>Impairment<br>Loss on<br>Held to<br>Maturity<br>Security | Unfunded<br>Pension<br>Liability | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|---|---|--|----------------------------------|--|
| (Dollars in thousands)  |   |  |                                  |  |
| Three Months Ended June 30, 2016:                                       |   |  |                                  |  |
| Balance, beginning of period  | \$ 420  | \$ (331 )  | \$ 96                            | \$ 185   |
| Other comprehensive income (loss) before reclassifications              | 470   | —  | 20                               | 490  |
| Amounts reclassified from accumulated other comprehensive income (loss) | —   | —  | (28 )                            | (28 )  |
| Other comprehensive income (loss)                                       | 470   | —  | (8 )                             | 462  |
| Balance, end of period  | \$ 890  | \$ (331 )  | \$ 88                            | \$ 647   |

|   | Unrealized<br>Holding<br>Gains<br>(Losses)<br>on<br>Available<br>for<br>Sale<br>Securities | Unrealized<br>Impairment<br>Loss on<br>Held to<br>Maturity<br>Security | Unfunded<br>Pension<br>Liability | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|---|--|--|----------------------------------|--|
| Three Months Ended June 30, 2015:                                       |  |  |                                  |  |
| Balance, beginning of period  | \$ 326   | \$ (331 )  | \$ 276                           | \$ 271   |
| Other comprehensive income (loss) before reclassifications              | (487 )   | —  | 55                               | (432 )   |
| Amounts reclassified from accumulated other comprehensive income (loss) | —  | —  | (66 )                            | (66 )  |
| Other comprehensive income (loss)                                       | (487 )   | —  | (11 )                            | (498 )   |
| Balance, end of period  | \$ (161 )  | \$ (331 )  | \$ 265                           | \$ (227 )  |

|   | Unrealized<br>Holding<br>Gains<br>(Losses)<br>on<br>Available<br>for<br>Sale<br>Securities | Unrealized<br>Impairment<br>Loss on<br>Held to<br>Maturity<br>Security | Unfunded<br>Pension<br>Liability | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|---|--|--|----------------------------------|--|
| (Dollars in thousands)  |  |  |                                  |  |
| Six Months Ended June 30, 2016:   |  |  |                                  |  |
| Balance, beginning of period  | \$ 90  | \$ (331 )  | \$ 111                           | \$ (130 )  |
| Other comprehensive income (loss) before reclassifications              | 800  | —  | 20                               | 820  |
| Amounts reclassified from accumulated other comprehensive income (loss) | —  | —  | (43 )                            | (43 )  |
| Other comprehensive income (loss)                                       | 800  | —  | (23 )                            | 777  |
| Balance, end of period  | \$ 890   | \$ (331 )  | \$ 88                            | \$ 647   |

|                                 | Unrealized<br>Holding<br>Gains<br>(Losses)<br>on<br>Available<br>for<br>Sale<br>Securities | Unrealized<br>Impairment<br>Loss on<br>Held to<br>Maturity<br>Security | Unfunded<br>Pension<br>Liability | Accumulated<br>Other<br>Comprehensive<br>Income (Loss) |
|---------------------------------|--|--|----------------------------------|--|
| Six Months Ended June 30, 2015: |  |  |                                  |  |
| Balance, beginning of period    | \$ 276   | \$ (331 )  | \$ 303                           | \$ 248   |
|                                 | (437 )   | —  | 55                               | (382 )   |

|   |         |   |         |     |         |
|---|---------|---|---------|-----|---------|
| Other comprehensive income (loss) before reclassifications              |         |   |         |     |         |
| Amounts reclassified from accumulated other comprehensive income (loss) | —       | — | (93     | )   | (93     |
| Other comprehensive income (loss)                                       | (437    | ) | —       | (38 | )       |
| Balance, end of period  | \$ (161 | ) | \$ (331 | )   | \$ 265  |
|   |         |   |         |     | \$ (227 |

(8) Recent Accounting Pronouncements

ASU Update 2016-13 Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.

In June 2016, the FASB issued ASU 2016-13 "Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" which requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument.

The ASU also replaces the current accounting model for purchased credit impaired loans and debt securities. The allowance for credit losses for purchased financial assets with a more-than-insignificant amount of credit deterioration since origination ("PCD assets") should be determined in a similar manner to other financial assets measured on an amortized cost basis. Upon initial recognition, the allowance for credit losses is added to the purchase price ("gross up approach") to determine the initial amortized cost basis. The subsequent accounting for PCD financial assets will use the CECL model described above.

The ASU made certain targeted amendments to the existing impairment model for available-for-sale (AFS) debt securities. For an AFS debt security for which there is neither the intent nor a more-likely-than-not requirement to sell, an entity will record credit losses as an allowance rather than a write-down of the amortized cost basis.

For public business entities that are SEC filers, the amendments are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for all entities as of the fiscal year beginning after December 15, 2018, including interim periods within those fiscal years.

The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

ASU Update 2016-09 Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.

In March 2016, the FASB issued ASU 2016-09 "Compensation-Stock Compensation: Improvements to Employee Share-Based Payment Accounting" to simplify the accounting for stock compensation. The ASU focuses on income tax accounting, award classification, estimating forfeitures and cash flow presentation. The ASU also provides certain accounting policy alternatives to nonpublic entities. The ASU simplifies several aspects of the stock compensation guidance in Topic 718 and other related guidance. The following six amendments apply to all entities: (1) accounting for income taxes upon vesting or exercise of share-based payments and related EPS effects, (2) classification of excess tax benefits on the statement of cash flows, (3) accounting for forfeitures, (4) liability classification exception for statutory tax withholding requirements, (5) cash flow presentation of employee taxes paid when an employer withholds shares for tax-withholding purposes and (6) elimination of the indefinite deferral in Topic 718.

For public business entities, the amendments are effective for annual periods beginning after December 15, 2016, and interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted for any entity in any interim or annual period for which the financial statements have not been issued or made available to be issued. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The Company is currently evaluating the

impact of the pending adoption of the new standard on its consolidated financial statements.

ASU Update 2016-02: Leases.

In February 2016, the FASB issued ASU 2016-02 "Leases." From the lessee's perspective, the new standard establishes a right-of-use ("ROU") model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessee. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing. If the lessor doesn't convey risks and rewards or control, an operating lease results.

The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Company is currently evaluating the impact of the pending adoption of the new standard on its consolidated financial statements.

ASU Update 2016-01 Financial Instruments-Overall: Recognition and Measurement of Financial Assets and Financial Liabilities.

In January 2016, the FASB issued ASU 2016-01 "Financial Instruments-Overall: Recognition and Measurement of Financial Assets and Financial Liabilities." The guidance in the ASU, among other things, requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income; simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; requires an entity to present separately in other comprehensive income the portion of the change in fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements; and clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. The guidance in this ASU is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements.

ASU Update 2015-16 Business Combination (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments.

In September 2015, the FASB issued ASU 2015-16 "Business Combination (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments," to require adjustments to provisional amounts that are identified during the measurement period to be recognized in the reporting period in which the adjustment amounts are determined. This includes any effect on earnings of changes in depreciation, amortization or other income effects as a result of the change to the provisional amounts, calculated as if the accounting had been completed at the acquisition date. The amendments in this update would require an entity to disclose (either on the face of the income statement or in the notes) the nature and amount of measurement-period adjustments recognized in the current period, including separately the amounts in current-period income statement line items that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The amendments are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015 and for all other entities for fiscal years beginning after December 31, 2016 and for interim periods within fiscal years beginning after December 15, 2017. Adoption of this guidance in 2016 did not have a material impact on the Company's consolidated financial statements.

ASU 2014-9 Revenue from Contracts with Customers (Topic 606)

In May 2014, the FASB issued ASU 2014-9, "Revenue from Contracts with Customers (Topic 606)." The objective of this amendment is to clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP. This update affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of non-financial assets unless those contracts are in the scope of other

standards. This ASU, which does not apply to financial instruments, is effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is permitted only as of annual reporting periods beginning after December 15, 2016, including interim periods within that year. The Company does not expect the adoption of this guidance to have a material impact on the Company's consolidated financial statements related to this guidance.



ASU 2014-12 Accounting for Share-Based-Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period (a consensus of the FAS Emerging Issues Task Force). In June 2014, the FASB issued ASU 2014-12, "Accounting for Share-Based-Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved After the Requisite Service Period," which requires that a performance target included in a share-based payment award that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. This update is effective for interim and annual periods beginning after December 15, 2015. The amendments can be applied prospectively to all awards granted or modified after the effective date or retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented and to all new or modified awards thereafter. Adoption of this guidance in 2016 did not have a material impact on the Company's consolidated financial statements.

(9) Fair Value Disclosures

U.S. GAAP has established a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported with little or no market activity).

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial assets and financial liabilities carried at fair value. In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and counterparty creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

Securities Available for Sale. Securities classified as available for sale are reported at fair value utilizing quoted market prices on nationally recognized exchanges (Level 1) or by using Level 2 inputs. For Level 2 securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayments speeds, credit information and the security's terms and conditions, among other things.

Impaired loans. Loans included in the following table are those which the Company has measured and recognized impairment, generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third party appraisals of the collateral or discounted cash flows based on the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of the loan balances less specific valuation allowances.

Other Real Estate Owned. Foreclosed properties are adjusted to fair value less estimated selling costs at the time of foreclosure in preparation for transfer from portfolio loans to other real estate owned ("OREO"), establishing a new

accounting basis. The Company subsequently adjusts the fair value of the OREO utilizing Level 3 inputs on a non-recurring basis to reflect partial write-downs based on the observable market price, current appraised value of the asset or other estimates of fair value. The

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fair value of other real estate owned is determined using appraisals, which may be discounted based on management's review and changes in market conditions.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| (Dollars in thousands)   | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair<br>Value |
|--|-------------------|-------------------|-------------------|------------------------|
| June 30, 2016:   |                   |                   |                   |                        |
| Securities available for sale:   |                   |                   |                   |                        |
| U. S. Treasury securities and obligations of U.S. Government sponsored corporations ("GSE") and agencies | \$—               | \$5,558           | \$—               | —\$5,558               |
| Residential collateralized mortgage obligations- GSE   | —                 | 17,832            | —                 | 17,832                 |
| Residential mortgage backed securities – GSE   | —                 | 35,779            | —                 | 35,779                 |
| Obligations of state and political subdivisions  | —                 | 21,672            | —                 | 21,672                 |
| Trust preferred debt securities – single issuer  | —                 | 2,088             | —                 | 2,088                  |
| Corporate debt securities  | 10,800            | 16,643            | —                 | 27,443                 |
| Other debt securities  | —                 | 955               | —                 | 955                    |
| Total  | \$10,800          | \$100,527         | \$—               | —\$111,327             |

| (Dollars in thousands)   | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair<br>Value |
|--|-------------------|-------------------|-------------------|------------------------|
| December 31, 2015:   |                   |                   |                   |                        |
| Securities available for sale:   |                   |                   |                   |                        |
| U. S. Treasury securities and obligations of U.S. Government sponsored corporations ("GSE") and agencies | \$—               | \$5,481           | \$—               | \$5,481                |
| Residential collateralized mortgage obligations- GSE   | —                 | 8,287             | —                 | 8,287                  |
| Residential mortgage backed securities – GSE   | —                 | 32,635            | —                 | 32,635                 |
| Obligations of state and political subdivisions  | —                 | 21,436            | —                 | 21,436                 |
| Trust preferred debt securities – single issuer  | —                 | 2,136             | —                 | 2,136                  |
| Corporate debt securities  | 14,043            | 6,379             | —                 | 20,422                 |
| Other debt securities  | —                 | 971               | 54                | 1,025                  |
| Total  | \$14,043          | \$77,325          | \$54              | \$91,422               |

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Assets and financial liabilities measured at fair value on a nonrecurring basis, where there was evidence of impairment, at June 30, 2016 and December 31, 2015 were as follows:

| (Dollars in thousands)  | Level 1<br>Inputs | Level 2<br>Inputs | Level 3<br>Inputs | Total<br>Fair<br>Value |
|-------------------------|-------------------|-------------------|-------------------|------------------------|
| June 30, 2016:          |                   |                   |                   |                        |
| Impaired loans          | \$—               | —\$               | —\$3,655          | \$3,655                |
| Other real estate owned | —                 | —                 | 166               | 166                    |
| December 31, 2015:      |                   |                   |                   |                        |
| Impaired loans          | \$—               | —\$               | —\$3,960          | \$3,960                |
| Other real estate owned | —                 | —                 | 966               | 966                    |

Impaired loans measured at fair value and included in the above table at June 30, 2016 consisted of 5 loans having an aggregate recorded investment of \$3.8 million and specific loan loss allowances of \$130,000. Impaired loans measured at fair value and included in the above table at December 31, 2015 consisted of 9 loans having an aggregate balance of \$4.3 million with a specific loan loss allowance of \$326,000.

The following table presents additional qualitative information about assets measured at fair value on a nonrecurring basis, where there was evidence of impairment, and for which the Company has utilized Level 3 inputs to determine fair value:

## Quantitative Information about Level 3 Fair Value Measurements

| (Dollars in thousands)  | Fair Value Estimate | Valuation Techniques        | Unobservable Input        | Range (Weighted Average) |
|-------------------------|---------------------|-----------------------------|---------------------------|--------------------------|
| June 30, 2016           |                     |                             |                           |                          |
| Impaired loans          | \$ 3,655            | Appraisal of collateral (1) | Appraisal adjustments (2) | 3% - 100% (41.6%)        |
| Other real estate owned | \$ 166              | Appraisal of collateral (1) | Appraisal adjustments (2) | 3.1%                     |
| December 31, 2015       |                     |                             |                           |                          |
| Impaired loans          | \$ 3,960            | Appraisal of collateral (1) | Appraisal adjustments (2) | 11%-44% (29.6%)          |
| Other real estate owned | \$ 966              | Appraisal of collateral (1) | Appraisal adjustments (2) | 11%                      |

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which generally include various Level 3 inputs which are not identifiable.

(2) Includes qualitative adjustments by management and estimated liquidation expenses.

The following is a summary of fair value versus carrying value of all of the Company's financial instruments. For the Company and the Bank, as with most financial institutions, the bulk of their assets and liabilities are considered financial instruments. Many of the financial instruments lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction. Therefore, significant estimations and present value calculations were used for the purpose of this note. Changes in assumptions could significantly affect these estimates. Estimated fair values have been determined by using the best available data and an estimation methodology suitable for each category of financial instruments as follows:

Cash and Cash Equivalents, Accrued Interest Receivable and Accrued Interest Payable (Carried at Cost). The carrying amounts reported in the balance sheet for cash and cash equivalents, accrued interest receivable and accrued interest payable approximate fair value.

Securities Held to Maturity (Carried at Amortized Cost). The fair values of securities held to maturity are determined in the same manner as for securities available for sale.

Loans Held For Sale (Carried at Lower of Aggregated Cost or Fair Value). The fair values of loans held for sale are determined, when possible, using quoted secondary market prices. If no such quoted market prices exist, fair values are determined using quoted prices for similar loans, adjusted for the specific attributes of the loans.

Gross Loans Receivable (Carried at Cost). The fair values of loans, excluding impaired loans subject to specific loss reserves, are estimated using discounted cash flow analyses that use market rates as of the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that re-price frequently and with no significant change in credit risk, fair values are based on carrying values. Deposit Liabilities (Carried at Cost). The fair values disclosed for demand deposits (e.g., interest and non-interest demand and savings accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates of deposit to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings and Subordinated Debt (Carried at Cost). The carrying amounts of short-term borrowings approximate their fair values. The fair values of long-term FHLB advances are estimated using discounted cash flow analysis, based on quoted or estimated interest rates for new borrowings with similar credit risk characteristics, terms and remaining maturity. For subordinated debt, which reprices quarterly, the fair value is based on inputs that are

observable either directly or indirectly for similar debt obligations.

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The estimated fair values and carrying amounts of financial assets and liabilities as of June 30, 2016 and December 31, 2015 were as follows:

June 30, 2016

| (Dollars in thousands)        | Carrying Value | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Fair Value |
|-------------------------------|----------------|----------------|----------------|----------------|------------|
| Cash and cash equivalents     | \$13,650       | \$13,650       | \$ —           | \$ —           | —\$13,650  |
| Securities available for sale | 111,327        | 10,800         | 100,527        | —              | 111,327    |
| Securities held to maturity   | 122,635        | —              | 127,899        | —              | 127,899    |
| Loans held for sale           | 3,228          | —              | 3,277          | —              | 3,277      |
| Net loans                     | 754,090        | —              | —              | 758,697        | 758,697    |
| Accrued interest receivable   | 3,051          | —              | 3,051          | —              | 3,051      |
| Deposits                      | (791,486)      | —              | (792,085)      | —              | (792,085)  |
| Borrowings                    | (149,865)      | —              | (150,232)      | —              | (150,232)  |
| Redeemable subordinated debt  | (18,557 )      | —              | (11,641 )      | —              | (11,641 )  |
| Accrued interest payable      | (846 )         | —              | (846 )         | —              | (846 )     |

December 31, 2015

| (Dollars in thousands)        | Carrying Value | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Fair Value |
|-------------------------------|----------------|----------------|----------------|----------------|------------|
| Cash and cash equivalents     | \$11,368       | \$11,368       | \$ —           | \$ —           | —\$11,368  |
| Securities available for sale | 91,422         | 14,043         | 77,325         | 54             | 91,422     |
| Securities held to maturity   | 123,261        | —              | 127,157        | —              | 127,157    |
| Loans held for sale           | 5,997          | —              | 6,115          | —              | 6,115      |
| Net loans                     | 674,561        | —              | —              | 680,719        | 680,719    |
| Accrued interest receivable   | 2,853          | —              | 2,853          | —              | 2,853      |
| Deposits                      | (786,757)      | —              | (786,594)      | —              | (786,594)  |
| Borrowings                    | (58,896 )      | —              | (59,347 )      | —              | (59,347 )  |
| Redeemable subordinated debt  | (18,557 )      | —              | (11,641 )      | —              | (11,641 )  |
| Accrued interest payable      | (846 )         | —              | (846 )         | —              | (846 )     |

Loan commitments and standby letters of credit as of June 30, 2016 and December 31, 2015 were based on fees charged for similar agreements; accordingly, the estimated fair value of loan commitments and standby letters of credit was nominal.

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

This discussion and analysis of the operating results for the three and six months ended June 30, 2016 and financial condition at June 30, 2016 is intended to help readers analyze the accompanying financial statements, notes and other supplemental information contained in this document. Results of operations for the three and six month period ended June 30, 2016 are not necessarily indicative of results to be attained for any other period.

This discussion and analysis should be read in conjunction with the consolidated financial statements, notes and tables included elsewhere in this report and Part II, Item 7 of the Company's Form 10-K (Management's Discussion and Analysis of Financial Condition and Results of Operation) for the year ended December 31, 2015, as filed with the Securities and Exchange Commission (the "SEC") on March 22, 2016.

General

Throughout the following sections, the "Company" refers to<sup>ST</sup> 1st Constitution Bancorp and, as the context requires, its wholly-owned subsidiary, 1<sup>ST</sup> Constitution Bank (the "Bank"), and the Bank's wholly-owned subsidiaries,<sup>ST1</sup> Constitution Investment Company of New Jersey, Inc., FCB Assets Holdings, Inc., LLC, 204 South Newman Street Corp. and 249 New York Avenue, LLC. 1<sup>ST</sup> Constitution Capital Trust II ("Trust II"), a subsidiary of the Company, is not included in the Company's consolidated financial statements as it is a variable interest entity and the Company is not the primary beneficiary.

Trust II, a subsidiary of the Company, was created in May 2006 to issue trust preferred securities to assist the Company in raising additional capital.

The Company is a bank holding company registered under the Bank Holding Company Act of 1956, as amended. The Company was organized under the laws of the State of New Jersey in February 1999 for the purpose of acquiring all of the issued and outstanding stock of the Bank, a full service commercial bank which began operations in August 1989, thereby enabling the Bank to operate within a bank holding company structure. The Company became an active bank holding company on July 1, 1999. Other than its ownership interest in the Bank, the Company currently conducts no other significant business activities.

The Bank operates nineteen branches and manages an investment portfolio through its subsidiary, 1<sup>ST</sup> Constitution Investment Company of New Jersey, Inc. FCB Assets Holdings, Inc., a subsidiary of the Bank, is used by the Bank to manage and dispose of repossessed real estate.

When used in this Quarterly Report on Form 10-Q for the three and six month periods ended June 30, 2016 (this "Form 10-Q"), the words "the Company," "we," "our," and "us" refer to 1st Constitution Bancorp and its wholly-owned subsidiaries, unless we indicate otherwise.

Forward-Looking Statements

This report contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Private Securities Litigation Reform Act of 1995 provides a "safe harbor" for forward-looking statements. When used in this and in future filings by the Company with the SEC, in the Company's press releases and in oral statements made with the approval of an authorized executive officer of the Company, the words or phrases "will," "will likely result," "could," "anticipates," "believes," "continues," "expects," "plans," "will continue," "is anticipated," "estimated," "project" or "outlook" expressions (including confirmations by an authorized executive officer of the Company of any such expressions made by a third party with respect to the Company) are intended to identify forward-looking statements. The Company cautions readers not to place undue reliance on any such forward-looking statements, each of which speaks only as of the date made. Such statements are subject to certain risks and uncertainties that could cause actual results to differ materially from historical earnings and those presently anticipated or projected.

Factors that may cause actual results to differ from those results expressed or implied, include, but are not limited to, those listed under "Business", "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Company's Annual Report on Form 10-K for the year ended December 31, 2015 filed with the SEC on March 22, 2016, such as the overall economy and the interest rate environment; the ability of customers to repay their obligations; the adequacy of the allowance for loan losses; competition; significant changes in accounting, tax or regulatory practices and requirements; certain interest rate risks; risks associated with



investments in mortgage-backed securities; risks associated with speculative construction lending; and risks associated with safeguarding information technology systems. Although management has taken certain steps to mitigate any negative effect of the aforementioned items, significant unfavorable changes could severely impact the assumptions used and could have an adverse effect on profitability. The Company undertakes no obligation to publicly revise any forward-looking statements to reflect anticipated or unanticipated events or circumstances occurring after the date of such statements, except as required by law.

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## RESULTS OF OPERATIONS

Three and Six Months Ended June 30, 2016 Compared to Three and Six Months Ended June 30, 2015

### Summary

The Company reported net income of \$2.3 million for the three months ended June 30, 2016 and the three months ended June 30, 2015. Net income per diluted share was \$0.28 for the second quarter of 2016 compared to net income per diluted share of \$0.29 for the second quarter of 2015. Net income per diluted share declined slightly due to the higher average number of diluted shares outstanding in 2016.

The Company reported net income of \$4.5 million or \$0.56 per diluted share for the six month period ended June 30, 2016 compared to net income of \$4.6 million or \$0.57 per diluted share for the six month period ended June 30, 2015. Return on average assets and return on average equity were 0.95% and 9.36%, respectively, for the three months ended June 30, 2016 compared to return on average assets and return on average equity of 0.95% and 10.42%, respectively, for the three months ended June 30, 2015. Book value and tangible book value per share were \$12.78 and \$11.13, respectively at June 30, 2016.

Return on average assets and return on average equity were 0.94% and 9.28%, respectively, for the six months ended June 30, 2016 compared to return on average assets and return on average equity of 0.95% and 10.42%, respectively, for the six months ended June 30, 2015.

### Second Quarter Highlights

Net income was \$2.3 million in the second quarter of 2016 and the second quarter of 2015.

Net interest income was \$8.6 million in the second quarter of 2016, a decrease of \$797,000 from \$9.4 million in the second quarter of 2015, and the net interest margin was 3.86% and 4.20% on a tax equivalent basis for the respective periods.

Loans held in portfolio increased \$102.1 million during the quarter to \$759.8 million at June 30, 2016 and the loan to asset ratio was 71.3% at June 30, 2016.

During the second quarter of 2016, \$1.3 million of non-performing assets were resolved and non-performing assets declined to \$5.3 million and 0.50% of assets at June 30, 2016 from \$7.0 million and 0.72% of assets, respectively, at December 31, 2015.

The Bank recorded a credit (negative) provision for loan losses of \$100,000 in the second quarter of 2016 due to lower historical loan loss reserve factors that reflected the improvement in loan credit quality, the resolution and reduction of non-performing loans, the low level of net charge-offs over the prior five quarters and net recoveries of \$280,000 in the second quarter of loans previously charged-off.

### Earnings Analysis

The Bank's results of operations depend primarily on net interest income, which is primarily affected by the market interest rate environment, the shape of the U.S. Treasury yield curve, and the difference between the yield on interest-earning assets and the rate paid on interest-bearing liabilities. Other factors that may affect the Bank's operating results are general and local economic and competitive conditions, government policies and actions of regulatory authorities.

### Net Interest Income

Net interest income, the Company's largest and most significant component of operating income, is the difference between interest and fees earned on loans and other earning assets and interest paid on deposits and borrowed funds. This component represented 84.9% of the Company's net revenues (defined as net interest income plus non-interest income) for the three months ended June 30, 2016 compared to 82.6% of net revenues for the three months ended June 30, 2015. Net interest income also depends upon the relative amount of average interest-earning assets, average interest-bearing liabilities, and the interest rate earned or paid on them, respectively.

For the six months ended June 30, 2016, net interest income represented 84.5% of the Company's net revenues compared to 81.3% of net revenues for the six months ended June 30, 2015.

The following tables set forth the Company's consolidated average balances of assets and liabilities and shareholders' equity as well as interest income and expense on related items, and the Company's average yield or rate for the three and six month periods



ended June 30 2016 and 2015. The average rates are derived by dividing interest income and expense by the average balance of assets and liabilities, respectively.

| (Dollars in thousands)                       | Three months ended June 30,<br>2016 |           |                  | Three months ended June 30,<br>2015 |           |                  |   |  |
|--|-------------------------------------|-----------|------------------|-------------------------------------|-----------|------------------|---|--|
|  | Average<br>Balance                  | Interest  | Average<br>Yield | Average<br>Balance                  | Interest  | Average<br>Yield |   |  |
| <b>Assets:</b>                               |                                     |           |                  |                                     |           |                  |   |  |
| Federal Funds Sold/Short-Term Investments    | \$ 18,659                           | \$ 18     | 0.38             | % \$ 8,223                          | \$ 6      | 0.28             | % |  |
| <b>Investment Securities:</b>                |                                     |           |                  |                                     |           |                  |   |  |
| Taxable                                      | 149,629                             | 815       | 2.18             | % 129,888                           | 790       | 2.43             | % |  |
| Tax-exempt (4)                               | 80,036                              | 770       | 3.85             | % 80,121                            | 785       | 3.92             | % |  |
| Total  | 229,665                             | 1,585     | 2.76             | % 210,009                           | 1,575     | 3.00             | % |  |
| <b>Loan Portfolio: (1)</b>                   |                                     |           |                  |                                     |           |                  |   |  |
| Construction                                 | 88,411                              | 1,309     | 5.95             | % 96,764                            | 1,539     | 6.38             | % |  |
| Residential real estate                      | 42,125                              | 449       | 4.27             | % 43,904                            | 463       | 4.22             | % |  |
| Home Equity                                  | 23,895                              | 251       | 4.23             | % 22,460                            | 267       | 4.78             | % |  |
| Commercial and commercial<br>real estate     | 321,983                             | 4,431     | 5.53             | % 313,610                           | 4,528     | 5.79             | % |  |
| Mortgage warehouse lines                     | 192,553                             | 2,048     | 4.28             | % 217,199                           | 2,360     | 4.36             | % |  |
| Installment                                  | 580                                 | 6         | 4.34             | % 505                               | 6         | 4.54             | % |  |
| All Other Loans                              | 4,615                               | 24        | 2.09             | % 11,221                            | 75        | 2.67             | % |  |
| Total  | 674,162                             | 8,518     | 5.08             | % 705,663                           | 9,238     | 5.27             | % |  |
| Total Interest-Earning Assets                | 922,486                             | \$ 10,121 | 4.41             | % 923,895                           | \$ 10,819 | 4.71             | % |  |
| Allowance for Loan Losses                    | (7,432 )                            |           |                  | (7,698 )                            |           |                  |   |  |
| Cash and Due From Bank                       | 5,065                               |           |                  | 7,680                               |           |                  |   |  |
| Other Assets                                 | 60,092                              |           |                  | 63,073                              |           |                  |   |  |
| Total Assets                                 | \$ 980,211                          |           |                  | \$ 986,950                          |           |                  |   |  |
| <b>Liabilities and Shareholders' Equity:</b> |                                     |           |                  |                                     |           |                  |   |  |
| Money Market and NOW Accounts                | \$ 294,048                          | \$ 270    | 0.37             | % \$ 304,755                        | \$ 250    | 0.33             | % |  |
| Savings Accounts                             | 205,997                             | 302       | 0.59             | % 198,252                           | 230       | 0.47             | % |  |
| Certificates of Deposit                      | 143,057                             | 416       | 1.17             | % 152,253                           | 432       | 1.14             | % |  |
| Other Borrowed Funds                         | 47,028                              | 165       | 1.41             | % 51,085                            | 153       | 1.21             | % |  |
| Redeemable Subordinated Debt                 | 18,557                              | 104       | 2.24             | % 18,557                            | 88        | 1.89             | % |  |
| Total Interest-Bearing Liabilities           | 708,687                             | \$ 1,257  | 0.71             | % 724,902                           | \$ 1,153  | 0.64             | % |  |
| Net Interest Spread (2)                      |                                     |           | 3.70             | %                                   |           | 4.07             | % |  |
| Demand Deposits                              | 165,396                             |           |                  | 163,223                             |           |                  |   |  |
| Other Liabilities                            | 6,737                               |           |                  | 8,975                               |           |                  |   |  |
| Total Liabilities                            | 880,820                             |           |                  | 897,100                             |           |                  |   |  |
| Shareholders' Equity                         | 99,391                              |           |                  | 89,850                              |           |                  |   |  |
| Total Liabilities and Shareholders' Equity   | \$ 980,211                          |           |                  | \$ 986,950                          |           |                  |   |  |
| Net Interest Margin (3)                      |                                     | \$ 8,864  | 3.86             | %                                   | \$ 9,666  | 4.20             | % |  |

Loan origination fees are considered an adjustment to interest income. For the purpose of calculating loan yields, average loan balances include non-accrual loans with no related interest income and the average balance of loans (1) held for sale. Please refer to Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation under the heading "Non-Performing Assets" for a discussion of the Bank's policy with regard to non-accrual loans.

(2) The net interest rate spread is the difference between the average yield on interest-earning assets and the average rate paid on interest-bearing liabilities.

(3) The net interest margin is equal to net interest income divided by average interest earning assets.



(4) Tax-equivalent basis. The tax equivalent adjustment was \$250 and \$255 for the three months ended June 30, 2016 and June 30 2015, respectively.

| (Dollars in thousands)                       | Six months ended June 30,<br>2016 |          |                  | Six months ended June 30,<br>2015 |          |                  |   |  |
|--|-----------------------------------|----------|------------------|-----------------------------------|----------|------------------|---|--|
|  | Average<br>Balance                | Interest | Average<br>Yield | Average<br>Balance                | Interest | Average<br>Yield |   |  |
| <b>Assets:</b>                               |                                   |          |                  |                                   |          |                  |   |  |
| Federal Funds Sold/Short-Term Investments    | \$30,611                          | \$67     | 0.44             | % \$24,420                        | \$31     | 0.25             | % |  |
| <b>Investment Securities:</b>                |                                   |          |                  |                                   |          |                  |   |  |
| Taxable                                      | 142,420                           | 1,632    | 2.29             | % 131,611                         | 1,607    | 2.44             | % |  |
| Tax-exempt (4)                               | 80,348                            | 1,540    | 3.83             | % 84,867                          | 1,645    | 3.88             | % |  |
| Total  | 222,768                           | 3,172    | 2.85             | % 216,478                         | 3,252    | 3.00             | % |  |
| <b>Loan Portfolio: (1)</b>                   |                                   |          |                  |                                   |          |                  |   |  |
| Construction                                 | 92,392                            | 2,661    | 5.79             | % 96,944                          | 3,080    | 6.41             | % |  |
| Residential real estate                      | 40,583                            | 858      | 4.23             | % 44,797                          | 936      | 4.22             | % |  |
| Home Equity                                  | 23,539                            | 490      | 4.19             | % 22,305                          | 506      | 4.58             | % |  |
| Commercial and commercial<br>real estate     | 313,655                           | 8,884    | 5.70             | % 310,249                         | 8,782    | 5.71             | % |  |
| Mortgage warehouse lines                     | 178,912                           | 3,836    | 4.31             | % 186,682                         | 4,079    | 4.41             | % |  |
| Installment                                  | 564                               | 12       | 4.29             | % 443                             | 11       | 4.81             | % |  |
| All Other Loans                              | 6,185                             | 84       | 2.73             | % 9,732                           | 133      | 2.73             | % |  |
| Total  | 655,830                           | 16,825   | 5.16             | % 671,152                         | 17,527   | 5.27             | % |  |
| Total Interest-Earning Assets                | 909,209                           | \$20,064 | 4.43             | % 912,050                         | \$20,810 | 4.60             | % |  |
| Allowance for Loan Losses                    | (7,525 )                          |          |                  | (7,467 )                          |          |                  |   |  |
| Cash and Due From Bank                       | 5,120                             |          |                  | 10,127                            |          |                  |   |  |
| Other Assets                                 | 59,534                            |          |                  | 62,664                            |          |                  |   |  |
| Total Assets                                 | \$966,338                         |          |                  | \$977,374                         |          |                  |   |  |
| <b>Liabilities and Shareholders' Equity:</b> |                                   |          |                  |                                   |          |                  |   |  |
| Money Market and NOW Accounts                | \$295,382                         | \$539    | 0.37             | % \$306,486                       | \$506    | 0.33             | % |  |
| Savings Accounts                             | 204,663                           | 573      | 0.56             | % 196,889                         | 455      | 0.47             | % |  |
| Certificates of Deposit                      | 143,379                           | 826      | 1.16             | % 157,809                         | 883      | 1.13             | % |  |
| Other Borrowed Funds                         | 37,054                            | 301      | 1.63             | % 36,524                          | 279      | 1.54             | % |  |
| Trust Preferred Securities                   | 18,557                            | 203      | 2.19             | % 18,557                          | 174      | 1.86             | % |  |
| Total Interest-Bearing Liabilities           | 699,035                           | \$2,442  | 0.70             | % 716,265                         | \$2,297  | 0.64             | % |  |
| Net Interest Spread (2)                      |                                   |          | 3.73             | %                                 |          | 3.96             | % |  |
| Demand Deposits                              | 161,593                           |          |                  | 163,516                           |          |                  |   |  |
| Other Liabilities                            | 7,435                             |          |                  | 8,677                             |          |                  |   |  |
| Total Liabilities                            | 868,063                           |          |                  | 888,458                           |          |                  |   |  |
| Shareholders' Equity                         | 98,275                            |          |                  | 88,916                            |          |                  |   |  |
| Total Liabilities and Shareholders' Equity   | \$966,338                         |          |                  | \$977,374                         |          |                  |   |  |
| Net Interest Margin (3)                      |                                   | \$17,622 | 3.89             | %                                 | \$18,513 | 4.09             | % |  |

Loan origination fees are considered an adjustment to interest income. For the purpose of calculating loan yields, average loan balances include non-accrual loans with no related interest income and the average balance of loans (1) held for sale. Please refer to Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operation under the heading "Non-Performing Assets" for a discussion of the Bank's policy with regard to non-accrual loans.

(2) The net interest rate spread is the difference between the average yield on interest-earning assets and the average rate paid on interest-bearing liabilities.

(3) The net interest margin is equal to net interest income divided by average interest earning assets.



(4) Tax-equivalent basis. The tax equivalent adjustment was \$500 and \$559 for the six months ended June 30, 2016 and June 30 2015, respectively.

Three months ended June 30, 2016 compared to three months ended June 30, 2015

Net interest income was \$8.6 million for the three months ended June 30, 2016, which represented a decrease of \$797,000 compared to net interest income of \$9.4 million for the three months ended June 30, 2015. The decrease in net interest income in the second quarter of 2016 compared to the second quarter of 2015 was due primarily to a decrease of \$720,000 in interest income on loans and an increase of \$104,000 in interest expense on interest-bearing liabilities. Interest income on average earning assets, on a tax-equivalent basis, was \$10.1 million for the three months ended June 30, 2016 compared to \$10.8 million for the three months ended June 30, 2015. The decrease of \$698,000 in interest income was due primarily to a decrease in average loan balances to \$674.2 million for the three month period ended June 30, 2016 from \$705.7 million for the three month period ended June 30, 2015 and the lower yield on loans of 5.08% for the three months ended June 30, 2016 compared to the yield on loans of 5.27% for the three months ended June 30, 2015. The yield on loans declined due to the continued low interest rate environment as new loans were originated at yields lower than the average yield on loans in the prior period.

Interest expense on average interest-bearing liabilities was \$1.3 million, or 0.71%, for the second quarter of 2016 compared to \$1.2 million, or 0.64%, for the second quarter of 2015. The increase of \$104,000 in interest expense on interest-bearing liabilities for the second quarter of 2016 compared to the second quarter of 2015 primarily reflects higher short-term market interest rates in 2016 compared to 2015. The Federal Reserve Board increased the targeted federal funds rate in December 2015 by 25 basis points, which impacted short-term market rates in 2016.

The net interest margin, on a tax-equivalent basis, declined to 3.86% for the three months ended June 30, 2016 compared to 4.20% for the three months ended June 30, 2015, primarily due to the lower yield on interest-earning assets.

Average interest-earning assets decreased by \$1.4 million, or 0.15%, to \$922.5 million for the three month period ended June 30, 2016 from \$923.9 million for the three month period ended June 30, 2015 due to the decrease in average loan balances, which was partially offset by the increase in average investment securities. The overall yield on interest-earning assets, on a tax-equivalent basis, decreased 30 basis points to 4.41% for the three month period ended June 30, 2016 compared to 4.71% for the three month period ended June 30, 2015 due primarily to the decrease in the average balance of loans, primarily mortgage warehouse lines utilized, for the quarter ended June 30, 2016 compared to the quarter ended June 30, 2015.

Average interest-bearing liabilities decreased by \$16.2 million, or 2.2%, to \$708.7 million for the three months ended June 30, 2016 from \$724.9 million for the three months ended June 30, 2015 due primarily to decreases in certificates of deposit and money market and NOW accounts. Overall, the cost of total interest-bearing liabilities increased 7 basis points to 0.71% for the three months ended June 30, 2016 from 0.64% for the three months ended June 30, 2015.

Six months ended June 30, 2016 compared to six months ended June 30, 2015

For the six months ended June 30, 2016, the Company's net interest income decreased by \$832,000, or 4.6%, to \$17.1 million compared to \$18.0 million for the six months ended June 30, 2015. This decrease was due primarily to the decrease in average loan balances, a decrease in the average yield on interest-earning assets and an increase in interest expense on average interest-bearing liabilities.

Interest expense on average interest-bearing liabilities was \$2.4 million, or 0.70%, for the six months ended June 30, 2016 compared to \$2.3 million, or 0.64%, for the six months ended June 30, 2015. The increase of \$145,000 in interest expense on interest-bearing liabilities for the first six months of 2016 compared to the first six months of 2015 primarily reflects higher short-term market interest rates in 2016 compared to 2015. The Federal Reserve Board increased the targeted federal funds rate in December 2015 by 25 basis points, which impacted short-term market rates in 2016.

For the six months ended June 30, 2016, the net interest margin (on a tax-equivalent basis) was 3.89% compared to 4.09% for the six months ended June 30, 2015.

Average interest-earning assets decreased by \$2.8 million, or 0.3%, to \$909.2 million for the six month period ended June 30, 2016 from \$912.1 million for the six month period ended June 30, 2015. The overall yield on interest-earning assets, on a tax-equivalent basis, decreased 17 basis points to 4.43% for the six months ended June 30, 2016 compared



to 4.60% for the six months ended June 30, 2015, primarily due to the \$15.3 million decrease in the average balance of the loan portfolio for the six months ended June 30, 2016 compared to the six months ended June 30, 2015 and the decline in the yield on average loans to 5.16% for the six months ended June 30, 2016 compared to the yield on average loans of 5.27% for the six months ended June 30, 2015.

Average interest-bearing liabilities decreased by \$17.2 million, or 2.4%, to \$699.0 million for the six months ended June 30, 2016 compared to \$716.3 million for the six months ended June 30, 2015 due primarily to decreases in money market and NOW accounts

and certificates of deposit. The decrease in deposits was due primarily to a decline in NOW accounts and savings deposits from municipalities of \$33.1 million, which was partially offset by an increase of \$16.0 million in consumer and business deposits. The total cost of interest-bearing liabilities increased by 6 basis points to 0.70% for the six months ended June 30, 2016 from 0.64% for the six months ended June 30, 2015 primarily due to higher short-term market interest rates in 2016.

#### Provision for Loan Losses

Three months ended June 30, 2016 compared to three months ended June 30, 2015

Management considers a complete review of the following specific factors in determining the provisions for loan losses: historical losses by loan category, the level of non-accrual loans and problem loans as identified through internal review and classification, collateral values and the growth and size of the loan portfolio. In addition to these factors, management takes into consideration current economic conditions and local real estate market conditions.

In general, over the last two years, the Bank experienced an improvement in loan credit quality and achieved a steady resolution of non-performing loans and assets related to the severe recession, which was reflected in the current lower level of non-performing loans at June 30, 2016. During the last five quarters, net charge-offs declined significantly, which resulted in a reduction of the historical loss factors for certain segments of the loan portfolio that were applied by management to estimate the allowance for loan losses at June 30, 2016. In the second quarter of 2016, net recoveries of \$280,000 were recorded. The lower historical loss factors due to the improvement in loan credit quality resulted in a lower estimated allowance for loan losses of \$7.5 million at June 30, 2016. Accordingly, a credit (negative) provision for loan losses of \$100,000 was recorded for the second quarter of 2016 compared to no provision being recorded in the second quarter of 2015.

At June 30, 2016, non-performing loans decreased by \$861,000, or 14.3%, to \$5.2 million from \$6.0 million at December 31, 2015 and the ratio of non-performing loans to total loans decreased to 0.68% at June 30, 2016 compared to 0.88% at December 31, 2015.

Six months ended June 30, 2016 compared to six months ended June 30, 2015

A credit (negative) provision for loan losses of \$300,000 was recorded for the six months ended June 30, 2016 compared to a provision for loan losses in the amount of \$500,000 for the six months ended June 30, 2015. The credit provision for loan losses for the first six months of 2016 reflected gross recoveries of loans previously charged-off of \$383,000, gross charge-offs of \$161,000 and net recoveries of \$222,000 compared to net charge-offs of \$74,000 for the first six months of 2015. Non-performing loans declined to \$5.2 million at June 30, 2016 compared to \$6.0 million at December 31, 2015.

#### Non-Interest Income

Three months ended June 30, 2016 compared to three months ended June 30, 2015

Total non-interest income was \$1.5 million for the second quarter of 2016, a decrease of \$452,000, or 22.7%, compared to \$2.0 million for the second quarter of 2015. The Bank originates and sells commercial loans guaranteed by the Small Business Administration ("SBA") and residential mortgage loans in the secondary market. Lower gains of \$747,000 from the sales of residential mortgages and SBA loans for the second quarter of 2016 compared to gains of \$1.2 million in the second quarter of 2015 were the primary reason for the decrease in non-interest income.

In the second quarter of 2016, \$14.5 million of residential mortgages were sold and \$308,000 of gains were recorded compared to \$43.3 million of loans sold and \$685,000 of gains recorded in the second quarter of 2015. Residential mortgage lending activity was lower in the second quarter of 2016 compared to the second quarter of 2015 due principally to turnover of employees in the Bank's residential mortgage unit.

On July 25, 2016, the Bank hired approximately 20 employees, including residential mortgage originators and operations personnel, who will now make up the majority of the Bank's residential mortgage unit since this unit recently experienced significant employee turnover. The addition of this experienced and productive residential mortgage lending team is expected to enhance the Bank's residential mortgage lending capabilities and broaden its lending products to include Federal Housing Administration insured residential mortgages.

SBA guaranteed commercial lending activity and loan sales vary from period to period. In the second quarter of 2016, \$4.6 million of SBA loans were sold and gains of \$439,000 were recorded compared to \$5.2 million of loans sold and gains of \$518,000 recorded in the second quarter of 2015.



Service charge revenues decreased to \$176,000 for the three months ended June 30, 2016 from \$190,000 for the three months ended June 30, 2015 due to a lower volume of service charges and overdraft fees collected on deposit accounts during the second quarter of 2016 compared to the second quarter of 2015.

Non-interest income also includes income from bank-owned life insurance (“BOLI”), which amounted to \$157,000 for the three months ended June 30, 2016 compared to \$142,000 for the three months ended June 30, 2015.

The Bank also generates non-interest income from a variety of fee-based services. These include safe deposit box rental fees, wire transfer service fees and automated teller machine fees for non-Bank customers. The other income component of non-interest income increased to \$456,000 for the three months ended June 30, 2016 compared to \$453,000 for the three months ended June 30, 2015.

Six months ended June 30, 2016 compared to six months ended June 30, 2015

Total non-interest income for the six months ended June 30, 2016 was \$3.1 million, a decrease of \$985,000, or 23.9%, compared to total non-interest income of \$4.1 million for the six months ended June 30, 2015. This decrease was due primarily to a decrease of \$845,000 in gains on the sale of loans.

Service charge revenues decreased to \$373,000 for the six months ended June 30, 2016 from \$429,000 for the six months ended June 30, 2015. This decrease was due primarily to lower overdraft fees collected on deposit accounts. Gains on sales of loans originated for sale decreased by \$845,000 to \$1.7 million for the six months ended June 30, 2016 compared to \$2.5 million for the six months ended June 30, 2015. The Bank sells both loans guaranteed by the SBA and residential mortgage loans in the secondary market. For the six months ended June 30, 2016, SBA loan sales were \$9.8 million and generated gains on sales of loans of approximately \$921,000 compared to SBA loan sales of \$11.9 million that generated gains on sales of \$1.2 million for the six months ended June 30, 2015.

For the six months ended June 30, 2016, the Bank's residential mortgage banking operation sold \$38.5 million of residential mortgage loans, which generated gains from the sales of loans of \$729,000. For the six months ended June 30, 2015, the Bank's residential mortgage banking operation sold \$77.7 million residential mortgage loans, which generated gains on sale of loans of \$1.3 million.

Non-interest income also includes income from BOLI, which amounted to \$301,000 for the six months ended June 30, 2016 compared to \$276,000 for the six months ended June 30, 2015.

The Bank also generates non-interest income from a variety of fee-based services. These include safe deposit box fees, wire transfer fees and automated teller machine fees for non-Bank customers. The other income component of non-interest income decreased to \$808,000 for the six months ended June 30, 2016 compared to \$917,000 for the six months ended June 30, 2015 due to lower transaction activity.

#### Non-Interest Expenses

Non-interest expenses were \$6.8 million for the three months ended June 30, 2016, a decrease of \$1.1 million, or 14.4%, compared to \$8.0 million for the second quarter of 2015. Non-interest expenses decreased in the second quarter of 2016 compared to the second quarter of 2015 due primarily to a \$418,000, or 27.1%, decrease in other operating expenses and a decrease in other real estate owned expenses of \$381,000.

Non-interest expenses were \$13.9 million for the six months ended June 30, 2016, a decrease of \$972,000, or 6.6%, compared to \$14.8 million for the six months ended June 30, 2015. Non-interest expenses decreased in the second quarter of 2016 compared to the second quarter of 2015 due primarily to a \$448,000, or 87.3%, decrease in other real estate owned expenses and a \$217,000 decrease in occupancy expense.

The following table presents the major components of non-interest expenses for the three and six months ended June 30, 2016 and 2015:

## Non-interest Expenses

| (Dollars in thousands)                  | Three months ended June 30, |         | Six months ended June 30, |          |
|---|-----------------------------|---------|---------------------------|----------|
|   | 2016                        | 2015    | 2015                      | 2015     |
| Salaries and employee benefits          | \$4,291                     | \$4,478 | \$8,607                   | \$8,665  |
| Occupancy expense                       | 952                         | 1,048   | 1,941                     | 2,158    |
| Data processing expenses                | 314                         | 306     | 627                       | 625      |
| FDIC insurance expense                  | 105                         | 180     | 223                       | 370      |
| Other real estate owned expenses        | 35                          | 416     | 65                        | 513      |
| Equipment expense                       | 8                           | 13      | 14                        | 32       |
| Marketing                               | 46                          | 22      | 82                        | 110      |
| Regulatory, professional and other fees | 228                         | 245     | 410                       | 348      |
| Directors' fees                         | 23                          | 20      | 47                        | 48       |
| Amortization of intangible assets       | 97                          | 106     | 202                       | 215      |
| Other expenses                          | 724                         | 1,138   | 1,639                     | 1,745    |
| Total                                   | \$6,823                     | \$7,972 | \$13,857                  | \$14,829 |

Three months ended June 30, 2016 compared to three months ended June 30, 2015

Salaries and employee benefits, which represent the largest portion of non-interest expenses, decreased by \$187,000, or 4.2%, to \$4.3 million for the three months ended June 30, 2016 compared to \$4.5 million for the three months ended June 30, 2015. The decrease in salaries and employee benefits was a result of a decrease in full-time equivalent employees, primarily in the residential lending group, and lower commissions in the amount of \$243,000 paid to residential loan officers as a result of the lower volume of residential mortgage loans originated. Full-time equivalent employees at June 30, 2016 decreased to 175 as compared to 181 full-time equivalent employees at June 30, 2015. Occupancy expense decreased by \$96,000, or 9.2%, to \$952,000 for the three months ended June 30, 2016 compared to \$1.0 million for the three months ended June 30, 2015. The decrease for the three months ended June 30, 2016 compared to the three months ended June 30, 2015 was due to lower depreciation and facilities maintenance expenses. The cost of data processing services increased slightly to \$314,000 for the three months ended June 30, 2016 from \$306,000 for the three months ended June 30, 2015.

FDIC insurance expense decreased \$75,000 to \$105,000 for the three months ended June 30, 2016 compared to \$180,000 for the three months ended June 30, 2015 primarily due to a lower assessment rate that reflects the improvement in asset quality and the improved financial performance of the Bank in the last six quarters.

Other real estate owned expenses decreased by \$381,000 to \$35,000 for the three months ended June 30, 2016 compared to \$416,000 for the three months ended June 30, 2015 due to the \$382,000 write-down of one OREO property in the second quarter of 2015 and the lower level of OREO in 2016 compared to 2015. At June 30, 2016, the Company held one commercial property with a value of \$166,000 as other real estate owned compared to three properties with an aggregate value of \$5.3 million at June 30, 2015.

Regulatory, professional and other fees decreased by \$17,000, or 6.9%, to \$228,000 for the three months ended June 30, 2016 compared to \$245,000 for the three months ended June 30, 2015 due primarily to a decrease in consulting fees.

Other expenses decreased by \$414,000 to \$724,000 for the three months ended June 30, 2016 compared to \$1.1 million for the three months ended June 30, 2015 due primarily to decreases in legal expense incurred for the collection and recovery of non-performing assets and telephone and various other operating expenses.

Six months ended June 30, 2016 compared to six months ended June 30, 2015

Salaries and employee benefits, which represent the largest portion of non-interest expenses, decreased by \$58,000, or 0.7%, to \$8.6 million for the six months ended June 30, 2016 compared to \$8.7 million for the six months ended June 30, 2015. The decrease in salaries and employee benefits was the result of a decrease in the number of employees and lower commissions paid to residential loan officers as a result of the lower volume of residential mortgage loans originated in the first six months of 2016.



Occupancy expense decreased by \$217,000, or 10.1%, to \$1.9 million for the six months ended June 30, 2016 compared to \$2.2 million for the six months ended June 30, 2015. The decrease in occupancy expense resulted primarily from decreases in building maintenance expense and depreciation expense.

The cost of data processing services increased slightly to \$627,000 for the six months ended June 30, 2016 from \$625,000 for the six months ended June 30, 2015.

FDIC insurance expense decreased to \$223,000 for the six months ended June 30, 2016 compared to \$370,000 for the six months ended June 30, 2015 primarily as a result of a lower assessment rate, which reflected the lower level of net charge-offs, the lower level of non-performing assets and the improved financial performance of the Bank in the last six quarters.

Other real estate owned expenses decreased by \$448,000 to \$65,000 for the six months ended June 30, 2016 compared to \$513,000 for the six months ended June 30, 2015 primarily due to no write-downs of the carrying value of OREO assets compared to a \$382,000 write-down in the first six months of 2015 and the significant reduction in OREO assets. At June 30, 2016, there was one commercial property with a value of \$166,000 compared to three properties with an aggregate value of \$5.3 million at June 30, 2015.

Regulatory, professional and other fees increased by \$62,000, or 17.8%, to \$410,000 for the six months ended June 30, 2016 compared to \$348,000 for the six months ended June 30, 2015 due primarily to higher examination fees.

Other expenses decreased \$106,000 to \$1.6 million for the six months ended June 30, 2016 compared to \$1.7 million for the six months ended June 30, 2015 as a result of decreases in legal fees and telephone expense. All other expenses are comprised of a variety of operating expenses, as well as expenses associated with lending activities.

#### Income Taxes

Three months ended June 30, 2016 compared to three months ended June 30, 2015

Pre-tax income was \$3.4 million for the three months ended June 30, 2016 and the three months ended June 30, 2015. The Company recorded income tax expense of \$1.1 million for the three months ended June 30, 2016 and the three months ended June 30, 2015. The effective income tax rate was 32.5% for the three months ended June 30, 2016 and the three months ended June 30, 2015.

Six months ended June 30, 2016 compared to six months ended June 30, 2015

Pre-tax income decreased \$45,000 to \$6.7 million for the six months ended June 30, 2016 compared to pre-tax income of \$6.7 million for the six months ended June 30, 2015.

The Company recorded income tax expense of \$2.2 million for the six months ended June 30, 2016, which resulted in an effective tax rate of 32.3%, compared to income tax expense of \$2.2 million and an effective tax rate of 32.1% for the six months ended June 30, 2015. The slight decrease in income tax expense for the six months ended June 30, 2016 was primarily due to the lower amount of pre-tax income in the period compared to the six months ended June 30, 2015.

#### Financial Condition

June 30, 2016 Compared with December 31, 2015

Total consolidated assets at June 30, 2016 were \$1.07 billion, representing an increase of \$100.7 million, or 10.4%, from total consolidated assets of \$968.0 million at December 31, 2015. The increase in assets was primarily attributable to an increase of \$79.5 million in net loans and a \$19.3 million increase in investment securities which were funded primarily by a \$91.0 million increase in borrowed funds and an increase of \$4.7 million in deposits.

#### Cash and Cash Equivalents

Cash and cash equivalents at June 30, 2016 totaled \$13.7 million compared to \$11.4 million at December 31, 2015, an increase of \$2.3 million, or 20.1%. To the extent that the Bank does not utilize funds for loan originations or securities purchases, the cash inflows are invested in overnight deposits at the Federal Reserve Bank of New York.

#### Loans Held for Sale

Loans held for sale at June 30, 2016 were \$3.2 million compared to \$6.0 million at December 31, 2015. As indicated in the Consolidated Statements of Cash Flows, residential mortgage loans originated for sale were \$35.7 million for the six months ended June 30, 2016 compared to \$78.5 million for the six months ended June 30, 2015. As a result of turnover of employees in the Bank's residential mortgage unit in the first six months of 2016, the Bank originated and sold a lower level of residential mortgage loans during the first six months of 2016 compared to the first six months of 2015. The amount of loans held for sale varies from period to period due to changes in the amount and timing of sales of residential mortgages.



### Investment Securities

Investment securities represented approximately 21.9% of total assets at June 30, 2016 and approximately 22.2% of total assets at December 31, 2015. Total investment securities increased \$19.3 million, or 9.0%, to \$234.0 million at June 30, 2016 from \$214.7 million at December 31, 2015. Purchases of investment securities totaled \$40.1 million during the six months ended June 30, 2016, and proceeds from calls, maturities and repayments totaled \$22.2 million during the period.

Securities available for sale are investments that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk and to take advantage of market conditions that create economically attractive returns. At June 30, 2016, securities available for sale totaled \$111.3 million, an increase of \$19.9 million, or 21.8%, compared to securities available for sale totaling \$91.4 million at December 31, 2015.

At June 30, 2016, the securities available for sale portfolio had net unrealized gains of \$1.5 million compared to net unrealized gains of \$203,000 at December 31, 2015. These unrealized gains were reflected, net of tax, in shareholders' equity as a component of accumulated other comprehensive income.

Securities held to maturity, which are carried at amortized historical cost, are investments for which there is the positive intent and ability to hold to maturity. At June 30, 2016, securities held to maturity were \$122.6 million, a decrease of \$626,000 from \$123.3 million at December 31, 2015. The fair value of the held to maturity portfolio at June 30, 2016 was \$127.9 million.

### Loans

The loan portfolio, which represents the Bank's largest asset, is a significant source of both interest and fee income. Elements of the loan portfolio are subject to differing levels of credit and interest rate risk. The Bank's primary lending focus continues to be financing mortgage warehouse lines, construction loans, commercial business loans, owner-occupied commercial mortgage loans and commercial real estate loans on income producing assets.

The following table represents the components of the loan portfolio at June 30, 2016 and December 31, 2015:

#### Loan Portfolio Composition

(Dollars in thousands)

| Component                         | June 30, 2016 |      | December 31, 2015 |      |
|-----------------------------------|---------------|------|-------------------|------|
|                                   | Amount        | %    | Amount            | %    |
| Construction loans                | \$93,221      | 12 % | \$93,745          | 14 % |
| Residential real estate loans     | 49,087        | 7 %  | 40,744            | 6 %  |
| Commercial business               | 105,103       | 14 % | 99,277            | 15 % |
| Commercial real estate            | 223,124       | 29 % | 207,250           | 30 % |
| Mortgage warehouse lines          | 264,344       | 35 % | 216,572           | 32 % |
| Loans to individuals              | 24,730        | 3 %  | 23,074            | 3 %  |
| All other loans                   | 197           | — %  | 233               | — %  |
| Gross loans                       | 759,806       | — %  | 680,895           | — %  |
| Deferred loan fees and costs, net | 1,766         |      | 1,226             |      |
| Total loans                       | \$761,572     | 100% | \$682,121         | 100% |

Total loans increased by \$79.5 million, or 11.6%, to \$761.6 million at June 30, 2016 compared to \$682.1 million at December 31, 2015.

Mortgage warehouse lines' outstanding balances increased \$47.8 million to \$264.3 million compared to \$216.6 million at December 31, 2015, reflecting higher levels of residential mortgage originations by the Bank's mortgage banking customers that were due to the seasonality of home purchase activity in our markets.

The Bank's mortgage warehouse funding group provides revolving lines of credit that are available to licensed mortgage banking companies. The warehouse line of credit is used by the mortgage banker to finance the origination of one-to-four family residential mortgage loans that are pre-sold to the secondary mortgage market, which includes state and national banks, national mortgage banking firms, insurance companies and government-sponsored enterprises, including the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and

the Government National Mortgage Association. On average, an advance under the warehouse line of credit remains outstanding for a period of less than 30 days, with repayment coming directly from the sale of the loan into the secondary mortgage market. Interest and a transaction fee are collected by the Bank at the time of repayment. In the second quarter of 2016, the Bank funded \$998.0 million of residential mortgages through customers' warehouse lines of

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credit compared to \$1.1 billion in the second quarter of 2015. The decline in the volume of loans funded was primarily due to a \$144.0 million decrease in the amount of refinanced loans, which was partially offset by an increase of \$66.0 million of loans for the purchase of homes.

Commercial business loans increased \$5.8 million, or 5.9%, during the first six months of 2016. Commercial business loans consist primarily of loans to small and middle market businesses and are typically working capital loans used to finance inventory, receivables or equipment needs. These loans are generally secured by business assets of the commercial borrower.

Commercial real estate loans increased \$15.9 million, or 7.7%, during the first six months of 2016. Commercial real estate loans consist primarily of loans to businesses collateralized by real estate employed in the business and loans to finance income producing properties.

Construction loans decreased \$524,000 to \$93.2 million during the first six months of 2016. Construction financing is provided to businesses to expand their facilities and operations and to real estate developers for the acquisition, development and construction of residential properties and income producing properties. First mortgage construction loans are made to developers and builders for single family homes or multi-family buildings that are presold, or are to be sold or leased on a speculative basis. The Bank lends to developers and builders with established relationships, successful operating histories and sound financial resources.

The Bank also finances the construction of individual, owner-occupied single family homes. These loans are made to qualified individual borrowers and are generally supported by a take-out commitment from a permanent lender.

The ability of the Company to enter into larger loan relationships and management's philosophy of relationship banking are key factors in the Company's strategy for loan growth. The ultimate collectability of the loan portfolio and recovery of the carrying amount of real estate are subject to changes in the economic environment and real estate market in the Company's market region.

### Non-Performing Assets

Non-performing assets consist of non-performing loans and other real estate owned. Non-performing loans are composed of (1) loans on a non-accrual basis and (2) loans which are contractually past due 90 days or more as to interest and principal payments but which have not been classified as non-accrual. Included in non-accrual loans are loans whose terms have been restructured to provide a reduction or deferral of interest and/or principal because of deterioration in the financial position of the borrower and which have not performed in accordance with the restructured terms.

The Bank's policy with regard to non-accrual loans is that, generally, loans are placed on a non-accrual status when they are 90 days past due, unless these loans are well secured and in process of collection or, regardless of the past due status of the loan, when management determines that the complete recovery of principal or interest is in doubt. Consumer loans are generally charged off after they become 120 days past due. Subsequent payments on loans in non-accrual status are credited to income only if collection of principal is not in doubt.

Non-accrual loans decreased \$861,000 to \$5.2 million at June 30, 2016 from \$6.0 million at December 31, 2015. The major segments of non-accrual loans consist of commercial real estate loans and residential real estate loans, which are in the process of collection. The table below sets forth non-performing assets and risk elements in the Bank's portfolio for the periods indicated.

| Non-Performing Assets and Loans   | June<br>30<br>2016 | December<br>31,<br>2015 |
|---|--------------------|-------------------------|
| (Dollars in thousands)  |                    |                         |
| Non-performing loans:   |                    |                         |
| Loans 90 days or more past due and still accruing                       | \$—                | \$—                     |
| Non-accrual loans   | 5,159              | 6,020                   |
| Total non-performing loans  | 5,159              | 6,020                   |
| Other real estate owned   | 166                | 966                     |
| Other repossessed assets  | —                  | —                       |
| Total non-performing assets   | 5,325              | 6,986                   |
| Performing troubled debt restructurings                                 | 1,022              | 1,535                   |
| Performing troubled debt restructurings and total non-performing assets | \$6,347            | \$8,521                 |

|   |      |   |      |   |
|---|------|---|------|---|
| Non-performing loans to total loans   | 0.68 | % | 0.88 | % |
| Non-performing loans to total loans excluding mortgage warehouse lines                  | 1.04 | % | 1.29 | % |
| Non-performing assets to total assets   | 0.50 | % | 0.72 | % |
| Non-performing assets to total assets excluding mortgage warehouse lines                | 0.66 | % | 0.93 | % |
| Total non-performing assets and performing troubled debt restructurings to total assets | 0.59 | % | 0.88 | % |

Non-performing loans to total loans decreased to 0.68% at June 30, 2016 from 0.88% at December 31, 2015 principally due to the improvement in loan credit quality and a decrease in non-performing loans. Loan quality is considered to be sound. This was accomplished through quality loan underwriting, a proactive approach to loan monitoring and aggressive workout strategies.

Non-performing assets decreased by \$1.7 million to \$5.3 million at June 30, 2016 from \$7.0 million at December 31, 2015. Other real estate owned totaled \$166,000 at June 30, 2016 compared to \$966,000 at December 31, 2015. OREO at June 30, 2016 was comprised of one commercial real estate property with a value of \$166,000.

At June 30, 2016, the Bank had nine loans totaling \$4.1 million which were troubled debt restructurings. Four of these loans totaling \$3.1 million are included in the above table as non-accrual loans; the remaining five loans totaling \$1.0 million are considered performing. At December 31, 2015, the Bank had ten loans totaling \$4.7 million that were troubled debt restructurings. Three of these loans totaling \$3.2 million are included in the above table as non-accrual loans and the remaining loans totaling \$1.5 million are considered performing.

As provided by ASC 310-30, the excess of cash flows expected at acquisition over the initial investment in the loan is recognized as interest income over the life of the loan. Accordingly, loans acquired with evidence of deteriorated credit quality totaling \$464,000 at June 30, 2016 and \$759,000 at December 31, 2015 were not classified as

non-performing loans.

Non-performing assets represented 0.50% of total assets at June 30, 2016 compared to 0.72% of total assets at December 31, 2015.

Management takes a proactive approach in addressing delinquent loans. The Company's President and Chief Executive Officer meets weekly with all loan officers to review the status of credits past-due 10 days or more. An action plan is discussed for delinquent

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loans to determine the steps necessary to induce the borrower to cure the delinquency and restore the loan to a current status. In addition, delinquency notices are system-generated when loans are five days past-due and again at 15 days past-due.

In most cases, the Company's collateral is real estate. If the collateral is foreclosed upon, the real estate is carried at fair market value less the estimated selling costs. The amount, if any, by which the recorded amount of the loan exceeds the fair market value of the collateral, less estimated selling costs, is a loss which is charged to the allowance for loan losses at the time of foreclosure or repossession. Resolution of a past-due loan through foreclosure can be delayed if the borrower files a bankruptcy petition because a collection action cannot be continued unless the Company first obtains relief from the automatic stay provided by the bankruptcy code.

#### Summary of Real Estate Owned Activity

(in thousands)

|   | Three<br>months<br>ended<br>June 30,<br>2016 |   | Six<br>months<br>ended<br>June<br>30,<br>2016 |
|---|--|---|---|
| Balance - March 31, 2016                  | \$1,144                                      | Balance - January 1, 2016                 | \$ 966  |
| Transfers into real estate owned          | —  | Transfer into real estate owned           | 142   |
| Sale of real estate owned                 | (1,002 )                                     | Sale of real estate owned                 | (1,002 )                                      |
| Cost of improvements on real estate owned | 24   | Cost of improvements on real estate owned | 60  |
| Balance - June 30, 2016                   | \$ 166                                       | Balance - June 30, 2016                   | \$ 166  |

Changes in other real estate owned during the three months ended June 30, 2016 consisted principally of the sale of one residential property with a fair value of \$1.0 million.

#### Allowance for Loan Losses and Related Provision

The allowance for loan losses is maintained at a level sufficient to absorb estimated credit losses in the loan portfolio as of the date of the financial statements. The allowance for loan losses is a valuation reserve available for losses incurred or inherent in the loan portfolio and other extensions of credit. The determination of the adequacy of the allowance for loan losses is a critical accounting policy of the Company.

The Company's primary lending emphasis is the origination of commercial and commercial real estate loans and mortgage warehouse lines of credit. Based on the composition of the loan portfolio, the inherent primary risks are deteriorating credit quality, a decline in the economy, and a decline in New Jersey real estate market values. Any one, or a combination, of these events may adversely affect the loan portfolio and may result in increased delinquencies, loan losses and increased future provision levels.

All, or part, of the principal balance of commercial and commercial real estate loans and construction loans are charged off against the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Consumer loans are generally charged off no later than 120 days past due on a contractual basis, earlier in the event of bankruptcy, or if there is an amount deemed uncollectible. Because all identified losses are charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans and the entire allowance is available to absorb any and all loan losses.

Management reviews the adequacy of the allowance on at least a quarterly basis to ensure that the provision for loan losses has been charged against earnings in an amount necessary to maintain the allowance at a level that is adequate based on management's assessment of probable estimated losses. The Company's methodology for assessing the adequacy of the allowance for loan losses consists of several key elements and is consistent with U.S. GAAP and interagency supervisory guidance. The allowance for loan losses methodology consists of two major components. The first component is an estimation of losses associated with individually identified impaired loans, which follows Accounting Standards Codification ASC Topic 310 (formerly SFAS 114). The second major component is an estimation of losses under ASC Topic 450 (formerly SFAS 5), which provides guidance for estimating losses on groups of loans with similar risk characteristics. The Company's methodology results in an allowance for loan losses that includes a specific reserve for impaired loans, an allocated reserve and an unallocated portion.

When analyzing groups of loans under ASC Topic 450, the Bank follows the Interagency Policy Statement on the Allowance for Loan and Lease Losses. The methodology considers the Company's historical loss experience adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans as of the evaluation date. These adjustment factors, known as qualitative factors, include:

- Delinquencies and non-accruals
- Portfolio quality
- Concentration of credit
- Trends in volume of loans
- Quality of collateral
- Policy and procedures
- Experience, ability, and depth of management
- Economic trends – national and local
- External factors – competition, legal and regulatory

The methodology includes the segregation of the loan portfolio into loan types with a further segregation into risk rating categories, such as special mention, substandard, doubtful and loss. This allows for an allocation of the allowance for loan losses by loan type; however, the allowance is available to absorb any loan loss without restriction. Larger-balance, non-homogeneous loans representing significant individual credit exposures are evaluated individually through the internal loan review process. It is this process that produces the watch list. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated. Based on these reviews, an estimate of probable losses for the individual larger-balance loans is determined, whenever possible, and used to establish specific loan loss reserves. In general, for non-homogeneous loans not individually assessed and for homogeneous groups of loans, such as residential mortgages and consumer credits, the loans are

collectively evaluated based on delinquency status, loan type, and historical losses. These loan groups are then internally risk rated.

The watch list includes loans that are assigned a rating of special mention, substandard, doubtful and loss. Loans classified as special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as doubtful have all the weaknesses inherent in loans classified as substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans rated as doubtful in whole, or in part, are placed in non-accrual status. Loans classified as a loss are considered uncollectible and are charged-off against the allowance for loan losses.



The specific allowance for impaired loans is established for specific loans which have been identified by management as being impaired. These loans are considered to be impaired primarily because the loans have not performed according to payment terms and there is reason to believe that repayment of the loan principal in whole, or in part, is unlikely. The specific portion of the allowance is the total amount of potential unconfirmed losses for these individual impaired loans. To assist in determining the fair value of loan collateral, the Company often utilizes independent third party qualified appraisal firms, which employ their own criteria and assumptions that may include occupancy rates, rental rates, and property expenses, among others.

The second category of reserves consists of the allocated portion of the allowance. The allocated portion of the allowance is determined by taking pools of outstanding loans that have similar characteristics and applying historical loss experience for each pool. This estimate represents the potential unconfirmed losses within the portfolio.

Individual loan pools are created for commercial and commercial real estate loans, construction loans, warehouse lines of credit, and various types of loans to individuals. The historical estimation for each loan pool is then adjusted to account for current conditions, current loan portfolio performance, loan policy or management changes, or any other qualitative factor which may cause future losses to deviate from historical levels.

The Company also maintains an unallocated allowance. The unallocated allowance is used to cover any factors or conditions which may cause a potential loan loss but are not specifically identifiable. It is prudent to maintain an unallocated portion of the allowance because no matter how detailed an analysis of potential loan losses is performed, these estimates, by definition, lack precision. Management must make estimates using assumptions and information that is often subjective and changing rapidly.

The following discusses the risk characteristics of each of our loan portfolio segments-commercial, mortgage warehouse lines of credit, and consumer.

#### Commercial

The Company's primary lending emphasis is the origination of commercial and commercial real estate loans. Based on the composition of the loan portfolio, the inherent primary risks are deteriorating credit quality, a decline in the economy, and a decline in New Jersey real estate market values. Any one, or a combination, of these events may adversely affect the loan portfolio and may result in increased delinquencies, loan losses and increased future provision levels.

#### Mortgage Warehouse Lines of Credit

The Company's Mortgage Warehouse Unit provides revolving lines of credit that are available to licensed mortgage banking companies. The warehouse line of credit is used by the mortgage banker to originate one-to-four family residential mortgage loans that are pre-sold to the secondary mortgage market, which includes state and national banks, national mortgage banking firms, insurance companies and government-sponsored enterprises, including the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation and others. On average, an advance under the warehouse line of credit remains outstanding for a period of less than 30 days, with repayment coming directly from the sale of the loan into the secondary mortgage market. Interest and a transaction fee are collected by the Bank at the time of repayment.

As a separate segment of the total portfolio, the warehouse loan portfolio is individually analyzed as a whole for allowance for loan loss purposes. Warehouse lines of credit are subject to the same inherent risks as other commercial lending, but the overall degree of risk differs. While the Company's loss experience with this type of lending has been non-existent since the product was introduced in 2008, there are other risks unique to this lending that still must be considered in assessing the adequacy of the allowance for loan losses. These unique risks may include, but are not limited to, (i) credit risks relating to the mortgage bankers that borrow from the Bank, (ii) the risk of intentional misrepresentation or fraud by any of such mortgage bankers, (iii) changes in the market value of mortgage loans originated by the mortgage banker, the sale of which is the expected source of repayment of the borrowings under a warehouse line of credit, due to changes in interest rates during the time in warehouse, or (iv) unsalable or impaired mortgage loans so originated, which could lead to decreased collateral value and the failure of a purchaser of the mortgage loan to purchase the loan from the mortgage banker.

These factors, along with the other qualitative factors such as economic trends, concentrations of credit, trends in the volume of loans, portfolio quality, delinquencies and non-accruals, are also considered and may have positive or

negative effects on the allocated allowance. The aggregate amount resulting from the application of these qualitative factors determines the overall risk for the portfolio and results in an allocated allowance for warehouse lines of credit.

Consumer

The Company's consumer loan segment is comprised of residential real estate loans, home equity loans and other loans to individuals. Individual loan pools are created for the various types of loans to individuals.

In general, for homogeneous groups such as residential mortgages and consumer credits, the loans are collectively evaluated based on delinquency status, loan type and historical losses. These loan groups are then internally risk rated. The Company considers the following credit quality indicators in assessing the risk in the loan portfolio:

Consumer credit scores

- Internal credit risk grades

Loan-to-value ratios

Collateral

Collection experience

The following table presents, for the periods indicated, an analysis of the allowance for loan losses and other related data:

Allowance for Loan Losses (Dollars in thousands)

|   | Six Months<br>Ended June<br>30,<br>2016 | Year Ended<br>December<br>31,<br>2015 | Six Months<br>Ended June<br>30,<br>2015 |   |
|---|---|---------------------------------------|---|---|
| Balance, beginning of period  | \$7,560                                 | \$6,925                               | \$6,925                                 |   |
| (Credit) provision charged to operating expenses  | (300 )                                  | 1,100                                 | 500                                     |   |
| Loans charged off :   |   |                                       |   |   |
| Construction loans  | —                                       | —                                     | —                                       |   |
| Residential real estate loans   | —                                       | —                                     | —                                       |   |
| Commercial business and commercial real estate  | (161 )                                  | (477 )                                | (88 )                                   |   |
| Loans to individuals  | —                                       | (14 )                                 | —                                       |   |
| Lease financing   | —                                       | —                                     | —                                       |   |
| All other loans   | —                                       | —                                     | —                                       |   |
|   | (161 )                                  | (491 )                                | (88 )                                   |   |
| Recoveries  |   |                                       |   |   |
| Construction loans  | —                                       | —                                     | —                                       |   |
| Residential real estate loans   | —                                       | —                                     | —                                       |   |
| Commercial business and commercial real estate  | 380                                     | 20                                    | 12                                      |   |
| Loans to individuals  | 3                                       | 6                                     | 2                                       |   |
| Lease financing   | —                                       | —                                     | —                                       |   |
| All other loans   | —                                       | —                                     | —                                       |   |
|   | 383                                     | 26                                    | 14                                      |   |
| Net charge offs   | 222                                     | (465 )                                | (74 )                                   |   |
| Balance, end of period  | \$7,482                                 | \$7,560                               | \$7,351                                 |   |
| Loans :   |   |                                       |   |   |
| At period end   | \$761,572                               | \$682,121                             | \$758,506                               |   |
| Average during the period   | 651,160                                 | 675,531                               | 662,652                                 |   |
| Net recoveries (charge offs) to average loans outstanding                                     | 0.03                                    | % (0.07 )%                            | (0.01 )%                                |   |
| Net recoveries (charge offs) to average loans outstanding, excluding mortgage warehouse loans | 0.04                                    | % (0.10 )%                            | (0.02 )%                                |   |
| Allowance for loan losses to :  |   |                                       |   |   |
| Total loans at period end   | 0.98                                    | % 1.11                                | % 0.97                                  | % |
| Total loans at period end excluding mortgage warehouse loans                                  | 1.27                                    | % 1.44                                | % 1.30                                  | % |
| Non-performing loans  | 145.02                                  | % 125.59                              | % 158.78                                | % |



The following table represents the allocation of the allowance for loan losses (“ALL”) among the various categories of loans and certain other information as of June 30, 2016 and December 31, 2015, respectively. The allocation is made for analytical purposes and is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of loans.

(Dollars in thousands)

|  | June 30, 2016                |                       |               | December 31, 2015            |                       |               |
|--|------------------------------|-----------------------|---------------|------------------------------|-----------------------|---------------|
|  | ALL<br>Amount<br>of<br>Loans | as a %<br>of<br>Loans | % of<br>Loans | ALL<br>Amount<br>of<br>Loans | as a %<br>of<br>Loans | % of<br>Loans |
| Commercial business and commercial real estate loans | \$4,380                      | 1.33%                 | 43%           | \$5,054                      | 1.65%                 | 45%           |
| Construction loans                                   | 975                          | 1.05%                 | 12%           | 1,025                        | 1.09%                 | 14%           |
| Residential real estate loans                        | 294                          | 0.60%                 | 7%            | 288                          | 0.71%                 | 6%            |
| Loans to individuals                                 | 119                          | 0.48%                 | 3%            | 109                          | 0.47%                 | 3%            |
| Subtotal   | 5,768                        | 1.16%                 | 65%           | 6,476                        | 1.39%                 | 68%           |
| Mortgage warehouse lines                             | 1,190                        | 0.45%                 | 35%           | 866                          | 0.40%                 | 32%           |
| Unallocated reserves                                 | 524                          | —                     | —             | 218                          | —                     | —             |
| Total  | \$7,482                      | 0.98%                 | 100%          | \$7,560                      | 1.11%                 | 100%          |

The Company recorded a credit (negative) provision for loan losses in the amount of \$100,000 for the three months ended June 30, 2016 and did not record a provision for the three months ended June 30, 2015. The Company recorded a credit to the provision for loan losses in the amount of \$100,000 in the second quarter of 2016 due to lower historical loan loss factors resulting from the resolution and reduction of non-performing loans, the improvement in loan credit quality and the low level of charge-offs over the past five quarters. Net recoveries on loans that were previously charged-off were \$280,000 for the three months ended June 30, 2016 compared to net charge-offs of \$13,000 for the three months ended June 30, 2015. Net recoveries of loans that were previously charged-off were \$222,000 for the six months ended June 30, 2016 compared to net charge-offs of \$74,000 for the six months ended June 30, 2015. There was a significant favorable impact on the amount of the allowance for loan losses allocated to commercial business loans at June 30, 2016 due to the significant reduction of net charge-offs in the two year historical loss calculation period. In the second quarter of 2014, the Bank recorded a charge-off of approximately \$3.7 million due to fraudulent misrepresentations by a commercial borrower and its principals. This substantial charge-off was no longer included in the historical loss calculation period at June 30, 2016 and the historical loss rate declined accordingly.

At June 30, 2016, the allowance for loan losses was \$7.5 million, a \$78,000 decrease from the allowance for loan losses at December 31, 2015. As a percentage of total loans, the allowance was 0.98% at the end of the second quarter of 2016 and 1.11% at year-end 2015. The allowance for loan losses was 145% of non-accrual loans at June 30, 2016 compared to 126% of non-accrual loans at December 31, 2015. Management believes that the quality of the loan portfolio remains sound considering the economic climate in the State of New Jersey and that the allowance for loan losses is adequate in relation to credit risk exposure levels and the estimated incurred and inherent losses in the loan portfolio.

#### Deposits

Deposits, which include demand deposits (interest bearing and non-interest bearing), savings deposits and time deposits, are a fundamental and cost-effective source of funding. The flow of deposits is influenced significantly by general economic conditions, changes in market interest rates and competition. The Bank offers a variety of products designed to attract and retain customers, with the Bank’s primary focus on the building and expanding of long-term relationships.

The following table summarizes deposits at June 30, 2016 and December 31, 2015.

(Dollars in thousands)

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|                      | June 30,<br>2016 | December 31,<br>2015 |
|----------------------|------------------|----------------------|
| Demand               |                  |                      |
| Non-interest bearing | \$ 170,793       | \$ 159,918           |
| Interest bearing     | 275,498          | 284,547              |
| Savings              | 201,692          | 196,324              |
| Time                 | 143,503          | 145,968              |
| Total                | \$ 791,486       | \$ 786,757           |

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At June 30, 2016, total deposits were \$791.5 million, an increase of \$4.7 million, or 0.60%, from \$786.8 million at December 31, 2015. Overall, the increase in deposits was due primarily to an increase of \$10.9 million in non-interest bearing demand deposits and an increase of \$5.4 million in savings deposits, which were partially offset by a decrease of \$9.0 million in interest bearing demand deposits and a decrease of \$2.5 million in time deposits. Since December 31, 2015, total deposits from consumers and businesses have increased \$20.4 million and deposits from municipalities have declined by \$15.7 million, which includes a decline of \$9.1 million in savings deposits.

### Borrowings

Borrowings are mainly comprised of Federal Home Loan Bank (“FHLB”) borrowings and overnight funds purchased. These borrowings are primarily used to fund asset growth not supported by deposit generation. The balance of borrowings was \$149.9 million at June 30, 2016, consisting of \$97.7 million in overnight borrowings from the FHLB, \$32.0 million in fed funds purchased from correspondent banks and \$20.2 million of long-term FHLB borrowings, compared to \$58.9 million at December 31, 2015, which consisted of \$38.6 million of overnight borrowings from the FHLB and \$20.3 million of long-term FHLB borrowings.

### Liquidity

At June 30, 2016, the amount of liquid assets and the Bank's access to off-balance sheet liquidity remained at a level management deemed adequate to ensure that contractual liabilities, depositors' withdrawal requirements, and other operational and customer credit needs could be satisfied.

Liquidity management refers to the Company's ability to support asset growth while satisfying the borrowing needs and deposit withdrawal requirements of customers. In addition to maintaining liquid assets, factors such as capital position, profitability, asset quality and availability of funding affect a bank's ability to meet its liquidity needs. On the asset side, liquid funds are maintained in the form of cash and cash equivalents, federal funds sold, investment securities held to maturity maturing within one year, securities available for sale and loans held for sale. Additional asset-based liquidity is derived from scheduled loan repayments as well as investment repayments of principal and interest. Investment securities and loans may also be pledged to the FHLB to collateralize additional borrowings. On the liability side, the primary source of liquidity is the ability to generate core deposits. Long-term and short-term borrowings are used as supplemental funding sources when growth in the core deposit base does not keep pace with that of earnings assets.

The Bank has established a borrowing relationship with the FHLB which further supports and enhances liquidity. During 2010, the FHLB replaced its Overnight Line of Credit and One-Month Overnight Repricing Line of Credit facilities available to member banks with a fully secured line of up to 50 percent of a bank's quarter-end total assets. Under the terms of this facility, the Bank's total credit exposure to the FHLB cannot exceed 50 percent, or \$534.4 million, of its total assets at June 30, 2016. In addition, the aggregate outstanding principal amount of the Bank's advances, letters of credit, the dollar amount of the FHLB's minimum collateral requirement for off-balance sheet financial contracts and advance commitments cannot exceed 30 percent of the Bank's total assets, unless the Bank obtains approval from the FHLB's Board of Directors or its Executive Committee. These limits are further restricted by a member's ability to provide eligible collateral to support its obligations to the FHLB as well as the ability to meet the FHLB's stock requirement. At June 30, 2016, the Bank pledged collateral to the FHLB to support additional borrowing capacity of \$69.8 million. The Bank also maintains unsecured federal funds lines of \$46.0 million with two correspondent banks, of which \$32.0 million was utilized.

The Consolidated Statements of Cash Flows present the changes in cash from operating, investing and financing activities. At June 30, 2016, the balance of cash and cash equivalents was \$13.7 million.

Net cash provided by operating activities totaled \$6.0 million for the six months ended June 30, 2016 compared to net cash provided by operating activities of \$4.6 million for the six months ended June 30, 2015. A source of funds is net income from operations adjusted for activity related to loans originated for sale and sold, the provision for loan losses, depreciation and amortization expenses, and net amortization of premiums and discounts on securities. Net cash provided by operating activities for the six months ended June 30, 2016 was greater than net cash provided by operating activities for the six months ended June 30, 2015 due primarily to a higher amount of net proceeds from the origination and sale of loans.

Net cash used in investing activities totaled \$99.4 million for the six months ended June 30, 2016 compared to net cash used in investing activities of \$88.8 million for the six months ended June 30, 2015. The primary use of cash in investing activities for the first six months of 2016 was the net increase in loans of \$79.5 million compared to a net increase in loans of \$104.2 million for the first six months of 2015. The securities portfolios are also a source of liquidity, providing cash flows from maturities and periodic repayments of principal. For the six months ended June 30, 2016 and June 30, 2015, prepayments and maturities of investment securities totaled \$22.2 million and \$35.5 million, respectively. Cash was used to purchase investment securities of \$40.1 million for the six months ended June



30, 2016 compared to purchases of \$14.6 million of investment securities for the six months ended June 30, 2015. Net cash provided by financing activities was \$95.7 million for the six months ended June 30, 2016 compared to \$85.9 million of net cash provided by financing activities for the six months ended June 30, 2015. The primary source of funds for the 2016 period was the increase in borrowed funds of \$91.0 million and an increase in deposits of \$4.7 million. The primary source of funds in the 2015 period was the increase in borrowed funds of \$105.6 million, which was partially offset by a decrease in deposits of \$19.7 million.

## Shareholders' Equity and Dividends

Shareholders' equity increased by \$5.7 million, or 5.9%, to \$101.6 million at June 30, 2016 from \$96.0 million at December 31, 2015. Tangible book value per common share increased by \$0.69 to \$11.13 at June 30, 2016 from \$10.44 at December 31, 2015. The ratio of average shareholders' equity to total average assets was 10.17% at June 30, 2016 compared to 9.34% at December 31, 2015.

Shareholders' equity increased \$5.7 million due to an increase of \$4.5 million in retained earnings, an increase of \$777,000 in accumulated other comprehensive income, and \$379,000 in share based compensation, which were partially offset by \$24,000 in treasury stock purchases for the six months ended June 30, 2016.

In lieu of cash dividends to common shareholders, the Company (and its predecessor, the Bank) has paid common stock dividends every year since 1993 (except 2014 due to the acquisition of Rumson). On December 18, 2015, the Board of Directors of the Company declared a five percent common stock dividend to common shareholders of record as of the close of business on January 14, 2016, which was paid on February 1, 2016. Per share amounts for the prior periods have been adjusted to reflect the common stock dividend.

The Company's common stock is quoted on the Nasdaq Global Market under the symbol "FCCY."

On January 21, 2016, the Board of Directors of the Company authorized a new common stock repurchase program. Under the new common stock repurchase program, the Company may repurchase in open market or privately negotiated transactions up to five (5%) percent of its common stock outstanding on the date of approval of the stock repurchase program, which limitation will be adjusted for any future stock dividends. This new repurchase program replaces the repurchase program authorized on August 3, 2005.

Disclosure of repurchases of Company shares made during the quarter ended June 30, 2016 is set forth under Part II, Item 2 of this report, "Unregistered Sales of Equity Securities and Use of Proceeds."

Actual capital amounts and ratios for the Company and the Bank as of June 30, 2016 and December 31, 2015 were as follows:

| (Dollars in thousands)                 | Actual    |        | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provision |       |
|--|-----------|--------|-------------------------------|-------|---|-------|
|  | Amount    | Ratio  | Amount                        | Ratio | Amount  | Ratio |
| As of June 30, 2016                    |           |        |                               |       |   |       |
| Company                                |           |        |                               |       |   |       |
| Common equity Tier 1 (CET1)            | \$88,611  | 9.52%  | \$41,884                      | >4.5% | N/A   | N/A   |
| Total Capital to Risk Weighted Assets  | 114,093   | 12.26% | 74,461                        | >8%   | N/A   | N/A   |
| Tier 1 Capital to Risk Weighted Assets | 106,611   | 11.45% | 55,846                        | >6%   | N/A   | N/A   |
| Tier 1 Leverage Capital                | 106,611   | 11.02% | 38,714                        | >4%   | N/A   | N/A   |
| Bank                                   |           |        |                               |       |   |       |
| Common equity Tier 1 (CET1)            | \$104,195 | 11.19% | \$41,884                      | >4.5% | \$60,500  | ≥6.5% |
| Total Capital to Risk Weighted Assets  | 111,677   | 12.00% | 74,461                        | >8%   | 93,076  | ≥10%  |
| Tier 1 Capital to Risk Weighted Assets | 104,195   | 11.19% | 55,846                        | >6%   | 74,461  | ≥8%   |
| Tier 1 Leverage Capital                | 104,195   | 10.77% | 38,714                        | >4%   | 48,392  | >5%   |

As of December 31, 2015

## Company

|  |           |        |          |       |     |     |
|--|-----------|--------|----------|-------|-----|-----|
| Common equity Tier 1 (CET1)            | \$83,994  | 10.03% | \$37,628 | >4.5% | N/A | N/A |
| Total Capital to Risk Weighted Assets  | \$109,554 | 13.08% | \$66,894 | >8%   | N/A | N/A |
| Tier 1 Capital to Risk Weighted Assets | 101,994   | 12.18% | 50,170   | >6%   | N/A | N/A |
| Tier 1 Leverage Capital                | 101,994   | 10.80% | 37,765   | >4%   | N/A | N/A |

## Bank

|  |           |        |          |       |          |       |
|--|-----------|--------|----------|-------|----------|-------|
| Common equity Tier 1 (CET1)            | \$99,631  | 11.90% | \$37,628 | >4.5% | \$54,431 | ≥6.5% |
| Total Capital to Risk Weighted Assets  | \$107,191 | 12.80% | \$66,894 | >8%   | \$83,739 | >10%  |
| Tier 1 Capital to Risk Weighted Assets | 99,631    | 11.90% | 50,170   | >6%   | 66,991   | ≥8%   |
| Tier 1 Leverage Capital                | 99,631    | 10.55% | 37,765   | >4%   | 47,211   | >5%   |

In July 2013, the Federal Reserve Board and the FDIC approved revisions to their capital adequacy guidelines and prompt corrective action rules that implemented and addressed the revised standards of Basel III and addressed relevant provisions of the Dodd-Frank Act. The Federal Reserve Board's final rules and the FDIC's interim final rules (which became final in April 2014 with no substantive changes) apply to all depository institutions, top-tier bank holding companies with total consolidated assets of \$500 million or more, and top-tier savings and loan holding companies ("banking organizations"). Among other things, the rules establish a common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets) and increase the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets). Banking organizations are also required to have a total capital ratio of at least 8% and a Tier 1 leverage ratio of at least 4%.

The rules also limit a banking organization's ability to pay dividends, engage in share repurchases or pay discretionary bonuses if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirements began phasing in on January 1, 2016 at 0.625% of common equity Tier 1 capital to risk-weighted assets and will increase by that amount each year until fully implemented in January 2019 at 2.50% of common equity Tier 1 capital to risk-weighted assets.

At June 30, 2016, the capital ratios of the Company exceeded the minimum Basel III capital requirements. It is management's goal to monitor and maintain adequate capital levels to continue to support asset growth and the expansion of the Bank and to continue its status as a well-capitalized institution.

## Interest Rate Sensitivity Analysis

The largest component of the Company's total income is net interest income, and the majority of the Company's financial instruments are composed of interest rate-sensitive assets and liabilities with various terms and maturities. The primary objective of management is to maximize net interest income while minimizing interest rate risk. Interest rate risk is derived from timing differences and the magnitude of relative changes in the repricing of assets and liabilities, loan prepayments, deposit withdrawals, and differences in lending and funding rates. Management actively seeks to monitor and control the mix of interest rate-sensitive assets and interest rate-sensitive liabilities. Under the interest rate risk policy established by the Company's Board of Directors, the Company established quantitative guidelines with respect to interest rate risk and how interest rate shocks are projected to affect net interest income and economic value of equity. Due to the current low level of market interest rates, the current monetary policy of the Federal Reserve Board and recent communications from the Federal Reserve Board, management believes that it is more likely that market interest rates may increase than decrease over the intermediate term. Summarized below is the projected effect of a parallel shift of an increase of 200 and 300 basis points, respectively, in market interest rates on net interest income and economic value of equity.

Based upon the current interest rate environment, as of June 30, 2016, sensitivity to interest rate risk was as follows:

| (Dollars in thousands)                              | Next 12 Months |           |          |               | Economic Value           |          |  |
|---|----------------|-----------|----------|---------------|--------------------------|----------|--|
|   | Net Interest   |           | Income   |               | of Equity <sup>(2)</sup> |          |  |
| Interest Rate Change in Basis Points <sup>(1)</sup> | Dollar Amount  | \$ Change | % Change | Dollar Amount | \$ Change                | % Change |  |
| +300  | \$42,237       | \$3,085   | 7.9 %    | \$140,810     | \$(2,562)                | (1.8)%   |  |
| +200  | 41,049         | 1,897     | 4.8 %    | 142,429       | (943)                    | (0.7)%   |  |
| —   | 39,152         | —         | — %      | 143,372       | —                        | — %      |  |

<sup>(1)</sup> Assumes an instantaneous and parallel shift in interest rates at all maturities.

<sup>(2)</sup> EVE is the discounted present value of expected cash flows from assets, liabilities and off-balance sheet contracts.

The Company employs many assumptions to calculate the impact of changes in interest rates on assets and liabilities, and actual results may not be similar to 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 management's actions, if any, in response to changing rates. In calculating these exposures, the Company utilized an interest rate simulation model which is validated by third-party reviewers on an annual basis.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Not required.

Item 4. Controls and Procedures.

The Company has established disclosure controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms and is accumulated and communicated to management, including the principal executive officer and principal financial officer, to allow timely decisions regarding required disclosure.

The Company's principal executive officer and principal financial officer, with the assistance of other members of the Company's management, have evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this quarterly report. Based upon such evaluation, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures are effective as of the end of the period covered by this quarterly report.

The Company's principal executive officer and principal financial officer have also concluded that there was no change in the Company's internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act) that occurred during the quarter ended June 30, 2016 that has materially affected, or is reasonably

likely to materially affect, the Company's internal control over financial reporting.

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## PART II. OTHER INFORMATION

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

## Issuer Purchases of Equity Securities

On January 21, 2016, the Board of Directors of the Company authorized a new common stock repurchase program. Under the new common stock repurchase program, the Company may repurchase in open market or privately negotiated transactions up to five (5%) percent of its common stock outstanding on the date of approval of the stock repurchase program, which limitation will be adjusted for any future stock dividends. This new repurchase program replaces the repurchase program authorized on August 3, 2005.

The following table provides common stock repurchases made by or on behalf of the Company during the three months ended June 30, 2016.

Issuer Purchases of Equity Securities <sup>(1)</sup>

| Period                   | Total<br>Number<br>of<br>Shares<br>Purchased | Average<br>Price<br>Paid<br>Per<br>Share | Total<br>Number of<br>Shares<br>Purchased<br>As<br>Part of<br>Publicly<br>Announced<br>Plan<br>or Program | Maximum<br>Number<br>of Shares<br>That May<br>Yet be<br>Purchased<br>Under the<br>Plan or<br>Program |
|--------------------------|--|--|---|--|
| Beginning                |  |  |   |  |
| April 1, 2016            | —  | \$                                       | —   | 394,141  |
| Ending<br>April 30, 2016 | —  | \$                                       | —   | 394,141  |
| May 1, 2016              | —  | \$                                       | —   | 394,141  |
| Ending<br>May 31, 2016   | —  | \$                                       | —   | 394,141  |
| June 1, 2016             | —  | \$                                       | —   | 394,141  |
| Ending<br>June 30, 2016  | —  | \$                                       | —   | 394,141  |
| Total                    | —  | \$                                       | —   | 394,141  |

The Company's common stock repurchase program covers a maximum of 396,141 shares of common stock of the (1)Company, representing 5% of the outstanding common stock of the Company on January 27, 2016, as adjusted for subsequent common stock dividends.

Item 6. Exhibits.

- 3(ii)(A) By-laws of 1st Constitution Bancorp, as amended (conformed copy) (incorporated by reference to Exhibit 3(ii)(A) to the Company’s Form 8-K filed with the SEC on March 23, 2016)
- 3(ii)(B) 1st Constitution Bancorp Amendment No. 3 to By-laws (incorporated by reference to Exhibit 3(ii)(B) to the Company’s Form 8-K filed with the SEC on March 23, 2016)
- 10.1 Second Amendment, effective as of April 12, 2016, to the Amended and Restated Employment Agreement, dated as of July 1, 2010, by and between 1st Constitution Bancorp and Robert F. Mangano (the “Employment Agreement”), as amended by the Amendment to the Employment Agreement, effective as of April 4, 2014 (the “First Amendment”), by and between 1st Constitution Bancorp and Robert F. Mangano (incorporated by reference to Exhibit 10.1 to the Company’s Form 8-K filed with the SEC on April 12, 2016)
- 10.2 Amended and Restated Indemnification Agreement, dated as of April 24, 2013, by and between \* Rumson-Fair Haven Bank and Trust Company and James G. Aaron (which was assumed by 1st Constitution Bank following the merger of Rumson-Fair Haven Bank and Trust Company with and into 1st Constitution Bank)
- 10.3 \* Form of Restricted Stock Agreement for Non-Employee Directors under the 1st Constitution Bancorp 2015 Directors Stock Plan
- 31.1 \* Certification of Robert F. Mangano, principal executive officer of the Company, pursuant to Securities Exchange Act Rule 13a-14(a)
- 31.2 \* Certification of Stephen J. Gilhooly, principal financial officer of the Company, pursuant to Securities Exchange Act Rule 13a-14(a)
- 32 Certifications pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of The \* Sarbanes-Oxley Act of 2002, signed by Robert F. Mangano, principal executive officer of the Company, and Stephen J. Gilhooly, principal financial officer of the Company
- 101.INS \*XBRL Instance Document
- 101.SCH \*XBRL Taxonomy Extension Schema Document
- 101.CAL \*XBRL Taxonomy Extension Calculation Linkbase Document
- 101.DEF \*XBRL Taxonomy Extension Definition Linkbase Document
- 101.LAB \*XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE \*XBRL Taxonomy Extension Presentation Linkbase Document

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\* Filed herewith.

SIGNATURES

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

1ST CONSTITUTION BANCORP

Date: August 10, 2016      By: /s/ ROBERT F. MANGANO  
Robert F. Mangano  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 10, 2016      By: /s/ STEPHEN J. GILHOOLY  
Stephen J. Gilhooly  
Senior Vice President, Treasurer and Chief Financial Officer  
(Principal Financial Officer)



1<sup>ST</sup> CONSTITUTION BANCORP  
FORM 10-Q  
Index to Exhibits

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